Cal. Prac. Guide Real Prop. Trans. Highlights

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

2024 Update

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It's been another eventful year! Among the many changes, the Legislature enacted the Affordable Housing on Faith and Higher Education Lands Act of 2023, sellers who accept offers for the sale of single-family residential property must, among other things, disclose room additions and structural modifications, as statutorily specified, and the California Supreme Court determined in a case of "first impression" that an exclusive, implied easement precluding a servient owner from making the most practical use of the easement's area is permissible.

These Highlights summarize the most significant developments over the past year. The paragraph numbers are keyed to the 2024 edition of the Practice Guide where the topics are discussed in greater detail. Our cut-off date for this Update was July 30, 2024. Some of the new cases cited were not final as of that date, so be sure to check the subsequent histories before citing or relying on them.

Thank You! As always, we appreciate your comments and suggestions regarding this Practice Guide. *Please keep them coming!*

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2024 UPDATE HIGHLIGHTS

CHAPTER 2

REAL ESTATE BROKERS AND LISTING AGREEMENTS

Disclosure Obligations

[2:214-214.1] **Room additions, structural modifications, alterations, or repairs made by contractors:** On or after July 1, 2024, a seller who accepts an offer for the sale of a single-family residential property within 18 months from the date title

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to the property was transferred to the seller must, among other things, disclose to the buyer any room additions, structural modifications, other alterations, or repairs made to the property by a contractor with whom the seller entered into a contract since the transfer of title. [New Civ.C. § 1102.6h]

CHAPTER 3

TITLE INSURANCE

Policy Liability

[3:372] **Insured owners; measuring differential value damages:** One case has concluded that loss should be based on the diminution in a property's value according to its "*highest and best use"* as of the date the covered defect is discovered. [*Tait v. Commonwealth Land Title Insurance Co.* (2024) 103 CA5th 271, _, 322 CR3d 877, 888]

CHAPTER 4

PURCHASE AND SALE AGREEMENT

Mineral, Oil and Gas Rights

[4:53.1] **Reserved:** The holders of mineral rights in 19 parcels of land were entitled to a one-half interest in the sand and gravel extracted by the surface estate owners. Reason: The sand and gravel had commercial value, could be mined, and had been mined in the area since the 1920s. [*Vulcan Lands, Inc. v. Currie* (2023) 98 CA5th 113, 117, 123, 316 CR3d 494, 497, 502]

Covenants Running with the Land

[4:66.2] **Recordation of planned community CC&Rs:** A tree-cutting covenant contained in the original recorded declaration that established a subdivision's general plan did not bind the purchaser of property that was not described therein. [*Colyear v. Rolling Hills Community Ass'n of Rancho Palos Verdes* (2024) 100 CA5th 110, 125-127, 31 CR3d 805, 817-818 (certified for partial publication)]

Public Permits

[4:69.2] **Short-term rentals (STRs) in coastal zone:** An online marketplace that connected residential STR owners with renters was neither directly nor vicariously liable for allowing STR owners to list and rent unpermitted STRs on its website. [*Coastal Protection Alliance, Inc. v. AIRBNB, INC.* (2023) 95 CA5th 207, 212, 215-219, 313 CR3d 262, 265, 267-271]

Laws Facilitating Higher Density Housing

[4:89.7] **Residential development on land owned by higher education or religious institutions:** The Affordable Housing on Faith and Higher Education Lands Act of 2023 provides a streamlined, ministerial process for approving housing development projects that meet specified criteria with respect to land owned by independent higher education or religious institutions. Projects that meet all the Act's specific criteria are deemed a "use by right" on the land. [New Gov.C. § 65913.16]

Exclusive Implied Easements

[4:102.1c; 4:102.2; 4:102.4j] **Permissibility:** Although not favored, the California Supreme Court has determined in a case of "first impression" that an exclusive implied easement precluding a servient owner from making the most practical use of the easement's surface area is permissible. [*Romero v. Shih* (2024) 15 C5th 680, 687-688, 317 CR3d 478, 481]

Prescriptive Easements

[4:102.16] **Judicial determination requirement:** Although a judicial determination ordinarily is required before a prescriptive easement can arise, the California Coastal Commission did not err in relying on its own staff report when it concluded the public "very likely" acquired a prescriptive right to use an existing trail situated over private property. [*Cave Landing, LLC v. California Coastal Comm'n* (2023) 94 CA5th 654, 656-657, 659, 312 CR3d 447, 448, 440]

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Sale of Real Property Negotiated at Settlement Conference

[4:263.2] **Enforceability under CCP § 664.6:** A settlement term sheet entered into between a commercial landlord and its cannabis dispensary tenant following mediation was fully enforceable under CCP § 664.6. However, an unauthorized prejudgment interest award that differed "materially" from the parties' agreement was reversed. [*BTHHM Berkeley, LLC v. Johnston* (2024) 100 CA5th 1220, 1222, 1225-1226, 319 CR3d 853, 853, 855-856 (certified for partial publication)]

Written Agreements

[4:270.4; 4:270.6; 4:270.7] **Parol evidence:** With the help of parol evidence, a hand-written deal to purchase multiple gas stations was deemed sufficiently definite for judicial enforcement even though it (i) failed to indicate whether the transaction included only the parties or also their business entities, (ii) used "X" to denote a price-related term, and (iii) failed to identify the stations' locations. [*Tiffany Builders, LLC v. Delrahim* (2023) 97 CA5th 536, 545-547, 315 CR3d 582, 588-590]

Attorney Fees

[4:516] **Civ.C. § 1717 reciprocal prevailing party fee recovery right in actions "on the contract":** *See* ¶ 11:138 & 11:138.2a *of the Highlights Summaries.*

CHAPTER 5

ENVIRONMENTAL HAZARDS LIABILITY

Federal Clean Water Act (CWA, 33 USC § 1251 et seq.)

[5:21] "**Citizen suits":** An environmental organization's "citizen suit" against a miner who committed ongoing CWA violations by operating a suction dredge in a river without a proper CWA permit was upheld. [*Idaho Conservation League v. Poe* (9th Cir. 2023) 86 F4th 1243, 1244]

California Superfund (Remediation and Clean-Up Liability)

[5:29] **Disclosure requirements:** A lease provision limiting a commercial landlord/owner's liability was invalid and therefore did not preclude a tenant/lessee's damages award. Reason: The provision necessarily violated the landlord/owner's statutory duty to disclose the presence of asbestos on the leased property. [*Epochal Enterprises, Inc. v. LF Encinitas Properties, LLC* (2024) 99 CA5th 44, 49-50, 57, 317 CR3d 573, 577, 583-584]

Resource Conservation and Recovery Act (RCRA, 42 USC § 6901 et seq.)

[5:125.10] **"Citizen suits":** An environmental group's suit against the U.S. Forest Service for allegedly *contributing* to the contamination of a national forest through the disposal of hazardous lead ammunition by hunters was denied. [*Center for Biological Diversity v. United States Forest Service* (9th Cir. 2023) 80 F4th 943, 946-955]

CHAPTER 6

FINANCING AND APPRAISALS

Government Loans and Grants

[6:22.8] **CalHome Program:** Commencing January 1, 2024, units within home ownership development projects that are receiving CalHome funds must be initially sold to and occupied by lower income households. [Amended Health & Saf.C. § 50650.3(c)(3)]

Promissory Notes

[6:241; 6:242.2] **Attorney Fees and Costs of Collection (Civ.C. § 1717):** *See* ¶ 11:138 *of the Highlights summaries.*

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Personal Property Security Agreements

[6:495] **Signed record:** Security agreements must be *signed by the debtor* (borrower). And "sign" means to execute or adopt a tangible symbol, or attach an electronic symbol, to a record with present intent to authenticate or adopt the record. [Amended Comm'l C. §§ 9203(b)(3)(A) & 1201(b)(37)]

CHAPTER 7

GROUND LEASEHOLDS

Tax Concerns

[7:267.2] **Sale of property subject to lease:** *See* ¶ 13:70 *of the Highlights summaries.*

CHAPTER 11

REMEDIES IN PURCHASE AND SALE TRANSACTIONS

Attorney Fees

[11:138; 11:138.2a] **Civ.C. § 1717 reciprocal prevailing party right of recovery in actions "on the contract":** It was error to deny § 1717 fees to a homeowner seeking rescission of loan agreements that impermissibly limited the fee provisions to judicial foreclosure actions. [*Andrade v. Western Riverside Council of Governments* (2024) 99 CA5th 1020, 1026-1027, 318 CR3d 396, 401-402]

Lis Pendens Expungement

[11:708] **Based on failure to establish "probable validity" of underlying claim:** It was error to apply a prima facie standard in determining whether a commercial property purchaser established her claim's probable validity. Reason: The party who records a lis pendens must show by a *preponderance of the evidence* that the underlying action is "probably valid." [*De Martini v. Sup.Ct. (Gupta)* (2024) 98 CA5th 1269, 1278-1280, 317 CR3d 441, 448-449]

[11:735] **Refiling prohibited:** A commercial property purchaser was required to obtain court permission before filing a second lis pendens in a subsequent action following the vendor's successful expungement of the purchaser's original lis pendens in an earlier related action. [*De Martini v. Sup.Ct. (Gupta)* (2024) 98 CA5th 1269, 1276-1277, 317 CR3d 441, 446-447]

CHAPTER 13

REAL PROPERTY PURCHASE AND SALE TAX CONCERNS

Change in Ownership

[13:70] **Lessor transfers subject to leases of less than 35 years:** A change in ownership was triggered where a property lessor's lease term was less than 35 years even though the lessor was the property's original owner. [*Equinix LLC v. County of Los Angeles* (2024) 101 CA5th 1108, 1117-1118, 320 CR3d 803, 809]

[13:78] **Transfers involving entities:** The California Supreme Court has confirmed a "change in ownership" is measured by proportional beneficial ownership interests in corporate *real property* and cannot be limited to an analysis of voting stock only. [*Prang v. Los Angeles County Assessment Appeals Bd. (Amen)* (2024) 15 C5th 1152, 1168, 1176-1179, 321 CR3d 351, 358, 364-366]

$7000 Homeowner's Exemption

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[13:96.8a] **Owners confined to hospitals or other care facilities:** If persons receiving the homeowner's exemption are not occupying certain statutorily specified dwellings because they are confined to a hospital or other care facility, they may still be eligible for the homeowner's exemption. [Amended Rev. & Tax.C. § 218(b)(4)]

Property Damaged/Destroyed by Disaster

[13:107] **Base-year value transfers:** The five-year period for transferring the base-year value of damaged or destroyed property to comparable property is extended by *three years* provided the original property was substantially damaged or destroyed on or after November 1, 2018, but on or before November 20, 2018. [Amended Rev. & Tax.C. § 69(i)]

Foreclosure

[13:117] **Public auctions:** If a property owner defaults on its property tax obligations, the county tax collector can sell the property to the highest bidder in a public auction (Rev. & Tax.C. § 3691 et seq.). Although the auction might produce a price that exceeds the amount of property tax owed, the original owner is entitled to the difference between the property tax due and the proceeds from the foreclosure. [*Tyler v. Hennepin County, Minnesota* (2023) 598 US 631, 647, 143 S.Ct. 1369, 1380]

Charitable Contributions of Conservation Easements

[13:394.4a] **Extinguishment clauses:** A majority of the Tax Court has reversed its own ruling that was upheld on appeal by concluding Treas.Reg. § 1.170A-14(g)(6)(ii) is invalid under the Administrative Procedure Act (APA). [*Valley Park Ranch LLC v. Commissioner* (2024) 162 T.C. No. 6]

Moreover, the Supreme Court's 2024 decision overturning the *Chevron* Doctrine could affect any appellate court decision. [See *Loper Bright Enterprises v. Raimondo* (2024) _ US _, _, 144 S.Ct. 2244, 2273—per APA, courts may not defer to agency's legal interpretation simply because statute is ambiguous]

Valuation

- [13:394.7a] **Inventory issue:** The IRS has challenged some deductions on the ground the donated property was inventory in the taxpayer's hands and therefore either sold in violation of the five-year disposition rule or excluded from the capital asset definition. [See *Glade Creek Partners,* TC Memo 2023-82; *Mill Roads 36 Henry, LLC v. Commissioner,* TC Memo 2023-129; *Oconee Landing Property LLC v. Commissioner,* TC Memo 2024-25]

- [13:394.7b] **Qualified appraisal requirement:** Some courts, but not all, have accepted almost any appraisal as evidence for valuation purposes. [See *Elgin 78 LLC v. Commissioner,* No. 26892-21 (T.C. 2024) (accepting appraisal despite numerous omissions); compare *Savannah Shoals LLC v. Commissioner,* TC Memo 2024-35 (rejecting "qualified appraisal" where conclusions were inconsistent with facts)]

- [13:394.9] **Listed transactions:** The 11th Circuit has upheld a district court's holding that struck down the IRS's syndicated conservation easements listing notice. Reason: The notice failed to comply with the Administrative Procedure Act's notice and comment requirements. [*Green Rock, LLC v. Internal Revenue Service* (11th Cir. 2024) 104 F4th 220, 222]

- [13:394.12] **Penalties:** Disclosing a taxpayer's cost basis in donated property may negate the intent to conceal which is necessary for a fraud penalty. [*Mill Road 36 Henry, LLC v. Commissioner,* TC Memo 2023-129]

  On the other hand, doing so may not be enough on its own if there are other indicia of fraud. [*North Donald LA Property LLC v. Commissioner,* No. 24703-21 (TC 4/10/24)]

Timing of Recognition of Income, Gain or Loss

[13:514.3] **Common Improvement Costs:** For common improvement costs, which include improvements to real property that benefit two or more properties for sale (e.g., streets, sidewalks, sewer lines, etc.), developers may use an optional "safe harbor" method of accounting called the "Alternative Cost Method." [See Rev.Proc. 2023-9, 2023-7 IRB 471]

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Cal. Prac. Guide Real Prop. Trans. Preliminary Materials

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PREFACE

This book is designed to guide practitioners through the plethora of legal and practical issues pertaining to the purchase and sale of real property interests, commencing with the inception of negotiations through consummation of the transaction (including certain postclosing issues). Toward that end, this Practice Guide takes the following general approach:

• Pertinent statutory, case and administrative law is cited and explained.

• Where appropriate, explanations are presented in a checklist format to facilitate step-by-step guidance through the particular matter.

• Various chapters include sample forms of instruments and agreements which are commonly necessary or desirable in a purchase and sale transaction.

• A separate tax analysis chapter (written by Professor Michael Asimow) alerts counsel to the tax issues and tax consequences with which the client needs to be concerned.

• Finally, each issue is discussed and analyzed with a view toward providing *practical guidance* in dealing with the client, negotiating with the other side, and creatively and expeditiously solving problems and drafting the relevant documentation.

There are, however, two caveats:

• This Practice Guide is not intended as a treatise on all areas of real estate law or on every issue that could affect a purchase and sale transaction. The book's principal focus is a practical guide to the purchase and sale of real property. Many subjects and doctrines, although pertinent to a real property transaction, are too broad or too attenuated to warrant extensive discussion; when applicable, however, other Rutter Group Practice Guides are cross-referenced for more detailed treatment.

• The forms presented in this Practice Guide should, like any form, be used as a starting point and not as a substitute for your own analysis. Do not assume that the author's language is necessarily appropriate for the deal at hand. *Tailor these forms as necessary to fit your particular transaction*.

This book will be updated annually to keep tack of current developments in the law, as well as emerging trends and approaches. Your comments for future revisions are also invited.

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AUTHOR DEDICATION

This book is dedicated to Honi and Austin.

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Cal. Prac. Guide Real Prop. Trans. Ch. 1-A

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Chapter 1. Commencing Representation: Scope of Attorney's Work and Fee Arrangements

A. Scope of Work in Handling Real Estate Transactions

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1. [1:1] **In General:** One of the first tasks for attorneys approached to represent a party (or parties) in a real estate transaction is to determine the *scope of work to be performed* in order to consummate the transaction. Certain functions legal counsel *can and should* perform; but others, counsel *cannot or should not* perform.

Identifying who will perform the various tasks required to close the transaction is principally a function of *cost*, *time*, *efficiency* and *competence*.

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a. [1:2] **Checklist approach:** At the outset, counsel should generate a checklist of matters to be attended to and the persons who will be responsible for them—i.e., attorney, client, real estate broker, architect, engineer, accountant, escrow holder, etc. A thorough and thoughtfully prepared checklist facilitates (1) costs management, coordination and efficient timing of the multifaceted components of the transaction, (2) identification of competence and conflict of interest issues, and (3) significantly, the *avoidance of malpractice exposure*.

Checklist items will vary with each particular transaction. Broadly, however, a comprehensive checklist in a real estate transaction will cover the points addressed in this Chapter at *¶ 1:6 ff.*

b. [1:3] **Clarification in attorney fee agreement:** The scope of work to be performed by counsel on the client's behalf should *always* be formalized in a written fee agreement. This is both statutorily required (Bus. & Prof.C. § 6148(a)(2)—agreement must specify "general nature of the legal services to be provided for the client," *¶ 1:192*) and a matter of *prudent* practice (circumventing potential charges that counsel agreed to perform matters beyond the scope of the undertaking). *See ¶ 1:195 ff.; and Form 1:A.1*.

c. [1:4] **Relevance of type of property involved:** The scope of work in any real property transaction depends in large part upon the kind of property being sold. Clearly, some purchase and sale transactions are relatively "routine" and can be consummated faster and with less attorney involvement than others.

➪ [1:5] ***PRACTICE POINTER:*** Even so, never assume consummation of the purchase and sale of a given type of property will *always* be easier as compared with any other type of property.

For example, many lawyers are inclined to believe the purchase and sale of *undeveloped* ("raw") land is a relatively "routine" or "problem free" transaction because it does not involve the transfer of improvements, and, typically, the land is not substantially encumbered by leases or other third-party rights. Nevertheless, in many ways, the sale of undeveloped land can present the greatest complexities because there are a host of subdivision, environmental and other development issues that counsel for both buyer and seller may be called upon to analyze and resolve.

Similarly, the purchase and sale of a *single-family home* is often regarded as a "simple" transaction. While this generally may be the case, clients buying or selling their own homes tend to be emotionally involved in the transaction; even the most seemingly minor issue can become of great consequence to the parties and their counsel, requiring an inordinate amount of negotiation, time, energy and expense.

2. [1:6] **Defining Scope of Work—Fundamental Steps:** The scope of counsel's work and the time and expense involved necessarily turn on several fundamental aspects of the contemplated transaction. Thus, in approaching representation on a real property purchase and sale matter, the following points should be addressed at the outset:

a. [1:7] **Extent of property being sold—real, personal and intangible:** First of all, ascertain what *type* of property is being sold. In addition to the underlying real property, determine whether the transaction contemplates a sale of *personal* and/or *intangible* property (contract rights and other choses in action). (*See ¶ 4:1 ff.*)

For example, a transaction involving the transfer of substantial or complicated personal property, intangible property or appurtenances will affect the amount of documentation to be reviewed and prepared and, therefore, the timing of counsel's work and the structure and amount of counsel's fees.

b. [1:8] **Current use of property:** Determine the current *usage* of the real property to be sold—e.g., residential, industrial, commercial (office or retail), mixed use, tenant-occupied (or vacant), improved or unimproved.

The particular usage will determine how much investigation you and third-party experts will need to conduct regarding the property (*¶ 4:367 ff.*). For example:

• [1:9] *Industrial property* transactions present a significant concern over the existence of *hazardous materials* (*see Ch. 5*). In contrast, environmental (pollution) issues are generally of little concern in most single-family residence transactions.

• [1:10] If the property to be sold is presently *vacant*, the attorney's work may be less cumbersome in certain respects because there are no leases and often no management contracts or other third-party agreements to review.

c. [1:11] **Interest to be sold:** Determine what type of *interest* is to be transferred:

• **Fee interest:** Establish whether the parties contemplate a sale of the entire *fee* interest or something less. (*See ¶ 4:90 ff.*)

• **Ground lease:** *See Ch. 7*.

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• **License or easement:** *See ¶ 4:101 ff.*

• **Installment land contract:** *See ¶ 4:112 ff.*

• **Option to purchase:** *See Ch. 8*.

(1) [1:12] **Effect of collateral issues:** The type of interest to be conveyed impacts a host of collateral issues incident to the transaction and, necessarily, the time, cost and expertise that will be required. For example:

• [1:13] The sale of an interest in a *ground lease* is typically more complicated than the sale of a fee interest. More documents need to be reviewed and/or prepared by counsel, more tax issues need to be considered, and financing issues are more complex. (*See Ch. 7*.)

• [1:14] Similarly, a conveyance to be effected by an *installment land contract*, *license* or *easement* presents several issues not typically encountered in the conveyance of a fee interest. (*See* ¶ *4:101 ff., 4:112 ff.*)

d. [1:15] **Vesting of title:** Determine how the buyer intends to take *title* to the property—e.g., individually, as community property, partnership, tenants in common, joint tenancy, corporation, limited liability company, trust, etc. (*See ¶ 4:132 ff.*)

If more than one buyer is taking title, it may be necessary to draft a tenancy in common, partnership or other co-ownership agreement. (*See Ch. 12*.)

Or, the several buyers may contemplate acquisition and operation of the property as a *business entity* that does not yet exist. They may need threshold advice about the comparative advantages of taking title as a corporation, general partnership, limited partnership, limited liability company or trust, and then will need legal assistance in forming the desired entity. (*See ¶ 1:27*.)

e. [1:16] **Physical condition of property:** Determine what investigations need to be conducted concerning the *physical condition* of the property—e.g., geological, construction, access issues, etc. (*See ¶ 4:367 ff.*)

f. [1:17] **Buyer's intended use:** Determine the *buyer's intended use* of the property—e.g., owner occupancy, lease to new tenants, development, construction, etc. The intended use may require your services in connection with such things as preparing leases, investigating zoning, subdivision or other development matters, and/or hiring architects, contractors or other third parties (such as property managers or real estate brokers).

g. [1:18] **Condition of title:** To the extent possible, ascertain at the outset whether the condition of title might present significant problems.

• [1:19] **Comment:** Unfortunately, it is often difficult, if not impossible, to determine the existence and/or magnitude of title problems at the beginning of the transaction. This is because a preliminary title report is often not made available until several days (or more) after the purchase contract is signed. (*See ¶ 4:327 ff.*)

h. [1:20] **Compliance with law:** Determine whether the client needs or desires guidance with respect to such things as building permits, occupancy certificates or other legally-required permits or official approvals. Also determine whether the client wants or needs you to be involved in issues of environmentally hazardous materials, zoning, subdivision or other land use matters.

i. [1:21] **Financing:** Determine how the client contemplates financing the purchase transaction. (*See Ch. 6*.) They may want or need attorney guidance. (At a minimum, buyer's counsel ordinarily will be asked to review the loan documents on the buyer's behalf.)

➪ [1:22] ***PRACTICE POINTERS FOR BUYER'S COUNSEL:*** If the buyer is obtaining *third-party financing* (i.e., seller is *not* providing a purchase money loan), you and your client should be aware of two important preliminary points:

• Generally, institutional lenders (such as banks, savings and loans, insurance companies, pension funds, etc.) utilize preprinted standard form loan documents that are rarely negotiated or changed. Accordingly, your client should be advised that it may be a waste of time to even attempt engaging in expensive, time-consuming (and ultimately fruitless) negotiations with an institutional lender over many of the terms in the lender's standard form loan documents. (*See Ch. 6*.)

• Before any loan documents are signed, also review carefully the terms of the loan (amount, interest rate, duration, etc.) to be sure the client is actually getting a loan on the terms they expected.

j. [1:23] **Tax considerations:** Many clients (both buyers and sellers) will need tax advice. Of course, you should not attempt to counsel on tax and other specialized areas of law unless you have the appropriate expertise (*see* ¶ *1:46 ff.*). But, minimally, you should be prepared to spot the relevant tax issues; for example:

- **Tax advantages of allocating purchase price between real property, personal property, goodwill, etc.:** *See* ¶ *4:305 ff.*

- **Documentary transfer tax:** *See* ¶ *4:306*.

- **Real property taxes**—including *reassessment* (*see* ¶ *13:65 ff.*); and *proration* between buyer and seller (*see* ¶ *4:612 ff.*).

- **The "basis" of the acquired property,** which becomes especially important for purposes of calculating *depreciation*, as well as *gain or loss* upon disposition of the property. *See* ¶ *13:2 ff.*

- **IRC § 1031 tax-deferred "like-kind" exchanges:** *See* ¶ *13:304 ff.*

- **Other income tax issues upon acquisition or disposition of the property:** *See comprehensive discussion in Ch. 13*.

k. [1:24] **Real estate broker issues:** Almost every real property sales transaction involves a listing agreement between the seller and a real estate broker for the payment of a commission. Consequently, issues regarding brokers are particularly important to seller's counsel (*see Ch. 2*).

Seller's counsel should determine at the outset whether the client expects counsel to prepare or review the broker's listing agreement, or otherwise to play a role in negotiation or payment of the broker's commission. Even if the seller has already signed a listing agreement, you will probably be involved in arranging for payment of the commission at the closing (*see* ¶ *4:578 ff.*; and comprehensive discussion of brokers and listing agreements in *Ch. 2*).

➪ [1:25] ***PRACTICE POINTER FOR BUYER'S COUNSEL:*** Though principally a seller's concern, *buyer's counsel* also need to address the subject of broker issues. Typically, there are at least three potential broker issues for buyers:

- Purchase and sale agreements should contain a provision indicating who, as between buyer and seller, is required to *pay* the broker's commission; and also providing for *cross-indemnifications* between the parties (*see* ¶ *4:512*).

- Because the buyer's broker is the buyer's *agent* in the transaction, buyer and counsel need to be concerned about actions taken by the broker that might *bind* the buyer (as principal) (*see* ¶ *2:120 ff., 2:240 ff.*).

- Even the *seller's* broker may have certain obligations *to the buyer* (*see* ¶ *2:170 ff., 2:225 ff.*).

l. [1:26] **Existing agreements:** Identify any agreements (written *or* oral) affecting the transaction that your client may have entered into before consulting you. Often, a purchase and sale agreement will have been negotiated before counsel are consulted; indeed, the agreement and/or escrow instructions may already have been prepared (if not signed). In such cases, attorney roles could be minimal; your services may simply be needed in the preparation and review of a limited number of documents and in monitoring progress of the transaction.

m. [1:27] **Formation of entity to take title:** Some real property purchase transactions are part of a larger real estate venture among a group of persons who contemplate acquisition, development and operation of the property as a *business entity*. These buyers often need preliminary advice and counsel about the *formation* of an appropriate business entity that will meet their primary objectives.

As a threshold step, the buyers may need to be educated about the comparative advantages and disadvantages (tax and nontax considerations) of a corporation, general partnership, limited partnership, limited liability company and business trust. Although the various types of entities share some common characteristics, each also has distinct features. Counsel will have to probe the buyers to identify which features are most desirable. Then, having identified the type of entity that most satisfies the buyers' needs and goals, steps must be taken to properly form the entity.

Cross-refer: For a comprehensive treatment of choice of business entity and the comparative characteristics, see Friedman, Soza & Jann, *Cal. Prac. Guide: Corporations* (TRG), Ch. 2.

➪ [1:27.1] ***PRACTICE POINTER:*** Advising about choice and formation of business entity is itself a specialized field of practice that is beyond the expertise of many real estate transactional lawyers. You may have to recommend the association

of competent counsel in this area before the clients venture too far toward acquisition of the property. (*See* ¶ *1:46 ff.* re attorney competence.)

[1:28 - 1:29] ***Reserved.***

3. [1:30] **Impact of Client's Relative Sophistication and Expectations:** An extremely important but often overlooked issue bearing on the scope of counsel's work is the client's *experience* and level of *sophistication* in real property transactions. Counsel representing unsophisticated clients generally must play a greater role in such things as negotiations, due diligence investigations, and document review and preparation, as well as simply explaining the meaning of the various documents and the process of the transaction. Indeed, relatively routine transactions involving clients with little or no transactional experience may be more demanding of your time and attention than complex transactions involving clients with substantial business acumen.

A related concern is the client's *expectations*, which are not necessarily a reflection of their level of sophistication. Ascertain at the outset what the client expects of you both in terms of work to be performed *and* all collateral matters that will attend the attorney-client relationship—including your *availability* to the client (for telephone consultations and meetings), your *fees*, particular *time-frames* (e.g., “turn-around” time for document preparation), etc. Be direct with your client about all of these matters; and immediately dispel any unrealistic client expectations.

➪ [1:31] ***PRACTICE POINTER:*** The intensity of your tasks will naturally escalate where the client expects quick results (requiring you to do work within a compressed period of time) or where the transaction appears to present problems that might create various emergencies. The enhanced burdens from time pressures may justify charging higher fees or, alternatively, may require you to decline taking on the matter. Evaluate these points *before* investing time, energy and expense in the matter and, therefore, before accepting the proffered representation.

4. [1:32] ***CAVEATS:*** Several “caveats” merit consideration in determining the scope of attorney work.

a. [1:33] **Satisfying third parties:** Never assume any issue or problem is one that must be resolved *solely* to the buyer's and/or seller's satisfaction. In many instances, *third parties* must also be satisfied if the problem is to be solved and the transaction is to close. Therefore, carefully analyze all apparent issues to ascertain the identity of all potentially concerned parties.

Several matters appearing to present an issue for only one party will actually involve *both* buyer and seller; and/or, on further analysis, will pose issues for third parties—such as *lenders*, *title insurance companies*, *escrow holders*, or *government entities* having jurisdiction over the property. For example:

(1) [1:34] **Third-party claim impacting financing:** Assume the seller's title is clouded by the existence of a third-party claim. The buyer might be willing to accept the risk of a possible third-party claim, but the cloud on title might hinder the buyer's ability to obtain financing—i.e., a *lender* may be unwilling to fund a loan unless the cloud is removed (regardless of whether a title insurance policy can be obtained to cover the potential claim).

(2) [1:35] **Zoning, code violations impacting financing:** Assume the property violates existing zoning laws, or the improvements do not meet building code (or other legal) requirements. Again, a *lender* may be unwilling to make a loan even though the buyer is willing to accept the property in its deficient condition.

b. [1:36] **Attention to details:** Details tend to be of far greater importance in the sale of real property than in other transactions. Real property interests cannot be transferred in a piecemeal fashion. Unlike the sale of goods, “partial performance” of a real property sale contract is of no value to either party. The parties are generally dealing with an indivisible asset and one minor mistake (e.g., an error in the property's legal description, the misspelling of a name on a deed, or failing to timely record the deed) can cause significant—if not disastrous—consequences. Real property transactions historically have been one of the most fertile areas for *attorney malpractice* (¶ *1:46*), and much of that exposure can be avoided by attention to details.

c. [1:37] **Lasting effect of attorney's work:** The sale of real property involves the recordation of conveyancing instruments in the land records, and those documents will be in existence, read and relied upon for years to come. Consequently, counsel's work in real property sale transactions has a *lasting effect*—indeed, perhaps a far greater *permanent* effect than in other transactional matters. Bear in mind that poorly drafted language in an easement agreement, lease, deed or other relevant document could literally affect generations to come (and, again, increase your malpractice exposure).

d. [1:38] **Short time fuse:** Real property sales transactions are typically consummated within a relatively short time-frame. The interested parties (buyer and seller, as well as brokers, etc.) generally want the transaction documented, signed and closed

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as quickly as possible. In turn, counsel are under tremendous pressure to give *immediate and complete attention* to the matter. This necessarily requires you to evaluate at the *outset* whether you will have the *resources* and *availability* to handle the transaction within the expected time period.

➪ [1:39] ***PRACTICE POINTER:*** The demands on your time will vary throughout the course of the transaction; hence, you have to budget your availability accordingly. Be prepared to devote immediate and extensive energy to the matter during the initial stages—e.g., in negotiating and preparing the purchase and sale agreement. Depending upon the complexities of the transaction, a period of relative inactivity may follow; but, invariably, you will have to gear up again as the closing nears.

e. [1:40] **Unpredictability:** Defining the scope of attorney work is not a science and is subject to countless unpredictable variables and scenarios. Each element of a given transaction (title insurance, zoning, financing, brokerage, etc.) will present a range of problems and, in essence, has a life of its own. In turn, each single problem is likely to impact the timing and cost associated with other issues and, indeed, the parties' ability to consummate the transaction.

➪ [1:41] ***PRACTICE POINTER:*** Forewarn your clients that there are a myriad of unpredictable variables but that you will use your "best efforts" to consummate the transaction in a timely manner with a view toward keeping costs down. Beyond that, *never guarantee results*. Because you cannot pinpoint the various problems that might arise, any "guarantees" or "representations" regarding a particular "result" literally *invite* malpractice charges from a disappointed client.

[1:42 - 1:44] ***Reserved.***

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Cal. Prac. Guide Real Prop. Trans. Ch. 1-B

California Practice Guide: Real Property Transactions | September 2024 Update
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Chapter 1. Commencing Representation: Scope of Attorney's Work and Fee Arrangements

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[1:45] Before the scope of attorney work is determined, counsel must make a threshold decision on two preliminary crucial issues: (1) whether you have the *competence* to undertake representation in connection with the particular transaction; and (2) assuming you have the requisite expertise, whether you presently, or might in the foreseeable future, have an actual or potential *conflict of interest*.

Cross-refer: Ethical rules concerning attorney competence and conflicts of interest are overviewed in the sections at ¶ 1:46 ff. For a comprehensive treatment of these issues, see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Chs. 4 & 6.

1. [1:46] **Attorney Competence:** Your *competence* to handle the client's real estate matter is an essential threshold concern, for reasons of both attorney *ethics* (*¶ 1:47 ff.*) and an attorney's *duty of care* owed to a client (*¶ 1:57 ff.*).

(A report released by the ABA in 2016 ranks *real estate transactions* the *second highest* category of legal malpractice claims (14.89%; a drop from 23.36% in 2008). The report also notes that a large percentage of these claims arise from inadequate document preparation—e.g., drafting errors in contracts, leases and deeds. ABA "Profile of Legal Malpractice Claims: 2012-2015.")

a. [1:47] **California ethical standards:** Lawyers should never accept cases they are not *competent* to handle. The California Rules of Professional Conduct (CRPC) impose minimum standards of competence on California lawyers as a condition to accepting employment (or continuing employment) as counsel.

The California Rules state attorneys "shall not intentionally, recklessly, with gross negligence, or repeatedly fail to perform legal services with competence." [CRPC 1.1(a); see also ABA Model Code of Professional Responsibility, Canon 6, EC 6-1 & ABA Model Rules of Professional Conduct, Rule 1.1]

"Competence" for this purpose means "to apply the (i) learning and skill, and (ii) mental, emotional, and physical ability reasonably necessary for the performance" of the particular legal service. [CRPC 1.1(b)]

[1:48 - 1:49] ***Reserved.***

(1) [1:50] **Attorneys having managerial authority and supervisory duties, subordinate attorneys:** The duty of "competence" extends to lawyers with managerial authority and supervisory duties. Indeed, they must make "reasonable efforts" to establish internal policies and procedures that foster ethical conduct within a law firm and "reasonable efforts" to *supervise* the work of *subordinate* attorney and nonattorney employees or agents. [See CRPC 5.1 & 5.3; *Trousil v. State Bar* (1985) 38 C3d 337, 342, 211 CR 525, 527-528 (decided under former CRPC 3-110); *Palomo v. State Bar* (1984) 36 C3d 785, 795-796, 205 CR 834, 840 (decided under former CRPC 3-110)]

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Subordinate lawyers also have a duty of "competence" that extends to complying with the CRPC. This is so notwithstanding the fact they act at the direction of another lawyer or other person. In short, a subordinate lawyer generally cannot defend a disciplinary charge by blaming their supervisor. Nonetheless, a subordinate lawyer does *not* violate the CRPC if they act in accordance with a supervisory lawyer's "reasonable resolution of an arguable question of professional duty." [See CRPC 5.2]

➪ [1:50.1] ***PRACTICE POINTER:*** Burdens presented by complex and time-pressured matters may be mitigated somewhat by a sufficient and properly-managed support staff. But the duty of "competent" representation may not be "passed off" to subordinates in your office. Again, you must properly *supervise* those working under you; and *you* (the attorney) are ultimately responsible for their work. [CRPC 5.1-5.3; see *Farnham v. State Bar* (1988) 47 C3d 429, 445, 253 CR 249, 258 (decided under former CRPC 3-110)—failure to perform legal services not mitigated by attorney's "lack of management skills"; *McMorris v. State Bar* (1981) 29 C3d 96, 99, 171 CR 829, 831 (decided under former CRPC 3-110)—attorney misconduct not mitigated by failure to secure adequate secretarial help]

(2) [1:51] **Options in event of insufficient "competence":** An attorney lacking sufficient "learning and skill" need not necessarily decline representation. Either of these options is ethically available:

(a) [1:52] **Associate competent counsel:** Associate or professionally consult with another lawyer "reasonably" believed to be competent in the matter (CRPC 1.1(c)); or

(b) [1:53] **Become competent:** *Acquire* "sufficient learning and skill before performance is required" (CRPC 1.1(c)).

➪ [1:53.1] ***PRACTICE POINTERS:*** The *first option* (associating or professionally consulting with another lawyer) does not mean counsel may sit back and rely solely on another attorney's supposed expertise. "[E]ven when work on a case is performed by an experienced attorney, competent representation still requires knowing enough about the subject matter to be able to judge the quality of the attorney's work." [*Cole v. Patricia A. Meyer & Assocs., APC* (2012) 206 CA4th 1095, 1100, 1117, 142 CR3d 646, 651, 664—attorneys who appeared on all pleadings and papers filed by plaintiffs in underlying case could not avoid malicious prosecution liability merely by showing they took passive role as standby counsel who would try case should it go to trial]

The *second option* (gearing up to acquire the requisite learning and skill) is viable only if the time involved will not compromise your concomitant duty to *diligently* handle the matter (CRPC 1.3; ¶ *1:47*). An attorney's failure to use "best efforts" to accomplish with "reasonable speed" the purpose for which they were employed breaches the fiduciary duty owed the client and is itself ground for professional discipline. [See generally Bus. & Prof. § 6068; and, e.g., *Van Sloten v. State Bar* (1989) 48 C3d 921, 931-932, 258 CR 235, 240-241; *Farnham v. State Bar* (1988) 47 C3d 429, 446, 253 CR 249, 259]

In any event, consider whether you really *want* to venture into entirely new areas. Taking on a matter that you may have to stumble through could be a frustrating, negative experience for you and your client; and it may leave your client with the impression that you are not competent.

(3) [1:54] ***Caveat—aiding and abetting unauthorized practice of law:*** Following the California residential mortgage crisis, a number of real estate attorneys began working with various foreclosure consultants and other nonattorneys to assist distressed homeowners. As a result, the State Bar Committee on Professional Responsibility and Conduct issued an "Ethics Alert" to remind California lawyers of the rules that may apply in the event nonattorneys request assistance and/or refer potential distressed homeowner clients to the lawyers (*see* ¶ *6:546.8*).

Specifically, California attorneys are subject to discipline if, among other things, they *aid foreclosure consultants or anyone else in the unauthorized practice of law* (e.g., lawyers must not only closely supervise the work of nonattorney employees or agents (¶ *1:50*), they may *not form partnerships or joint ventures with nonattorneys* if any of the business activities involve providing legal services). [See CRPC 5.5(a)(2); *Matter of Huang* (Rev.Dept. 2014) 5 Cal. State Bar Ct.Rptr. 296, 303 (decided under former CRPC 1-300)—attorney aided and abetted unauthorized practice of law by allowing nonattorney staff to perform loan modification services and by failing to supervise their work]

Cross-refer: For a detailed treatment of the unauthorized practice of law and the ethical limitations placed on lawyers who utilize nonattorney services, see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 1.

b. [1:55] **Practical considerations:** Assuming you meet (or can diligently acquire the requisite "ability" to meet) the ethical standards of "competence," also consider whether your expertise is at a level that makes representation on the particular matter *practically* feasible:

(1) [1:56] **Cost and time:** If the matter will require your investment of time in learning or brushing up on an unfamiliar area, you will need to consider several factors: (a) whether you have the time; (b) if so, whether you can justify passing the cost of your "learning curve" on to the client (or whether that time have to go uncompensated); and (c) even if you can pass the cost on to your client, whether it is ethically permissible to do so. (*See ¶ 1:149 ff.*)

Also, though you may have the requisite expertise, consider whether the proposed transaction is one you can *expediently* handle without infringing on other commitments or overextending yourself. Even the most experienced practitioners must continually reevaluate their time and resources so as to avoid disservice to new clients, existing clients and themselves.

(2) [1:57] **Malpractice exposure:** "Incompetent" representation breaches the duty of care owed to the client and is actionable *malpractice*. For this purpose, "competent" representation is measured by whether counsel exercised "such skill, prudence, and diligence as lawyers of ordinary skill and capacity commonly possess and exercise" when confronted with a *similar factual situation*. [*Neel v. Magana, Olney, Levy, Cathcart & Gelfand* (1971) 6 C3d 176, 180, 98 CR 837, 838-839; *Kirsch v. Duryea* (1978) 21 C3d 303, 308, 146 CR 218, 221-222]

By the same token, adherence to "customary practice" is not necessarily a defense to a claim of professional negligence. [See *Starr v. Mooslin* (1971) 14 CA3d 988, 1000-1001, 92 CR 583, 590—attorney negligence in giving escrow instructions]

➪ [1:57.1] ***PRACTICE POINTER:*** The American Bar Association and most malpractice carriers report that real estate transactions account for a high percentage of all legal malpractice claims (*see ¶ 1:46*). Keep this in mind in deciding whether you are, or can become, "competent" to properly handle a proposed new real estate matter.

(a) [1:58] **Research and informed decision-making:** Attorneys are not insurers or predictors of accuracy; nor are they bound to anticipate the manner in which uncertain areas of the law ultimately will be resolved. [*Lucas v. Hamm* (1961) 56 C2d 583, 591, 15 CR 821, 825; *Smith v. Lewis* (1975) 13 C3d 349, 358-359, 118 CR 621, 627 (disapproved on other grounds by *Marriage of Brown* (1976) 15 C3d 838, 851, 126 CR 633, 641, fn. 14)]

Even so, the requisite standard of care requires that, regardless of the level of experience, counsel must ascertain the applicable law and rules which can readily be found by standard research techniques. Thus, attorneys owe a duty to their clients to undertake reasonable research to ascertain relevant legal principles and to make *informed decisions* as to a course of conduct based upon an *intelligent assessment* of the problem. [*Smith v. Lewis*, supra, 13 C3d at 358-359, 118 CR at 627; see *Stanley v. Richmond* (1995) 35 CA4th 1070, 1092-1095, 41 CR2d 768, 780-782]

(b) [1:58.1] **"Specialist" standard of care:** Malpractice exposure runs higher for attorneys who profess to be "specialists" in a given matter: Counsel who hold themselves out as a legal specialist in a particular area of law will be held to the standard of skill, prudence and diligence exercised by *specialists* in that field. [*Wright v. Williams* (1975) 47 CA3d 802, 810, 121 CR 194, 199]

(c) [1:59] **Duty to identify apparent legal problems and options:** Even when counsel is hired for a limited purpose, the duty of competent representation *includes* an obligation to alert the client to *all reasonably apparent* legal problems, alternatives and remedies, even though they are beyond the scope of retention.

"Not only should an attorney furnish advice when requested, but he or she should also *volunteer opinions when necessary to further the client's objectives*." The theory is that, as between lay client and attorney, the *attorney* is more qualified to recognize and analyze the client's legal needs. [See *Nichols v. Keller* (1993) 15 CA4th 1672, 1683-1686, 19 CR2d 601, 608-610 (emphasis added) (a workers' comp case involving potential third-party tort claim, but same general principle applicable to any legal services matter)]

➪ [1:59.1] ***PRACTICE POINTER:*** You have the right to limit the scope of your employment. [See CRPC 1.8.8, Comment [2]] Nonetheless, your duty to provide competent legal services requires you to assume the client lacks the experience, training and ability to recognize and analyze their legal needs and options and that they are likely to offer a selective or incomplete recitation of the pertinent facts and circumstances. Therefore, regardless of the breadth of legal advice or assistance the client purports to be seeking, you must be prepared to *identify* the full ambit of issues, rights and remedies pertinent to the client's matter; and, where appropriate, to advise the client of the need to consult

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another attorney competent in the relevant matters which are beyond the scope of your retention. [See *Nichols v. Keller* (1993) 15 CA4th 1672, 1684, 19 CR2d 601, 608]

For example, counsel to a real property purchase and sale transaction might limit the scope of their representation to exclude tax matters. However, despite those limitations on scope of retention, counsel minimally must alert their clients to the fact there will be *potential tax consequences*, that there might be strategies to avoid or minimize those consequences and, therefore, the client should consult with appropriate tax counsel.

Cross-refer: For a more detailed discussion of legal malpractice, see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 6.

(3) [1:60] **Other considerations:** Finally, despite your apparent competence (sufficient to meet ethical standards and minimize malpractice risks), give some thought to the less tangible factors. For example, determine:

— whether the transaction will be enjoyable to handle;

— whether the prospective client is someone you will be able to work with; and

— whether accepting the matter will lead to other worthwhile business and referrals.

c. [1:61] **Special concerns re out-of-jurisdiction transactions—associating local counsel:** You may be called upon to represent a client in a transaction involving the conveyance of out-of-state real property. Because the law of the situs state is likely to differ markedly from that of California, the duty to provide "competent" representation may require you to *associate local counsel*—at least for the purpose of ensuring that the sale contract, the closing and other procedures comply with the foreign state's law and customary practice (see CRPC 1.1(c); ¶ *1:52*).

(Similarly, if a purely California-based transaction might require compliance with a local municipal code (or other local land use law, such as rent control ordinances, zoning restrictions, building or occupancy permit requirements), you may not be competent to handle the matter without, at a minimum, associating local counsel in the particular county or city.)

(1) [1:62] **Disclosure and client consent:** In these circumstances, you should first disclose to your client your inability to represent them outside the jurisdiction. It is ultimately the *client's* choice whether they want you to associate competent co-counsel or instead wish to take the entire transaction to another lawyer. [See CRPC 1.5.1—client must consent to fee-splitting among co-counsel (*see* ¶ *1:154*)]

(2) [1:63] **Cost and expedience factors:** Even if the client is agreeable, associating local counsel may not be the most appropriate or practical option. Also consider whether it might be less expensive and/or more efficient to have the client retain local counsel for the *entire* transaction, rather than piecemealing the legal work across jurisdictional borders.

➪ [1:64] ***PRACTICE POINTER:*** When associating out-of-jurisdiction co-counsel, prudence suggests that you obtain some form of written opinion or other written confirmation that the documents, procedures and structure of the transaction (as drafted by you) do not violate local law and that the transaction is otherwise acceptable and appropriate under local law standards and customary practices.

Cross-refer: For a comprehensive discussion of the use of opinion letters in real property transactions, *see Ch. 9*.

(3) [1:65] **Attorney's "licensed" status affecting right to compensation:** Before spending time on an *out-of-state* transaction, look into the state's law regarding the authority of counsel not licensed by the state to "practice law" in the state. This might affect your right to collect attorney fees for the out-of-state services.

Other states may have restrictive laws similar to California's: The State Bar Act generally limits the authority to "practice law" in California to active members of the California State Bar—meaning attorneys *licensed by California* (Bus. & Prof.C. §§ 6125, 6126). Unless authorized by statute or court rule to practice law in California at the time of doing so (see, e.g., CRC 9.40 re pro hac vice appearance; and CRC 9.45, 9.46, 9.47 & 9.48 re limited practice, including under State Bar registration system), out-of-state counsel who are not active members of the California State Bar *cannot collect compensation* for legal services rendered in California because they have engaged in the unauthorized practice of law. [*Birbrower, Montalbano, Condon & Frank, P.C. v. Sup.Ct. (ESQ Business Services, Inc.)* (1998) 17 C4th 119, 137, 70 CR2d 304, 314; see also *Golba v. Dick's Sporting Goods, Inc.* (2015) 238 CA4th 1251, 1261-1265, 190 CR3d 337, 344-347—although out-of-state firm retained licensed local counsel to represent class action plaintiff, no error in denying attorney fees request for portion of work performed by out-of-state attorneys lacking pro hac vice admission; Bus. & Prof.C. § 6126—misdemeanor punishable by fine and/or imprisonment; and Bus. & Prof.C. § 6126.3 (granting

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superior court power to assume jurisdiction over law practice conducted by person engaged in unauthorized practice of law)]

(a) [1:65.1] **Activities constituting "practice of law":** "Practicing law" in California does not necessarily depend on or require the lawyer's physical presence in the state. Out-of-state counsel may engage in the practice of law "in" California simply by rendering legal advice and preparing legal instruments and contracts for a California client. [*Birbrower, Montalbano, Condon & Frank, P.C. v. Sup.Ct. (ESQ Business Services, Inc.)* (1998) 17 C4th 119, 128-129, 70 CR2d 304, 308-309; see *Estate of Condon* (1998) 65 CA4th 1138, 1142-1143, 76 CR2d 922, 925]

1) [1:65.1a] **Negotiating contracts:** Contracts may, of course, be negotiated without the assistance of counsel. However, an attorney *hired by a client* to negotiate a contract may *not delegate* the negotiations to a nonattorney; i.e., in those circumstances, negotiations conducted by counsel's nonattorney employees constitute the *unauthorized practice of law*. [*In re Carlos* (BC CD CA 1998) 227 BR 535, 538-539]

(b) [1:65.2] **Effect of out-of-state license:** Admission to practice law in a sister state does not ipso facto authorize the "practice of law" in California. "Competence in one jurisdiction does not necessarily guarantee competence in another." [*Birbrower, Montalbano, Condon & Frank, P.C. v. Sup.Ct. (ESQ Business Services, Inc.)* (1998) 17 C4th 119, 132, 70 CR2d 304, 311]

Under narrowly-drawn Rules of Court, however, attorneys in good standing of another state's bar may qualify to practice law in California on a limited basis, including under a State Bar registration system. [See CRC 9.45, 9.46, 9.47 & 9.48]

(c) [1:65.3] **Associating licensed counsel not enough:** Nor does California law allow out-of-state attorneys to practice law in California simply by *associating local counsel* in good standing with the California State Bar. [See *Birbrower, Montalbano, Condon & Frank, P.C. v. Sup.Ct. (ESQ Business Services, Inc.)* (1998) 17 C4th 119, 126, 70 CR2d 304, 307, fn. 3]

(d) [1:66] **Compare—legal services on behalf of *nonresident client:*** Bus. & Prof.C. § 6125 is intended to protect *California citizens* from incompetent practitioners. The statute is not implicated when a lawyer lacking a California license performs services in California for a *nonresident* client. In that situation, there is *no* § 6125 violation. [See *Estate of Condon* (1998) 65 CA4th 1138, 1145-1148, 76 CR2d 922, 927-928]

Cross-refer: For a more detailed discussion of statutes and rules regulating the "practice of law," see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 1.

[1:67 - 1:69] *Reserved.*

2. [1:70] **Conflicts of Interest:** Notwithstanding your competence to handle the transaction, actual or potential *conflicts of interest* may require that you decline representation. As developed at ¶ 1:71 ff., conflict of interest issues turn fundamentally on prescribed *ethical standards*.

Cross-refer: The sections at ¶ 1:71 ff. overview significant conflict of interest scenarios and the consequences for lawyers and parties involved. For a more in depth discussion of the topic, see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 4.

a. [1:71] **California ethical standards, generally:** The California Rules of Professional Conduct prescribe ethical standards for several discrete conflict of interest situations (see CRPC 1.7, 1.8.1, 1.8.6, 1.8.7 and 1.9; ¶ 1:72 ff.). California lawyers must adhere to these standards under risk of professional discipline and/or, in a litigation matter, disqualification.

(1) [1:72] **Application to attorney rendering combined legal *and nonlegal services:*** Attorneys rendering both legal *and nonlegal* services for a client (e.g., acting as real estate broker or investment adviser as well as providing legal advice, drafting legal documents, etc.) are bound to adhere to the conflict of interest rules (and, indeed, *all* professional conduct rules) in the provision of *all* those services. In such a "mixed services" scenario, *all* of the lawyer's services are considered to be *legal* in nature for purposes of applying attorney ethical rules and standards. [See *Kelly v. State Bar* (1991) 53 C3d 509, 517, 280 CR 298, 302; Cal. State Bar Form.Opn. 1999-154]

[1:73] *Reserved.*

(2) [1:73.1] **Avoiding representation of adverse interests:** CRPC 1.7, 1.8.6, 1.8.7 and 1.9 address conflicts of interest arising out of the representation of adverse interests. The Rules provide in pertinent part:

(a) [1:73.2] **Disclosure of attorney's adverse interests:** An attorney "shall not without informed written consent from each client" and, as otherwise provided:

• Represent a client if the representation is directly adverse to another client in the same or a separate matter (CRPC 1.7(a)); or

• Represent a client if there is a significant risk the lawyer's representation will be materially limited by their responsibilities to or relationships with another client, former client or third person, or by the lawyer's own interests. [CRPC 1.7(b)]

1) [1:73.2a] **Required "disclosure" and "informed written consent":** The "informed written consent" contemplated by the CRPC consists of a client's or former client's written agreement to the representation following written disclosure. [See *Gilbert v. National Corp. for Housing Partnerships* (1999) 71 CA4th 1240, 1255, 84 CR2d 204, 214 (decided under former CRPC 3-310)—"Clearly, as a threshold matter one must know of, understand and acknowledge the presence of a conflict of interest before one can give *informed* consent to its existence" (emphasis in original)]

• ***FORM:*** Client Waiver of Conflict of Interest, *see Form 1:D*.

(b) [1:73.3] **Representing potentially conflicting interests:** Even when a significant risk requiring the lawyer to comply with CRPC 1.7(b) (¶ 1:73.2) is not present, they must not represent a client without written disclosure to the client, and as otherwise provided, where the lawyer (i) has or knows that another lawyer in the firm has a legal, business, financial, professional or personal relationship with or responsibility to a party or witness in the same matter, or (ii) knows or reasonably should know that another party's lawyer is a spouse, parent, child or sibling of the lawyer, lives with the lawyer, is a client of the lawyer or another lawyer in the firm, or has an intimate relationship with the lawyer. [See CRPC 1.7(c); see also *Havasu Lakeshore Investments, LLC v. Fleming* (2013) 217 CA4th 770, 778, 158 CR3d 311, 318 (decided under former CRPC 3-310(C))—"conflict" exists when attorney's duty to one client obligates them to take action *prejudicial* to another client]

(c) [1:73.4] **Duties to former clients; potential breach of client confidences:** An attorney who previously represented a client in a matter must not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed written consent (¶ 1:73.2a). [CRPC 1.9(a); see *Costello v. Buckley* (2016) 245 CA4th 748, 754, 199 CR3d 891, 896 (decided under former CRPC 3-310(E))—if attorney possesses confidential information adverse to former client, and former client has not consented to current representation, disqualification follows "as a matter of course" (¶ *1:79.4*)]

Absent informed written consent (¶ 1:73.2a), the CRPC also prohibits an attorney from representing a person in the same or a substantially related matter where the "firm with which the lawyer formerly was associated had previously represented a client whose interests are materially adverse to that person." This is so, however, only if the attorney actually acquired material, confidential information protected under Bus. & Prof.C. § 6068(e) (duties of attorneys) and the CRPC. [CRPC 1.9(b), Comment [4]]

[1:73.5] ***Reserved.***

(d) [1:73.5a] **Attorney-client or other fiduciary relationship required:** The CRPC proscription against conflict of interest representation operates in the context of an attorney-client or other *fiduciary* relationship with the affected parties, from which the duties of loyalty (¶ *1:74*) and confidentiality (¶ *1:79*) arise. [*American Airlines, Inc. v. Sheppard, Mullin, Richter & Hampton* (2002) 96 CA4th 1017, 1032-1035, 117 CR2d 685, 696-698 (lawyer acted as witness/fiduciary for one adverse party); *DCH Health Services Corp. v. Waite* (2002) 95 CA4th 829, 832, 115 CR2d 847, 849]

Thus, a party has no standing to seek to disqualify an attorney under the CRPC with whom the party had no attorney-client or other fiduciary relationship. [*DCH Health Services Corp. v. Waite*, supra, 95 CA4th at 833, 115 CR2d at 850 (decided under former CRPC 3-310); *Marriage of Murchison* (2016) 245 CA4th 847, 851-852, 199 CR3d 800, 803 (former CRPC 3-300 proceeding)—standing requirement "implicit" in disqualification motions (noting even under minority view, moving *nonclient* must have "personal stake" sufficient to satisfy standing requirements); compare

Shen v. Miller (2012) 212 CA4th 48, 56, 150 CR3d 783, 789, fn. 3 (decided under former CRPC 3-310)—*generally,* complaining party must have (or have had) attorney-client relationship with attorney before disqualification is proper; and *Kennedy v. Eldridge* (2011) 201 CA4th 1197, 1205, 135 CR3d 545, 551 (decided under former CRPC 3-310) —even if opposing litigant was never attorney's client, they may bring motion to disqualify attorney under court's *inherent power* when attorney's continued representation threatens litigant with cognizable injury or would undermine integrity of judicial process]

1) [1:73.5b] **Attorney-client relationship—actual retention not required:** A formal retention agreement is not required. For purposes of a conflict of interest analysis, an attorney represents a "client" when the attorney knowingly obtains material confidential information from the client and renders legal advice or services as a result. [*People ex rel. Dept. of Corporations v. SpeeDee Oil Change Systems, Inc.* (1999) 20 C4th 1135, 1148, 86 CR2d 816, 825; see also *Shen v. Miller* (2012) 212 CA4th 48, 57, 150 CR3d 783, 790—attorney-client relationship is established *prima facie* when party seeking legal guidance consults attorney and secures advice]

2) [1:73.5c] **Payment of attorney's fees not determinative:** Conversely, simply paying an attorney's fees does not itself make the payor the attorney's "client" for conflict of interest disqualification purposes. [See *Strasbourger Pearson Tulcin Wolff Inc. v. Wiz Tech., Inc.* (1999) 69 CA4th 1399, 1404-1405, 82 CR2d 326, 329-330]

(3) [1:73.6] **Avoiding interests adverse to a client:** The California Rules also limit business transactions between attorney and client:

An attorney "shall not enter into a business transaction with a client; or knowingly acquire an ownership, possessory, security, or other pecuniary interest adverse to a client, unless each of the following requirements has been satisfied:

"(a) the transaction or acquisition and its terms are fair and reasonable to the client and the terms and the lawyer's role in the transaction or acquisition are fully disclosed and transmitted in writing to the client in a manner that should reasonably have been understood by the client;

"(b) the client either is represented in the transaction or acquisition by an independent lawyer of the client's choice or the client is advised in writing to seek the advice of an independent lawyer of the client's choice and is given a reasonable opportunity to seek that advice; and

"(c) the client thereafter provides informed written consent to the terms of the transaction or acquisition, and the lawyer's role in it." [CRPC 1.8.1; *Marriage of Murchison* (2016) 245 CA4th 847, 850, 199 CR3d 800, 802, fn. 2 (¶ *1:91*); see also *Matter of Allen* (Rev.Dept. 2010) 5 Cal. State Bar Ct.Rptr. 198, 204-205 (decided under former Rule 3-300)—restrictions normally are imposed on business transactions with current, *not* former, clients; *and* ¶ 1:73.2a (re informed written consent)]

[1:73.7 - 1:73.9] ***Reserved.***

(4) [1:73.10] **Compare—ABA and other conflict of interest rules:** Similar, but not identical, conflict of interest standards are prescribed by the ABA Model Rules of Professional Conduct (see ABA Model Rules, Rule 1.7). However, the ABA Rules have not been adopted in California and are not binding on California lawyers with regard to conduct expressly regulated by California rules. [See CRPC 1.0, Comment [4]—ethics opinions and rules and standards promulgated by other jurisdictions and bar associations may "also be considered" but are not binding; *Hetos Investments, Ltd. v. Kurtin* (2003) 110 CA4th 36, 46, 1 CR3d 472, 479; see also *State Comp. Ins. Fund v. WPS, Inc.* (1999) 70 CA4th 644, 655-656, 82 CR2d 799, 807—ABA formal opinion "does not establish an obligatory standard of conduct imposed on California lawyers" and thus cannot be basis for attorney sanctions]

• [1:73.10a] A law firm representing a client in challenging the validity of a document it prepared for the client arguably may create an "appearance of professional impropriety" in violation of ABA rules (see ABA Model Code, Canon 9). But an appearance of impropriety does not itself support a lawyer's disqualification under California ethical rules. [*Hetos Investments, Ltd. v. Kurtin* (2003) 110 CA4th 36, 47-48, 1 CR3d 472, 479-480—law firm that prepared promissory note for borrower not disqualified from representing borrower in borrower's lawsuit claiming note was usurious]

(5) [1:73.11] **Impact of conflict on attorney fees entitlement:** Attorneys who violate the ethical rules against *conflict-free* representation may jeopardize their entitlement to legal fees. Unless counsel obtained the affected client's "informed written consent" (¶ 1:73.2a), they may have to *forfeit* the right to recover fees for services rendered after the ethical breach. [*Cal Pak Delivery, Inc. v. United Parcel Service, Inc.* (1997) 52 CA4th 1, 14-16, 60 CR2d 207, 215-216; *A.I. Credit Corp.,*

Inc. v. Aguilar & Sebastinelli (2003) 113 CA4th 1072, 1076, 6 CR3d 813, 817; but see also *Pringle v. La Chapelle* (1999) 73 CA4th 1000, 1006-1007, 87 CR2d 90, 94—must be "serious violation" of attorney's responsibilities before ethical rule violation will require forfeiture of fees]

b. [1:74] **Representation compromising duty of loyalty to existing clients (simultaneous conflicting representations):** Attorneys owe their *existing* clients a duty of *undivided loyalty.* Therefore, counsel *cannot* accept representation of a new client on a matter adverse to the interests of existing clients, unless the affected clients give their informed written consent (¶ 1:73.2a). [CRPC 1.7(a); ABA Model Rule 1.7; *Flatt v. Sup.Ct. (Daniel)* (1994) 9 C4th 275, 284, 36 CR2d 537, 543; see also *Sheppard, Mullin, Richter & Hampton, LLP v. J-M Mfg. Co, Inc.* (2018) 6 C5th 59, 84, 86, 237 CR3d 424, 442, 444—to be informed, consent must be based on "all material facts the attorney knows and can reveal," including existing conflicts (applying former CRPC 3-310(C)(3)); *In re Charlisse C.* (2008) 45 C4th 145, 160, 84 CR3d 597, 607; *Santa Clara County Counsel Attys. Ass'n v. Woodside* (1994) 7 C4th 525, 548, 28 CR2d 617, 630 (superseded by statute on other grounds as stated in *Coachella Valley Mosquito & Vector Control Dist. v. California Pub. Employment Relations Bd.* (2005) 35 C4th 1072, 1077, 1084, 29 CR3d 234, 236, 243)—"attorney is precluded from assuming any relation which would prevent him from devoting his entire energies to his client's interests"]

(1) [1:75] **Subject matter relationship immaterial:** In such a scenario, disqualification on the new matter is *mandatory and automatic* whether or not there is any subject matter relationship between the simultaneous representations (and, indeed, even if they have *nothing in common*)—unless, after full disclosure, the clients agree in writing to waive the conflict. [*Flatt v. Sup.Ct. (Daniel)* (1994) 9 C4th 275, 284-286, 36 CR2d 537, 542-543 & fn. 4; see also *Havasu Lakeshore Investments, LLC v. Fleming* (2013) 217 CA4th 770, 777, 158 CR3d 311, 317—"with few exceptions," attorneys may not simultaneously represent clients (even as to unrelated matters) whose interests are adverse; *Banning Ranch Conservancy v. Sup.Ct. (City of Newport Beach)* (2011) 193 CA4th 903, 912, 123 CR3d 348, 354—prohibition against simultaneous conflicting representations is analogous to "biblical injunction" against serving two masters (rule precludes attorneys from having to choose between conflicting duties or reconcile conflicting interests)]

(2) [1:76] **Dropping existing client not an option:** A simultaneous representation conflict of interests cannot be cured by dropping the existing client in favor of the new client. The automatic disqualification rule applicable to simultaneous conflicting representation cannot be avoided by "unilaterally converting a present client into a former client" in order to trigger the more lenient "substantial relationship" disqualification standard applicable to former clients (*¶ 1:79*). [*Truck Ins. Exch. v. Fireman's Fund Ins. Co.* (1992) 6 CA4th 1050, 1059, 8 CR2d 228, 233; see also *Flatt v. Sup.Ct. (Daniel)* (1994) 9 C4th 275, 288, 36 CR2d 537, 544-545]

Indeed, such action may itself be a type of breach of the attorney's duty of loyalty that the concurrent representation rule is intended to avoid. [*American Airlines, Inc. v. Sheppard, Mullin, Richter & Hampton* (2002) 96 CA4th 1017, 1037, 117 CR2d 685, 700]

(3) [1:76.1] **Law firm vicarious disqualification:** Simultaneous representation of clients with conflicting interests (absent informed written consent, ¶ 1:73.2a) is so patently improper that the conflict will be imputed to the attorney's *entire law firm;* and the *entire firm* ordinarily will be *vicariously disqualified.* [*In re Charlisse C.* (2008) 45 C4th 145, 161, 84 CR3d 597, 608; see generally, *People ex rel. Dept. of Corporations v. SpeeDee Oil Change Systems, Inc.* (1999) 20 C4th 1135, 1153-1154, 86 CR2d 816, 829; *and ¶ 1:80* (re successive conflicting representations)]

(4) Application to representation of business organizations

(a) [1:77] **Conflict between individual member of entity and another client:** The automatic disqualification rule (¶ 1:74 ff.) does not necessarily apply when one of the clients is a business organization (e.g., a partnership) and the conflict arises between an *individual member of the entity* (e.g., a partner) and another client. Here, the threshold issue is whether there is an *attorney-client relationship* between counsel and the entity's individual.

Generally, where the client is a business entity, counsel's primary duty runs to the *entity*, not to its principals (see CRPC 1.13(f)). Accordingly, absent the attorney's express or implied agreement to represent a particular member individually, there is no basis for disqualification based on a conflict between the entity member and another client (i.e., the member individually is not an "existing client"). [*Responsible Citizens v. Sup.Ct. (Askins)* (1993) 16 CA4th 1717, 1731-1732, 20 CR2d 756, 765—automatic disqualification improper where lawyer, while representing partnership in real estate escrow, filed suit on unrelated matter against partner individually; see also *Lynn v. George* (2017) 15

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CA5th 630, 641-642, 223 CR3d 407, 417—"potential" attorney-client relationship with alleged partnership formed by real estate broker and investment company insufficient to disqualify investment company's attorney in broker's action against investment company (¶ 1:79.5)]

(b) [1:77.1] **Conflict between entity and its constituents:** By contrast, automatic attorney disqualification generally is triggered by simultaneous representation of a business entity and one or more of its *constituents* (directors, officers, members, shareholders, employees, etc.) once an *actual conflict* arises between them. [*La Jolla Cove Motel & Hotel Apartments, Inc. v. Sup.Ct. (Jackman)* (2004) 121 CA4th 773, 785, 17 CR3d 467, 475-476; see also *M'Guinness v. Johnson* (2015) 243 CA4th 602, 617-624, 196 CR3d 662, 673-678—although law firm may have completed its last specific engagement for corporation, error not to automatically disqualify firm from representing corporate constituent in litigation against corporation and its other constituents ("undisputed facts" showed law firm had ongoing relationship with corporation, including retention of deposit to secure future legal services, control over shareholder's access to corporate records and fee agreement evidencing parties' intent to establish "ongoing attorney-client relationship of an open-ended nature")]

The same is not true, however, for "*potential conflicts*"*:* Disqualification is mandated only if there is a *reasonable likelihood* that an *actual conflict* will arise. [See CRPC 1.13(g) (expressly permitting counsel to represent organizations and their constituents subject to CRPC 1.7, 1.8.2, 1.8.6 and 1.8.7); see also *Havasu Lakeshore Investments, LLC v. Fleming* (2013) 217 CA4th 770, 773, 778, 158 CR3d 311, 314, 318 (decided under former CRPC 3-600(E))—error to disqualify law firm from simultaneously representing LLC and nonmember individual who managed LLC's managing member (a partnership) in action against LLC's two minority members where no *actual* conflict existed between LLC and nonmember individual and no reasonable likelihood such conflict would arise]

[1:77.2 - 1:77.4] ***Reserved.***

(5) [1:77.5] **"Framework" retainer agreements distinguished:** "Framework" retainer agreements (i.e., open-ended agreements affording counsel and clients the *option* of creating *future* engagements without new writings) do not by themselves create "current" attorney-client relationships within the meaning of CRPC 1.7. Indeed, these agreements merely provide a structure for establishing *future* attorney-client relationships on an "as-requested" basis, subject to confirmation by the firm: "Framework retainer agreements are not the same as 'classic' retainer agreements, where the client pays a fee to secure the attorney's future time and availability, and where the attorney gives up the right to decline future legal work." [*Banning Ranch Conservancy v. Sup.Ct. (City of Newport Beach)* (2011) 193 CA4th 903, 908, 912, 123 CR3d 348, 351, 354—two framework retainer agreements between City and law firm entered into more than five years earlier did not create "current" attorney-client relationship so as to preclude firm from representing nature conservancy with interests adverse to City; but see *Sheppard, Mullin, Richter & Hampton, LLP v. J-M Mfg. Co, Inc.* (2018) 6 C5th 59, 83, 237 CR3d 424, 441—agreement permitting firm to represent client in general employment matters, under which firm regularly provided services over many years, was not framework agreement, but instead continuing agreement for work on employment matters as needed (absent express agreement severing relationship during periods of inactivity, client could reasonably believe it had ongoing attorney-client relationship, even when firm not currently working on specific project)]

c. [1:78] **Representation adverse to former client (successive conflicting representations):** Another type of disqualifying conflict of interest arises primarily in a litigation context, where counsel (or counsel's law firm) represented an opposing party in the past. Here, only potentially adverse interests are at stake and, therefore, disqualification is not automatic. [*Flatt v. Sup.Ct. (Daniel)* (1994) 9 C4th 275, 283, 36 CR2d 537, 541; *Adams v. Aerojet-General Corp.* (2001) 86 CA4th 1324, 1328, 104 CR2d 116, 119]

(1) [1:79] **"Substantial relationship" test for disqualifying breach of confidence conflict:** The "chief fiduciary value" at jeopardy in a "successive representation" situation is that of client *confidentiality*—i.e., the potential that the proposed new representation might involve reference to material confidential information obtained from the former client who is now on the opposing side. [CRPC 1.9; *In re Charlisse C.* (2008) 45 C4th 145, 159-160, 84 CR3d 597, 607; *Flatt v. Sup.Ct. (Daniel)* (1994) 9 C4th 275, 283, 36 CR2d 537, 541]

Whether the successive representation risks a potential breach of former client confidences so as to trigger disqualification is evaluated by a "substantial relationship" test: If there is a "substantial relationship" between the subjects of the former and current representations, counsel's knowledge of confidential information adverse to the former

client is *presumed.* [See *Banning Ranch Conservancy v. Sup.Ct. (City of Newport Beach)* (2011) 193 CA4th 903, 918, 123 CR3d 348, 358; *Knight v. Ferguson* (2007) 149 CA4th 1207, 1213, 57 CR3d 823, 827; *Adams v. Aerojet-General Corp.* (2001) 86 CA4th 1324, 1331, 104 CR2d 116, 120-121]

In turn, absent the former client's informed written consent (¶ 1:73.2a), or proof that no pertinent confidential information was in fact obtained, counsel is *disqualified* from representing the proposed new client. [*Flatt v. Sup.Ct.* (*Daniel*), supra, 9 C4th at 283, 36 CR2d at 541; see also *Fiduciary Trust Int'l of Calif. v. Sup.Ct.* (*Brown*) (2013) 218 CA4th 465, 479, 160 CR3d 216, 226—disqualification is mandatory if former client's representation was "direct and personal" and "substantial relationship" between subjects of prior and current representations is demonstrated]

(a) [1:79.1] **Three-pronged inquiry:** Application of the "substantial relationship" test requires inquiry into (i) similarities between the two factual situations; (ii) similarities between the legal issues posed; and (iii) the nature and extent of counsel's involvement with the former and proposed new representations and whether counsel was in a position to learn of the client's policy or strategy. [*H.F. Ahmanson & Co. v. Salomon Bros., Inc.* (1991) 229 CA3d 1445, 1455, 280 CR 614, 620; see also *Jessen v. Hartford Cas. Ins. Co.* (2003) 111 CA4th 698, 709, 3 CR3d 877, 884-885; see *Banning Ranch Conservancy v. Sup.Ct. (City of Newport Beach)* (2011) 193 CA4th 903, 918, 123 CR3d 348, 359—former representation alone does not give rise to "lifetime prohibition" against future representation of opposing party]

(b) Application

1) [1:79.2] **Former representation of joint clients—mandatory disqualification:** Where the prior representation involved *joint clients* and the new action relates to the same subject matter (e.g., Attorney represented Clients A and B in formation of their partnership and acquisition of partnership property, and thereafter A wants Attorney to represent her in litigation against B over mishandling of partnership affairs), a "substantial relationship" between the former representation and the subsequent action will *always* exist. In this situation, therefore, disqualification is *mandatory* unless the former joint clients consent to waive the conflict. [*Zador Corp., N.V. v. Kwan* (1995) 31 CA4th 1285, 1294, 37 CR2d 754, 759—conflict waived by written agreement not to disqualify Attorney "notwithstanding any adversity [between joint clients] that may develop"; see also *Fiduciary Trust Int'l of Calif. v. Sup.Ct.* (*Brown*) (2013) 218 CA4th 465, 482-485, 160 CR3d 216, 228-231 (rejecting Ev.C. § 962 "blanket exception" argument to ethical limitations on adverse, successive representations)—law firm jointly retained by H and W to prepare wills and trusts (including marital trust) disqualified from representing marital trust trustees in subsequent dispute with W's personal representative over estate tax liability; compare *Capra v. Capra* (2020) 58 CA5th 1072, 1097-1098, 273 CR3d 402, 420-421 (emphasizing former client must show past and present actions relate to same subject matter before mandatory disqualification applies)—attorney not disqualified from representing defendant in dispute over family cabin rights even if attorney previously represented plaintiffs and their corporation in various *unrelated* matters]

2) [1:79.3] **Switching sides in ongoing dispute—mandatory disqualification:** When a lawyer switches sides in an ongoing dispute (i.e., the two representations are in the same matter or the current representation involves the work performed for the former client), the nature of the former representation will *always* be such that the exchange of relevant confidences *must* be presumed; absent the clients' informed written consent (¶ 1:73.2a), disqualification will be required. [*City Nat'l Bank v. Adams* (2002) 96 CA4th 315, 330, 117 CR2d 125, 138]

(c) [1:79.4] **Compare—where access to confidential information *independently established:*** The "substantial relationship" test for a disqualifying conflict of interest (¶ *1:79 ff.*) applies only when the former client cannot *independently* establish that counsel acquired, or could have acquired, confidential information while representing the former client. If evidence is presented showing confidential information *was or may have been* acquired during the first representation, disqualification is required *even when there is no "substantial relationship" between the subjects of the former and current representations*. [See *Costello v. Buckley* (2016) 245 CA4th 748, 755-756, 199 CR3d 891, 896-897—P's former attorney disqualified from representing D in P's debt collection action (while representing P in unrelated matter, counsel had access to confidential information about P's prior romantic relationship with D that could be used against her)]

(d) [1:79.5] **Confidential, *nonclient relationships:*** An attorney also may be subject to disqualification when they owe a duty to a *nonclient* to preserve confidential information. In sum, "if an attorney is deemed to have a duty of confidentiality to a nonclient arising out of … past representation, courts apply the substantial relationship test from

successive representation doctrine to determine whether to disqualify counsel in a case against the nonclient." [*Acacia Patent Acquisition, LLC v. Sup.Ct.* (*Reddy*) (2015) 234 CA4th 1091, 1102, 184 CR3d 583, 591; see also *Lynn v. George* (2017) 15 CA5th 630, 637-641, 223 CR3d 407, 413-416—where evidence was insufficient to support finding of confidential nonclient relationship between broker and real estate investment company's attorney, error to disqualify counsel from representing investment company in broker's action against investment company (¶ 1:77)]

(2) [1:80] **Law firm vicarious disqualification:** The conflicted attorney's presumptive knowledge of the former client's (now adverse party's) material confidential information taints the *entire law firm.* Consequently, the *entire firm* ordinarily will be disqualified. [*Flatt v. Sup.Ct. (Daniel)* (1994) 9 C4th 275, 283, 36 CR2d 537, 541]

(a) [1:80.1] **"Ethical screening" rebuttal?** It is unclear, however, whether the presumption of shared confidences within a private law firm can be rebutted in a successive representation conflicts scenario, avoiding vicarious law firm disqualification, by evidence of an effective "ethical screening" within the firm. One appellate court, finding the California Supreme Court's apparent "absolute rule" of vicarious law firm disqualification to be dicta, sides with the view that, in proper circumstances, an ethical screening rebuttal is permitted. [*Kirk v. First American Title Ins. Co.* (2010) 183 CA4th 776, 814, 800-801, 108 CR3d 620, 637-638, 649]

Comment: The California Supreme Court has expressly approved of an ethical screening rebuttal in the context of *public sector* law firms (*In re Charlisse C.* (2008) 45 C4th 145, 162-163, 166, 84 CR3d 597, 609-610, 612-613 & fn. 11); but the Court has not yet considered and definitively decided the issue in a nongovernmental attorney context.

(b) [1:80.2] **Compare—vicarious disqualification of firm-switching attorney:** The situation may be different when an attorney leaves the former client's firm and later represents others in a suit against the former client on a "substantially related" matter: The attorney has a conflict of interest only when they have actual knowledge of material, confidential information protected by Bus. & Prof.C. § 6068(e) and the CRPC. [See CRPC 1.9(b), Comment [4], Executive Summary, 2., codifying *Adams v. Aerojet-General Corp.* (2001) 86 CA4th 1324, 1337, 104 CR2d 116, 125 (decided under former CRPC 3-310(E))—Lawyer's former firm advised Client on land use and toxic waste disposal at Client's manufacturing site but Lawyer was never personally involved in that representation (Lawyer started new firm years later and filed groundwater contamination suit on behalf of several plaintiffs against Client)]

Instead, in this situation, disqualification depends on a fact-based examination of the nature and extent of the attorney's involvement with and exposure to the former firm's earlier representation of the client and, specifically, whether confidential information material to the current lawsuit would "normally have been imparted" to the attorney while at the former firm. Disqualification should not be ordered where there is no reasonable probability the firm-switching attorney had access to confidential information while at the former firm that is related to the current representation. [*Adams v. Aerojet-General Corp.*, supra, 86 CA4th at 1328, 1340, 104 CR2d at 119, 127 (crafting modified version of *Ahmanson* "substantial relationship" test)]

d. [1:81] **Joint representation conflicts of interest:** Attorneys cannot ethically represent *more than one* client in the same matter unless *each* joint client gives *informed written consent* (¶ 1:73.2a). [CRPC 1.7(a) & (b), Comment [2]; see also ABA Model Rule 1.7; *Zador Corp., N.V. v. Kwan* (1995) 31 CA4th 1285, 1295, 37 CR2d 754, 759]

(1) [1:82] **Notwithstanding absence of presently conflicting interests:** This rule applies even if it appears there is only a *potential* conflict between the joint clients (no existing dispute among them). Should the "potential" conflict ripen into an "actual" conflict, continued joint representation requires their informed written consent *anew*. [CRPC 1.7(a) & (b), Comment [2]; *see* ¶ 1:73.2a]

(a) [1:83] **Conflicts disclosure—notice of "joint client waiver" of attorney-client privilege required:** A joint client's consent to waive the potential conflict is not "informed" unless counsel's written disclosure of the potential adverse consequences advised the clients that joint representation on a matter of common interest will result in each client's *waiver of the attorney-client privilege* with respect to communications with the common attorney in the event of subsequent litigation *between themselves* (Ev.C. § 962—"joint client exception to attorney-client privilege"). [*Zador Corp., N.V. v. Kwan* (1995) 31 CA4th 1285, 1294, 37 CR2d 754, 759; see also *Wortham & Van Liew v. Sup.Ct. (Clubb)* (1987) 188 CA3d 927, 933, 233 CR 725, 728-729—joint clients also waive any *confidences* from each other with respect to common matter]

FORM: Sample Joint Representation Disclosure and Consent Letter, *see Form 1:A.*

[1:84] ***Reserved.***

(2) Application

(a) [1:85] **Joint buyer or joint seller clients:** In real estate transactions, the "seller" or "buyer" may actually be two or more persons or entities. Because their interests will usually be aligned (if not identical) at the outset, they naturally will seek out *one* lawyer to represent them jointly. Nonetheless, it is reasonably foreseeable that they could develop divergent opinions or desires at some point during the transaction: For example, one may want to affirm the purchase and sale contract and the other may want to find a basis for its termination. The possibility of a subsequent conflict of interests *must be disclosed at the outset*; and counsel must obtain the clients' written consent (¶ 1:73.2a) to joint representation both at the inception and again *later* should the "potential" conflict become a reality (¶ *1:82*).

➪ [1:86] ***PRACTICE POINTER:*** Multiple client interests may be identical in regard to one aspect of the transaction and *divergent* as to another. In this situation, it is ethically permissible to represent them jointly on those aspects as to which they share common interests and to advise them to retain separate counsel on other divergent aspects.

For example, assume two buyers wish to purchase property as co-owners. Their interests purely as buyers may be identical; but they could well have differing objectives and desires regarding the terms of their co-ownership agreement (as to which they should prudently obtain independent legal advice). *See Ch. 12*.

(b) [1:87] **Representing both buyer and seller:** A far more apparent conflict of interest situation arises where counsel is approached to represent both *buyer and seller* in a transaction. Their interests are *necessarily* and *inherently adverse* from the outset and likely to become even more divergent as the deal progresses. As such, even if both are willing to sign a written waiver of conflicts, it is difficult to imagine a scenario when a single attorney can justify representing both buyer and seller in an arm's length purchase and sale transaction.

➪ [1:88] ***PRACTICE POINTER:*** Prudent counsel *always* avoid representing both buyer and seller—even when they profess to be in 100% agreement on all terms and conditions. As a practical matter, their objectives can never be identical; and representing clients with divergent interests undoubtedly will impair your independent judgment and duty of loyalty to each, posing a *serious malpractice trap*.

1) [1:89] **Special problem—related buyers and sellers:** A more difficult problem arises when buyer and seller are *related* in some manner and intend to effectuate the transaction for a mutually desirable objective that is not fundamentally an arm's length purchase and sale.

For example, spouses may want to transfer property between themselves or to another family member for tax or estate planning purposes; or a corporation may be interested in transferring certain realty to some of its shareholders; or a partnership may want to "cash out" one of its partners by way of a transfer of partnership real property.

➪ [1:89.1] ***PRACTICE POINTER:*** In the situations discussed at ¶ 1:89, all concerned parties may view the attorney's job as a mere ministerial task of documenting the deal points and preparing and recording a preprinted title company form deed. Even so, there are *potentially* conflicting interests which must be disclosed. Notably, the ownership of real property always carries with it various benefits and burdens, and attention must be given to a host of substantive issues (*see Ch.4*). Separate counsel may be required to advise and consult on matters of potential adverse interests; but even if independent counsel is not essential, a *written waiver of the potential conflicts* should be procured.

e. [1:90] **Conflict from attorney's participation in client transaction:** Ethical restrictions on acquiring a pecuniary interest adverse to a client (CRPC 1.8.1; ¶ *1:73.6*) effectively forbid counsel from participating with clients on a transactional (or business) matter *unless:*

- the transaction and its terms are "*fair and reasonable*" to the client, and the terms and the lawyer's role in the transaction are *fully disclosed* in writing (in an understandable manner) to the client;

- the client either is represented by an independent lawyer of the client's choice or is given written advice and reasonable opportunity to consult an *independent lawyer of their choice;* and

• the client thereafter provides informed written consent (¶ 1:73.2a) to the terms of the transaction and the lawyer's role in it. [CRPC 1.8.1; *Connor v. State Bar* (1990) 50 C3d 1047, 1056, 269 CR 742; *BGJ Assocs., LLC v. Wilson* (2003) 113 CA4th 1217, 1225-1226, 7 CR3d 140, 146-147 (decided under former CRPC 3-300)—client's consultation with independent counsel does not obviate duty to comply with all other Rule 3-300 requirements; see also *Matter of Allen* (Rev.Dept. 2010) 5 Cal. State Bar Ct.Rptr. 198, 204-205 (decided under former CRPC 3-300)—CRPC restrictions normally are imposed on business transactions with current, *not* former, clients]

(1) [1:91] **Regardless of actual effect on client's interests:** The concern is that counsel *not be tempted* to put personal interests ahead of the client's. Thus, neither the attorney's avowed “good intentions” to act in the client's best interests, nor the absence of actual injury to the client, excuses adherence to the ethical standards set forth at ¶ 1:90. [*Connor v. State Bar* (1990) 50 C3d 1047, 1057, 269 CR 742, 747 (decided under former rule)—acquiring legal title to client's property for purpose of assisting client in avoiding foreclosure triggers CRPC 3-300; compare *Marriage of Murchison* (2016) 245 CA4th 847, 854, 199 CR3d 800, 805 (decided under former rule)—purchasing marital residence from client (W) during dissolution proceeding to avoid foreclosure did not trigger CRPC 3-300 (order disqualifying W's attorney for his alleged violation of CRPC 3-300 reversed given W's desire to continue being represented, H's lack of standing to bring disqualification motion, no independent authority requiring disqualification and importance of respecting W's right to counsel); *Matter of Allen* (Rev.Dept. 2010) 5 Cal. State Bar Ct.Rptr. 198, 204 (decided under former rule)—purchasing *former* client's duplex did *not* trigger CRPC 3-300 (no attorney-client relationship existed at time of negotiation and sale)]

(2) [1:92] **Written recommendation to seek “independent” legal advice:** The ethical obligation to advise the client in writing to consult an “independent” lawyer is *not* discharged by referring the client to a partner, associate or other member of the interested attorney's law firm. “Independent” counsel cannot be one who (directly or indirectly) stands to profit from the attorney-client business transaction (e.g., by client's fee payments). [*Connor v. State Bar* (1990) 50 C3d 1047, 1058-1059, 269 CR 742, 748; see *Mayhew v. Benninghoff* (1997) 53 CA4th 1365, 1369-1370, 62 CR2d 27, 30—attorney with whom divorce client entrusted over $600,000 for “side business deal” (investments) failed to advise client to seek independent counsel]

(3) [1:92.1] **Transaction presumptively tainted by undue influence; voidable by client:** All business transactions between attorney and client in which the attorney is charged with obtaining an advantage over the client are presumptively the product of *undue influence* and are closely scrutinized for unfairness. In a client's suit to void the transaction, the attorney bears the burden of showing no advantage was taken and that the client was given full disclosure and advice. [See *Beery v. State Bar* (1987) 43 C3d 802, 812-813, 239 CR 121, 126; *BGJ Assocs., LLC v. Wilson* (2003) 113 CA4th 1217, 1227-1228, 7 CR3d 140, 148 (decided under former CRPC 3-300); see *Mayhew v. Benninghoff* (1997) 53 CA4th 1365, 1369-1370, 62 CR2d 27, 29-30 (decided under former CRPC 3-300)—having failed to make required disclosures, attorney could not dispel presumption he took advantage of client in connection with independent financial dealings and thus could not invoke ambiguous arbitration clause in unrelated retainer agreement to compel arbitration of client's claim that attorney converted sums entrusted to him for investment]

(4) [1:93] **Rule 1.8.1 as measure of fiduciary duty:** A violation of the Rules of Professional Conduct does not itself give rise to an independent cause of action (CRPC 1.0(b)(3)). However, together with statutes and general principles of law, the ethical rules help define counsel's fiduciary duty to a client and are relevant for that purpose in a client's civil suit against counsel. Indeed, the “scope of an attorney's fiduciary duty may be determined *as a matter of law* based on the Rules of Professional Conduct.” [*Stanley v. Richmond* (1995) 35 CA4th 1070, 1086, 41 CR2d 768, 776 (emphasis added); *BGJ Assocs., LLC v. Wilson* (2003) 113 CA4th 1217, 1227, 7 CR3d 140, 147]

Thus, in a client's breach of fiduciary duty suit against counsel for loss allegedly suffered on account of counsel's proscribed adverse interest, CRPC 1.8.1 *conclusively establishes* counsel's duty to the client. The attorney's breach of fiduciary duty may be measured by the CRPC 1.8.1 violation (and the jury may be instructed accordingly). [*Mirabito v. Liccardo* (1992) 4 CA4th 41, 45-47, 5 CR2d 571, 573-575 (decided under former rule)—attorney who induced client to make bad investments in violation of CRPC 3-300 liable for client's consequential losses on breach of fiduciary duty theory; see also *Day v. Rosenthal* (1985) 170 CA3d 1125, 1147-1148, 217 CR 89, 102-103]

(5) Compare—transactions not implicating Rule 1.8.1

(a) [1:94] **Independent parallel investments:** CRPC 1.8.1 does not apply where attorney and client each make *parallel* investments on terms offered to the general public or a significant portion of the public—so long as counsel did *not solicit* the client's investment. [See CRPC 1.8.1, Comment [6]]

(b) [1:94.1] **Independent escrow for payment of attorney fees:** CRPC 1.8.1 does not apply to an arrangement for the payment of attorney fees from funds deposited by the client in an *independent escrow*, so long as the fees are disbursed to the attorney only after the legal services are rendered in accordance with the attorney-client fee agreement and the escrow instructions condition payment to the attorney on the client's prior opportunity to review and contest the attorney's bill. [See Cal. State Bar Form.Opn. 2002-159 (decided under former CRPC 3-300); *see also* ¶ *1:160.1, 1:178.1*]

(c) [1:94.2] **Unsecured note for fees:** Nor does a lawyer acquire a pecuniary interest "adverse to the client" so as to trigger the CRPC 1.8.1 requirements by taking the client's *unsecured promissory note* as security for the payment of fees. [*Hawk v. State Bar* (1988) 45 C3d 589, 600-601, 247 CR 599, 605-606 (decided under former CRPC 3-300); see *Fletcher v. Davis* (2004) 33 C4th 61, 68, 14 CR3d 58, 63 (distinguishing attorney's charging lien, which is within ambit of former Rule 3-300); *and* ¶ *1:175*]

(d) [1:94.3] **Business transaction with *former client:*** CRPC 1.8.1 normally does *not* apply to business transactions with a *former* client. Indeed, the existence of an attorney-client relationship *at the time of the transaction* is an essential element of a Rule 1.8.1 violation. [See *Matter of Allen* (Rev.Dept. 2010) 5 Cal. State Bar Ct.Rptr. 198, 204-205 (decided under former CRPC 3-300)—attorney's prior relationship with client did not give attorney any advantage in negotiating purchase of client's duplex]

➪ ***PRACTICE POINTERS***

• [1:95] ***Practical implications from representation of potentially adverse interests:*** Even when an actual or potential conflict of interest representation passes ethical muster (¶ 1:90 ff.), attorneys should think twice before taking on matters that might possibly involve divided loyalties or a breach of client confidences. In consultations, negotiations and, if necessary, litigation, clients expect their attorneys to take a posture *consistent* with the client's interests and to be an *advocate* for the client's interests. An appearance of divided loyalties could impact your ability to collect fees, jeopardize the potential for receiving additional work and/or referrals from the client, perhaps affect your professional reputation, and (in the worst scenario) make you vulnerable to malpractice charges by a disappointed client.

• [1:96] ***Early focus on potential conflicts advisable:*** Parties to real property sales transactions are often quite willing to waive any actual or potential conflicts of interest. Typically, buyers and sellers are equally motivated to enter into a contract and consummate the transaction as rapidly as possible; for expedience sake, they do not want to be sidetracked with potential conflicts concerns and, in any event, frequently do not fully understand or appreciate those concerns. Also, most buyers and sellers do not view their relationship as necessarily "adversarial" (the way they would in a litigation context). Indeed, negotiations may have been completed (price and other material terms agreed upon) before an attorney is even consulted. Thus, counsel are often viewed simply as "mechanics" who finalize the paperwork and coordinate the closing—not individuals who will be an "advocate" for one party or an "adversary" of another.

For all of these reasons, it is extremely important that the *attorneys* directly and immediately focus on conflicts issues. You will be doing your client a disservice—in terms of both cost and time—if, halfway into the transaction, you become compelled to cease representation because a potential conflict has materialized into a reality.

f. [1:97] **Soliciting gifts from client:** An attorney may not solicit a client to make a "substantial gift," including a testamentary gift, directly to the attorney or a person related to the attorney *unless* the attorney or his/her relative is *related to the client.* [See CRPC 1.8.3(a)(1) & Comment [1]—attorneys and/or their relatives may accept gifts from clients subject to general standards of fairness and undue influence, but discipline is appropriate where impermissible influence occurs; see also Cal. State Bar Form.Opn. 2011-180 (decided under former rule)—attorney violated CRPC 4-400 by persuading reluctant client to let attorney stay at client's vacation property without payment of usual weekly rental fee; see also ABA Model Rule 1.8(c); Rest.3d Law Governing Lawyers § 127]

An attorney also may not prepare on behalf of a client an instrument giving the attorney (or their relative) any "substantial gift" unless (i) the attorney or their relative is related to the client or (ii) the client has been advised by an independent lawyer

who has provided a certificate of independent review that complies with Prob.C. § 21384(a) requirements. [See CRPC 1.8.3(a)(2), (b)—"related persons" include those who are "related by blood or affinity" as defined in Prob.C. § 21374(a)]

[1:98 - 1:99] ***Reserved.***

3. Initial Client Consultations and Preliminary Steps

a. [1:100] **First client contact:** In real property sales transactions, there is typically a perceived—and often actual—need for immediate attorney involvement. A seller who has an interested buyer wants to "sign the buyer up" or go on to a new buyer. Similarly, the buyer is anxious to "lock up the property" by securing a signed agreement or otherwise move on and pursue another parcel. Therefore, prospective clients usually want to meet with their counsel and provide counsel with the pertinent documents and information as quickly as possible.

Nevertheless, despite the client's perceived need for "immediate" legal attention, the time for counsel's first involvement and agenda for initial attorney-client substantive consultations should be fixed by *counsel* (not the client). The reasons are two-fold:

(1) [1:101] **Preliminary conflict screening:** It is best to avoid learning too much about the substantive aspects of the transaction until you have had an opportunity to perform a "conflict check" for potential conflicts of interest that might require you to decline representation.

Thus, your initial inquiry should be about the *principal parties* involved in the transaction (buyer, seller, broker, lender, tenants, etc.) to make certain neither you nor your law firm presently has *or* has had a professional relationship with any of them. [See CRPC 1.7, *discussed at ¶ 1:73.1 ff.*]

(2) [1:102] **Caseload management:** Busy lawyers, handling several matters at once, necessarily must budget their time and, indeed, are in the best position to do so. While clients are naturally inclined to want their attorneys' "undivided" attention, as a practical matter counsel must prioritize their workloads. Having skill, knowledge and training in the particular matter, the *attorney* (not the client) is best equipped to determine when counsel first needs to become involved and whether the situation actually requires "immediate" legal attention.

Transactional attorneys learn to expect phone calls from clients in an excited state, imploring counsel to meet with them and/or review and prepare documents the very same day. Sometimes the matter is in fact "urgent" (frequently with regard to single-family residence transactions) and sometimes it is not. Therefore, counsel should be prepared to weed out unjustifiable "panic" calls from prospective clients and fix a realistic schedule for attorney involvement.

➪ [1:103] ***PRACTICE POINTER:*** By the same token, if the matter is one that you would like to handle, do not indefinitely put off meeting with a new client. Timing is a crucial element of virtually all real property sales transactions; and clients who are put "on hold" may be compelled to take their business elsewhere.

b. Initial substantive consultations

(1) [1:104] **In person or by telephone?** The first substantive attorney-client consultations need not necessarily be at a face-to-face meeting. Indeed, as a practical matter, it may make better sense to proceed with preliminary discussions by telephone. There are several reasons:

• [1:105] If the client is truly "new" (i.e., neither you nor your law firm represented them in prior similar transactions), the first objective is not to identify and resolve all potential substantive issues. Rather, the *client* will want to decide whether you can and should represent them; and *you* will need to decide whether you can and should accept the proposed representation. Apart from personal preferences, that decision must turn on a couple of important preliminary determinations:

As indicated, before expending any time on the substantive aspects of the proposed new matter, you should ascertain whether there might be a *conflict of interest* bar to representation (*¶ 1:70 ff.*). A similarly important threshold concern is whether you are *competent* to undertake the proposed representation (*¶ 1:46 ff.*). These determinations do not require a face-to-face meeting with the prospective client; indeed, it is best to resolve these issues *before* the client comes to your office (where, in all likelihood, they will expect some "immediate" substantive advice).

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• [1:106] Except in very rare circumstances, the client will be able to provide you with the germane information orally, by mail, or via fax or email. For busy practitioners (and/or clients), this approach may be more expedient than waiting the several days it might otherwise take to arrange a mutually convenient in-person meeting.

• [1:107] If the client already has documents for you to review, there is little you will be able to tell them until you have read those documents. Prudence suggests that you review and analyze the pertinent documents without the client sitting on the other side of your desk waiting for "instant advice" and "answers." (In many cases, competent advice may have to await further investigation and research.)

➪ [1:108] ***PRACTICE POINTER:*** At this stage, while you are assimilating the pertinent information, make it clear you have not yet agreed to represent the client. Give the prospective client a timetable, fixing a date when you will get back to them or scheduling an in-office meeting.

By the same token, do not keep the prospective client "on hold" for too long. As noted, they undoubtedly will be expecting some immediate legal advice and, if your decision is not to accept representation, will want to seek out other counsel post haste.

(2) [1:109] **Protecting attorney-client privilege:** *Confidential* communications between attorney and client (including *prospective* clients who merely consult with but do not retain the attorney) are *privileged*. [Ev.C. § 952; ABA Model Code, Canon 4; *Sullivan v. Sup.Ct. (Spingola)* (1972) 29 CA3d 64, 69, 105 CR 241, 243; see also *McDermott Will & Emery LLP v. Sup.Ct.* (*Hausman*) (2017) 10 CA5th 1083, 1100-1102, 217 CR3d 47, 63-64 (discussing legal principles governing attorney-client privilege)]

However, the privilege is likely to be waived if another party (a nonclient) not essential to the attorney-client consultations is present. [See Ev.C. § 952—attorney client communications not "confidential" if disclosed to third persons *other than* those present "to further the interest of the client in the consultation or those to whom disclosure is reasonably necessary for … the accomplishment of the purpose for which the lawyer is consulted …"]

➪ [1:110] ***PRACTICE POINTER:*** Be careful about who is in attendance at attorney-client meetings, who is present during telephone calls between attorney and client, and what is said during those meetings and phone conversations. Obviously, you may need to confer jointly with the client and certain other nonclient third parties—such as the client's real estate broker, or other representative or consultant. However, to ensure that the attorney-client privilege is not inadvertently waived, any information intended to be kept confidential (inadmissible evidence) should be discussed *in private* with the client by asking all other parties to leave the room or get off the telephone line.

c. Special concerns re joint representation

(1) [1:111] **Keeping clients informed:** Among other obligations, lawyers have a duty to *communicate regularly* with their clients—i.e., to keep them "reasonably informed" about "significant developments" relating to the representation and to promptly comply with the client's reasonable requests for information and copies of significant documents when necessary to keep the client so informed. [See CRPC 1.4(a)(3); Bus. & Prof.C. § 6068(m); see *Matter of Yagman* (Rev.Dept. 1997) 3 Cal. State Bar Ct.Rptr. 788, 795; *Kent v. State Bar* (1987) 43 C3d 729, 735, 239 CR 77, 80]

It follows that, when representing more than one client jointly (such as multiple sellers or multiple buyers), you owe a professional obligation to make certain *each* is kept equally apprised of the status of the transaction.

Cross-refer: For more detailed coverage of the communication-related duties attorneys owe their clients, see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 3.

(2) [1:112] **Joint directions from multiple clients:** When representing joint clients, also make certain *all* of them consent to any action you are taking.

For example, several co-owners may want to use the same lawyer, but may have vastly different ideas about what should be negotiated and how the transaction should otherwise be handled. (Of course, in such a situation, you should not go forward with the joint representation unless and until the several clients give their "*informed written consent*" (¶ 1:73.2a) to waiving their potential *conflicts of interest; see ¶ 1:81 ff.*) Assuming the joint representation is properly accepted notwithstanding conflicts of interest, one method of avoiding miscommunications between you and the clients is to have the multiple clients designate *one representative* with authority to negotiate the deal and give you instructions.

➪ [1:113] ***PRACTICE POINTER:*** This point may be covered in your fee agreement, acknowledged and signed by each of the several clients. However, make sure each understands the designated "representative" will essentially be acting as

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"agent" for the others in attorney-client communications, with authority to *bind* the others by the directions given. Also, as a matter of prudence, directions given and decisions made by the representative should be documented by memos to the file, with a written confirmation to each of the several clients.

(3) [1:114] **Waiver of attorney-client privilege among joint clients:** Communications between you and any one or more of the joint clients regarding the subject of the representation do not enjoy attorney-client privilege protection as against the other joint clients. Make sure each of the several clients understands this point before you get too deeply into consultations. [Ev.C. § 962; *see* ¶ *1:83*]

d. [1:115] **Agenda for undertaking representation:** Having made the threshold decisions on competence and conflict of interest concerns (and assuming you otherwise wish to accept the matter), it is wise to educate the client about certain fundamental ground rules before you are formally retained:

(1) [1:116] **Clarify client or clients to be represented:** Explain who you will *and will not* represent. A lawyer's professional obligation to communicate with the client(s) and keep the client(s) informed about the representation (¶ *1:111*) runs to persons who, to the attorney's knowledge, *reasonably believe* they are clients—at least to the extent of advising them they are not clients. [*Butler v. State Bar* (1986) 42 C3d 323, 329, 228 CR 499, 503]

(2) [1:117] **Define responsibilities and timelines:** Assess the client's level of sophistication and expectations, and clearly identify those services you will and will not perform. Depending on the matter and the client, it may be necessary to "spell out" any related legal issues (e.g., tax and estate planning concerns) and/or specific tasks (e.g., reviewing property inspection reports) you will *not* be addressing as part of your representation. Correspondingly, let the client know (at least generally) the essential tasks they will have to perform.

Work with the client to assemble a team of consultants or representatives and divide up various tasks between them. Set up a preliminary timeline (or "critical path" of events) and corresponding responsibilities for each member of the team.

(3) [1:118] **Essential documents:** Give the client a sense of the various documents that will need to be procured, negotiated, prepared and reviewed. Provide a realistic estimate of how much time it will take you to draft or review those documents.

(For example, many clients believe a purchase and sale agreement can be generated off a standard word processing "form," with a minimal investment of counsel's time. This is *rarely* the case and the client should be advised accordingly.)

(4) [1:119] **Attorney availability and deadlines:** Educate the client as to your availability and explain the difference between true "emergencies" and the client's *perceived* emergencies.

For example, the preparation (or review) of certain documents need not be completed at the earliest possible time and your client should have a realistic understanding of when you will complete your various tasks. By the same token, it may be necessary to prod the client as to certain matters (e.g., a buyer is best advised to seek third-party financing at the earliest possible date).

(5) [1:120] **Client availability and deadlines:** Similarly, confirm the availability of your client (and other necessary parties) during critical times in the transaction.

For example, several documents inevitably must be executed just prior to the closing. Make certain the client will not be out of town (or otherwise unavailable) at this critical time when their notarized signature will be required.

(6) [1:121] **Fees and costs; advances:** Discuss and negotiate attorney fees, a retainer, and the various out-of-pocket costs you may incur on the client's behalf (*see detailed discussion at* ¶ *1:130 ff.*).

Also clarify what costs you will or will not advance on behalf of the client. For example, counsel may want the client to order the preliminary title report at client expense; or, alternatively, may expect the client to advance counsel the funds to do so.

➪ ***PRACTICE POINTERS***

• [1:122] So as to leave no room for misunderstanding, it may make sense to follow up with a letter to the client recapitulating the salient points discussed in your preliminary consultations. (This practice is particularly recommended when undertaking representation of a client with whom you have had no prior professional dealings or a client who is relatively unsophisticated in transactional matters.)

• [1:123] If you *decline* representation, *always* make that decision clear to the prospective client as quickly as possible; ordinarily, it is also advisable to *confirm* the decision in a *prompt letter.* Many malpractice suits are based on allegations that counsel orally agreed to accept representation and then "abandoned" the matter. Avoid the risk that a prospective

client might erroneously contend you gave advice or undertook responsibilities by setting the record straight—*in writing*—at the moment your decision is made.

[1:124] ***Reserved.***

e. [1:125] **Preliminary caveat about real estate and mortgage brokers:** There is frequently considerable friction between the real estate (and/or mortgage) broker and counsel for buyer or seller—typically when they represent the same party. This is because many brokers are more concerned about closing the sale than they are about completing the transaction properly. On the other hand, many lawyers do not think creatively enough to solve the very problems they identify and are dilatory in performing their own responsibilities in the transaction.

Regardless of who is to blame, attorney and client should come to a clear understanding as to the method and timing of dealing with the broker.

For example, brokers often want to contact you to discuss various issues or the progress of the transaction. They may be inclined to give instructions or “assignments” to counsel. Clients are often surprised—and disturbed—to subsequently learn they are expected to pay for the time you have spent dealing with their broker.

f. USA Patriot Act obligations

(1) [1:126] **Ensuring clients not engaged in money laundering:** Section 352 of the USA Patriot Act generally requires “financial institutions” to establish highly technical “anti-money laundering and countering the financing of terrorism” programs (31 USC § 5318(h)). “Financial institutions” as defined by the Act expressly *include* “*persons involved in real estate closings and settlements*” (31 USC § 5312(a)(2)(U) (emphasis added)). However, the statute is unclear whether the term specifically includes *lawyers representing clients* in the real estate transaction, brokers, title companies, appraisers, property inspectors and others who do not actually *conduct* the closing or settlement.

The Treasury Department's Financial Crimes Enforcement Network (FinCEN) has adopted a regulation that temporarily exempts a “[p]erson involved in real estate closings and settlements” from the Act's anti-money laundering requirements. [See 31 CFR § 1010.205(b)(1)(v), 75 Fed. Reg. 65816]

(2) [1:126.1] **Checking names against “Specially Designated Nationals” (SDN) List:** Pending the adoption of Treasury Regulations on the issue, Executive Order 13224 bars transactions involving individuals or groups named on the government's “Specially Designated Nationals” (SDN) List (persons and groups identified as committing or posing a significant risk of committing terrorist acts); also, under the Order, any assets from these transactions may be frozen by the Treasury Department. Although lawyers involved in real estate closings are exempted temporarily from the Patriot Act's anti-money laundering activities (*¶ 1:126*), they are required to *check the buyers' and sellers' names against the government's SDN List*. (The list is updated frequently; it is available online (*www.ustreas.gov*).) [See 66 Fed.Reg. 49079]

If a match is discovered or a name arouses suspicion, counsel should phone the Office of Foreign Assets Control (OFAC) Hotline at (800) 540-6322; or email the OFAC (*ofac_feedback@do.treas.gov)*.

g. [1:127] **Professional liability insurance disclosure obligation:** Attorneys who know or reasonably should know they do *not* have professional liability insurance must so inform their clients *in writing* at the *time of engagement*. The disclosure may be included in the written fee agreement (*see Form 1:A.1*) or a separate writing. [CRPC 1.4.2(a)& Comment [2]]

Likewise, attorneys who, subsequent to their retention, know or reasonably should know they *no longer* have professional liability insurance must so inform their clients *in writing* within 30 days of that fact. [CRPC 1.4.2(b)]

Exemptions: The CRPC 1.4.2 disclosure obligation does not apply (1) to attorneys who know or reasonably should know at the time of their engagement that their legal representation will not exceed four hours, provided said disclosure obligation is complied with when their representation subsequently exceeds four hours; (2) to government attorneys or in-house counsel when they represent or provide legal advice to a client in that capacity; (3) when legal services are rendered in an emergency to avoid foreseeable prejudice to a client's rights or interests; and (4) where attorneys have previously advised their clients in writing they do not have professional liability insurance. [CRPC 1.4.2(c)]

4. [1:128] **Reporting Attorney Misconduct:** California lawyers must report misconduct by other California attorneys. Specifically, reporting is required when an attorney "has committed a criminal act or has engaged in conduct involving dishonesty, fraud, deceit, or reckless or intentional misrepresentation or misappropriation of funds or property that raises a

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substantial question as to that lawyer's honesty, trustworthiness, or fitness as a lawyer in other respects." [CRPC 8.3 (oper. 8/1/23)]

[1:129] ***Reserved.***

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Cal. Prac. Guide Real Prop. Trans. Ch. 1-C

California Practice Guide: Real Property Transactions | September 2024 Update
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**Chapter 1. Commencing Representation:
Scope of Attorney's Work
and Fee Arrangements**

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1. [1:130] **Fees, Costs and Retainers:** Acceptance of representation culminates with the formalization of an attorney fees and costs agreement. Preliminarily, counsel should explain to the client the difference between counsel's fees, the client's obligation to reimburse counsel for various costs, the costs the client will be required to pay directly to third parties, and a "retainer."

a. [1:131] **Legal fees:** Depending on your internal billing practices, legal "fees" usually relate to time spent and legal services performed by attorneys, paralegals and law clerks (billed at varying rates). However, some attorneys bill secretarial time, word processing time, and time spent by file clerks and other employees. If you intend to bill for time spent by anyone other than attorneys and paralegals, that should be specially noted in your fee agreement along with the applicable rates or charges. [See Bus. & Prof.C. § 6148(a)(1); *¶ 1:191*; *and Form 1:A.1*]

b. [1:132] **Reimbursable (separately billed) costs:** The client should understand they will be responsible for certain of your internal costs (such as telephone, telecopier, travel and copying charges, etc.). Clients who have not had much occasion to hire attorneys may be surprised to learn they are separately charged for internal costs (thinking instead those costs are absorbed in the attorney's "fee"); hence, costs to be separately billed the client should be clearly identified in the fee agreement. [See Bus. & Prof.C. § 6148(a)(1); *¶ 1:191*; *and Form 1:A.1*]

To the extent feasible, preferred practice is to require the client to advance costs to be incurred by counsel (and, perhaps, to replenish those advances when necessary); *see ¶ 1:157 ff.* However, counsel may instead agree to advance "reasonable" costs on the client's behalf; *see ¶ 1:165*.

c. [1:133] **Costs payable to third parties:** Also describe (at least in general terms) what types of third-party expenses the client should anticipate (i.e., additional costs related to the transaction that will not be billed by counsel).

For example, unsophisticated clients may not otherwise know they will be required to purchase a preliminary title report or survey; explain that you will not be advancing these costs. (However, if it will be necessary for your office to order a preliminary title report, you may want to increase the amount of your retainer to cover that cost.)

d. [1:134] **Attorney "retainer":** A "retainer" may or may not be an earned "fee." In practice, the term is used to refer both to a "*classic retainer*" and to an *advance* against fees to be earned.

(1) [1:134.1] **"Classic retainer":** California law and ethical rules recognize the right of an attorney to collect a "classic retainer"—i.e., an up-front fee "earned in full" when paid by the client to secure counsel's availability over a certain period of time. A classic retainer is earned when paid since the attorney is entitled to the money regardless of whether they actually perform any services for the client. [See CRPC 1.16(e)(2); *Baranowski v. State Bar of Calif.* (1979) 24 C3d 153, 164, 154 CR 752, 757, fn. 4; *SEC v. Interlink Data Network of Los Angeles, Inc.* (9th Cir. 1996) 77 F3d 1201, 1205]

(2) [1:134.2] **Retainer collected as "advance":** More commonly, attorneys request a "retainer" as an *advance deposit* against fees for future legal services. Such a retainer is *not earned upon receipt;* it remains the client's property *until the services are rendered* and, therefore, must be held in a separate client trust account (*see ¶ 1:158*). [*SEC v. Interlink Data Network of Los Angeles, Inc.* (9th Cir. 1996) 77 F3d 1201, 1205]

Typically, retainers collected as an advance deposit are automatically applied as future fees are earned. However, it may be advisable to require the client to maintain a minimum retainer balance at all times (i.e., replenishing the "retainer" deposit as it is depleted); *see ¶ 1:163 ff.*

2. [1:135] **Types of Fee Agreements:** There are various types of fee agreements; some are more common in transactional matters and others in litigation:

a. [1:136] **Fixed or "task based" fee:** Many clients want to "budget" for attorney fees and thus prefer a "fixed fee" arrangement—i.e., an agreement to pay a specified amount (or at least an agreed-upon range) of total attorney fees to complete a transaction. Sometimes each component task is broken out as a separate fee item. For example, a fixed fee may be separately set for the negotiation and preparation of a broker's listing agreement; the negotiation and preparation of a purchase contract; review of a preliminary title report; coordination of closing with escrow, etc.

(1) [1:137] **Drawbacks:** From counsel's perspective, a fixed fee arrangement generally is *not* advisable even if based on the performance of definitive tasks. Each aspect of the transaction involves potential problems, the magnitude of which is not discernible at the inception of representation—e.g., unanticipated financing issues, unknown title matters, unsuspected

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environmental contamination, unpredictable zoning regulations, and, of course, the inherent uncertainty of negotiations generally. Accordingly, by agreeing to a fixed fee, you may ultimately find that a large portion of your time will be uncompensated, unless the client is willing to renegotiate the fee arrangement. [See *Grossman v. State Bar* (1983) 34 C3d 73, 78, 192 CR 397, 399—"under a fixed fee contract, an attorney may not take compensation over the fixed fee without the client's consent to a renegotiated fee agreement … even if the work becomes more onerous than originally anticipated"]

Similarly, a fixed fee or task-based arrangement will not always work to the client's advantage. Where the transaction proceeds relatively "problem free," the client may end up *saving money* by agreeing to an hourly rate.

➪ [1:137.1] ***PRACTICE POINTERS:*** As between buyer's and seller's counsel in a real estate transaction, a fixed fee arrangement is probably more appropriate when representing *sellers* because seller's counsel will be less involved in so-called "due diligence" investigations. Also, seller's counsel is often in a better position to pinpoint the number and scope of potential problems from the outset (before negotiation of a purchase agreement).

In any event, counsel amenable to fixed or task-based fees should leave some leeway in the written fee agreement for unforeseeable occurrences. For example, include language to the effect that the quoted fixed fee assumes there are no environmental, zoning, building code, etc. impediments to expeditious negotiation of a purchase agreement and consummation of the transaction; and that you reserve the right to renegotiate fees to handle such unexpected occurrences (as specified).

b. [1:138] **Hourly rate:** Under an hourly rate arrangement, the client pays for counsel's time (and, usually, designated support staff time) at an agreed-upon rate per hour. The rates typically vary for the "lead" attorney, associates, paralegals, legal secretaries and law clerks.

(1) [1:139] **Advantages:** Clients may benefit from an hourly rate arrangement because it enables them to use counsel's time more efficiently. For example, after counsel has identified the various tasks to be performed, the client can designate from a cost efficiency standpoint who will perform each component of the work (e.g., broker, accountant, client, attorney). Moreover, attorney and client can agree on the person in counsel's office who is the most cost efficient to perform the task (e.g., partner, associate, paralegal, clerk, etc.) (*see ¶ 1:117, 1:203; and Form 1:A.1*).

From counsel's perspective, an hourly rate arrangement offers the advantage of not "locking into" any ceiling on fees, thus ensuring no part of counsel's work will go uncompensated by the risk of unforeseeable events (*¶ 1:136*).

➪ [1:140] ***PRACTICE POINTERS:*** Maintaining *accurate time sheets* is critical to an hourly rate arrangement; if your fees are ever called into question, time records will be important evidence in support of your fee claims. Attorney time records should contain precise descriptions of the services performed, the date they were performed and the amount of time spent. [See *Martino v. Denevi* (1986) 182 CA3d 553, 558, 227 CR 354, 357 (noting that lawyers who fail to keep accurate time records may *lose or waste* up to 40% of their billable time)]

Although bills to clients for fees and charges must include certain statutorily-prescribed information (¶ 1:210 ff.), an attorney's detailed time logs need not necessarily be duplicated in client billings (*see* ¶ 1:212.1).

(2) [1:140.1] ***Caveat re "usual" or "customary" rate arrangements:*** Attorneys and clients who have had an ongoing professional relationship may be inclined to bypass a full-blown detailed fee contract, opting instead for a summary consensus to pay and receive counsel's (or the firm's) "usual" or "customary" rates. This approach is *risky*. At the very least, it invites later misunderstandings or disputes as to the "usual" or "customary" rate. Moreover, the "usual" or "customary" rate inevitably will change (*increase*) over time; and counsel *cannot* subject the client to a rate hike without the client's express consent. [See *Severson & Werson v. Bolinger* (1991) 235 CA3d 1569, 1572-1573, 1 CR2d 531, 533, *discussed further at ¶ 1:152*]

c. [1:141] **Percentage basis:** In some states, legal fees in real property sales transactions are based on a percentage of the purchase price; however, that approach is rarely (if ever) used in California (*but see ¶ 1:148 ff.* re real estate broker commission as legal fee).

In any event, "percentage basis" fee arrangements are likely to carry the same pitfalls as fixed fee arrangements. Notably, there is no certainty that the scope of legal services required in a given transaction will bear any relationship to the purchase price of the property. Negotiating obstacles, title problems, financing issues, zoning difficulties and other complexities can arise completely independent of the price tag for the property. (Conversely, a disadvantage from the clients' perspective is that, if the transaction proceeds relatively "problem free," they may end up paying a fee far in excess of what would have been due at an hourly rate.)

d. [1:142] **Contingency fees:** There is no ethical or legal prohibition per se against contingency fees in real property sales transactions—e.g., an agreement that legal fees are not earned, and hence not due, unless and until a closing occurs. Some clients may prefer such an arrangement, on the theory it might motivate counsel's "full-time" efforts and expedite the transaction.

(1) [1:143] **Disadvantages:** Nonetheless, a contingency fee generally is not advisable from the attorney's standpoint: The transaction may fail to close for a variety of reasons, virtually all of which are beyond counsel's control and many of which are beyond any of the parties' control.

e. [1:144] **Equity participation in property:** Buyer's counsel may want to take legal fees in the form of an interest in the property. However, this type of arrangement should be avoided:

(1) [1:145] **Conflict of interest:** First of all, contracting for an equity participation interest in the client's property puts counsel in a potential (if not actual) *conflict of interest* position. [See CRPC 1.8.1—ethical proscription against acquiring an "ownership, possessory, security or other pecuniary interest adverse to a client" unless specified requirements are met; *and discussion at ¶ 1:90 ff.*]

Even if the minimum ethical requirements can be satisfied, as a practical matter it is not a good idea to mix professional and business dealings with clients. Should your "business" relationship (as co-equity owners) sour, the disgruntled client may be tempted to press malpractice charges (be they well-founded or not). Moreover, prudent attorneys avoid any situation in which it might appear they are putting their personal interests ahead of the professional obligations owed their clients.

(2) [1:146] **Risk of no fees:** Also, as with a contingency fee arrangement, an equity participation agreement runs the risk that buyer's counsel will end up with nothing (legal services will go uncompensated) should the transaction not be consummated.

f. [1:147] **"Mixed fee" arrangement:** To meet the desires of both counsel and client, it may make sense to *combine* one or more fee arrangements; e.g., an hourly or fixed fee for certain tasks, plus a contingency bonus if the transaction closes or closes within a specified period of time.

g. [1:148] **Commission-based fee:** There is no blanket prohibition against a lawyer receiving both a legal fee and a commission or "finder's" fee; *or* a real estate broker's commission *as* the attorney's legal fee (*see* ¶ *2:86, 2:91* re attorney exemption from real estate license requirements when rendering legal services to client).

(1) [1:148.1] **Payment of commission-based fee to attorney-broker's law firm:** It may even be permissible under the real estate licensing law for a real estate commission-based legal fee to be paid to the attorney's law firm:

A partner in a law firm who holds a California real estate broker's license may represent a party to a real estate transaction in which the client agrees to pay the law firm a real estate brokerage commission instead of an hourly fee for legal services rendered in connection with the transaction, *provided* no person in the firm who does not hold a real estate license performs any act related to the transaction that requires a real estate license. [See 88 Ops.Cal.Atty.Gen. 203 (2005)]

Cross-refer: For a detailed discussion of the conditions for compensation under the real estate licensing law, *see ¶ 2:64 ff. and 2:277 ff.*

(2) [1:148.2] **Dual representation concerns:** There are, however, several "dual representation" ethical and legal concerns for attorneys who act as both lawyer and real estate broker for a client (see 88 Ops.Cal.Atty.Gen. 203 (2005), fn. 3 (noting ethical issues but leaving them undecided)). Significantly, such a "two hat" attorney will have various obligations (and potential liabilities) to the client that are different—and often greater—than the professional obligations owed strictly in an attorney capacity. Indeed, whereas attorney obligations ordinarily run strictly to the *client*, counsel acting in a *broker* capacity may have obligations to the *party on the other side* of the transaction (*see ¶ 2:120 ff.*).

3. [1:149] **Limitations on Amount of Fees:** While the amount of attorney fees may properly be the subject of attorney-client negotiations, there are ethical limitations on the ultimate amount that may be charged or collected.

The California Rules of Professional Conduct prohibit attorneys from entering into an agreement for, or charging or collecting, an "illegal" or "unconscionable" fee. [CRPC 1.5(a); see also ABA Model Rule 1.5 (limiting lawyer fees to "reasonable" amount)]

a. [1:150] **"Unconscionable" fees—relevant factors:** A particular legal fee may pass ethical muster even though it exceeds what other lawyers in the community commonly charge for the same services. "Reasonableness" or "unconscionability" is

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a question of all the facts and circumstances existing at the time the agreement is entered into (except where the parties contemplate the fee will be affected by later events—e.g., a contingency fee). [CRPC 1.5(b); *Matter of Yagman* (Rev.Dept. 1997) 3 Cal. State Bar Ct.Rptr. 788, 800]

A fee is unconscionable when it is "so exorbitant and wholly disproportionate to the services performed as to shock the conscience." Most such cases involve an "element of fraud or overreaching by the attorney, so that the fee charged … constitute[s] a practical appropriation of the client's funds." [*Bushman v. State Bar* (1974) 11 C3d 558, 563, 113 CR 904, 906; see *Matter of Taylor* (Rev.Dept. 2012) 5 Cal. State Bar Ct.Rptr. 221, 233—illegal residential mortgage loan modification fee may have been high but not unconscionable]

Essentially, the issue is addressed on a case-by-case basis. Among the factors to be considered in determining the "conscionability" of a fee are (CRPC 1.5(b)):

• Whether the attorney engaged in fraud or overreaching in negotiating or setting the fee;

• Whether the attorney has failed to disclose material facts;

• The amount of the fee in proportion to the value of services performed;

• The relative sophistication of attorney and client;

• The novelty and difficulty of the questions involved and the skill required to perform the legal services properly;

• The likelihood, if apparent to the client, that counsel's acceptance of the employment will preclude them from accepting other employment;

• The amount involved and the results obtained (see *Matter of Yagman*, supra, 3 Cal. State Bar Ct.Rptr. at 800—fee found "unconscionable" under former Rule 4-200(B) "particularly in that the amount of the fee outweighs the value of the services in light of the results obtained");

• The time limitations imposed by the client or the circumstances;

• The nature and length of counsel's professional relationship with the client;

• Counsel's experience, reputation and ability;

• Whether the fee is fixed or contingent;

• The time and labor required; and

• The client's informed consent to the fee. [CRPC 1.5(b)(1)-(13); see also ABA Model Rule 1.5(a)(1)-(8) (providing similar standards)]

(1) [1:150a] **Disproportion between fees and client's recovery:** A fee may be found "unconscionable" because it disproportionately exceeds the amount recovered for the client. [See *Matter of Yagman* (Rev.Dept. 1997) 3 Cal. State Bar Ct.Rptr. 788, 800]

(2) [1:150.1] **Attorney's profit margin irrelevant:** By contrast, "conscionability" of legal fees *cannot* be measured by the attorney's or law firm's *costs or profit margin*. Indeed, profit margin is *irrelevant* to the issue. [*Shaffer v. Sup.Ct. (Simms)* (1995) 33 CA4th 993, 1003, 39 CR2d 506, 513]

b. [1:151] **"Illegal" fees:** CRPC 1.5 does not define what amounts to prohibited "illegal" fees, leaving the matter largely to case law.

• [1:151.1] A fee is "illegal" to the extent it charges for services not actually performed. [*In re Goldstone* (1931) 214 C 490, 497-498, 6 P2d 513, 516 (billing for work not performed)]

• [1:151.2] A fee is also "illegal" to the extent the amount charged or collected exceeds that permitted by an applicable statute. [See *Matter of Harney* (Rev.Dept. 1995) 3 Cal. State Bar Ct.Rptr. 266, 273 (statutory limits in medical malpractice case); *Estate of Hastings* (1952) 108 CA2d 713, 716, 239 P2d 684, 686-687 (probate proceedings)]

• [1:151.3] An attorney fee is "illegal" when collected in violation of a statute requiring prior court approval. [See *Rossman v. State Bar* (1985) 39 C3d 539, 545, 216 CR 919, 922 (conservatorship proceedings)]

• [1:151.4] An attorney fee contract is "illegal" to the extent it requires compensation for legal services performed in California for a California client by someone *not licensed or otherwise authorized to practice law in California* (*see* ¶ *1:65 ff.*). [Compare *Estate of Condon* (1998) 65 CA4th 1138, 1148, 76 CR2d 922, 928—*Birbrower* no bar to statutory fee award to out-of-state probate attorney performing services for *out-of-state client* related to Calif. probate (*see* ¶ *1:66*)]

• [1:151.5] A fee arrangement might also be "illegal" if it fails to comply with applicable truth-in-lending laws (¶ *1:180*).

(1) [1:151.6] **Advance fees for residential mortgage loan modifications:** It is illegal in California for an attorney (or real estate licensee) to demand or receive advance fees, or any other type of pre-performance compensation, in connection with a residential mortgage loan modification or other form of residential mortgage loan forbearance. An attorney who violates this prohibition is subject to disciplinary action and can be fined and/or imprisoned for up to one year. [Bus. & Prof.C. § 6106.3; see also Civ.C. §§ 2944.7 & 2944.8 (authorizing state and local government officials to commence civil actions to recover up to $20,000 for each such violation, as well as additional penalties up to $2500 for every violation perpetrated against senior citizen or disabled person); *Matter of Taylor* (Rev.Dept. 2012) 5 Cal. State Bar Ct.Rptr. 221, 226 (attorney suspended and thereafter placed on probation for, among other things, charging illegal preperformance fees)—legislation prohibiting preperformance compensation was designed to prevent loan modification consultants from charging borrowers up-front fees, providing borrowers limited services that fail to help and leaving borrowers worse off than before seeking consultant's services]

c. [1:152] **No unilateral fee increases:** Counsel cannot unilaterally determine their own fees. Thus, even if the legal work turns out to be more onerous than anticipated, agreed-upon fees or fee rates cannot be changed midstream without notification to the client (presumably, giving the client an opportunity to consent or, instead, to switch attorneys). [*Severson & Werson v. Bolinger* (1991) 235 CA3d 1569, 1572-1573, 1 CR2d 531, 533—clients who agreed to pay quoted "regular hourly rates" could not be assessed higher rates without prior notice; see also *Grossman v. State Bar* (1983) 34 C3d 73, 78-79, 192 CR 397, 399-400—attorney subject to professional discipline for charging higher fees than agreed upon with client for same work]

4. [1:153] **Fee Sharing:** Lawyers handling real property sales transactions commonly retain co-counsel to consult and advise on particular areas of expertise (e.g., *tax* or *bankruptcy* matters); or, if the transaction involves extraterritorial issues, to provide guidance on applicable *local law and procedure* (¶ 1:61). Indeed, as a matter of *attorney competence*, associating or consulting with another lawyer may be an ethical necessity (CRPC 1.1(c); ¶ 1:51 ff.).

a. [1:154] **Enforceable fee-sharing agreement requirements:** Ethically, counsel may divide fees with another lawyer who is *not* in the same law firm *only* if:

• the lawyers enter into a *written agreement* to divide the fee;

• the *client consents in writing* either at the time the lawyers enter into the fee division agreement or as soon thereafter as reasonably practicable following full written disclosure to the client of (a) the fact that a division of fees will be made, (b) the identity of the lawyers or firms that are parties to the division, and (c) the terms of the fee division; *and*

• the *total fee* charged by all lawyers is *not increased* solely by reason of the agreement to divide fees. [CRPC 1.5.1(a); see also *Barnes, Crosby, Fitzgerald & Zeman, LLP v. Ringler* (2012) 212 CA4th 172, 180, 151 CR3d 134, 140 (decided under former rule)—rule's purpose is to protect clients from their attorneys' potential conflicts of interest created by fee-sharing agreements]

CRPC 1.5.1 is not limited to pure "referral fee" arrangements (where a lawyer receives a fee for doing nothing more than obtaining the client's signature on a retainer agreement while the lawyer to whom the case is referred does all the work). It applies as well to fee divisions in which the client's work is also divided (unless between members of the same firm; ¶ 1:154.1 ff.). [See *Chambers v. Kay* (2002) 29 C4th 142, 148-150, 126 CR2d 536, 541 (decided under former rule)]

(1) [1:154a] **Timing of client consent:** CRPC 1.5.1 requires the client's written consent after full disclosure *at or near the time that the lawyers enter into the agreement to divide the fee* (¶ 1:154).

Compare: Under former CRPC 2-200, there was no requirement that the client's consent be obtained before the lawyers entered into a fee-splitting agreement or before they commenced work on the case. [See *Mink v. Maccabee* (2004) 121

CA4th 835, 838, 17 CR3d 486, 488; see also *Cohen v. Brown* (2009) 173 CA4th 302, 320, 93 CR3d 24, 38 (decided under former Rule 2-200)—associated counsel's ability to recover under noncomplying fee-sharing agreement remains possible even after case concludes provided client gives written consent before actual fee division]

(2) [1:154.1] **Exemption for members of same law firm:** A fee-sharing agreement among lawyers in the same firm is not subject to the CRPC 1.5.1 client disclosure and consent requirements. [CRPC 1.5.1(a); *Chambers v. Kay* (2002) 29 C4th 142, 150, 126 CR2d 536, 542 (decided under former CRPC 2-200(A)); see also *Anderson, McPharlin & Connors v. Yee* (2005) 135 CA4th 129, 133, 37 CR3d 627, 630—law firm partnership agreement requiring departing partner to pay firm percentage of revenues received on firm's pending matters for clients who followed partner was not "fee-splitting" agreement subject to former CRPC 2-200(A)]

(a) [1:154.2] **"Law firm" defined:** A "law firm" means a law partnership, a professional law corporation, a lawyer acting as a sole proprietorship, an association authorized to practice law, or lawyers employed in a legal services organization or in the legal department, division, or office of a corporation, government organization or another organization. [CRPC 1.0.1(c)]

1) [1:154.2a] **Compare—former Rule:** Former CRPC 1-100(B)(1) defined "law firm" as any of the following:

• two or more lawyers whose activities constitute the practice of law, and who share its profits, expenses, and liabilities;

• a law corporation that employs more than one member;

• a division, department, office, or group within a business entity that includes more than one lawyer who performs legal services for the business entity; or

• a publicly funded entity that employs more than one lawyer to perform legal services. [Former CRPC 1-100(B)(1)]

(b) [1:154.2b] **"Partner" defined:** A "partner" means a member of a partnership, a shareholder in a law firm organized as a professional corporation, or a member of an association authorized to practice law. [CRPC 1.0.1(g)]

(c) [1:154.2c] **"Associate" defined; salaried relationship requirement:** An "associate" (which is not defined in the current or former Rules) is included within the former Rule 2-200(A) exemption. As such, it contemplates an *employer-employee, salaried relationship* between the "referring" and "referred" attorneys. The fact that one attorney controlled and supervised the other attorney's involvement in the matter does "not transmute the [attorneys'] compensation arrangement from one based on a division of fees to one reflecting an employer-employee relationship." [*Chambers v. Kay* (2002) 29 C4th 142, 152-154, 126 CR2d 536, 544-546 & fn. 7]

Arguably, former Rule 2-200(A)'s definition of "associate" continues to apply under CRPC 1.5.1.

(d) [1:154.2d] **Lawyers sharing office space distinguished:** A joint venture in which two lawyers share office space and facilities but maintain independent law practices with separate identities, addresses, clients, expenses, and liabilities does not constitute a "law firm," and fee-sharing agreements between such lawyers are unenforceable absent compliance with CRPC 1.5.1. [*Chambers v. Kay* (2002) 29 C4th 142, 150, 126 CR2d 536, 543 (decided under former rule)]

(3) [1:154.3] **Fee-sharing agreement must be in writing:** Under CRPC 1.5.1, the fee-sharing agreement must be in writing (¶ 1:154).

Compare: There was no requirement under former CRPC 2-200 that the attorneys' fee-sharing agreement be in writing (the Rule required only that the *client's consent* be written). [See *Mink v. Maccabee* (2004) 121 CA4th 835, 838, 17 CR3d 486, 488]

(4) [1:154.4] **Noncomplying agreements unenforceable:** Absent strict compliance with CRPC 1.5.1, a fee-sharing agreement among attorneys who are not in the same law firm is *void and unenforceable.* [*Chambers v. Kay* (2002) 29 C4th 142, 156-161, 126 CR2d 536, 549-551; *Margolin v. Shemaria* (2000) 85 CA4th 891, 899-903, 102 CR2d 502, 507-511 (decided under former CRPC 2-200(A))—no "equitable estoppel" relief from bar to enforcement of noncomplying fee-sharing agreement; but see also *Barnes, Crosby, Fitzgerald & Zeman, LLP v. Ringler* (2012) 212 CA4th 172, 173, 185, 151 CR3d 134, 136, 145 (decided under former CRPC 2-200(A) and finding noncomplying agreements "*potentially unenforceable*")—attorney may be "equitably estopped" from claiming agreement is unenforceable where they are *responsible* for such noncompliance and have unfairly prevented another lawyer from complying with Rule 2-200(A)]

(a) [1:154.5] **Compare—quantum meruit recovery:** On the other hand, noncompliance with CRPC 1.5.1 does *not* bar recovery *between the attorneys* on a quantum meruit theory for the reasonable value of services rendered. "[S]uch an award involves no apportionment of the fees that the client paid or has agreed to pay and therefore is not a fee division subject to [former] rule 2-200's client disclosure and consent requirements." [*Huskinson & Brown, LLP v. Wolf* (2004) 32 C4th 453, 456, 459, 9 CR3d 693, 695, 697]

But the associated attorney has *no* right to quantum meruit fees from the *client* who neither contracted with that attorney nor requested their services. [*Strong v. Beydoun* (2008) 166 CA4th 1398, 1404, 83 CR3d 632, 635-636; *see also* ¶ *1:155*]

b. [1:155] **Client's liability to associated attorney:** Even when the client agrees to association of co-counsel, the client is personally liable to pay the associate's fee share *only* if they explicitly consented to do so. Otherwise, the associate's claim for fees is against the primary attorney whom the client hired (not against the client). [See *Trimble v. Steinfeldt* (1986) 178 CA3d 646, 651-652, 224 CR 195, 197-198 (decided under former CRPC 2-200(A))—retainer agreement authorized attorney to associate any other lawyer "at no expense to me" (the client)]

c. [1:156] **Prohibited fee splits for referrals:** Competence and/or practical considerations may require you to decline representation and, occasionally, you may deem it appropriate to refer the prospective client to another competent lawyer. Except to the extent a fee-sharing arrangement is permitted by CRPC 1.5.1 (¶ 1:154 ff.) or otherwise under the CRPC, attorney "referral fees," "gifts" or "gratuities" for the purpose of recommending or securing employment or as a "reward" for having done so are prohibited if made pursuant to a *preexisting* understanding or agreement between the forwarding and receiving attorneys. [CRPC 7.2(b)(4), (5)]

(1) [1:156.1] **Compare—lawyer's receipt of fee for nonlegal services referral as adverse pecuniary interest:** A lawyer's receipt of a fee from a nonlegal services provider for referring the client to the provider (e.g., lawyer refers client to real estate broker or investment manager) is not impermissible fee-splitting within the scope of CRPC 1.5.1. However, the referral fee arrangement gives the lawyer a financial interest in the client's matter, thus triggering the CRPC 1.8.1 *disclosure and client consent requirements* (¶ *1:73.6, 1:90 ff.*). [See Cal. State Bar Form.Opn. 1999-154 (decided under former CRPC 3-300)]

5. [1:157] **Fees and Costs Advances:** Whether to insist upon an advance deposit against your legal fees (as distinguished from a "classic retainer," ¶ 1:134 ff.) and/or the costs you will need to incur on the client's behalf is ordinarily a judgment call. The decision may turn on your past professional relationship with the client (if any), the client's financial condition ("creditworthiness") and level of sophistication, and/or your office overhead and "cash flow."

a. [1:157.1] **Limitation if prohibited by law:** Of course, advance fees and costs cannot be collected to the extent *prohibited* by law—e.g., advance fees for residential loan modification services (Bus. & Prof.C. § 6106.3; Civ.C. §§ 2944.7 & 2944.8). *See discussion at* ¶ *1:151.6*.

b. [1:158] **Segregation in client trust account:** A client's *advance* deposit represents *unearned* fees for services *to be performed*. Until the legal services are rendered, the advance against fees is technically property of the client. [*SEC v. Interlink Data Network of Los Angeles, Inc.* (9th Cir. 1996) 77 F3d 1201, 1205]

Except as otherwise provided for "a flat fee paid in advance," all funds received or held by counsel for the benefit of the client or another person to whom the attorney owes a contractual, statutory or other legal duty—*including advances for fees, costs and expenses*—*must* be held in a *client trust account* (one or more identifiable bank accounts labeled "Trust Account" or words of similar import), maintained *separately* from counsel's and the law firm's funds. A client trust account may be created in California, or with the client's written consent, in any other jurisdiction "where there is a substantial relationship between the client or the client's business and the other jurisdiction." [CRPC 1.15(a)-(c)]

(1) [1:159] **Interest on lawyer's trust account (IOLTA) deposits:** "Nominal" or "short term" client deposits must be maintained or invested in an "IOLTA account" with an eligible financial institution that meets detailed statutory requirements. The interest and dividends earned are paid to the State Bar of California to fund free legal services programs for the indigent. [See Bus. & Prof.C. §§ 6211, 6212—attorney/law firm must report IOLTA account compliance and all other IOLTA account information required by State Bar in manner specified by State Bar; *Carroll v. State Bar* (1985) 166 CA3d 1193, 1203-1208, 213 CR 305, 311-314 (upholding constitutionality of California's former IOLTA program);

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Brown v. Legal Found. of Washington (2003) 538 US 216, 239-240, 123 S.Ct. 1406, 1421 (upholding constitutionality of Wash. state IOLTA program)]

Cross-refer: For further discussion of California's IOLTA program, see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 9.

[1:159.1 - 1:159.4] ***Reserved.***

(2) [1:159.5] **Recordkeeping and accounting requirements:** Complete *records* of the client's or another person's funds (as well as securities and other properties) coming into counsel's possession must be maintained and preserved for at least five years after "final appropriate distribution of such funds" (or property); and appropriate *accountings* therefor must be given the client. [CRPC 1.15(d)(3)-(5)]

The explicit recordkeeping requirements for the client or another person's trust account funds, securities and properties are prescribed by the State Bar Board of Trustees' standards adopted pursuant to CRPC 1.15. [See CRPC 1.15, Standards]

➪ [1:160] ***PRACTICE POINTER:*** *Commingling* attorney and client funds, *misappropriating* client funds, or failing to *adequately supervise* a client trust account usually will warrant significant professional discipline—even *disbarment*. [*In re Basinger* (1988) 45 C3d 1348, 1358, 249 CR 110, 114—"misappropriation of client trust funds" deemed most serious offense; *Read v. State Bar* (1991) 53 C3d 394, 425, 279 CR 818, 833; but see also *In re Malek-Yonan* (Rev.Dept. 2003) 4 Cal. State Bar Ct.Rptr. 627 (attorney's gross inattention to safeguarding client funds from theft by office staff)—significant discipline warranted, but not disbarment]

(3) [1:160.1] **Compare—advance fees/costs held in independent escrow account:** An arrangement under which the client deposits "advance" fees and costs into an *independent escrow account* for payment to the attorney only as the legal services are rendered pursuant to the fees and costs agreement does not require compliance with CRPC 1.15. In this scenario, the "advance" fees are never "received or held" by the attorney; the lawyer is paid the fees from the escrow only when they are "fixed and earned," at which point they belong to the attorney and should not be placed in a client trust account (*see ¶ 1:161 ff.*). [See Cal. State Bar Form.Opn. 2002-159]

c. [1:161] **Withdrawals from client trust account:** Where funds on deposit in a client trust account belong partly to the client or another person and in part presently or potentially to counsel (e.g., advances that have been "earned" by counsel), the portion belonging to counsel (or the law firm) must be *withdrawn "at the earliest reasonable time"* after counsel's interest therein becomes "fixed." [CRPC 1.15(c)(2) (emphasis added)]

However, when the client or other person *disputes* counsel's right to receive a portion of the client trust account funds, the disputed portion "*shall not be withdrawn until the dispute is finally resolved*." [CRPC 1.15(c)(2) (emphasis added)]

➪ [1:162] ***PRACTICE POINTER:*** You cannot "invade" a client trust account to pay yourself attorney fees *unless* those fees have been *earned* (i.e., they represent compensation owing for legal services *actually performed*) *and* the client does *not dispute* the amount owing. Otherwise, withdrawal from the account for your own benefit amounts to prohibited "misappropriation," for which professional discipline may be imposed. [See *Sternlieb v. State Bar* (1990) 52 C3d 317, 329-330, 276 CR 346, 352-353; *Chang v. State Bar* (1989) 49 C3d 114, 128, 260 CR 280, 287-288]

d. [1:163] **Minimum retainer balance:** Clients have no obligation to replenish advance fee deposits (as funds are depleted therefrom to compensate for services performed and costs incurred) *unless* they have agreed to do so. Hence, counsel should decide at the outset whether they want the client to maintain a minimum retainer balance at all times during the transaction.

➪ [1:164] ***PRACTICE POINTER:*** Again, the decision is essentially a judgment call. But prudence may dictate insisting upon a minimum retainer balance until the transaction is completed (or substantially completed).

For example, though the initial retainer may seem like a hefty sum up front, as soon as you incur that amount in time (legal services) and costs, you will have no security for the balance of your fees and expenses. That may be of little concern in representing a financially sound ("credit-worthy") client; but it could be problematic for attorneys who have high office overheads, unpredictable cash flows, and/or unreliable clients. In such circumstances, it may make sense to require the client to keep the retainer balance at a specified minimum.

Of course, once the transaction closes and your legal services are completed, any retainer balance to which the client or another person is entitled must promptly be distributed, as requested. [See CRPC 1.15(d)(7)]

e. Compare—costs advances *by counsel* and *personal loans* to client

(1) [1:165] **Client obligation to reimburse advances, subject to agreed-upon contingencies:** Counsel may ethically agree to advance legal services costs on the client's behalf (i.e., no retainer). Normally, the client must be obligated to *reimburse* counsel therefor; however, the repayment may be "contingent on the outcome of the matter" (apparently meaning, e.g., that attorney and client may agree that counsel's right to be reimbursed for costs advances will be triggered only if the transaction closes). [CRPC 1.8.5(b)(3); *see also ¶ 1:142 re contingency fees*]

(2) [1:166] **Personal loans to client:** A related issue concerns the propriety of counsel's making *personal loans* to a client, not related to the legal services to be rendered. (For example, client approaches counsel for a "loan" to cover part of a down payment, "points" or closing costs until client's current property sells.)

There are ethical as well as practical constraints on an attorney's loaning personal funds to a client:

(a) [1:167] **Improper before representation formalized:** Lawyers may not pay (directly or indirectly), or agree to pay, guarantee or represent that they or their firm will pay, a *prospective or existing* client's personal or business expenses *or agree to loan or actually loan* funds for this purpose *before* the lawyers are *actually hired* by the client. [CRPC 1.8.5(a), (b)(1) & (2)]

(b) [1:168] **Ethically permissible after attorney retained:** However, once *employed* by the client, counsel may lend the client money for *any reason*, upon the client's *written* promise to repay the loan—provided the attorney complies with CRPC 1.7(b)-(c) (conflict of interests rule) and CRPC 1.8.1 (business transactions/pecuniary interests adverse to client rule) and before making the loan or agreeing to do so. [CRPC 1.8.5(b)(2)]

(c) [1:169] **Payment of client debts out of funds to be collected:** Also, with the client's consent, counsel may pay or agree to pay the client's personal or business debts owed to a third party *out of funds collected or to be collected for* the client as a result of the representation (CRPC 1.8.5(b)(1)). (Thus, e.g., seller's counsel could agree to use part of the sale proceeds to pay client third-party debts.)

➪ [1:170] ***PRACTICE POINTER:*** Notwithstanding the ethical propriety (*¶ 1:166 ff.*), it is best to *avoid* making personal loans to clients. The practice could increase the risk of *malpractice* charges; i.e., if you loan money to a client who ultimately is dissatisfied with your services, the client may be tempted to "blame" you for the unsatisfactory results in order to avoid repaying the loan. [See, e.g., *Donnelly v. Ayer* (1986) 183 CA3d 978, 981-982, 228 CR 764, 766]

[1:171 - 1:174] ***Reserved.***

6. Security for Fees and Interest Charges

a. Promissory notes—secured vs. unsecured

(1) [1:175] **Unsecured notes permissible; CRPC 1.8.1 requirements inapplicable:** Counsel may ethically accept the client's *unsecured* promissory note for legal fees. Such an arrangement is not subject to the CRPC 1.8.1 restrictions against counsel acquiring a possessory or pecuniary interest "adverse to a client" (¶ *1:73.6, 1:90 ff.*) because, if a fee dispute arises, the attorney can enforce the note against the client's assets only through a judicial proceeding where the court will oversee the fundamental fairness of the transaction. [*Hawk v. State Bar* (1988) 45 C3d 589, 600-601, 247 CR 599, 605-606 (decided under former CRPC 3-300); see also *Fletcher v. Davis* (2004) 33 C4th 61, 68, 14 CR3d 58, 63 (decided under former CRPC 3-300)]

• [1:176] **Comment:** The *Hawk* reasoning is debatable. Even an unsecured promissory note may be transferred to a holder in due course, and certain defenses that would otherwise be available to the client against the attorney might not be available against the third party holder. (*See ¶ 6:196 ff.*)

(2) [1:177] **Ethical restraints on secured notes:** On the other hand, there are *significant ethical restraints* on securing legal fees by a *secured promissory note*—e.g., accepting a *deed of trust* on the client's property:

(a) [1:178] **CRPC 1.8.1 "adverse interest" obligations:** A secured note gives the lawyer a *present possessory interest* in the client's property which can be used to *summarily extinguish* the client's interest in the property without judicial supervision (e.g., under a private foreclosure sale of personal property pursuant to Comm'l C. § 9503; or a nonjudicial real property foreclosure proceeding under Civ.C. § 2924 et seq.; *see ¶ 6:514 ff.*). Therefore, by taking a secured note for

past due or future fees, counsel acquires an *interest adverse to the client*, triggering the CRPC 1.8.1 conflict of interest obligations. [See *Hawk v. State Bar* (1988) 45 C3d 589, 600-601, 247 CR 599, 605-606; see also *Fletcher v. Davis* (2004) 33 C4th 61, 67-68, 14 CR3d 58, 62-63 (decided under former CRPC 3-300)]

It follows that secured promissory note fee arrangements are enforceable against the client only if (i) the transaction and its terms are *fair and reasonable*, (ii) the *implications* to the client and the lawyer's role are *fully explained in writing* and in a manner *understandable* by the client, (iii) the client is either represented by independent counsel of their choice or advised in writing to *seek independent legal counsel*, and (iv) the client then *consents in writing*. [See CRPC 1.8.1; *and* ¶ 1:90 ff.]

1) [1:178.1] **Compare—referral to independent broker for real property secured loan to finance attorney fees through independent escrow:** An attorney may ethically refer a client to an *independent broker* to arrange for a real property secured loan to finance the legal representation where the resulting loan funds will be placed in an *independent escrow account* for payment to the attorney only as the legal services are rendered and pursuant to the fee agreement. Such an arrangement does not require compliance with the CRPC requirements. [See Cal. State Bar Form.Opn. 2002-159 (decided under former CRPC 3-300); *and* ¶ *1:94.1*]

(b) [1:179] **CRPC 1.8.9 "power of sale" bar:** At least for purposes of avoiding professional discipline, counsel may not take advantage of any power of sale granted through a secured instrument given to counsel for fees. CRPC 1.8.9 expressly *bars* attorneys from, directly or indirectly, purchasing property "at a probate, foreclosure, receiver's, trustee's, or judicial sale" in an action or proceeding in which the attorney (or an affiliated attorney) is "acting as a lawyer for a party or as executor, receiver, trustee, administrator, guardian, or conservator." [CRPC 1.8.9(a) & Comment—attorneys may lawfully participate in transactions involving probate proceedings that concern clients by following process described in Prob.C. § 9880 et seq.]

In addition to the above, an attorney may not represent the seller at a probate, foreclosure, receiver, trustee, or judicial sale in any action or proceeding in which the purchaser is a spouse or relative of the attorney or of another lawyer in the attorney's firm, or is an employee of the attorney in the attorney's firm. [CRPC 1.8.9(b)]

Comment: CRPC does not prohibit a lawyer's participation in transactions that are specifically authorized by and comply with Prob.C. §§ 9880-9885, but such transactions remain subject to CRPC 1.8.1 (business transactions/ pecuniary interests adverse to client rule) and 1.7 (conflicts of interest rule). [CRPC 1.8.9(c)]

[1:179.1 - 1:179.4] ***Reserved.***

(3) [1:179.5] ***Caution—securing payment of fees for residential mortgage loan modifications prohibited:*** It is unlawful in California for an attorney to take any type of lien on real or personal property, or any other form of security, to secure the payment of their fees for services rendered or to be rendered in connection with a residential mortgage loan modification or other form of residential mortgage loan forbearance. An attorney who violates this prohibition is subject to disciplinary action and can be fined and/or imprisoned for up to one year. [Bus. & Prof.C. § 6106.3; see also Civ.C. §§ 2944.7 & 2944.8 (authorizing state and local government officials to commence civil actions to recover up to $20,000 for each such violation, as well as additional penalties up to $2500 for every violation perpetrated against a senior citizen or disabled person)]

b. [1:180] **Credit terms and interest charges:** Promissory notes for fees, or other credit arrangements with the client (as where client agrees to pay fees in installments), may be subject to federal *truth-in-lending laws* (e.g., 15 USC § 1601 et seq.; and see 12 CFR § 226.1 et seq. ("Regulation Z")). Briefly, pursuant to Regulation Z, the client may have to be furnished with a written disclosure statement detailing the *interest* rate (if any), the dollar cost of credit provided, a payment schedule, an itemization of interest and late charges, etc. [See 12 CFR § 226.18]

Further, the client should *expressly agree* to any provision for interest charges on past-due fee obligations (i.e., incorporate same into the written fee agreement to be signed by the client). Unilaterally advising the client that interest will be charged on overdue or installment payments will not contractually bind the client to pay the interest.

7. Fee Agreement and Client Billing Formalities

a. [1:181] **Written fee agreement usually mandatory:** A lawyer's "contract for services" must be *in writing* whenever it is "*reasonably foreseeable* that *total* expense" to the client (including attorney fees and costs) will *exceed $1,000*. [Bus. & Prof.C. § 6148(a) (emphasis added)]

➪ [1:181.1] ***PRACTICE POINTER:*** It is always prudent to reduce attorney-client fees and costs arrangements to a *written agreement*; this is so even when a signed writing is not statutorily required (*see ¶ 1:181*). Accepting representation on a verbal understanding invites *misunderstandings* over the applicable terms and inevitably results in attorney-client fee disputes. Moreover, committing your agreement to writing will impress upon clients less sophisticated in real property sales transactions the nature and scope of the work to be performed, who is to perform it, the sequence of events likely to transpire, as well as the legal fees and costs commitment.

[1:182] ***Reserved.***

b. [1:183] **Type of written fee agreement:** No special statutes or rules dictate the form of a written fee agreement. So long as the agreement accomplishes the desired results, its form is really a matter of personal preference.

(1) [1:184] **Letter agreement:** Particularly in transactional matters, many attorneys prefer to use a *letter* agreement "confirming" the client's retention of counsel (or the law firm), recapitulating the oral understanding reached, and requesting the client to sign and return a copy as evidence of their agreement and acceptance on the terms stated.

Typically, these letters are informal in tone and thus may be the best approach when representing less sophisticated clients and clients whom you have represented on prior occasions.

FORM: Sample Fee Letter, *see Form 1:A.1*.

(2) [1:185] **Formal fee contract:** Another approach is to reduce the agreement to a more formal "contract." While contract agreements are used by many firms, their formal "legalistic style" may be intimidating to clients not well-versed in transactional matters.

➪ [1:185.1] ***PRACTICE POINTER:*** The most important goal in drafting a written retention agreement is to ensure the client *understands* the scope of the agreed-upon representation and the terms and conditions for payment of legal fees and costs. Accordingly, whether documented in an informal letter or a formal "contract," the agreement should use *lay language* and be free from ambiguities.

Under general rules of contract interpretation, ambiguous provisions will be construed against the drafter (Civ.C. § 1654); and that rule applies with even greater force when the person who prepared the agreement is a lawyer. [*Mayhew v. Benninghoff* (1997) 53 CA4th 1365, 1370, 62 CR2d 27, 30—ambiguous arbitration clause in retainer agreement construed against attorney-drafter]

Encourage the client to discuss uncertain provisions with you before signing; and always have the client *acknowledge* by signature that they have read and understand the terms. (*See Form 1:A.1*.)

[1:186] ***Reserved.***

c. [1:187] **Minimum statutory requirements for fee agreements:** All attorney fee agreements must comply with minimum standards imposed by statute. Those agreements for which the basis of compensation is hourly, a flat rate or set by statute are governed by Bus. & Prof.C. § 6148 (*see ¶ 1:189 ff.*).

(1) [1:187.1] **Compare—contingency fee agreements:** Contingency fee agreements are governed by Bus. & Prof.C. § 6147, requiring, among other things, a *written* agreement that includes both the client's and attorney's signatures and a statement that the fee is not set by law but is negotiable. [See *Arnall v. Sup.Ct. (Liker)* (2010) 190 CA4th 360, 366-371, 118 CR3d 379, 383-387—failure to include fee negotiability statement renders *any* contingency fee agreement voidable, including transactional and/or "hybrid" agreements (i.e., those that combine fixed monthly payments with variable success fees); *Stroud v. Tunzi* (2008) 160 CA4th 377, 381, 72 CR3d 756, 759—material changes to contingency fee agreement also must comply with § 6147]

Cross-refer: For further discussion, see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 5.

[1:188] ***Reserved.***

(2) [1:189] **Conformed executed copy to client:** At the time the contract is entered into, counsel must provide the client with a duplicate copy signed by both attorney and client. [Bus. & Prof.C. § 6148(a)]

(3) [1:190] **Contents:** Agreements subject to Bus. & Prof.C. § 6148 must contain all of the following:

(a) [1:191] **Charges:** The *basis of compensation*, including, but not limited to, "hourly rates, statutory fees or flat fees, and other standard rates, fees, and charges applicable to the case" (i.e., the legal "fees" per se; in hourly rate cases, the method of computing fees for services performed; *plus* costs to be billed the client). [Bus. & Prof.C. § 6148(a)(1)]

(b) [1:192] **Work to be performed:** The "general nature of the legal services to be provided to the client." [Bus. & Prof.C. § 6148(a)(2)]

(c) [1:193] **Division of responsibility:** The "respective responsibilities of the attorney and the client as to the performance of the contract." [Bus. & Prof.C. § 6148(a)(3)]

(4) [1:194] **Residential mortgage loan modification fee agreements; preliminary written disclosure required:** *Before entering into any fee agreement*, an attorney who renders compensable services in connection with a residential mortgage loan modification or other form of residential mortgage loan forbearance must provide their client with a statutorily-prescribed written disclosure, in *minimum 14-point boldface type*, as follows (Civ.C. § 2944.6(a) & Bus. & Prof.C. § 6106.3):

> "It is not necessary to pay a third party to arrange for a loan modification or other form of forbearance from your mortgage lender or servicer. You may call your lender directly to ask for a change in your loan terms. Nonprofit housing counseling agencies also offer these and other forms of borrower assistance free of charge. A list of nonprofit housing counseling agencies approved by the United States Department of Housing and Urban Development (HUD) is available from your local HUD office or by visiting www.hud.gov."

(a) [1:194.1] **Violation of written disclosure requirement:** An attorney who violates the above written disclosure requirement (¶ *1:194*) is subject to disciplinary action and can be fined and/or imprisoned for up to one year. [Bus. & Prof.C. § 6106.3 & Civ.C. § 2944.6(c); see also *Matter of Taylor* (Rev.Dept. 2012) 5 Cal. State Bar Ct.Rptr. 221, 231—attorney suspended and thereafter placed on probation for, among other things, failing to provide statutory written disclosure requirement]

(b) [1:194.2] **Translated copies:** If loan modification services are offered or negotiated in one of the Civ.C. § 1632 languages (i.e., Spanish, Chinese, Tagalog, Vietnamese or Korean), a translated copy of the Civ.C. § 2944.6(a) written disclosure (¶ *1:194*) must be provided to the client in that language. An attorney who violates this requirement is subject to disciplinary action and can be fined and/or imprisoned for up to one year. [Civ.C. § 2944.6(b) & Bus. & Prof.C. § 6106.3]

d. [1:195] **Fee agreement checklist:** Consider the following checklist items when preparing your fee agreements:

(1) [1:196] **Work to be performed:** Provide a general description of the matter for which you have been hired and explain the *specific scope* of work or tasks you will perform.

(2) [1:197] **Excluded services:** If there might be confusion about the services you will and will not perform, identify those tasks you will *not* perform.

(3) [1:198] **Client(s):** Identify precisely whom you are representing. If necessary to clarify the matter, also identify those whom you are *not* representing (e.g., if retained by a partnership, indicate you are not representing the partners individually).

(4) [1:199] **Authority and decision-making among joint clients:** When representing joint clients (e.g., several buyers or sellers), set up some methodology for expeditious transmission of communications and decision-making.

For example, identify one party as the client "representative" with authority to make certain (or all) decisions on behalf of the others (*see* ¶ *1:112 ff.*).

(5) [1:200] **Legal fees and billings:** Describe the legal fees arrangement (fixed or task-based fee, hourly rate, etc.) and billing methodology. For example, note your periodic billing cycles (e.g., every 30 days) and the time period within which payment will be required. If applicable, carefully delineate interest to be charged on past due amounts. If you represent several parties, make it clear in the agreement that each is jointly and severally liable for billings.

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If your fees might vary from a strict hourly rate, you may want to list the various factors determining a "reasonable" fee (*see ¶ 1:150*). And, if it appears the matter could extend over a protracted period of time, you may want to reserve the right to increase your hourly rate at a later date (*but see ¶ 1:152*—client must *consent* to fee increases).

➪ [1:200.1] ***PRACTICE POINTER FOR SELLER'S COUNSEL— TIME FOR PAYMENT*:** Seller's counsel should make every effort to ensure their fees are paid, at the latest, upon closing of the sale, when the seller will have readily available cash funds. Seller's counsel can prepare a simple disbursement instruction from (and to be executed by) the seller, directing the escrow holder to pay counsel out of the seller's proceeds upon close of escrow. (However, a simple letter or any other written instruction from the client to the escrow will usually suffice.)

To pass ethical scrutiny, be sure any disbursement of your fees out of the escrow is conditioned on the client's prior opportunity to review and contest your billings; i.e., the disbursement instructions should come from the *client* after approving your final bill. [See Cal. State Bar Form.Opn. 2002-159]

FORM: Seller's Disbursement Instruction to Escrow for Payment of Counsel Fees, *see Form 1:B*.

(6) [1:201] **Costs:** Discuss the anticipated costs and describe those costs you will (and will not) advance on the client's behalf, spelling out the reimbursement obligation.

For example, advise the client you intend to charge separately for such things as long-distance telephone calls, messenger charges, travel expenses, etc. Specify per item charges, such as rates per page for telecopying and copying charges.

(Depending on the client's sophistication and experience in real property sales transactions, it may be prudent also to identify those costs you will *not* be advancing on the client's behalf—e.g., recording costs, title fees, filing fees in connection with the formation of a partnership or corporation, etc.)

(7) [1:202] **Retainer against future fees:** If a deposit against future fees will be expected, identify the amount and (if applicable) the client's obligation to replenish the deposit when it falls below a specified level.

(8) [1:203] **Division of attorney work, varying rates:** Where the work will be divided among different lawyers and support staff in your firm (at varying hourly rates), it is a good idea to specify who will be the principal attorney working on the matter. Also include a schedule of the various hourly billing rates as between attorneys (or classes of attorneys), law clerks, paralegals, etc.

(9) [1:204] **Conflicts of interest:** Where there are actual or potential conflicts of interest requiring the client's "informed written consent" (*¶ 1:73.2a*), some attorneys make the requisite disclosures and obtain the client's waiver by a separate conflicts letter executed prior to, or in conjunction with, the fee agreement. Others incorporate conflicts disclosures and provide for the requisite client waiver directly in the written fee agreement.

Under the latter approach, by signing the fee agreement, the client should effectively waive actual or potential conflicts. As an added precaution, to be certain the client understands the disclosures and their rights in the face of an actual or potential conflict of interest, the client should be asked to separately initial the conflicts paragraph, thereby explicitly acknowledging their informed written consent (*¶ 1:73.2a*) to counsel's representation notwithstanding the conflict.

(10) [1:205] **Right of withdrawal:** To encourage prompt payment of fees and costs, some attorneys include a provision expressly reserving the right to cease representation, upon reasonable notice to the client, in the event bills are not timely paid (or for any other legitimate reason). Conversely, since the attorney-client relationship is basically an "at will" employment, some counsel also include a concomitant provision indicating the client's right to discharge counsel at any time (before the matter otherwise draws to a natural conclusion).

➪ [1:205.1] ***PRACTICE POINTER:*** An express withdrawal provision is not essential, since counsel has the right to withdraw when, among other things, the client "renders it unreasonably difficult" for counsel to "carry out the representation effectively" or "breaches a material term of an agreement with, or obligation" to, counsel relating to the representation, and the lawyer has given the client a reasonable warning after the breach that the lawyer will withdraw unless the client fulfills the agreement or performs the obligation. [See CRPC 1.16(b)(4)-(5) (compare former 3-700(C)(1)(f)—expressly permitting withdrawal where client breaches agreement or obligation to counsel "as to expenses or fees")] Likewise, whether or not specified in the agreement, a client has the absolute right to discharge counsel at any time, with or without "cause." [*Fracasse v. Brent* (1972) 6 C3d 784, 790-791, 100 CR 385, 389]

Unlike in a litigation setting, withdrawal as counsel in sales transactions is relatively easy and court approval need not be obtained (even if the client objects thereto; compare CCP § 284). Nonetheless, should you reach the point where withdrawal is deemed necessary or prudent, be sure to adhere to your *ethical* obligations (*see ¶ 1:234 ff.*); significantly,

always time your withdrawal to be sufficiently in advance of any critical date in the transaction so that the client will have adequate opportunity to obtain new counsel (see CRPC 1.16(d)); ¶ *1:235*).

(11) [1:206] **Arbitration of disputes:** As a general rule, attorneys may legally and ethically include in their retention agreements a provision requiring *binding arbitration* of attorney-client disputes arising out of the engagement. [*Powers v. Dickson, Carlson & Campillo* (1997) 54 CA4th 1102, 1108-1109, 63 CR2d 261, 264; Cal. State Bar Form.Opn. 1989-116]

(a) [1:206.1] **Enforceability:** So long as the contract is not one of adhesion (not a standardized contract presented to the client on a "take it or leave it basis"), and the terms of the arbitration clause are unambiguous and understandable to the client, retention agreements requiring arbitration of client disputes—*including legal malpractice claims*—are valid and enforceable. [*Powers v. Dickson, Carlson & Campillo* (1997) 54 CA4th 1102, 1115, 63 CR2d 261, 269—provisions requiring arbitration of "any dispute arising out of or related to professional services" held to encompass legal malpractice claims (enforceable even though clients did not carefully read agreement)]

1) [1:206.2] **Limitation re provision for binding MFAA arbitration of fees/costs disputes:** *See discussion at ¶ 1:225.6 ff.*

(b) [1:206.3] **Warning to client required:** To ensure clients understand the legal effect of binding arbitration, they should be fully *advised of the possible consequences*—i.e., no right to jury trial, possible limitations on discovery, limited appellate review, etc. "Absent notification and at least some explanation, the [client] cannot be said to have exercised a 'real choice' in selecting arbitration over litigation." [See *Wheeler v. St. Joseph Hosp.* (1976) 63 CA3d 345, 361, 133 CR 775, 786]

The requisite warnings can—and, as a matter of prudence, *should*—be included in the retention agreement. *See Form 1:A.1*.

On the other hand, an enforceable arbitration provision need not contain an express waiver of the right to jury trial or any other client waivers. [*Powers v. Dickson, Carlson & Campillo* (1997) 54 CA4th 1102, 1115, 63 CR2d 261, 269]

(c) [1:206.4] **Higher disclosure standards re existing clients:** In an advisory opinion, the State Bar distinguishes between arbitration provisions in an *initial* retainer agreement by which the attorney-client relationship is first established and those negotiated with an *existing* client (e.g., in an amendment to an existing fee agreement).

With regard to an *initial* agreement with a *new* client, the State Bar opinion states that the extent to which the client is aware of the provision and freely consents to it goes to the legal enforceability of the agreement and not its ethical propriety. By contrast, where the arbitration provision is negotiated with an *existing* client, ethical considerations (distinct from any legal considerations) require the attorney *fully disclose* the terms and consequences of the provision and that the client *knowingly* consent to it. [Cal. State Bar Form.Opn. 1989-116; *Powers v. Dickson, Carlson & Campillo* (1997) 54 CA4th 1102, 1113, 63 CR2d 261, 267-268—both initial retainer agreement and amendment thereto satisfied disclosure and client consent requirements, unambiguously requiring arbitration of legal malpractice claims; compare *Desert Outdoor Advertising v. Sup.Ct. (Murphy)* (2011) 196 CA4th 866, 875-877, 127 CR3d 158, 165-167—attorney had no duty to *separately explain* clearly written arbitration clause to existing, sophisticated business clients who failed to carefully read new fee agreement (explaining Cal. State Bar Form.Opn. 1989-116 and *Powers* decision "presume" clients "*will read"* retainer agreements)]

(d) [1:206.5] **Scope of coverage—ambiguities resolved against attorney:** As the *drafter* of the retention agreement, the *attorney* is chargeable with the consequences of ambiguities therein (¶ *1:185.1*). Any uncertainty about the scope or validity of an arbitration clause will be resolved *against the attorney* and therefore against arbitration of the particular dispute (Civ.C. § 1654). [*Mayhew v. Benninghoff* (1997) 53 CA4th 1365, 1370, 62 CR2d 27, 30]

1) Examples

• [1:206.6] An ambiguous provision in a divorce retainer agreement requiring arbitration of "any controversy arising out of or related to [Client's] engagement for legal matters" could not be construed to compel arbitration of an unrelated dispute arising out of the client's "side business deal" with counsel. [*Mayhew v. Benninghoff* (1997) 53 CA4th 1365, 1368, 62 CR2d 27, 28]

• [1:206.7] A provision requiring binding arbitration of disputes "regarding fees, costs or any other aspect of our attorney-client relationship" was construed (from the client's perspective) as most likely limited to financial matters

and thus inapplicable to legal malpractice claims. [*Lawrence v. Walzer & Gabrielson* (1989) 207 CA3d 1501, 1507, 256 CR 6, 10]

(e) [1:206.8] **No special form required:** An enforceable attorney-client arbitration provision need not adhere to any statutory formalities. [See *Powers v. Dickson, Carlson & Campillo* (1997) 54 CA4th 1102, 1115, 63 CR2d 261, 269 (rejecting suggestion in Cal. State Bar Form.Opn. 1989-116 that attorney-client dispute arbitration provisions comply with CCP § 1295 formalities for arbitration of medical malpractice claims in physician-patient contracts); *Desert Outdoor Advertising v. Sup.Ct. (Murphy)* (2011) 196 CA4th 866, 877, 127 CR3d 158, 167 (same)]

Nonetheless, to ensure the client is *aware* of the arbitration provision, prudence suggests that it be highlighted in prominent type; and that it be *separately initialed* by the client to signify their understanding and acknowledgment.

FORM: A sample arbitration clause and client acknowledgment are included in the Sample Fee Letter, *Form 1:A.1*.

Cross-refer: For further discussion of arbitration provisions in fee agreements, see Weil & Brown et al., *Cal. Prac. Guide: Civ. Pro. Before Trial* (TRG), Ch. 1; and Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 5.

(12) [1:207] **Disposition of client files:** Though not essential, some attorneys include a statement in the fee agreement indicating how and when client files will be disposed of once representation has ceased. (Other attorneys prefer to send a separate letter on this subject upon conclusion of the representation.)

On this issue, bear in mind your *ethical obligations* regarding the return of client files; *see ¶ 1:236*.

(13) [1:208] **Disclosure re no professional liability insurance:** *See discussion at ¶ 1:127*.

(14) [1:209] **Signatures:** Attorney and client(s) should each date and sign the agreement; and the client (or each of several joint clients) should be given a conformed copy (*¶ 1:189*).

FORM: Sample Fee Letter, *see Form 1:A.1*.

e. Client billings

(1) [1:210] **Mandatory specifications:** All bills to clients for services rendered must "clearly state the basis thereof." [Bus. & Prof.C. § 6148(b)]

More particularly:

(a) [1:211] **Fee portion:** The fee portion of the bill must include the amount, rate, basis for calculation, or other method of determining counsel's "fees and costs." [Bus. & Prof.C. § 6148(b)]

(b) [1:212] **Expense portion:** The costs and expense portion of the bill must clearly identify the costs and expenses incurred and the amount thereof. [Bus. & Prof.C. § 6148(b)]

➪ [1:212.1] ***PRACTICE POINTER:*** Bus. & Prof.C. § 6148(b) essentially requires only "bare bones" itemized information in client bills. In practice, client bills rarely mirror the detailed time logs counsel should keep for their files (*¶ 1:140*).

Various billing approaches are utilized:

- Some attorneys simply provide clients with a statement of the amount due, the applicable rate, accompanied by a general description (e.g., "for legal services in connection with … [a general reference to the matter]"), plus an itemization of related expenses.

- Other lawyers give their clients a breakdown of the specific acts performed—such as telephone conferences, meetings, preparation of certain documents, etc., providing dates and some specifics, but no hourly breakdown.

- Still others furnish an hourly breakdown either by the day or the specific act performed (e.g., telephone call, attend meeting, draft document, etc.).

Of course, a large bill accompanied by only a general notation (e.g., "for services rendered") is likely to be met with a phone call from the client for further explanation. Hence, at least when a monthly bill might exceed the client's expectations, it may be prudent to include detailed descriptions and itemizations regarding each particular service rendered and expense incurred.

(2) [1:213] **How often:** Counsel must provide the client with a bill no later than 10 days after the client's request for same —except that, if a bill was provided the client within 31 days before the request, the next bill may be furnished up to 31 days after the last billing date. [Bus. & Prof.C. § 6148(b)]

Clients are entitled to make similar billing requests at intervals of no less than 30 days following the initial request. [Bus. & Prof.C. § 6148(b)]

(3) [1:214] **Estimates:** In responding to client requests for billing information, counsel "may use billing data that is currently effective on the date of the request"; or, to the extent fees or costs as of the date of the request cannot be accurately determined, they "shall be described and estimated." [Bus. & Prof.C. § 6148(b)]

f. [1:215] **Exceptions:** The requirements of Bus. & Prof.C. § 6148 do *not* apply in the following situations:

(1) [1:216] **Emergencies:** When legal services are rendered in an "emergency" to avoid foreseeable prejudice to the client's rights or interests "or where a writing is otherwise impractical." [Bus. & Prof.C. § 6148(d)(1)]

(2) [1:217] **Fee arrangement implied by prior similar dealings:** When an arrangement as to legal fees can be implied by the fact counsel's services "are of the same general kind as previously rendered to and paid for by the client." [Bus. & Prof.C. § 6148(d)(2)]

(3) [1:218] **Client's waiver:** When, after full disclosure of Bus. & Prof.C. § 6148, the client knowingly states in writing that a writing concerning fees is not required. [Bus. & Prof.C. § 6148(d)(3)]

(4) [1:219] **Corporate clients:** When the client is a corporation. [Bus. & Prof.C. § 6148(d)(4)]

➪ [1:219.1] ***PRACTICE POINTER:*** As indicated earlier (¶ *1:181.1*), a *written* fee agreement is *always* prudent—even when the circumstances bring the matter outside the scope of Bus. & Prof.C. § 6148. Relying on informal oral "understandings" or "implied" agreements based on prior dealings all too often invites later fee disputes.

g. [1:220] **Effect of noncompliance:** Absent an applicable exception (¶ *1:215 ff.*), failure to comply with Bus. & Prof.C. § 6148 renders the agreement *voidable* at the *client's* option. Should the client exercise the right of avoidance, counsel will be limited to "reasonable fees" for services rendered (i.e., a *quantum meruit* claim). [Bus. & Prof.C. § 6148(c); see *Flannery v. Prentice* (2001) 26 C4th 572, 589, 110 CR2d 809, 822]

h. [1:221] **Confidentiality:** A written fee contract is deemed a *confidential communication* for purposes of Bus. & Prof.C. § 6068(e) (attorney's duty to "maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client") and Ev.C. § 952 (attorney-client privilege). [Bus. & Prof.C. § 6149]

Cross-refer: For further discussion of the confidentiality of attorney fee agreements and billing statements, see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 7.

[1:222 - 1:224] ***Reserved.***

8. [1:225] **Client's Statutory Right to Arbitrate Fees/Costs Disputes:** The Mandatory Fee Arbitration Act (MFAA) provides a "quick and inexpensive method" for clients to resolve fees and costs disputes with their attorneys. [*Law Offices of Dixon R. Howell v. Valley* (2005) 129 CA4th 1076, 1083, 29 CR3d 499, 502] Pursuant to the MFAA, the State Bar regulates and administers a system for the arbitration of such disputes, conducted under approved local bar association programs. [Bus. & Prof.C. § 6200 et seq.; State Bar Rule 3.500 et seq.]

a. [1:225.1] **Notice to client of right to MFAA arbitration:** Counsel wishing to sue a client over disputed fees and costs must give the client written notice (in a form prescribed by the State Bar), before or with service of summons, advising of the client's right to submit the dispute to arbitration under the MFAA. [Bus. & Prof.C. § 6201(a); State Bar Rule 3.501(B); *Schatz v. Allen Matkins Leck Gamble & Mallory LLP* (2009) 45 C4th 557, 566, 87 CR3d 700, 706]

(1) [1:225.1a] **"Client" defined:** A "client" entitled to the notice is the person who has *agreed to pay* the lawyer's fees (i.e., the attorney's *debtor* on account of the services provided); this person may actually be a nonclient (e.g., a third-party guarantor). [*Wager v. Mirzayance* (1998) 67 CA4th 1187, 1190, 79 CR2d 661, 663]

(2) [1:225.1b] **Timing:** This notice also must be given before commencing arbitration proceedings through another dispute resolution provider pursuant to a contract between attorney and client. [Bus. & Prof.C. § 6201(a); *Schatz v. Allen Matkins Leck Gamble & Mallory LLP*, supra]

• ***FORM:*** The requisite client notice must be served on a State Bar-approved form "Notice of Client's Right to Arbitration" (available at www.calbar.ca.gov, under "Forms"; see *Form 1:C*).

(3) [1:225.1c] **Must be given *after* dispute arises, *not in retention agreement:*** A notice of right to arbitrate included in the retention agreement or the initial billing is *ineffective*. The Bus. & Prof.C. § 6201 notice must be given *after* the fees/costs dispute arises. [*Huang v. Cheng* (1998) 66 CA4th 1230, 1234, 78 CR2d 550, 552—notice sent 2 years before dispute (around time of original billing) insufficient]

(4) [1:225.2] **Dismissal of action for failure to give client notice:** Counsel's failure to give the right to arbitrate notice is ground for *dismissal* of the attorney's lawsuit for fees/costs. [Bus. & Prof.C. § 6201(a); State Bar Rule 3.501(C)] But dismissal is *discretionary* with the trial court, not mandatory. [*Law Offices of Dixon R. Howell v. Valley* (2005) 129 CA4th 1076, 1088-1090, 29 CR3d 499, 506-508 (collecting cases)]

b. [1:225.3] **Arbitration mandatory upon client's timely request; exemptions and waiver:** There are limited exceptions to Bus. & Prof.C. § 6200 et seq. arbitration (e.g., fees/costs disputes with out-of-state lawyers who maintain no California office and rendered no "material part" of the legal services in this State). [See Bus. & Prof.C. § 6200(b)]

Clients also can waive their right to § 6200 et seq. arbitration (e.g., by failure to request same within the postnotice 30-day period). [See Bus. & Prof.C. § 6201(a), (b), (d) & (e); *and ¶ 1:225.7*]

Otherwise, unless the client has agreed in writing (e.g., in the retention contract) to § 6200 et seq. arbitration of all fees/costs disputes, arbitration under § 6200 et seq. is *voluntary for the client* but *mandatory for the attorney* if timely commenced by the client. [Bus. & Prof.C. § 6200(c); *Fagelbaum & Heller, LLP v. Smylie* (2009) 174 CA4th 1351, 1360, 95 CR3d 252, 260]

(1) [1:225.4] **Compare—State Bar mediation program:** The State Bar also is empowered to establish a system and procedure for *mediation* of attorney-client fees and costs disputes. Such mediation is *voluntary* for *both* attorney and client. Moreover, no notice of right to mediate is required. [Bus. & Prof.C. §§ 6200(a), (c), (h) & 6201(a)]

(2) [1:225.5] **Client's timely arbitration request stays other proceedings:** The client's timely request for arbitration (within 30 days of receipt of the notice of right to arbitrate and before filing an answer in the attorney's lawsuit or an equivalent response in another dispute resolution proceeding) *stays* the attorney's lawsuit or other dispute resolution proceeding until the arbitration award issues, the arbitration is otherwise terminated, or the stay is vacated by court order finding the dispute not arbitrable. [See Bus. & Prof.C. § 6201(b), (c); State Bar Rule 3.511]

c. [1:225.6] **Predispute agreement for binding MFAA arbitration ineffective; right to trial de novo:** An agreement for binding MFAA arbitration is enforceable only if the agreement is reached *after the fees/costs dispute arises*. Otherwise, either party is entitled to request a trial de novo within 30 days after mailing of notice of the arbitration award (optional Judicial Council form ADR-104 may be used for this purpose). [Bus. & Prof.C. § 6204(a); see also Bus. & Prof.C. § 6204(b), (c) re procedure for initiating right to trial de novo; State Bar Rule 3.508; *Maynard v. Brandon* (2005) 36 C4th 364, 369, 30 CR3d 558, 559—30-day deadline for requesting trial de novo is *jurisdictional* and cannot be extended by CCP § 473(b) relief]

Exception: A party who willfully fails to appear at the arbitration hearing *forfeits* the right to a trial after arbitration. [Bus. & Prof.C. § 6204(a)]

(1) [1:225.7] **Subject to client's waiver of MFAA rights:** Clients waive their MFAA rights by commencing suit against the attorney seeking (a) judicial resolution of the fees/costs dispute; or (b) damages for attorney malpractice (Bus. & Prof.C. § 6201(d); State Bar Rule 3.502(A)(2)). In that event, a provision for binding arbitration of fees/costs disputes in a preexisting contract between attorney and client is fully enforceable against the client. [*Aguilar v. Lerner* (2004) 32 C4th 975, 989-990, 12 CR3d 287, 297; and see *Fagelbaum & Heller, LLP v. Smylie* (2009) 174 CA4th 1351, 1362, 95 CR3d 252, 261—client waived right to MFAA arbitration by filing cross-demand for attorney malpractice damages in pending contractual arbitration proceeding]

(2) [1:225.8] **Compare—predispute agreement for private binding arbitration *after nonbinding MFAA arbitration:*** Moreover, after nonbinding MFAA arbitration has concluded, a pre-dispute agreement for private binding arbitration under the California Arbitration Act (CCP § 1280 et seq.) is enforceable; in effect, the private contractual arbitration is the "trial de novo" to which either party is entitled upon timely request after a nonbinding MFAA arbitration award. [*Schatz v. Allen Matkins Leck Gamble & Mallory LLP* (2009) 45 C4th 557, 562, 572, 575, 87 CR3d 700, 703, 711, 714—client's MFAA right to "trial de novo" not limited to court litigation; *Fagelbaum & Heller, LLP v. Smylie* (2009) 174 CA4th 1351, 1361, 95 CR3d 252, 260 (same); see also *Greenberg Glusker Fields Claman & Machtinger LLP v. Rosenson* (2012) 203 CA4th 688,

694, 137 CR3d 489, 492—following nonbinding MFAA award, law firm had valid contractual right to *binding* arbitration pursuant to preexisting retainer agreement provision]

d. [1:225.9] **State Bar enforcement of arbitration award:** The State Bar Act provides for an internal administrative enforcement remedy to expedite an attorney's compliance with a Bus. & Prof.C. § 6200 et seq. fees and costs arbitration (or mediation) award to the client (attorney may be placed on involuntary inactive status pending payment of the award; and administrative penalties and costs may be assessed for noncompliance). [See Bus. & Prof.C. § 6203(d); State Bar Rule 3.560]

Cross-refer: For a comprehensive discussion of the State Bar fees/costs dispute arbitration program, see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 5.

[1:226 - 1:229] ***Reserved.***

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Cal. Prac. Guide Real Prop. Trans. Ch. 1-D

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 1. Commencing Representation: Scope of Attorney's Work and Fee Arrangements

D. Termination of Employment/Withdrawal as Counsel

- 1. [1:230] "Natural" Termination Upon Conclusion of Transaction
  - a. [1:232] Returning client materials and other property
- 2. [1:233] Early Termination Before Conclusion of Transaction
  - a. [1:234] Attorney ethical obligations
    - (1) [1:235] Avoiding client prejudice; reasonable notice to client
    - (2) [1:236] Return of client materials and property
      - (a) [1:237] No "retaining liens"
    - (3) [1:238] Return of unearned fees
  - b. Fees for services rendered to date
    - (1) [1:239] Upon early discharge by client
      - (a) [1:240] Hourly rate cases
      - (b) [1:241] Fixed fee (and other) cases
    - (2) [1:242] Upon early withdrawal by counsel

1. [1:230] **"Natural" Termination Upon Conclusion of Transaction:** Normally, legal representation ceases at or shortly after closing of the transaction, even though various postclosing matters are contemplated by the purchase and sale agreement.

➪ [1:231] ***PRACTICE POINTER:*** When negotiating a fee agreement, explain to your clients that the scope of your undertaking *ceases* when the transaction closes. Further, so as to leave no room for misunderstanding, this point should be clarified in the *written fee agreement*. In other words, dispel any client expectations that you will attend to various postclosing matters.

For example, some clients may assume that because you drafted the purchase-money note, you will be calendaring dates for notices and/or maturity; or clients may expect you to remind them of a date for the exercise of an option to purchase. It is almost *never* advisable to assume responsibility to clients with regard to postclosing deadlines for notices, payments and the like. Among other reasons, (i) you greatly enhance your *malpractice* exposure for missing any number of pertinent deadlines; and (ii) your calendar will eventually become overwhelmed with a multitude of postclosing tasks for different clients.

Upon the closing of a transaction, cautious counsel should give their clients *written confirmation* that legal representation has ceased and you are "out of the loop" on these (or any other) postclosing steps (unless and until a new agreement directed at those tasks is reached).

a. [1:232] **Returning client materials and other property:** As soon as employment ceases, upon client request, counsel must return to the client all client materials and property relating to the representation—*whether or not fees are still owing*. [CRPC 1.16(e)(1); *see* ¶ *1:236*]

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2. [1:233] **Early Termination Before Conclusion of Transaction:** Counsel and client, respectively, have the right to terminate representation at any time, even before the matter comes to a natural conclusion (¶ 1:230 ff.). [CRPC 1.16(b)—attorney's "permissive" right of withdrawal; *Fracasse v. Brent* (1972) 6 C3d 784, 790-791, 100 CR 385, 389—client's "absolute right" to discharge counsel at any time; *see* ¶ *1:205.1*]

a. [1:234] **Attorney ethical obligations:** In purely transactional matters (including representation in a purchase and sale) where there are no pending court or administrative proceedings, counsel's withdrawal is not conditioned on prior court approval. However, minimum ethical obligations must be adhered to:

(1) [1:235] **Avoiding client prejudice; reasonable notice to client:** Counsel may not withdraw from employment until they have taken "reasonable steps to avoid reasonably foreseeable prejudice" to the client's rights—including giving the client "sufficient notice" to permit the client to retain other counsel, and complying with CRPC 1.16(e) (¶ 1:236 ff.). [CRPC 1.16(d); see also ABA Model Rule 1.16—counsel may withdraw if it can be accomplished "without material adverse effect" on client's interests]

(2) [1:236] **Return of client materials and property:** Upon withdrawal, and at the client's request, counsel must *promptly release* to the client all "client materials and property," including correspondence, exhibits, experts' reports and other writings, "whether in tangible, electronic or other form, and other items reasonably necessary to the client's representation, *whether the client has paid for them or not*." [CRPC 1.16(e)(1) (emphasis added)]

(a) [1:237] **No "retaining liens":** It is both unethical and unlawful for counsel to unilaterally insist on retaining the client's files and other materials as security for fees still owing (so-called "retaining liens"). Withdrawing (or discharged) counsel may retain *copies* of the original papers and files at their own expense; but the *originals* must be released even if the client owes money for expenses incurred in connection with them. [See CRPC 1.16 & Comment [6]; *Academy of California Optometrists, Inc. v. Sup.Ct. (Damir)* (1975) 51 CA3d 999, 1005-1006, 124 CR 668, 671-672; *Kallen v. Delug* (1984) 157 CA3d 940, 950, 203 CR 879, 884-885; see also Cal. State Bar Form.Opn. 1994-134]

(3) [1:238] **Return of unearned fees:** Also, upon withdrawal, counsel must *promptly refund* "any part of a fee or expense paid in advance that the lawyer has not earned or incurred." [CRPC 1.16(e)(2)—inapplicable to "classic retainer" fee paid solely to ensure counsel's availability for matter (¶ *1:134.1*)]

If attorney and client *dispute* the amount of "unearned" fee advances to be returned to the client, the disputed sum must be left in the client trust account until the matter is finally resolved. [See CRPC 1.15(c)(2); *and* ¶ *1:161*]

b. Fees for services rendered to date

(1) [1:239] **Upon early discharge by client:** Of course, a client's inherent right to discharge counsel at any time does not relieve the client of the obligation to pay for legal services rendered. [*Fracasse v. Brent* (1972) 6 C3d 784, 791, 100 CR 385, 389-390]

(a) [1:240] **Hourly rate cases:** If the fee agreement called for an hourly rate, discharged counsel is entitled to recover on the hourly rate basis for the time expended so far. [See *Oliver v. Campbell* (1954) 43 C2d 298, 306, 273 P2d 15, 20; *Countryman v. California Trona Co.* (1917) 35 CA 728, 736, 170 P 1069, 1073]

(b) [1:241] **Fixed fee (and other) cases:** If the fee agreement called for a lump-sum amount (or another form of compensation that cannot be reduced to hourly rate computation), and no provision was made for compensation in the event of premature discharge by the client, counsel has a *quantum meruit* claim for the *reasonable value* of services rendered to date.

[*Fracasse v. Brent*, supra; *Hansen v. Jacobsen* (1986) 186 CA3d 350, 356, 230 CR 580, 584—discharged attorney's contractual lien survives as lien for quantum meruit fees]

However, if the obligation to pay legal fees was made *contingent* on a particular event (or events), discharged counsel is entitled to recover fees only upon occurrence of the specified contingency. [*Fracasse v. Brent* (1972) 6 C3d 784, 792, 100 CR 385, 390-391]

(2) [1:242] **Upon early withdrawal by counsel:** Like a discharged attorney (¶ 1:239 ff.), an attorney who *withdraws* prematurely may recover specified hourly rate fees for services rendered to date. But if hourly rate fees were not contracted for, the right to a *quantum meruit* recovery (compensation for "reasonable value" of services rendered) depends on the *reason* for the withdrawal.

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A quantum meruit fee recovery turns on whether counsel had “justifiable cause” for withdrawal. Generally, the withdrawal must be *mandated* by ethical rules (see CRPC 1.16(a)). On the other hand, a permissive withdrawal under ethical rules (see CRPC 1.16(b)) is not necessarily “justifiable cause” warranting quantum meruit fees. [See *Estate of Falco* (1987) 188 CA3d 1004, 1016, 233 CR 807, 814 (five-part test for what attorney must show to warrant fees on allegation ethics compelled their withdrawal); *Rus, Miliband & Smith v. Conkle & Olesten* (2003) 113 CA4th 656, 674-678, 6 CR3d 612, 625-627]

Cross-refer: For more detailed coverage of attorney withdrawal and discharge and terminated counsel's fee recovery rights, see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Chs. 5 & 10.

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Cal. Prac. Guide Real Prop. Trans. Form 1:A

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Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

**Chapter 1. Commencing Representation:
Scope of Attorney's Work
and Fee Arrangements**

Forms

[Form 1:A] Sample Joint Representation Disclosure and Consent Letter

[Letterhead of Counsel]

[Date]
[Clients]
Re: Joint Representation Disclosure and Consent
Dear ___ and ___:

You have asked this firm to represent _____ on the one hand, and _____, on the other hand, respectively, in connection with. Our joint representation of multiple clients may involve or otherwise lead to conflicts of interest between you. Thus, our representation of multiple interests has significant implications that each of you should consider.

Our representation of multiple parties could result in the following circumstances (which are not exhaustive):

- Conflicting client instructions, where following one client's instructions violates another client's instructions;
- Disputes that may arise among the clients;
- Disagreements among clients as to the matter or how any agreement is to be structured or drafted;
- Your interests and objectives on certain issues may become inconsistent with the interests and objectives of one another;
- Advocating certain positions that are advantageous to one client may be disadvantageous to another client; and/or
- One client discloses information to the attorney and demands that it not be disclosed to the other clients.

Further, under California Evidence Code § 962 and California case law, there is no attorney-client privilege between or among joint clients. Thus, the attorney-client privilege does not apply to communications between us and each of you if subsequent litigation arises between you. However, the privilege will remain intact as to other third parties. Also, we caution you that any communications among you outside of our presence or communications with other third parties would be discoverable by third parties.

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Pursuant to the California Rules of Professional Conduct, Rule 1.7 requires us to obtain your informed written consent in order to accept representation of more than one client in a matter in which the interests of the clients potentially conflict. Specifically, Rule 1.7 provides in part:

“(a) A lawyer shall not, without informed written consent from each client and compliance with paragraph (d), represent a client if the representation is directly adverse to another client in the same or a separate matter.

(b) A lawyer shall not, without informed written consent from each affected client and compliance with paragraph (d), represent a client if there is a significant risk the lawyer's representation of the client will be materially limited by the lawyer's responsibilities to or relationships with another client, a former client or a third person, or by the lawyer's own interests.

(c) Even when a significant risk requiring a lawyer to comply with paragraph (b) is not present, a lawyer shall not represent a client without written disclosure of the relationship to the client and compliance with paragraph (d) where:

(1) the lawyer has, or knows that another lawyer in the lawyer's firm has, a legal, business, financial, professional, or personal relationship with or responsibility to a party or witness in the same matter; or

(2) the lawyer knows or reasonably should know that another party's lawyer is a spouse, parent, child or sibling of the lawyer, lives with the lawyer, is a client of the lawyer or another lawyer in the lawyer's firm, or has an intimate personal relationship with the lawyer.

(d) Representation is permitted under this rule only if the lawyer complies with paragraphs (a), (b), and (c), and:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law; and

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal.”

By signing this letter, you acknowledge that (1) we have advised you of Rule 1.7 and of the potential conflicts associated with your respective interests; (2) you have the right to consult with separate legal counsel concerning your potential conflicts and should do so.

We stress that each of you remains completely free to seek other counsel at any time even if you decide to sign the consent set forth below. Should you have any questions concerning this disclosure, or the consent, please discuss them with your own counsel before signing and returning this letter.

Very truly yours,
ACKNOWLEDGED AND AGREED TO:
Dated:

__________ __________

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Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 1. Commencing Representation: Scope of Attorney's Work and Fee Arrangements

Forms

[Form 1:A.1] Sample Fee Letter

(Date)

____

____

____

RE: ________________*(Client matter)*
Dear *(Client)*:

This letter confirms the terms under which you have retained this firm in the above-referenced matter and our fees and costs arrangement.

You have requested this firm to represent you in connection with ___________ *(specify by general description; e.g., "the [sale] [purchase] of Blackacre." Also, consider detailing specific services to be rendered; e.g., negotiating the purchase agreement, reviewing the inspection reports, monitoring escrow, etc.)*. At this time, the scope of our representation will concern only the aforementioned matter and will not relate to general or other legal representation of you, although, should you desire, we would be delighted to represent you in other matters on terms to be separately agreed upon.

[If Client May Expect Services You Will Not Provide, Add:]

As discussed with you, we will not be performing the following in connection with this transaction *(specify)*:

[For example]

1. Procuring financing for you.
2. ___________ *(Continue)*

We have agreed to represent you through the closing of this transaction. Postclosing matters are not covered by this Agreement; any obligation to represent, advise or consult with you on postclosing matters will arise only in the event we separately undertake to do so by mutual agreement with you. Thus, unless a new Agreement is reached with you, this letter shall serve as the only Agreement between us.

Fees to be Paid

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Our fees are based upon guidelines in the California Rules of Professional Conduct, Rule 1.5, which, among other things, focus on the novelty and difficulty of the questions involved and the skill required to perform the legal service properly; time limitations imposed by the client or the circumstances; the time and labor required; the attorney's experience, reputation and ability; the amount involved and results obtained; and the nature and length of the attorney-client professional relationship.

In general, the principal consideration is the time involved, which includes not only time spent directly on the matter, but also in conferences (by phone, in person or otherwise) with you and others. This firm's time is normally billed at rates between $________ and $________ per hour, although the precise rate may vary depending on who in our firm (partner, associate or paralegal) is working on the matter and the factors enumerated above.

It is presently anticipated that I will be doing the majority of the work in this matter. My rate is currently $________ per hour. A schedule of our various hourly rates is attached. However, we reserve the right to change fee rates at any time by giving you 10 days' written notice. Services rendered after the date of a revised rate notice will be billed at the revised rate.

Costs and Expenses to be Paid

You have authorized us to incur on your behalf whatever costs and expenses are reasonably required in connection with the rendition of legal services in this matter. Without limitation, those costs and expenses may include: _____ *(specify; e.g., photocopying at $________ per page, long distance telephone calls, facsimile transmission and messenger charges, travel expenses, fees and mileage to investigators, court filing fees, process server fees, (continue))*.

Billings

[Where Retainer Required]

We acknowledge receipt of your check in the sum of $________, which will be deposited in our Client Trust Account, subject to future billings. At the end of each month, we will send you an itemized statement of our time, costs and expenses for services rendered on your behalf and will deduct that amount from the balance credited to you in the Client Trust Account. Any unexpended balance credited to you in the Client Trust Account shall be returned to you upon termination of our services under this Agreement.

[If Minimum Retainer Balance Required, Continue:]

We also require that you maintain a minimum of $________ in the Client Trust Account at all times as against our final billing. Our monthly statements will indicate a balance due as necessary to bring your Client Trust Account deposit up to that minimum amount. Balance due amounts shall be paid within _ days of your receipt of the monthly statement. If at any time you ask us to discontinue legal services on this matter, we will of course do so and provide you with a final billing within 30 days, returning to you any funds credited to you in the Client Trust Account that are not necessary to pay our fees and costs then owing.

[If No Retainer Required, Substitute:]

At the end of each month, we will send you an itemized statement of attorney fees, costs and expenses for services rendered on your behalf through the 25th day of the month. Balances shown are due upon your receipt of each month's statement. In the event any monthly statement balance remains unpaid for more than 30 days after receipt of the statement, interest thereon at the rate

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of _ percent (____%) shall be due and payable from the date of the statement until the date of ultimate payment. We also reserve the right to discontinue rendering legal services for you on any matter for which a bill is in arrears, but we trust this will not be necessary. By your signature on this Agreement, you grant us a security interest in all claims, suits, causes of action, remedies, judgments and settlements in which we represent you, now or in the future, to secure payment of all unpaid fees and costs.

[If Mandatory Arbitration is Desired] Arbitration of Disputes

Any dispute between the parties as to attorney fees and/or costs charged shall be arbitrated pursuant to the provisions of California Business & Professions Code § 6200 et seq.

Any other dispute arising under this Agreement or in connection with the provision of legal services by this firm, including, without limitation, any claim for breach of contract, professional negligence or breach of fiduciary duty, shall be resolved by binding arbitration in accordance with the rules of ___ *(e.g., American Arbitration Association or JAMS, or* CCP § 1280 et seq.*)*.

We have explained to you that, by agreeing to arbitration, (i) the parties are waiving their right to a jury trial and to seek remedies available in court proceedings; (ii) prearbitration discovery is generally more limited than and different from court proceedings; (iii) the arbitrator's award is not required to include factual findings or legal reasoning; and (iv) any party's right to appeal or to seek modification of the arbitration award is strictly limited, and the award is final and binding on the parties.

You acknowledge that we have explained to you that such binding arbitration may deprive you of various rights that you otherwise might have in a legal action, including, without limitation, the right to a jury trial, the right to appeal, and full discovery rights. Your initials below signify your acknowledgment and understanding of this explanation.

___________ *(Client initials)*

*[If Desired]*Fees and Costs Recovery in Action Arising Under Agreement; Place of Forum

In any dispute arising under this Agreement, whether concerning its validity or enforcement, the collection of amounts due thereunder, or otherwise, the prevailing party shall be entitled to recover reasonable attorney fees and costs incurred in the course of prosecuting or defending the claim. If our firm represents itself in such action without counsel and is the prevailing party, you agree to compensate our firm for all time reasonably expended in prosecuting or defending the claim.

All disputes arising under this Agreement shall be resolved in a forum located within ___ County.

Electronic Mail

This firm frequently uses electronic mail ("email") to communicate with our clients, counsel and third parties. The use of email generally permits faster transmission of information and documents and aids in reducing certain facsimile and mail costs. Thus, we assume that our use of email to communicate with you, counsel and various third parties is acceptable. **If email communication is not acceptable, please notify us in writing within 10 days and we will discuss other methods of communication that are acceptable.**

Client Files, Etc.

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After our services conclude, upon your request, we will deliver your files to ___ *[you] [name of company]*, along with any funds or property belonging to ___ *[you] [name of company]* that are in our possession. Please note that this firm automatically destroys client files five years after the conclusion of our representation for the matter that is the subject of the file.

*[If Applicable]*Professional Liability Insurance

Pursuant to Rule 1.4.2 of the California Rules of Professional Conduct, this firm informs you that it does not carry professional liability insurance.

Counterpart Execution; Facsimile and Electronic Signatures

This Agreement may be executed in one or more counterparts, each of which will be deemed an original, and all of which will constitute one and the same instrument. In order to expedite the transaction contemplated herein, facsimile and electronic signatures may be used in place of original signatures on this Agreement or any document delivered pursuant hereto. All parties to this Agreement intend to be bound by the signatures on the faxed or emailed document, are aware that the other party or parties will rely on the faxed or emailed signatures, and hereby waive any defenses to the enforcement of the terms of this Agreement based on the form of signature.

We welcome discussion with you concerning our legal services in this matter and any charges therefor. We believe it is essential to a good relationship that there be open communication on all matters and full disclosure of all pertinent facts. We will keep you regularly apprised of all significant developments in this matter and ask that you promptly let us know of all events and occurrences affecting the contemplated transaction and our representation of you in this matter.

We will use or best efforts to bring about an expeditious completion of this transaction but we have advised you, and you acknowledge, that there are many unpredictable variables that could affect the timing and costs associated with consummation of the transaction. For that reason, we make no representations regarding applicable timeframes and expense.

Please acknowledge your agreement by signing the enclosed copy of this letter where indicated below *[or, if via fax, strike out reference to "the enclosed copy of"]* and return it to us. Unless we make a different Agreement in writing, this Agreement will control all services we perform for ___ *[you] [name of company]*.

We look forward to representing you in this matter. Should you have any questions, please do not hesitate to call.

Very sincerely yours,
/s/ (Attorney)
for *(Law Firm)*
Encl.
AGREED AND ACCEPTED
BY: _________________ *(Client)*
DATED: _________________

RATE SCHEDULE

A. Hourly Rates for Legal Personnel

1. Partners	$350 - $600/hour
2. Associates	$200 - $300/hour

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3. Paralegals $ 95 - $175/hour

B. Standard Charges

We charge for our time in minimum units of 1/4 hour.

C. Costs and Expenses

1. In-Office Reproduction - $.20/page

2. Mileage - $.32/mile

3. Clerical Staff Overtime - $35/hour

4. Telecopying - $2/outgoing page; $1/incoming page

5. Computer-Accessed Research - cost plus percentage

D. Subject to Change

The rates shown on this schedule are subject to change on 10 days' written notice. If you decline to pay the increased rates, we have the right to withdraw as your attorneys after reasonable notice to you.

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Cal. Prac. Guide Real Prop. Trans. Form 1:B

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Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 1. Commencing Representation: Scope of Attorney's Work and Fee Arrangements

Forms

[Form 1:B] Seller's Disbursement Instruction to Escrow for Payment of Counsel Fees

TO: .... _ Escrow
....
,..California ....
Attention: ___________ *[Escrow Officer]*

Seller hereby authorizes and instructs Escrow Holder to pay the law firm of ___________ the sum of ___________ Dollars ($________) from Seller's proceeds from Escrow No. ___ upon the close of escrow. This instruction shall be deemed unconditional and irrevocable, and no further notice need be given by or to Escrow Holder.

DATED: ___________

SELLER		
By:	/s/	

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Cal. Prac. Guide Real Prop. Trans. Form 1:C

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

**Chapter 1. Commencing Representation:
Scope of Attorney's Work
and Fee Arrangements**

Forms

[Form 1:C] Notice of Client's Right to Arbitration

Image 1 within document in PDF format.

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Cal. Prac. Guide Real Prop. Trans. Form 1:D

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 1. Commencing Representation: Scope of Attorney's Work and Fee Arrangements

Forms

[Form 1:D] Client Waiver of Conflict of Interest

[***Ed. Note:*** *This sample form may be used as a model to document a client's "informed consent" when no actual conflict of interests between clients has arisen but the potential for a conflict exists.*]

(Date)
Client 1's Name and Address

____

____

____

Client 2's Name and Address

____

____

____

Re: Consent of *Client 1* and *Client 2* to Representation of *Client 1*
Dear ___________*(Client 1)* and ___________*(Client 2)*:

Client 1 has requested that this firm represent it in connection with ___________ *[specify by general description; e.g., "the [sale][purchase] of Blackacre"]* (the "Transaction") between *Client 1* and *Client 2.* As you know, this firm has represented (and desires to continue to represent) *Client 1* and *Client 2* in a variety of matters unrelated to the Transaction. The purpose of this letter is to obtain the specific consent of *Client 1* and *Client 2* to the following:

1. This firm's representation of *Client 1* in connection with the Transaction, both now and in the future.

2. This firm's continued representation of *Client 1* and *Client 2* in matters unrelated to the Transaction, both now and in the future.

3. This firm's representation of *Client 1* in any dispute (whether in litigation or any other proceeding) that may arise in the future between *Client 1* and *Client 2*, or between *Client 1* and any other party, relating to the Transaction.

> [***Ed. Note:*** It may not be possible for Client 2 to waive a conflict of interest that might arise in the future from a dispute between Client 1 and Client 2 in connection with the Transaction when, e.g., after signing the Consent, counsel's representation of Client 2 in matters unrelated to the Transaction provides a new basis for Client 2 to object to counsel's representation of Client 1 in the dispute between Client 1 and Client 2.]

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Please carefully consider the contents of this letter. If you consent to this firm's representation as stated herein, indicate your approval by signing and dating this letter where indicated below, and return it to this firm in the enclosed preaddressed envelope (a duplicate copy is also enclosed for your records). Note that we are *not* giving you legal advice with respect to this letter, as we would have a conflict of interest in doing so. Therefore, you each are urged to seek the advice of *independent counsel* regarding your execution of this letter; you should not sign this letter unless and until you have carefully considered the issues discussed herein.

Should you or other legal counsel have any questions regarding this letter or need additional information, we invite you or such counsel to call us.

Sincerely,
/s/
[Attorney]
for
[Law Firm]
Encls.

CONSENT

The undersigned have read the foregoing letter and hereby expressly and specifically consent to the terms thereof, including the firm's (i) representation of *Client 1* in connection with the Transaction; (ii) continuing representation of *Client 1* and *Client 2* in matters unrelated to the Transaction; and (iii) representation of *Client 1* in any dispute that may arise between *Client 1* and *Client 2* (or between *Client 1* and any other party) with respect to the Transaction.

AGREED AND ACCEPTED:	**AGREED AND ACCEPTED:**
Client 1	*Client 2*
By: ___________	By: ___________
Dated: ___________	Dated: ___________

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Cal. Prac. Guide Real Prop. Trans. Ch. 2-A

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 2. Real Estate Brokers and Listing Agreements

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1. [2:1] **Basic Functions of Real Estate Brokers:** Many (if not most) buyers and sellers approach the use of real estate brokers with trepidation, typically out of a misconceived notion about the utility of brokerage services in purchase and sale transactions; few buyers and sellers know how to effectively maximize the use of a broker.

Sellers tend to view their broker's function as simply procuring a buyer; and buyers tend to view their broker's role as limited to finding a property. However, as indicated at ¶ 2:3 ff., experienced brokers can perform many other valuable functions.

➪ [2:2] ***PRACTICE POINTER:*** Despite the vast range of potential brokerage services (¶ 2:3 ff.), very few brokers have strengths in each of these areas. Depending on the nature of the transaction, the type of property involved, and the particular broker's expertise, it may be necessary for counsel to step in at certain points to perform or reassign particular broker functions.

Relying on a broker to perform services in any step of a purchase and sale transaction will save the client money (to the extent *counsel* undertakes such services, it is likely to be reflected in increased *attorney fees and costs*). Even so, buyers and sellers should *never* rely on brokers to do anything for which they *lack* essential *knowledge, training and expertise;* indeed, counsel who suggest a client look to a broker to perform services which the broker is not adept at handling could be inviting a *malpractice* claim.

a. [2:3] **Seller's broker:** Depending upon individual training and expertise, a seller's broker can perform a broad range of services:

• Ascertain the best time for putting the property up for sale.

• Conduct market studies (reviewing “comparable sales” in the locale, etc.) to determine an appropriate fair market value for the property.

• Determine an appropriate “asking” (or “listing”) price, from which the actual desired selling price can realistically be negotiated.

• Prepare a marketing strategy—i.e., where the property will be advertised for sale, how often it will be advertised, whether there will be “open houses” (typically, only for residential property), and precisely how and when the property will be shown to prospective buyers.

• Determine the seller's long-range goals (e.g., whether the sale needs to be structured with tax considerations in mind or to conform to the timing of the purchase of another piece of property, etc.).

• Catalog what is to be included in the purchase price (e.g., whether certain development permits or other entitlements should be transferred and, if so, at what value; whether certain built-in amenities or appliances are to be included, etc.).

• Advise and assist the seller in making necessary disclosures to the buyer.

• Assist in determining what work may need to be completed to put the property in compliance with law (or, alternatively, advise on the disclosure of such noncompliance to the buyer).

• Determine if the seller needs additional professional guidance—e.g., from accountants, attorneys, contractors, movers, etc.

• Prepare counteroffers, conduct negotiations on the seller's behalf and assist in getting a purchase contract signed.

• Identify and help resolve problems relating to the condition of title to the property.

• Assist in opening the escrow, procuring a title report, monitoring progress of the escrow, and completing the closing (e.g., making certain the escrow holder timely receives essential documents; verifying the buyer is in a position to close; and reviewing the escrow holder's closing statement).

• Coordinate and work with others involved in the transaction—including attorneys, accountants, escrow officers, title officers, etc.

• Prepare or procure various operating, financial and other information concerning the property which the buyer may need (e.g., a rent roll, operating statements, geological reports, surveys, plans and specifications, etc.).

b. [2:4] **Buyer's broker:** The range of potential services by a buyer's broker (again, depending on individual experience and expertise) is equally broad in scope:

• Assist in defining the buyer's needs—e.g., kind of property, price range and location.

• Select and show the buyer suitable property on the market.

• Advise the buyer regarding financing and assist in applying for same.

• In a commercial property matter, review financial and operating information about prospective properties.

• Assist in reviewing reports concerning the physical condition of the property (geological and building inspection reports, etc.).

• Direct the buyer to, and coordinate with, various experts … including, as appropriate, attorneys, appraisers, accountants, loan brokers, architects, space planners, contractors, etc.

• Prepare offers and counteroffers on the buyer's behalf and, ultimately, arrange for execution of the purchase contract.

• Assist in resolving title problems.

• Help determine a property's compliance with law (zoning ordinances, building codes, environmental regulations, etc.).

• Assist in the opening, monitoring and closing of escrow, including procuring and delivering necessary documents to the escrow holder and/or seller.

c. [2:5] **Limitation—nonattorney brokers cannot practice law:** As a general rule, only *active licensees of the California State Bar* are authorized to practice law in California. [Bus. & Prof.C. §§ 6125, 6126; see also CRPC 5.5(a)(2) (formerly

CRPC 1-300)—lawyer admitted to practice in CA shall not "knowingly assist a person in the unauthorized practice of law in that jurisdiction"]

Although there are narrow exceptions under which *out-of-state licensed attorneys* may practice law in California to a limited extent, none of these exceptions authorize the "practice of law" by a nonattorney real estate broker. [See, e.g., CRC 9.40 (counsel pro hac vice), 9.45 (registered legal aid attorneys), 9.46 (registered in-house counsel), 9.47 (attorneys practicing law temporarily in California as part of litigation) & 9.48 (nonlitigating attorneys temporarily in California to provide legal services)] Thus, unless they are also duly-licensed by the California State Bar (or fall within a limited exception for certain out-of-state licensed attorneys), real estate brokers *cannot perform functions amounting to the "practice of law" in this state.*

Moreover, the *unauthorized* practice of law in California is a misdemeanor, punishable by fine and/or imprisonment. [Bus. & Prof.C. § 6126; see also CCP § 1029.8—treble damages liability for injury or damages suffered from unlicensed practice of law] And *no compensation* may be recovered for legal services amounting to the unauthorized practice of law in California. [See *Birbrower, Montalbano, Condon & Frank, P.C. v. Sup.Ct. (ESQ Business Services, Inc.)* (1998) 17 C4th 119, 127, 136, 70 CR2d 304, 308, 313-314; *and further discussion at ¶ 1:65 ff.*]

(1) [2:6] **Activities constituting "practice of law"—giving legal advice re legal documents:** The "practice of law" is not statutorily defined. But case law explains that it clearly includes the *giving of legal advice* in the preparation of legal instruments or contracts, as well as the *drafting* of legal instruments and contracts (whether or not in the course of litigation). [*Birbrower, Montalbano, Condon & Frank, P.C. v. Sup.Ct. (ESQ Business Services, Inc.)* (1998) 17 C4th 119, 127, 128, 70 CR2d 304, 308; see *Baron v. City of Los Angeles* (1970) 2 C3d 535, 542, 86 CR 673, 677; *Estate of Condon* (1998) 65 CA4th 1138, 1142-1143, 76 CR2d 922, 925]

Deciding when a nonattorney broker crosses the line into this "off limits" territory is not clear-cut. But in "close cases," courts have held that the "resolution of legal questions for another by advice and action is practicing law if difficult or doubtful legal questions are involved which, to safeguard the public, reasonably demand the application of a trained legal mind." [*Baron v. City of Los Angeles*, supra, 2 C3d at 543, 86 CR at 678 (internal quotes omitted)]

(a) [2:7] **Preparing offers/counteroffers:** Brokers customarily prepare offers and counteroffers for their clients … which, if accepted, constitute a legally binding purchase and sale contract (*¶ 4:264 ff.*). Nonetheless, pursuant to general case law guidelines, this activity does *not* amount to the "unauthorized practice of law" *so long as* the broker is performing a *strictly clerical* role of filling in *nondiscretionary* information on the form as directed by the client (buyer or seller). [See *People v. Landlords Professional Services* (1989) 215 CA3d 1599, 1605, 264 CR 548, 551; *People v. Sipper* (1943) 61 CA2d Supp. 844, 846-847, 142 P2d 960, 962 (disapproved on other grounds by *Murgia v. Mun.Ct. (People)* (1975) 15 C3d 286, 301, 124 CR 204, 214, fn. 11)]

On the other hand, any work on a buyer's or seller's behalf involving *legal judgment* must be performed by a *licensed attorney* (or at least under the attorney's supervision and direction). [*People v. Sipper*, supra, 61 CA2d Supp. at 846-847, 142 P2d at 962—broker engaged in "unauthorized practice of law" by determining for parties kind of legal document they should execute to secure loan]

(2) [2:8] **Comment:** As a practical matter, under the foregoing standards, almost every broker probably engages in the "unauthorized practice of law" to a certain extent. This is because brokers routinely assist their clients in everything from choosing the form of the purchase and sale agreement to selecting which provisions to leave in and which ones to delete or modify; typically, they also offer suggestions on the pros and cons of particular provisions (e.g., a liquidated damages clause). Nonetheless, no known reported authority has held these traditional broker functions "off limits" (but see *People v. Sipper* (1943) 61 CA2d Supp. 844, 846-847, 142 P2d 960, 962 (disapproved on other grounds by *Murgia v. Mun.Ct. (People)* (1975) 15 C3d 286, 301, 124 CR 204, 214, fn. 11, re broker advice concerning loan documents).

Cross-refer: For a more detailed discussion of the "unauthorized practice of law," see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 1.

[2:9] ***Reserved.***

d. Considerations re using broker

(1) [2:10] **Buyer's perspective:** Generally, it makes little sense for buyers not to use the services of a broker.

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(a) [2:11] **Cost-savings concerns:** From the buyer's perspective, cost concerns are usually irrelevant:

• Buyers rarely *directly* pay a real estate broker's commission (*but see ¶ 2:327 ff.*).

• Moreover, although the impact of a broker's commission will usually be reflected in a higher purchase price, the seller typically has already committed to pay a full commission to its broker … which will ultimately be shared with any buyer's broker. Thus, a buyer who foregoes the use of a broker will not thereby reduce the seller's brokerage commission costs nor, in turn, reduce the purchase price; rather, when there is no buyer's broker, the seller's broker simply takes the entire commission.

It follows that the only conceivable situation in which it might be cost effective to forego a buyer's broker is where the *seller* is proceeding without a broker (*see ¶ 2:13*), thereby eliminating commission costs from the transaction and (theoretically, at least) leaving greater room to negotiate a lower purchase price.

(b) [2:12] **Market familiarity; negotiating skills concerns:** Though not affecting the buyer's pocketbook, other concerns will militate in favor of buyers utilizing a real estate broker.

Notably, it can take *time* to find suitable property meeting the buyer's specifications and budget; particularly in large metropolitan areas, buyers may need a broker simply to get them pointed in the right direction (narrowing the prospective properties for consideration). Likewise, even after a suitable property (or properties) is identified, it takes *time, effort and skill* to negotiate a deal (preparing a suitable offer/counteroffer); brokers—who, by profession, are experts at doing this work—can perform an invaluable service for buyers.

(2) Seller's perspective

(a) [2:13] **Cost-savings concerns:** In theory, sellers who are schooled and experienced in matters performed by brokers (*¶ 2:3 ff.*) could forego the use of a broker and save themselves commission costs. But the cost-savings expediency of such a decision necessarily depends on whether a buyer's broker will be involved in the transaction: Brokers representing buyers are not likely to pursue a property on behalf of their clients without compensation.

(b) [2:14] **Marketing and negotiating concerns:** Notwithstanding the seller's expertise in property brokerage matters, a broker listing may be prudent from a pure *marketing* standpoint: Properties listed for sale through a broker get maximum exposure when they appear in a multiple listing service (which is received by all brokers in the community; *see ¶ 2:371 ff.*). Sellers who forego a broker rarely get this kind of marketing exposure.

Also, like buyers, sellers will often benefit from the well-honed negotiating skills of a seasoned broker.

e. [2:15] **Choosing a broker:** Counsel are frequently asked to recommend a broker or advise the client in selecting one.

(1) [2:16] **Relevant considerations:** Two fundamental qualities in a broker are essential:

• Knowledge of, and experience with, the *kind of property* to be bought or sold; and

• Knowledge of the relevant *geographical area*.

Secondarily, because brokers may be called upon to provide so many other services (*¶ 2:3 ff.*), it is also important to consider such things as the broker's:

• Negotiating skills;

• Competence in preparing offers and counteroffers;

• Experience in dealing with financing issues;

• Knowledge of construction; and

• Ability to understand and familiarity in dealing with such matters as a survey, appraisal, title report, geological study, architectural plans and specifications, etc.

(2) [2:17] **Referral sources:** Unlike many bar associations and other professional organizations that offer "referral services" to the public, very few broker organizations provide such a service. Therefore, locating a reputable broker is

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usually accomplished by making inquiries of colleagues and friends whose judgments are trusted. As stated, the key concern in finding a competent broker is to ascertain whether the broker has experience with *similar property* in the *same geographic locale*.

➪ [2:17.1] ***PRACTICE POINTER:*** In handling transactions for other clients, counsel may have had dealings with several brokers, and may have formed opinions (pro and con) on the brokers' competence. Nonetheless, counsel should be *cautious* in recommending brokers to clients:

Significantly, if the broker you recommend does a poor job, your client's view of your judgment will be diminished. Further, a client who concludes you recommended an "incompetent" broker might contend you have committed malpractice. Also, there may be potential ethical problems if the broker you recommend is a source of business for you (at a minimum, you would have to disclose that relationship to the client; *see ¶ 1:70 ff.*).

(3) [2:18] **Selective assignment of broker tasks:** Again, not all brokers have the knowledge and experience needed to competently perform the full range of potential brokerage services. Therefore, early in the transaction, counsel may need to assist in identifying which services the broker is competent (and legally permitted) to perform as opposed to those services the broker cannot (or should not) perform. As noted in greater detail in *Ch. 4*, counsel should be prepared in such cases to help allocate specific tasks among the brokers and various other parties involved in the transaction.

[2:19] ***Reserved.***

2. [2:20] **Definitions:** Real estate brokerage activities are highly regulated in California and subject to strict licensing requirements. Although there are certain specialty licenses, it is important to first understand the fundamental difference between a real estate "broker," a "salesperson" and a "finder."

[*Ed. Note:* In practice, the term "broker" is customarily used to refer not only to true real estate "brokers," but also to real estate sales *agents* (i.e., the "*salesperson*"). For convenience, this Practice Guide uses the term "broker" in the same "loose" sense: Except where specifically noted otherwise, reference to "broker" in this text generally means the licensed real estate broker *or* the particular sales agent involved in the transaction.]

a. [2:21] **"Real estate broker":** A "real estate broker" within the meaning of the state "broker" licensing laws is "a person who, for a compensation or in expectation of a compensation, regardless of the form or time of payment, *does or negotiates to do* one or more [certain statutorily specified] acts for *another or others* …" [Bus. & Prof.C. § 10131 (emphasis added); *Horning v. Shilberg* (2005) 130 CA4th 197, 203, 29 CR3d 717, 723; *see* ¶ 2:22 ff. re statutorily specified acts]

In the hierarchy of various real estate brokerage licenses, a "broker's" license is the highest and most encompassing.

(1) [2:21.1] **Acting on behalf of another:** By definition (¶ 2:21), a person acts as a "broker" only if they are acting *both* (a) for compensation *and* (b) on *behalf of someone else*. Someone acting on their *own* behalf (i.e., as buyer or seller) in a real estate transaction is *not* a broker within the meaning of Bus. & Prof.C. § 10131 even though they are performing activities regulated by the broker licensing statutes. [*Horning v. Shilberg* (2005) 130 CA4th 197, 203, 29 CR3d 717, 723]

(2) [2:22] **General activities requiring "broker" license:** The general statutory definition of a "broker" (¶ 2:21) contemplates one who does, or negotiates to do (again, for compensation and on behalf of another), any of the following:

(a) [2:23] **Purchase and sale transactions:** "Sells or offers to sell, buys or offers to buy, solicits prospective sellers or buyers of, solicits or obtains listings of, or negotiates the purchase, sale, or exchange of real property or a business opportunity." [Bus. & Prof.C. § 10131(a); see also *Salazar v. Interland, Inc.* (2007) 152 CA4th 1031, 1036, 62 CR3d 24, 27]

(b) [2:24] **Rental transactions:** "Leases or rents or offers to lease or rent, or places for rent, or solicits listings of places for rent, or solicits for prospective tenants, or negotiates the sale, purchase, or exchanges of leases on real property, or on a business opportunity, or collects rents from real property, or improvements thereon, or from business opportunities." [Bus. & Prof.C. § 10131(b); see also *MKB Mgmt., Inc. v. Melikian* (2010) 184 CA4th 796, 802, 108

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CR3d 899, 904—property management company needed broker's license to lease apartments and collect rents, but not for causing repairs to be made, decorating and general maintenance]

(c) [2:25] **Government land purchase/lease transactions:** "Assists or offers to assist in filing an application for the purchase or lease of, or in locating or entering upon, lands owned by the state or federal government." [Bus. & Prof.C. § 10131(c)]

(d) [2:26] **Financing-related activities:** "Solicits borrowers or lenders for or negotiates loans or collects payments or performs services for borrowers or lenders or note owners in connection with loans secured directly or collaterally by liens on real property or on a business opportunity." [Bus. & Prof.C. § 10131(d); see *Smith v. Home Loan Funding, Inc.* (2011) 192 CA4th 1331, 1335, 121 CR3d 857, 860 (broker acting as borrower's agent); *Onofrio v. Rice* (1997) 55 CA4th 413, 420, 64 CR2d 74, 77 (citing text)]

(Individuals who *make* certain specified loans from their "own funds" also are considered real estate brokers; *see ¶ 2:30 ff.*)

(e) [2:27] **Real property sales contracts/secured notes:** "Sells or offers to sell, buys or offers to buy, or exchanges or offers to exchange a real property sales contract, or a promissory note secured directly or collaterally by a lien on real property or on a business opportunity, and performs services for the holders thereof." [Bus. & Prof.C. § 10131(e)]

[2:28] *Cross-refer—exemptions:* Certain persons, though performing the activities described at ¶ 2:22 ff., are exempt from the broker license requirement. *See ¶ 2:86 ff.*

(3) [2:29] **Additional "broker" activities:** "Real estate brokers" under the California licensing law also include:

(a) [2:30] **Loans and publicly-traded real property sales contracts/secured notes:** Any "person who engages as a principal *in the business* of making loans or buying from, selling to, or exchanging with the public, real property sales contracts or promissory notes secured directly or collaterally by liens on real property, or who makes agreements with the public for the collection of payments or for the performance of services in connection with real property sales contracts or [such] promissory notes …" [See Bus. & Prof.C. § 10131.1(a) (emphasis added)]

1) [2:30.1] **"In the business":** A person who acquires for resale or sells to, or exchanges with, the public eight or more real property sales contracts or secured promissory notes is considered "in the business"—i.e., a real estate broker. [Bus. & Prof.C. § 10131.1(b)(1)(A), (B)]

Likewise, individuals who use their "own funds" in one calendar year to make eight or more secured residential loans to the public (i.e., loans on single condo/cooperative dwelling units or parcels containing only residential buildings of four units or less) are considered "in the business" and therefore real estate brokers. [See Bus. & Prof.C. § 10131.1(b)(1)(C) & (b)(3)—"own funds" means cash, corporate capital or warehouse credit lines at commercial banks, S&Ls, etc., that are liability items, secured or otherwise, on individual's or their affiliate's financial statements]

2) [2:30.2] **Residential mortgage loans:** Brokers (and their salespeople) who are in the business of making, buying, etc., loans and publicly-traded real property sales contracts or secured promissory notes (*¶ 2:30*), *and* who make, arrange or service residential mortgage loans, are deemed "mortgage loan originators" and subject to specified statutory requirements. [See Bus. & Prof.C. §§ 10166.01(b)(1) & 10166.02(a) (*discussed further at ¶ 2:109.5 ff.*)]

(b) [2:31] **Advance fees:** Any "person who engages in the business of claiming, demanding, charging, receiving, collecting or contracting for the collection of an advance fee in connection with any employment undertaken to promote the sale or lease of real property or of a business opportunity by advance fee listing, advertisement or other offering to sell, lease, exchange or rent property or a business opportunity, or to obtain a loan or loans thereon." [Bus. & Prof.C. § 10131.2]

1) [2:31.1] **"Advance fee" defined:** An "advance fee" within the meaning of the real estate licensing law is a fee, regardless of form, that is claimed, demanded, charged, received or collected by a licensee for services requiring a license, or for a listing, as defined, before the licensee fully completes the services they contracted to perform or represented would be performed. [Bus. & Prof.C. § 10026(a)]

An "advance fee" does *not* include (i) "security" regulated by Civ.C. § 1950.5 (advance payment, deposit, etc. given by a tenant for a residential rental agreement); (ii) an applicant "screening fee" regulated by Civ.C. § 1950.6 (fee charged prospective residential tenants to investigate references and creditworthiness); (iii) a fee that is claimed, demanded, charged, received or collected for the purpose of advertising the sale, lease or exchange of real estate

or a business opportunity in a newspaper, written publication or other electronic media, as specified; (iv) money earned for real estate services under a "limited service" contract, as defined, for stand-alone task-by-task services; and (v) the commission to be paid to a real estate broker by its principal after the underlying contract is fully performed (i.e., the broker-principal compensation contract does *not* represent an advance fee agreement). [See Bus. & Prof.C. § 10026(b), (c)]

(c) [2:32] **Real property securities transactions:** Any "person who, for another or others, for compensation or in expectation of compensation, issues or sells, solicits prospective sellers or purchasers of, solicits or obtains listings of, or negotiates the purchase, sale, or exchange of securities as specified in Section 25206 of the Corporations Code." [Bus. & Prof.C. § 10131.3—exception for broker-dealers or agents of broker-dealers licensed by Commissioner of Financial Protection and Innovation under 1968 Corporate Securities Law]

The securities transactions contemplated are those "in any interest in any general or limited partnership, joint venture, unincorporated association, or similar organization (but not a corporation) owned beneficially by no more than 100 persons and formed for the sole purpose of, and engaged solely in, *investment in or gain from an interest in real property*, including, but not limited to, a sale, exchange, trade, or development." [See Corps.C. § 25206 (emphasis added)]

(d) [2:33] **Mineral, oil and gas transactions:** Persons engaging in a range of activities or transactions involving mineral, oil or gas property are also "real estate brokers" within the meaning of the licensing law. [See Bus. & Prof.C. §§ 10131.4 & 10131.45; see also Bus. & Prof.C. §§ 10500 & 10500.5 (*either* mineral, oil and gas broker license *or* real estate broker license suffices)]

(4) [2:34] **Mobilehome/manufactured home sales:** A person licensed as a real estate broker "may sell or offer to sell, buy or offer to buy, solicit prospective purchasers of, solicit or obtain listings of, or negotiate the purchase, sale, or exchange of any manufactured home or mobilehome," provided the manufactured home or mobilehome is registered under Health & Saf.C. § 18000 et seq. [See Bus. & Prof.C. § 10131.6]

[2:34.1 - 2:34.4] ***Reserved.***

(5) [2:34.5] **Prepaid rental listing services:** Licensed real estate brokers may also conduct a "prepaid rental listing service" (supplying prospective tenants, in exchange for a fee, with listings of available residential rentals; see Bus. & Prof.C. § 10167(a)) under their broker's license. [Bus. & Prof.C. § 10167 et seq.]

However, prepaid rental listing services may be provided at a real estate brokerage office only if business is conducted under the immediate supervision of the broker or of a real estate salesperson (¶ 2:35 ff.) licensed to, and acting on behalf of, the broker. [Bus. & Prof.C. § 10167.3(b)]

b. [2:35] **"Real estate salesperson":** As distinguished from a "broker" (¶ 2:21), a "real estate salesperson" is statutorily defined as "a natural person licensed as a salesperson … who, for a compensation or in expectation of a compensation, is *retained by a real estate broker* to do one or more of the acts set forth in Sections 10131, 10131.1, 10131.2, 10131.3, 10131.4, and 10131.6" (i.e., acts for which a real estate *broker's license* is required, discussed at ¶ 2:22 ff.). [Bus. & Prof.C. § 10016; see also Bus. & Prof.C. § 10018.01—"'Retained' means the relationship between a broker and a licensee who is either an independent contractor affiliated with, or an employee of, a broker to perform activities that require a license and are performed under a broker's supervision"]

Indeed, there must be a written agreement between the broker and salesperson that covers the "material aspects of the relationship." [10 CCR § 2726]

Thus, the critical distinction is that a salesperson operates *under* the authority of a licensed broker; while a salesperson does not hold a "broker's" license, they cannot operate *independently* of a broker's license (¶ *2:47*). In other words, for purposes of administration of the Real Estate Law, a salesperson—whether an independent contractor or employee—is the *employee and agent* of a real estate broker. [See *Grubb & Ellis Co. v. Spengler* (1983) 143 CA3d 890, 895, 192 CR 637, 640 (decided under former law); *Venturi & Co. LLC v. Pacific Malibu Develop. Corp.* (2009) 172 CA4th 1417, 1424, 92 CR3d 123, 129—broker under whose authority salesperson may act must itself be party to real estate contract]

[2:36] ***Reserved.***

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c. [2:37] **"Finders":** A "finder" (sometimes called a "middleman" or "intermediary") is a judicially-created term. Those who act strictly in the capacity of a finder (¶ 2:38 ff.) need not hold a broker's or salesperson's license. [*Tyrone v. Kelley* (1973) 9 C3d 1, 8, 106 CR 761, 765—so-called "finder's exception" to real estate licensing laws; *GreenLake Capital, LLC v. Bingo Investments, LLC* (2010) 185 CA4th 731, 736, 111 CR3d 82, 85]

(1) [2:38] **"Introduces" parties; no role in negotiations:** The fundamental distinction from a "broker" or "salesperson" is that a "finder" simply "introduces" the parties but does *not* negotiate terms or engage in any other transactional activity. A finder's employment "is limited to bringing the parties together so that they may negotiate their own contract, and the distinction between the finder and the broker frequently turns upon whether the intermediary has been invested with authority or duties beyond merely bringing the parties together, usually the authority to participate in negotiations." [*Tyrone v. Kelley* (1973) 9 C3d 1, 9, 106 CR 761, 766; *Lindenstadt v. Staff Builders, Inc.* (1997) 55 CA4th 882, 893, 64 CR2d 484, 490-491; *Rees v. Department of Real Estate* (1977) 76 CA3d 286, 295, 142 CR 789, 794-795]

"If the broker takes any part in the negotiations, no matter how slight, he is not a middleman [finder] but a broker." [*Rees v. Department of Real Estate* (1977) 76 CA3d 286, 295, 142 CR 789, 795; see *Preach v. Monter Rainbow* (1993) 12 CA4th 1441, 1452, 16 CR2d 320, 326—alleged "finder" continued to communicate with and advise parties in negotiations after introducing them, thus functioning as "broker"]

(a) [2:38.1] **"Two-hat" finders in series of acquisitions:** Whether an unlicensed person has acted as a mere finder or crossed the line into brokerage activities in a *series* of purchase and sale transactions on behalf of a particular party is not an "all or nothing" proposition. The finder's exception to the real estate licensing law applies on a *transaction-by-transaction basis*. [*Lindenstadt v. Staff Builders, Inc.* (1997) 55 CA4th 882, 894, 64 CR2d 484, 491; *see* ¶ *2:280.6*]

(2) [2:39] **No agency relationship or fiduciary duties:** A secondary distinction is that a finder, unlike a broker/salesperson, has no agency relationship with, or fiduciary duty toward, any party to the transaction. (Real estate brokers and salespersons stand in a clear fiduciary relationship with their principals. *See* ¶ *2:123, 2:155 ff.*)

(3) [2:40] **Compare—statute of frauds applies:** Although purely "finder" activities are exempt from the licensing laws, an agreement *employing* a *licensed broker* to act as finder, like an agreement employing a licensee to perform brokerage services, is subject to the statute of frauds (Civ.C. § 1624(a)(4)). *See* ¶ *2:303*.

[2:41 - 2:45] ***Reserved.***

3. Relationship Between Brokers and Salespersons

a. [2:46] **Two major distinctions:** In practice, the day-to-day activities of real estate brokers and salespersons (at least vis-à-vis the client) are virtually identical. Nonetheless, the two licenses are substantially different. Aside from the distinct licensing requirements (¶ *2:70 ff.*), the chief differences are two-fold:

(1) [2:47] **Salesperson operates under responsible broker's retention:** A salesperson cannot engage in any activities requiring a real estate license unless licensed under the "responsible broker" who retained or is compensating that salesperson. [Bus. & Prof.C. §§ 10016 & 10137; see also Bus. & Prof.C. § 10015.1 (defining "responsible broker")]

(2) [2:48] **Broker supervision of salesperson activities:** A licensed real estate broker must *supervise* the licensed acts of salespersons who the broker has retained (¶ 2:47). [See Bus. & Prof.C. § 10010.5(a)(5) & (b) (explaining responsible broker's duty to supervise/oversee licensed acts of its salespersons, whether they are independent contractors or employees, and broker's liability for their "actions or negligence")]

Where the licensed broker is a corporation, its "designated officer/broker" (*see* ¶ *2:108*) is personally responsible for such supervision. [Bus. & Prof.C. § 10159.2; *Holley v. Crank* (9th Cir. 2005) 400 F3d 667, 671-672 (applying Calif. law)]

Brokers who fail to exercise reasonable supervision over their salespersons' brokerage activities are subject to *disciplinary action* (license suspension, revocation or delayed renewal). [Bus. & Prof.C. § 10177(h); *Holley v. Crank*, supra, 400 F3d at 673; *Schaffter v. Creative Capital Leasing Group, LLC* (2008) 166 CA4th 745, 757, 83 CR3d 19, 27; see also *Sandler v. Sanchez* (2012) 206 CA4th 1431, 1434, 142 CR3d 771, 773—designated officers who fail to reasonably supervise corporate employees in violation of § 10159.2 are subject to disciplinary action but *not third-party liability*]

(a) [2:48a] **Scope:** A broker is responsible for supervising a salesperson's compliance with state and federal laws. [*Holley v. Crank* (9th Cir. 2005) 400 F3d 667, 672-673; see also *Milner v. Fox* (1980) 102 CA3d 567, 575-576, 162 CR 584, 590; *Norman v. Department of Real Estate* (1979) 93 CA3d 768, 776-777, 155 CR 715, 720]

(b) [2:48.1] **Licensed salesperson appointed to manage responsible broker's branch office:** Responsible brokers (or corporate designated broker officers) may appoint a licensed salesperson to manage their branch office or a division of their real estate business and delegate to that manager responsibility for overseeing and supervising its day-to-day operations and activities, as statutorily specified. [Bus. & Prof.C. §§ 10164, 10015.1 (defining "responsible broker") & 10015.2 (defining "manager")]

Appointing a manager, however, does not in any way limit the responsibilities of the responsible broker (or corporate designated broker officer) to supervise the salesperson (¶ *2:48*). Moreover, the Commissioner may suspend or permanently revoke the appointed manager's license for failure to properly oversee and supervise operations. [See Bus. & Prof.C. §§ 10164(b) & 10165]

b. [2:49] **Salesperson as "employee" vs. "independent contractor"—limited effect of "independent contractor" status:** As a practical matter, many broker-salesperson arrangements are structured as an "independent contractor" relationship (rather than as "employer-employee"). Such "independent contractor" arrangements are perfectly valid for purposes of defining the legal relationship *between* the broker and salesperson and their obligations *to each other*. [Bus. & Prof.C. § 10032(b)]

On the other hand, brokers and salespersons *cannot* evade their statutory and regulatory obligations—*including their obligations to the public*—under the umbrella of a purported "independent contractor" agreement. [Bus. & Prof.C. § 10032(a)]

(1) [2:50] **Salespersons treated as broker "employees" vis-à-vis brokerage activities:** For purposes of the Business and Professions Code and the California Code of Regulations regarding broker and salesperson obligations, a salesperson is *deemed* to be a broker's "*employee*" regardless of whether the written agreement between them creates an "independent contractor" or "employer and employee" relationship. [Bus. & Prof.C. § 10032(a)]

(2) [2:51] **Application:** As a result, even though a broker and salesperson characterize their relationship as "independent contractor," the following consequences obtain:

(a) [2:52] **Agency:** A real estate salesperson is the broker's "agent" and, therefore, cannot truly be an "independent contractor." [*Payne v. White House Properties, Inc.* (1980) 112 CA3d 465, 471, 169 CR 373, 376; *Gipson v. Davis Realty Co.* (1963) 215 CA2d 190, 206, 30 CR 253, 262—salesperson is broker's agent "as a matter of law"]

(b) [2:53] **Vicarious tort liability:** Notwithstanding the salesperson's purported "independent contractor" status, the broker under whom they are acting remains vicariously liable (under doctrine of respondeat superior) for the salesperson's tortious acts within the course and scope of the licensing activities. [*Gipson v. Davis Realty Co.* (1963) 215 CA2d 190, 206-207, 30 CR 253, 262-263; see *Meyer v. Holley* (2003) 537 US 280, 285-286, 123 S.Ct. 824, 829]

"[R]eal estate salespersons cannot be classified as independent contractors for purposes of liability to third parties and … any provision in a contract which purports to change that relationship from that of an agent to independent contractor is *invalid as being contrary to law* for purposes of tort liability to third parties." [See Stats. 1991, Ch. 679, § 2 (uncodified statement of legislative intent) (emphasis added); and *Gipson v. Davis Realty Co.*, supra, 215 CA2d at 207, 30 CR at 263]

1) [2:53.1] **Individual officer/owner imputed liability under *corporate license:*** Under general (common law) principles of corporate liability, the corporation, not its individual officers or owners, is the principal or employer and thus subject to vicarious liability for its employees' torts. [*Meyer v. Holley* (2003) 537 US 280, 286, 123 S.Ct. 824, 829—Fair Housing Act does not change traditional vicarious liability principles so as to render corporate licensee's officer/owner liable for salesperson's discriminatory brokerage services in violation of FHA; see *Sandler v. Sanchez* (2012) 206 CA4th 1431, 1442-1443, 142 CR3d 771, 779]

Liability may be imputed to the corporation's designated officer/broker, however, if the officer and salesperson were in a true agency relationship (¶ 2:53.2); and, in exceptional circumstances, liability may be imputed to the corporation's individual owners on a corporate "veil-piercing" theory. [*Meyer v. Holley*, supra, 537 US at 291-292, 123 S.Ct. at 832; see *Holley v. Crank* (9th Cir. 2005) 400 F3d 667, 671-676 (remanded to consider whether corporate licensee's sole shareholder could be liable under veil-piercing theory for FHA violation)]

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a) [2:53.2] **Agency basis for vicarious liability:** The corporate officer's/broker's right to control (supervise) the salesperson does not itself create the requisite agency. But a principal-agent relationship may arise from the officer's *delegation* of its duties under the real estate law to the salesperson; in turn, the officer may be vicariously liable for the salesperson's wrongdoing within the scope of that "delegated agency." [*Holley v. Crank* (9th Cir. 2005) 400 F3d 667, 671-674—corporate officer's/broker's delegation of supervisorial responsibility to employee salesperson created agency relationship, making officer vicariously liable for salesperson's discriminatory actions within scope of agency; but see also *Sandler v. Sanchez* (2012) 206 CA4th 1431, 1445, 142 CR3d 771, 782—"We need not decide whether we agree with the Ninth Circuit [in *Holley v. Crank*] that, by way of an express agreement or some other similar circumstance, a designated officer and real estate salesperson can ever create a principal-agent relationship"]

(c) [2:54] **Other issues not involving brokerage licensing activities:** A salesperson designated as an independent contractor may be treated as such for purposes *other than administration of the real estate broker law*—e.g., income tax wage withholding or workers' compensation claim coverage.

"Characterization of a relationship as either 'employer and employee' or 'independent contractor' for statutory purposes, including, but not limited to, *withholding taxes on wages* and for purposes of *unemployment compensation*, shall be governed by [Unemp.Ins.C. §§ 650 and 13000-13054]. For purposes of *workers' compensation* the characterization of the relationship shall be governed by [Lab.C. § 3200 et seq.]." [Bus. & Prof.C. § 10032(b) (emphasis added); see generally, *S.G. Borello & Sons, Inc. v. Department of Industrial Relations* (1989) 48 C3d 341, 353-359, 256 CR 543, 550-554 (detailed discussion of "independent contractor" vs. "employee" status for workers' comp purposes)]

[2:55 - 2:59] ***Reserved.***

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Chapter 2. Real Estate Brokers and Listing Agreements

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1. Regulatory Framework

a. [2:60] **Governing law:** All real property purchase and sale transactions included within the statutory definitions of "real estate broker" activities (*¶ 2:21 ff.*) are subject to licensing and other requirements under the laws of the State of California. Laws relating to real estate brokerage licensing requirements are principally set forth in the Business and Professions Code (Bus. & Prof.C. § 10130 et seq.) and the California Code of Regulations (Real Estate Commissioner Regulations, 10 CCR § 2700 et seq.).

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b. [2:61] **Department of Real Estate jurisdiction:** The California Department of Real Estate (DRE), within the Business, Consumer Services, and Housing Agency (BCSH), is the state agency in charge of regulating real property brokerage matters. It maintains offices in Sacramento, San Francisco, Los Angeles and such other cities as are approved by the California Department of Finance. [Bus. & Prof.C. § 10077]

(The DRE was formerly known as the Bureau of Real Estate. Wherever the term "Bureau of Real Estate" appears in Division 4 of the Business and Professions Code or any other law, it means the DRE; see Bus. & Prof.C. § 10005.)

(1) [2:62] **Real Estate Commissioner:** The DRE's chief officer is the Real Estate Commissioner (Bus. & Prof.C. § 10050), appointed by the Governor (Bus. & Prof.C. § 10051).

The Real Estate Commissioner has "full power to regulate and control the issuance and revocation, both temporary and permanent, of all [real estate] licenses …" [Bus. & Prof.C. § 10071]

[2:63] ***Reserved.***

2. [2:64] **Necessity for License:** It is *unlawful* for anyone to "engage in the business of, act in the capacity of, advertise as, or assume to act" as a *real estate broker or real estate salesperson* in the State of California "*without first obtaining a real estate license*" from the DRE. Likewise, it is *unlawful* for anyone, including real estate licensees, to function as a *mortgage loan originator* (*¶ 2:109.5 ff.*) in California "*without having obtained a license endorsement.*" [See Bus. & Prof.C. § 10130 (emphasis added); see also *MKB Mgmt., Inc. v. Melikian* (2010) 184 CA4th 796, 804, 108 CR3d 899, 906; *GreenLake Capital, LLC v. Bingo Investments, LLC* (2010) 185 CA4th 731, 736, 111 CR3d 82, 85]

In addition, except for paying a commission to an out-of-state broker, it is *unlawful* for a licensed real estate broker to *retain or compensate* any person to perform acts requiring a real estate license if that person is *not* a licensed real estate broker or real estate salesperson licensed under the responsible broker who has retained or is compensating them. Also, except for paying a commission to an out-of-state broker, it is unlawful to retain or compensate any licensee engaged in any activity for which a mortgage loan originator license endorsement is required, if that licensee does not hold a mortgage loan originator license endorsement (*¶ 2:109.6*). [Bus. & Prof.C. § 10137—license suspension or revocation penalty (*¶ 2:115.20*); see also Bus. & Prof.C. § 10509(a) (same re retention to perform mineral, oil and gas transactions requiring license)]

And, it is *unlawful* for any person (obligor, escrowholder or otherwise) to *pay or deliver compensation* for the performance of acts requiring a real estate license where the payee is not known to be licensed or does not present evidence of the payee's licensed status at the time the compensation is earned. [Bus. & Prof.C. § 10138—$100 misdemeanor fine for each offense; see also Bus. & Prof.C. § 10509(b) (same re payment to person performing mineral, oil and gas transactions requiring license)]

Cross-refer: As earlier discussed, the range of brokerage activities requiring a real estate license is vast; *see ¶ 2:21 ff.*

➪ [2:65] ***PRACTICE POINTER:*** There are *no* exceptions to the Bus. & Prof.C. § 10131 licensing rule. Hence, an unlicensed person who conducts any activity in California for which a license is required (even an *isolated* act in a series of brokerage activities), in any one transaction, *violates the law* (*Rench v. Harris* (1947) 79 CA2d 125, 127, 179 P2d 341, 342) and suffers the consequential penalties (¶ 2:66 ff.).

a. [2:65.1] **Application to out-of-state brokers:** Out-of-state brokers are subject to the California licensing requirements if any regulated activity takes place in California. [See *Consul Ltd. v. Solide Enterprises, Inc.* (9th Cir. 1986) 802 F2d 1143, 1148-1149]

b. Consequences of acting without license

(1) [2:66] **Compensation barred:** A valid real estate license is a mandatory *condition precedent* to the collection of compensation for activities requiring a real estate broker or salesperson's license: *No person* acting in the capacity of a real estate broker or salesperson within California may bring or maintain any action in a California court to collect compensation for the performance of licensed acts *without alleging and proving* they were a *duly licensed* broker or salesperson *at the time the alleged cause of action arose*—i.e., when the activities were performed (¶ 2:279 ff.). [Bus. & Prof.C. § 10136; *Venturi & Co. LLC v. Pacific Malibu Develop. Corp.* (2009) 172 CA4th 1417, 1421, 92 CR3d 123, 127—unlicensed finance company not entitled to compensation for portion of contractually-agreed upon activities related to real estate broker services; see also *Salazar v. Interland, Inc.* (2007) 152 CA4th 1031, 1033-1034, 62 CR3d 24, 25 (affirming summary judgment in favor of Internet service provider on unlicensed broker's contractual claim for commissions)]

Compare: Third-party nonbrokers who are *assigned the rights* to *earned* commissions may file suit thereon; *see ¶ 2:280.15 ff.*

(a) [2:67] **Comment:** The denial of compensation for what otherwise may have been the rendition of valuable services is itself an onerous penalty. Bus. & Prof.C. § 10136 effectively *nullifies any contract* for the payment of compensation to an unlicensed broker/salesperson. [*Salazar v. Interland, Inc.* (2007) 152 CA4th 1031, 1041, 62 CR3d 24, 31—statute prohibits compensating unlicensed broker regardless of how compensation is characterized]

Section 10136 also rules out any *noncontractual* basis for the unlicensed claimant's recovery of brokerage services compensation (e.g., a claim in quantum meruit or one based on defendant's waiver or estoppel).

(b) [2:67.1] **Compare—compensation as "finder":** Persons who act strictly as "finders" (intermediaries in bringing the parties together, *¶ 2:38*) need not be licensed under the real estate law. Therefore, unlicensed persons may recover an agreed-upon finder's fee in transactions where they acted *strictly in a finder's capacity.* [*Tyrone v. Kelley* (1973) 9 C3d 1, 11-12, 106 CR 761, 768]

- [2:67.2] An unlicensed finance company was entitled to a contractually agreed-upon fee for finding potential financing sources. [*Venturi & Co. LLC v. Pacific Malibu Develop. Corp.* (2009) 172 CA4th 1417, 1421, 92 CR3d 123, 127]
- [2:67.3] An individual who may have acted as an unlicensed broker for *some* business opportunities was still entitled to compensation for those transactions in which he acted strictly as a finder. [See *Lindenstadt v. Staff Builders, Inc.* (1997) 55 CA4th 882, 893-894, 64 CR2d 484, 490-491; *and ¶ 2:280 ff.*]
- [2:67.4] An unlicensed company retained to assist a "bridge" lender in identifying and procuring a $150 million credit facility was not barred from recovering compensation for the portion of its services rendered as a "finder and facilitator." [*GreenLake Capital, LLC v. Bingo Investments, LLC* (2010) 185 CA4th 731, 739-742, 111 CR3d 82, 88-90 (*discussed further at ¶ 2:280.12*)]

(c) [2:67.5] **Compare—compensation for severable nonbrokerage services:** Similarly, the real estate licensing law does not preclude an unlicensed person from recovering compensation for any other *severable* services not requiring a broker's license even though the principal object of the agreement may have contemplated services requiring a license. [*MKB Mgmt., Inc. v. Melikian* (2010) 184 CA4th 796, 804-805, 108 CR3d 899, 906-907; *GreenLake Capital, LLC v. Bingo Investments, LLC* (2010) 185 CA4th 731, 739-740, 111 CR3d 82, 88] *See discussion at ¶ 2:280.10 ff.*

[2:67.6 - 2:67.9] ***Reserved.***

(2) [2:67.10] **Citation:** Unlicensed persons engaged in activities for which a real estate license or prepaid rental listing service license (*¶ 2:34.5*) is required may be issued a citation by the Commissioner that contains an order to correct the violation and/or assesses an administrative fine of up to $2,500. Failure to comply with the citation's terms or pay the assessed fine "shall" result in disciplinary action. [Bus & Prof.C. § 10080.9(a), (f)]

(3) [2:68] **"Desist and refrain" orders:** Activities in violation of the state licensing laws may be *enjoined* by DRE administrative action ("cease and desist" orders). In effect, the violator may be put out of the brokerage business until the requisite license is obtained. [See Bus. & Prof.C. § 10086; *Rees v. Department of Real Estate* (1977) 76 CA3d 286, 294-295, 142 CR 789, 794]

After the filing of a "desist and refrain" order, and upon a finding that action is warranted to protect and prevent "grievous harm" to the public, the Commissioner may publicly confirm the existence of an investigation into or proceeding regarding an unlicensed person's real estate activities as statutorily specified. [See Bus. & Prof.C. § 10088]

(4) [2:69] **Fine/imprisonment:** Moreover, acting as a real estate broker, salesperson or mortgage loan originator without a license or license endorsement (*¶ 2:109.6*), or simply *advertising* one's self as a real estate broker, salesperson or mortgage loan originator without being so licensed or having obtained a license endorsement, is a "public offense" punishable by a maximum $20,000 fine and/or up to six months' imprisonment (maximum $60,000 fine if the violation is by a corporation). [See Bus. & Prof.C. § 10139]

(If a Real Estate Fraud Prosecution Trust Fund exists in the county where the person or corporation is convicted, any fine collected in excess of $10,000 from the convicted person (or in excess of $50,000 from the convicted corporation) must be deposited in that Fund. (Bus. & Prof.C. § 10139).)

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c. [2:70] **Requirements for broker's/salesperson's license:** The issuance of a real estate broker's or salesperson's license is subject to the following conditions:

(1) [2:71] **Brokers—experience and training:** There are statutory threshold experience and training conditions to the issuance of an “original” real estate broker's license (as opposed to renewal of the license). The requisite experience and training depends upon whether the applicant previously held a real estate salesperson's license. [See Bus. & Prof.C. §§ 10150.6 & 10153; *Salazar v. Interland, Inc.* (2007) 152 CA4th 1031, 1036, 62 CR3d 24, 27—purpose of licensing requirements is to protect public from incompetent or untrustworthy practitioners]

(2) [2:72] **Proof of character:** The Real Estate Commissioner “may” require proof concerning the applicant's “honesty and truthfulness,” and may call a hearing for that purpose. Additionally, every applicant for an original license must be fingerprinted. [Bus. & Prof.C. § 10152(a) (corporate applicant to provide character proof for its officers, directors or persons owning 10% or more of stock)]

(3) [2:73] **Written examination:** Broker and salesperson applicants must pass a written examination (testing knowledge of English language and mathematical skills; and understanding of relevant real estate principles of law, principal-agent obligations, canons of business ethics, and DRE regulations). [Bus. & Prof.C. § 10153; see also Bus. & Prof.C. §§ 10150, 10151, 10153.3, 10153.4, 10210 & 10213.5 (re applications for license examination and fees)]

Application for the exam may be made contemporaneously with an application for a broker or salesperson license, but a license may not be issued until the applicant passes the requisite exam. [Bus. & Prof.C. §§ 10150(b), 10151(b)] And if the applicant fails to pass the exam within two years of filing the license application, the license application “shall lapse and no further proceedings thereon shall be taken.” [Bus. & Prof.C. §§ 10210(b), 10215(b)]

(a) [2:73.1] **Penalty for cheating, subverting or attempting to subvert examination:** “No person shall cheat on, subvert, or attempt to subvert a licensing examination.” The Commissioner may bar “any candidate” who willfully engages in such conduct from taking any license examination and from holding an active real estate license for up to three years. [See Bus. & Prof.C. § 10153.01]

(4) Education

(a) [2:74] **Prerequisite to written examination:** Eligibility to take the written examination for a real estate broker's or salesperson's license (¶ 2:70 ff.) is conditioned on satisfaction of specified educational requirements:

1) [2:74.1] **For broker's license:** The requirements for taking the broker's license exam are set forth in Bus. & Prof.C. § 10153.2(a).

2) [2:74.2] **For salesperson's license:** The requirements for taking the salesperson's license exam are set forth in Bus. & Prof.C. § 10151(c)(2).

3) [2:74.3] **Waiver for State Bar members:** These requirements are waived for members of the California State Bar. [See Bus. & Prof.C. §§ 10151(d), 10153.2(b)]

[2:75] *Reserved.*

(b) [2:76] **Continuing education for license renewal:** As a condition for renewal of a broker's or salesperson's license, applicants must have successfully completed a minimum “45 clock hours” of approved continuing education in the four-year period preceding the renewal application, including minimum hours in specified subjects. [See Bus. & Prof.C. § 10170.5(a)-(b)—brokers must, as part of their “45 clock hours,” successfully complete 3-hour course in office management and supervision of licensed activities, as statutorily specified; see also Bus. & Prof.C. § 10170.4 & 10 CCR § 3005 et seq.]

“Successful completion” of any of the specified courses means passing a final examination. [Bus. & Prof.C. § 10170.5(d)]

(5) [2:77] **Compare—restricted license:** The Commissioner has discretion to issue a “restricted license” to certain applicants not meeting all of the conditions set forth at ¶ 2:70 ff. (Bus. & Prof.C. § 10156.5). *See ¶ 2:83*.

(6) [2:77.1] **Military applicants; expedited process:** If an individual applying for licensure is, or previously was, a member of the United States Armed Forces, as defined, the Commissioner must expedite and assist the initial licensure process, provided the applicant supplies satisfactory evidence to the DRE that they served as an active duty member and were honorably discharged. [Bus. & Prof.C. § 10151.2(c)]

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In addition, the Commissioner must expedite the licensure process for an applicant who (i) supplies satisfactory evidence that they are married to, or in a domestic partnership or other legal union with, an active duty member of the Armed Forces assigned to a duty station in California, and (ii) holds a current license in another state, district, or U.S. territory in the profession/vocation for which the applicant is seeking a California license. [Bus. & Prof.C. § 10151.2(d)]

d. [2:78] **Term of license:** A real estate broker's or salesperson's license is valid for a *four-year* term (and hence must be renewed every four years). [Bus. & Prof.C. §§ 10153.6 (broker's license) & 10153.7 (salesperson's license); see also Bus. & Prof.C. § 10170 et seq. (continuing education prerequisites to license renewal)]

(1) [2:79] **"Military licensees":** Real estate licensees entering active military service (or in training/education preliminary thereto) who notify the Commissioner within six months of such entry are *not* required to renew their licenses or license endorsements (*¶ 2:109.6*) until (a) the beginning of the license or license endorsement period first commencing after they return to the real estate business; or (b) one year following termination of their military service, whichever is earlier. [See Bus. & Prof.C. §§ 10460 & 10461]

For license renewal purposes, only the following qualify as military personnel: members of the U.S. Army, Navy, Air Force, Marine Corps, Merchant Marine in time of war, Coast Guard, National Guard and all Army/Naval officers of the Public Health Services. [Bus. & Prof.C. § 10460(b)]

[2:80 - 2:82] ***Reserved.***

e. [2:83] **Restricted license:** The Real Estate Commissioner "may" (in the Commissioner's discretion) issue a "restricted license" to (1) a broker or salesperson whose license could be suspended or revoked for a violation of the licensing laws, or (2) applicants who have satisfied the examination and experience requirements but who have not met all other requirements for the license "where such failure would justify the denial of the license applied for." [Bus. & Prof.C. § 10156.5]

(1) [2:84] **Authorized restrictions:** Such a license may be restricted as follows (in the Commissioner's discretion):

• By term;

• If a salesperson, to employment by a particular real estate broker;

• By "conditions to be observed in the exercise of the privileges granted"; and/or

• If a salesperson licensee or applicant has not complied with Bus. & Prof.C. § 10153.4 (regarding education) within 18 months after issuance of the license. [Bus. & Prof.C. § 10156.6]

(2) [2:85] **Bond; revocable "privilege":** The Commissioner may require the filing of surety bonds as a condition to issuance of a restricted license. [Bus. & Prof.C. § 10156.8] Further, a restricted license is a pure "privilege" (no "property rights" therein) and may be suspended or revoked in the Commissioner's sole discretion. [See Bus. & Prof.C. § 10156.7 (no absolute right to renewal)]

(3) [2:85.1] **Monitoring costs; restitution:** The Commissioner also may require the restricted licensee to pay the costs associated with monitoring the licensee's licensed activities and, if applicable, pay restitution to any person damaged by the licensee's prior misconduct. The restrictions may not be removed, nor may an unrestricted license be reinstated, if the licensee fails to pay all costs ordered. [See Bus. & Prof.C. § 10186]

f. Exemptions from licensing requirements

(1) [2:86] **General exemptions—brokerage activities performed by specified persons for specified purposes:** By statute, certain persons are authorized to perform activities normally requiring a real estate broker's license even though lacking a valid broker's license. [Bus. & Prof.C. § 10133]

(a) [2:87] **Which persons:** Brokerage activities described in Bus. & Prof.C. § 10131 (*¶ 2:22 ff.*) "are not acts for which a real estate license is required if performed by" (Bus. & Prof.C. § 10133(a)):

1) [2:88] **Corporate/partnership officers for corporate/partnership purpose:** A "regular" officer of a corporation or general partner of a partnership in connection with real property *owned or leased by the corporation or partnership* or the proposed purchase or leasing of real property *by the corporation or partnership* … *provided* the activities are

not performed in expectation of "special compensation." [Bus. & Prof.C. § 10133(a)(1); *Broffman v. Newman* (1989) 213 CA3d 252, 261, 261 CR 532, 538-539]

2) [2:89] **Holder of power of attorney:** A person holding a duly executed power of attorney from the property owner *with respect to the acts performed*. [Bus. & Prof.C. § 10133(a)(2)]

a) [2:90] **Isolated transactions only:** The power of attorney exemption, like all of the Bus. & Prof.C. § 10133 exemptions, may not be used as a subterfuge to evade the licensing law (¶ *2:94*). Thus, the exemption applies only where "personal necessity" compels a property owner to empower another to consummate a *particular* or *isolated* brokerage transaction; it does *not* excuse licensing to conduct brokerage activities on an *ongoing basis*. [See *Sheetz v. Edmonds (Lein)* (1988) 201 CA3d 1432, 1435-1436, 247 CR 776, 778—personal friend managing over 23 properties for compensation under owners' power of attorney not exempt from broker licensing requirements (cease and desist order issued)]

3) [2:91] **Attorney at law:** An attorney at law rendering legal services to a client. [Bus. & Prof.C. § 10133(a)(3); see *Queen of Angels Hosp. v. Younger* (1977) 66 CA3d 359, 375, 136 CR 36, 45—attorney negotiating lease of hospital properties for hospital client (immaterial that attorney also member of hospital's board of directors); 88 Ops.Cal.Atty.Gen. 203 (2005); but see also *Del Mar v. Caspe* (1990) 222 CA3d 1316, 1333, 272 CR 446, 456—attorney exemption from broker license requirement does not qualify lawyers lacking broker's license for real estate broker exemption from usury law (Cal.Const. Art. XV; Civ.C. § 1916.1)]

4) [2:92] **Receivers, bankruptcy trustees, etc.:** A receiver, trustee in bankruptcy "or other person acting under order of a court of competent jurisdiction." [Bus. & Prof.C. § 10133(a)(4)]

5) [2:93] **Trustee under deed of trust:** A trustee for the beneficiary of a deed of trust *when selling under authority of that deed of trust*. [Bus. & Prof.C. § 10133(a)(5)]

(b) [2:94] **Limitation—not to evade licensing laws:** The Bus. & Prof.C. § 10133 exemptions (¶ 2:86 ff.) are narrowly construed. They do not apply to a person who uses or attempts to use the exemptions "for the purpose of evading" the license laws. [Bus. & Prof.C. § 10133 (b); see, e.g., *Sheetz v. Edmonds (Lein)* (1988) 201 CA3d 1432, 1435-1436, 247 CR 776, 778; *and* ¶ *2:90*]

(2) [2:95] **Other exemptions:** Other Code provisions delineate more limited exemptions for certain persons performing specified brokerage activities:

(a) [2:96] **Clerical exemption:** The license requirements do not apply to stenographers, bookkeepers, receptionists, telephone operators or other *clerical* help "*in carrying out their functions as such*" (i.e., *clerical* functions only). [Bus. & Prof.C. § 10133.2; see *Grand v. Griesinger* (1958) 160 CA2d 397, 409, 325 P2d 475, 483—exemption inapplicable to activities not purely clerical and routine (interviewing, filling out registration cards and accepting registration fees)]

(b) [2:97] **Rental activities by property managers, etc.:** Rental/leasing activities normally requiring a real estate license (Bus. & Prof.C. § 10131(b); ¶ *2:24*) may be performed by:

1) [2:97.1] **Property managers:** Unlicensed managers of hotels, motels, auto and trailer parks and resident managers of apartment buildings (or their employees). [Bus. & Prof.C. § 10131.01(a)(1)]

2) [2:97.2] **Agents handling reservations or payments:** An unlicensed person or entity, including persons employed by a real estate broker, who, on behalf of others, solicits or arranges, or accepts reservations and/or money for transient occupancies (described in Civ.C. § 1940(b)(1), (2)) in a dwelling unit in a common interest development (as defined in Civ.C. § 4100), in a dwelling unit in an apartment building, or in a single-family home. [Bus. & Prof.C. § 10131.01(a)(2)]

3) [2:97.3] **Employees of apartment property management firms:** An unlicensed person, other than the resident manager or manager's employees, who is the employee of the property management firm retained to manage a residential apartment building and who is performing under the supervision and control of a broker of record who is an employee of that property management firm or a salesperson licensed to the broker "who meets certain minimum requirements as specified in a regulation issued by the commissioner." This exemption is *limited* to the following activities:

— showing rental units and common areas to prospective tenants;

— providing or accepting preprinted rental applications, or responding to inquiries from prospective tenants concerning completion of the application;

— accepting deposits or fees for credit checks or administrative costs and accepting security deposits and rents;

— providing information about rental rates and other terms and provisions of a lease or rental agreement, as set out in a schedule provided by an employer; and

— accepting signed leases and rental agreements from prospective tenants. [Bus. & Prof.C. § 10131.01(a)(3)(A)-(E)] In any event, a licensed *broker or salesperson* must exercise "reasonable supervision and control" over unlicensed persons acting under the Bus. & Prof.C. § 10131.01(a)(3) exemption. [Bus. & Prof.C. § 10131.01(b); see also Bus. & Prof.C. § 10131.01(c)—broker employing such unlicensed persons must comply with Bus. & Prof.C. § 10163 (broker's branch office licenses) for each building where the person is employed]

(c) [2:98] **Real estate securities broker/dealers—sale, lease or exchange of "business opportunities":** A person licensed as a securities broker or dealer (or any employee, officer or agent of such securities broker/dealer) need not have a real estate license to engage in transactions involving the "sale, lease or exchange of a business opportunity." [Bus. & Prof.C. § 10008.5]

But the exemption does *not* apply to activities described in Bus. & Prof.C. §§ 10131 or 10131.2 (¶ *2:22 ff., 2:31*) "if the substance of the transaction is to transfer, sell, lease, or exchange an interest in real property for the purpose of evading" the real estate licensing laws. [Bus. & Prof.C. § 10008.5]

(d) [2:99] **Mortgage loan exemption:** Mortgage loan transactions covered by the real estate licensing law (¶ *2:26, 2:27, 2:30*) may be performed by a broad range of persons/associations lacking a real estate license including (Bus. & Prof.C. § 10133.1):

These persons and associations include:

1) [2:100] **Financial institutions:** Persons or their employees doing business under any state or federal law relating to banks, trust companies, savings and loan associations, industrial loan companies, pension trusts, credit unions or insurance companies. [Bus. & Prof.C. § 10133.1(a)(1)]

2) [2:101] **Attorneys:** Attorneys licensed to practice in California, *not actively and principally engaged in the business of negotiating loans secured by real property*, when rendering legal services *and* when the attorney's disbursements, whether paid by the borrower or other person, are not charges or costs and expenses regulated by or subject to Bus. & Prof.C. § 10240 et seq. (re broker's loan statement to borrower), provided the fees and disbursements "are not shared, directly or indirectly, with the person negotiating the loan or the lender." [Bus. & Prof.C. § 10133.1(a)(5)]

3) [2:102] **Licensed securities broker/dealers:** Any licensed securities broker/dealer (or the broker's/dealer's agents, officers or employees) if acting within the scope of authority granted by the license in connection with a transaction involving the offer, sale, purchase or exchange of a security representing an ownership interest in a pool of promissory notes secured directly or indirectly by liens on real property, "which transaction is subject to any law of this state or the United States regulating the offer or sale of securities." [Bus. & Prof.C. § 10133.1(a)(9); see *Venturi & Co. LLC v. Pacific Malibu Develop. Corp.* (2009) 172 CA4th 1417, 1424, 92 CR3d 123, 129—no exemption for finance company's managing principal notwithstanding fact he passed certain securities-related tests (no evidence tests meant he was licensed securities broker/dealer or that subject transaction involved promissory note pool)]

4) [2:102.1] **Federally-approved organizations providing no-cost loan modification counseling:** Organizations (and their employees) approved by the U.S. Department of Housing and Urban Development to provide no-cost counseling services in connection with residential mortgage loan modifications. [Bus. & Prof.C. § 10133.1(a)(11)]

5) [2:102.2] **PACE program administrators, solicitors and solicitor agents:** Any person licensed as a PACE program administrator when acting under the authority of that license, as well as (i) PACE solicitors enrolled by a licensed program administrator and acting pursuant to an agreement with that administrator, and (ii) PACE solicitor agents enrolled by a licensed program administrator and acting pursuant to an agreement between a PACE solicitor and that administrator. [Bus. & Prof.C. § 10133.1(a)(12), (13), (14)]

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6) [2:103] **Other licensees:** Any person licensed as a finance lender, or a residential mortgage lender or servicer, *when acting under the authority of that license*. [Bus. & Prof.C. § 10133.1(a)(6) & (10)]

7) [2:103.1] **Broker employees assisting broker:** In addition, financing activities ordinarily requiring a broker's license under Bus. & Prof.C. § 10131(d) (¶ *2:26*) may be performed by a real estate broker's unlicensed employees who are simply *assisting* the broker in meeting the broker's obligations to its customers in residential mortgage loan transactions, where the lender is an institutional lender, provided those employees do not participate in negotiations between the principals. [Bus. & Prof.C. § 10133.1(c)(1)]

Brokers must, however, exercise "reasonable supervision and control" over the nonlicensed employees' activities, and are subject to professional discipline (¶ *2:112 ff.*) for the misconduct of nonlicensed employees acting under this exemption. [See Bus. & Prof.C. § 10133.1(c)(2)—brokers also must comply with Bus. & Prof.C. § 10163 (broker's branch office licenses) for each location employing nonlicensed persons]

[2:103.2 - 2:103.4] ***Reserved.***

8) [2:103.5] **Miscellaneous persons and associations:** Associations lending money for food and agricultural purposes on a cooperative nonprofit basis, cemetery authorities, authorized agents of savings institutions, and various other persons and associations also are covered by the Bus. & Prof.C. § 10133.1 mortgage loan exemption. [See Bus. & Prof.C. § 10133.1(a)(2), (3), (4), (7), (8) & (b)]

(e) [2:104] **Certain mineral, oil or gas property transactions:** Several activities with respect to mineral, oil or gas property may be performed without a license (Bus. & Prof.C. § 10133.35):

• Acting as a depository under an oil/gas lease other than for purposes of a sale (Bus. & Prof.C. § 10133.35(a));

• Engaging in a transaction subject to court order (Bus. & Prof.C. § 10133.35(b));

• Engaging in the business of drilling for or producing oil or gas or mining for or producing minerals (Bus. & Prof.C. § 10133.35(c));

• Negotiating leases or agreements between an owner of mineral, oil or gas lands, leases or mineral rights, and a person organized for or engaging in oil or gas or mineral or metal production; or entering into leases or agreements with an owner of mineral, oil or gas lands, leases, or mineral rights on behalf of a person (disclosed or undisclosed) organized for or engaging in oil or gas or mineral or metal production (Bus. & Prof.C. § 10133.35(d)); *and*

• Dealing with mineral rights or land, other than oil or gas rights or land, as the owner thereof (Bus. & Prof.C. § 10133.35(e)).

(f) [2:105] **Miscellaneous activities:** Some exemptions relate solely to brokerage services performed in specialty industries, not typically encountered in ordinary purchase and sales transactions. [See, e.g., Bus. & Prof.C. § 10133.3 (radio, television or cable enterprise brokering); Bus. & Prof.C. § 10133.4 (certain film location representative activities)]

g. [2:106] **Licensed activities by partnerships and corporations:** Brokers may, under California law, conduct their brokerage services through a corporation or partnership and/or under a fictitious name:

(1) [2:107] **Partnerships:** A partnership entity cannot obtain a real estate license in the partnership name. However, partnerships may perform actions for which a broker's license is required *provided every partner* through whom the partnership so acts is a licensed real estate broker. [Bus. & Prof.C. § 10137.1; see 88 Ops.Cal.Atty.Gen. 203 (2005)]

(2) [2:108] **Corporations:** In contrast, a real estate license may be issued to a corporation. But the entity may operate as a corporate real estate broker only through and because of a *designated officer's license*. If there is no licensed officer, no licensed activities may be performed for or in the name of the corporation. [Bus. & Prof.C. § 10211; 10 CCR § 2740; see *Meyer v. Holley* (2003) 537 US 280, 283, 123 S.Ct. 824, 827; *Holley v. Crank* (9th Cir. 2005) 400 F3d 667, 671; *Amvest Mortg. Corp. v. Antt* (1997) 58 CA4th 1239, 1243, 68 CR2d 457, 459 & fn. 4]

Only the *designated officer* may conduct licensed activities on the corporation's behalf. Other officers may act under its license only if the corporation procures additional licenses to retain each additional officer (unless the designated

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broker-officer dies or is incapacitated, in which case the corporation may operate as a licensee without interruption under its existing license, as statutorily prescribed). [See Bus. & Prof.C. §§ 10158 & 10211; see also *Creative Ventures, LLC v. Jim Ward & Assocs.* (2011) 195 CA4th 1430, 1442, 126 CR3d 564, 573—mortgage lender and loan processing corporation with no "designated officer's license" could not qualify for Civ.C. § 1916.1 usury exemption even though its primary officer/director was personally licensed; compare *Bock v. California Capital Loans, Inc.* (2013) 216 CA4th 264, 268, 156 CR3d 874, 876—"arranging" broker's wholly owned corporation qualified for Civ.C. § 1916.1 usury exemption (*discussed further at ¶ 6:293 ff.*)]

(a) [2:108.1] **No individual broker authority under corporate license:** Corporate officers acting under a *corporation's* real estate license (rather than an individual broker's license) are authorized to conduct brokerage activities only "*for and on behalf of the corporation* as an officer" (*not* in an individual capacity). This does not, however, preclude a designated corporate officer who has a separate individual license from conducting licensed activity for another entity so long as that entity is clearly disclosed and apparent to any member of the public using the officer's services outside the corporation. [Bus. & Prof.C. § 10159 (emphasis added)—corporations wishing to act as real estate brokers must be licensed by DRE through qualified broker-officers, as statutorily prescribed; see also Bus. & Prof.C. § 10159.2 (responsibilities of designated officer under corporate license); *Sandler v. Sanchez* (2012) 206 CA4th 1431, 1434, 142 CR3d 771, 773—designated officer's statutory responsibilities include supervising and controlling activities conducted on corporation's behalf by its officers and employees (¶ *2:48*)]

(3) [2:109] **Fictitious business name:** Brokers (whether individuals or entities) and their salespersons, as statutorily specified, may operate under a fictitious business name by filing with the license application a certified copy of a fictitious business name statement filed with the county clerk pursuant to Bus. & Prof.C. § 17900 et seq. [See Bus. & Prof.C. § 10159.5(a); see also Bus. & Prof.C. § 10159.7 (defining "fictitious business name" and related content)]

[2:109.1 - 2:109.4] ***Reserved.***

h. [2:109.5] **Licensees acting as residential "mortgage loan originators":** Real estate licensees are "mortgage loan originators" with respect to activities involving residential mortgage loans if they, pursuant to Bus. & Prof.C. § 10131(d), solicit borrowers or lenders, negotiate loans, collect payments, or perform services for borrowers or lenders relative to loans secured by real property. As such, they are subject to additional statutory requirements (¶ *2:109.5 ff.*). [See Bus. & Prof.C. § 10166.01 et seq.]

(1) [2:109.6] **Special license endorsement:** A real estate broker (as well as any salesperson under the broker's supervision) may not act as a mortgage loan originator without first obtaining and maintaining a real estate license endorsement to act as a mortgage loan originator. [Bus. & Prof.C. § 10166.02(b), (c)—endorsement valid for one year, expiring every 12/31; see also Bus. & Prof.C. §§ 10150(d) & 10151(e) re endorsement applications]

(2) [2:109.7] **DRE notification:** A real estate broker (and any salesperson under the broker's supervision) who engages in financing-related activities; or who sells, buys, exchanges or offers to sell, buy or exchange real property sales contracts and/or secured notes; or who is in the business of making loans or publicly-traded real property sales contracts or secured loans; *and* who makes, arranges or services loans secured by residential real property, must so notify the DRE in writing by 1/31/10, or within 30 days of commencing that activity, whichever is later. [Bus. & Prof.C. § 10166.02(a)]

(3) [2:109.8] **Consequences of failure to notify DRE or obtain license endorsement:** A real estate broker or salesperson acting as a mortgage loan originator who fails to so notify the DRE or obtain the requisite license endorsement (¶ *2:109.6*) "shall be" assessed statutorily-prescribed monetary penalties; and the Commissioner may suspend or revoke the broker's or salesperson's license for failure to pay the penalties. [Bus. & Prof.C. § 10166.02(f), (g)]

(4) [2:109.9] **Background information; educational requirements; written examination:** Applicants for a mortgage loan originator license endorsement must furnish the Nationwide Multistate Licensing System and Registry with prescribed information concerning their identity (e.g., fingerprints, personal history, experience, etc.). [Bus. & Prof.C. § 10166.04; see also Bus. & Prof.C. § 10166.17 (Commissioner's authority to establish requirements for furnishing identity information)]

Applicants also must complete at least 20 hours of education courses, as specified, and pass a qualified written test. Once endorsed, they must complete annually at least eight hours of continuing education requirements. [See Bus. & Prof.C. §§ 10166.06 & 10166.10]

(5) [2:109.10] **Business activity reports; condition reports; special reports:** A real estate broker who engages in financing-related activities; sells, buys, exchanges or offers to sell, buy or exchange real property sales contracts and/or secured notes; or who is in the business of making loans or publicly-traded real property sales contracts or secured loans; *and* who makes, arranges or services one or more loans in a calendar year that are secured by residential real property, must file annually a specified business activities report. [See Bus. & Prof.C. § 10166.07] The broker also must make any special reports the Commissioner may require. [See Bus. & Prof.C. § 10166.13]

In addition, mortgage loan originators must submit "reports of condition" to the Nationwide Multistate Licensing System and Registry. [See Bus. & Prof.C. § 10166.08]

(6) [2:109.11] **Documents and records; examination of licensee's affairs:** A real estate broker who engages in financing-related activities; sells, buys, exchanges or offers to sell, buy or exchange real property sales contracts and/or secured notes; or who is in the business of making loans or publicly-traded real property sales contracts or secured loans; *and* who makes, arranges or services loans secured by residential real property, must keep documents and records that will properly enable the Commissioner to determine whether the residential mortgage brokerage, servicing and lending functions performed by the broker comply with all applicable statutes, rules and orders made by the Commissioner. As often as the Commissioner deems necessary and appropriate, the Commissioner will examine the affairs of each such real estate broker. [See Bus. & Prof.C. §§ 10166.11(a), 10166.12(a)]

The Commissioner may impose a penalty against a real estate broker or salesperson based on the findings of the above examination, and may suspend or revoke the license or license endorsement of a broker/salesperson who fails to pay the penalty. [See Bus. & Prof.C. § 10166.12(b)]

(7) [2:109.12] **Use and disclosure of unique identifier in advertisements/solicitations:** Recipients of a mortgage loan originator license endorsement are required to use or disclose in advertisements and solicitations a "unique identifier" provided by the Nationwide Multistate Licensing System and Registry. [See Bus. & Prof.C. §§ 10140.6(b)(1), 10166.01(e), 10166.03(c)]

(8) [2:109.13] **Denial, suspension, revocation, etc., of license endorsement:** In addition to any other authorized penalties, the Commissioner may, after notice and opportunity for hearing, deny, suspend, revoke, restrict, condition or decline to renew a mortgage loan originator license endorsement if the applicant/holder (a) fails to meet various rules and/or regulatory/statutory requirements (e.g., fails to satisfy annual continuing education requirements or has a felony conviction involving fraud, dishonesty, breach of trust or money laundering); or (b) withholds information or makes a material misstatement in an application for a license endorsement/license endorsement renewal. [Bus. & Prof.C. § 10166.051(a), (b); see also Bus. & Prof.C. § 10166.05(b)(1) (prohibiting issuance of mortgage loan originator license endorsement if, among other things, applicant convicted of felony during 7-year period preceding application date)]

In addition, the Commissioner may, among other things, issue orders/directives instructing license endorsement holders to desist and refrain from conducting business and/or cease engaging in harmful activities. [See Bus. & Prof.C. § 10166.051(c)]

(a) [2:109.14] **Expunged or pardoned felony conviction:** An expunged or pardoned felony conviction does not require denial of a license endorsement. However, the Commissioner may consider "the underlying crime, facts, or circumstances" when deciding whether to issue a license endorsement. [Bus. & Prof.C. § 10166.05(b)(2)]

i. [2:109.15] **Licensees engaging in escrow activities:** Real estate brokers exempt from the Escrow Law who engage in escrow activities for five or more transactions in a calendar year, or whose escrow activities equal or exceed $1,000,000 in a calendar year, must file a specified report with the DRE within 60 days following completion of the calendar year. [Bus. & Prof.C. § 10141.6(a)]

Brokers who fail to provide the above report are subject to statutory penalties and their licenses may be suspended or revoked for failure to pay those penalties. [Bus. & Prof.C. § 10141.6(c), (d)]

3. [2:110] **Licensing of Real Estate Appraisers:** Any person engaging in "federally related real estate appraisal activity" must be licensed pursuant to the California Real Estate Appraisers' Licensing and Certification Law (Bus. & Prof.C. § 11300 et seq.). [Bus. & Prof.C. § 11320—willful violation of licensing requirement punishable by imprisonment and/or maximum $10,000 fine]

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For purposes of the appraisers' license requirement, a "federally related real estate appraisal activity" means "the act or process of making or performing an appraisal on real estate or real property in a federally related transaction and preparing an appraisal as a result of that activity." [Bus. & Prof.C. § 11302(s)]

A "federally related transaction" is "any real estate-related financial transaction that a federal financial institution[']s regulatory agency engages in, contracts for or regulates and that requires the services of a state licensed real estate appraiser regulated by [Bus. & Prof.C. § 11300 et seq.]." It also includes "any transaction identified as such by a federal financial institution's regulatory agency." [Bus. & Prof.C. § 11302(t)]

Cross-refer: The California real estate appraiser licensing law is discussed in greater detail at *¶ 6:690 ff.* in connection with real estate appraisals.

[2:111] ***Reserved.***

4. [2:112] **Disciplinary Matters:** Standards of conduct for brokers and salespersons, and grounds for professional discipline against real estate licensees, are set forth in the Business and Professions Code and the California Code of Regulations. Additionally, internal codes of ethics have been promulgated by the California Association of Realtors, the National Association of Realtors and other broker professional organizations (which also provide for private broker dispute and disciplinary procedures).

a. [2:113] **Department of Real Estate disciplinary action:** The California DRE (through the Commissioner) has the authority to discipline licensees for violation of the licensing laws—including the power to *suspend or revoke* real estate licenses or levy monetary penalties. [See Bus. & Prof.C. §§ 10071, 10080.9, 10137, 10175, 10175.2]

Investigation of and disciplinary action against licensees may be initiated at the Commissioner's behest and *must* be initiated upon receipt of a verified complaint filed by any member of the public. Indeed, protecting the public is the DRE's "highest priority" in exercising its licensing, regulatory and disciplinary functions. [See Bus. & Prof.C. §§ 10050.1 & 10176 et seq.; see also Bus. & Prof.C. § 10088 (authorizing public disclosure of certain investigations/proceedings)]

However, a noticed hearing with opportunity to respond to the charges must be held before a license or license endorsement (*¶ 2:109.6*) may be suspended or revoked. [Bus. & Prof.C. § 10100(a)] (The procedure that must be followed by the DRE when a license/license endorsement application is *denied* is set forth at Bus. & Prof.C. § 485 et seq.; *see ¶ 2:118*.)

(1) [2:113.1] **"Internet" information:** The DRE is responsible for publishing on the Internet information regarding the status of every license issued, including any accusations, suspensions or license revocations relative to persons or businesses subject to licensure or regulation (see *www.dre.ca.gov*). [Bus. & Prof.C. § 10083.2]

Licensees may petition to remove disciplinary items that have been posted on the DRE's internet website for no less than 10 years and for which the licensees provide evidence of rehabilitation as statutorily prescribed. [Bus. & Prof.C. § 10083.2(c); see also *Skulason v. California Bureau of Real Estate* (2017) 14 CA5th 562, 570, 223 CR3d 7, 12-13—neither labor statute nor licensee's privacy right imposed duty on DRE to remove from its website public information regarding said licensee's three dismissed misdemeanor convictions (¶ 2:115.3a)]

b. Statutory grounds for discipline

(1) [2:114] **Improper acts in performance of licensed activities (Bus. & Prof.C. §§ 10176 & 10177.3):** Salespersons or brokers are subject to discipline for doing any of the following while performing brokerage activities:

- Making any "substantial misrepresentation" (Bus. & Prof.C. § 10176(a); *Warren v. Merrill* (2006) 143 CA4th 96, 109, 49 CR3d 122, 131, fn. 5);
- Making any "false promises of a character likely to influence, persuade, or induce" (Bus. & Prof.C. § 10176(b); *Warren v. Merrill*, supra);
- Engaging in a "continued and flagrant course of misrepresentation" or making "false promises through licensees" (Bus. & Prof.C. § 10176(c));

• "Acting for more than one party in a transaction without the knowledge or consent of all parties" to the transaction (Bus. & Prof.C. § 10176(d); *see ¶ 2:139 ff.* on "dual agency" disclosure requirements);

• Commingling their own money or property with the property of others received and held by the licensee (Bus. & Prof.C. § 10176(e));

• "Claiming, demanding, or receiving" compensation under any exclusive agreement where the agreement does not contain a "definite, specified date of final and complete termination" (Bus. & Prof.C. § 10176(f); *see ¶ 2:379*);

• Claiming or taking "any secret or undisclosed amount of compensation" or failing to reveal to the buyer/seller contracting with the licensee the full amount of compensation under any agreement authorizing or employing the licensee to engage in activities requiring a license prior to or coincident with the signing of the agreement (Bus. & Prof.C. § 10176(g); *Roberts v. Lomanto* (2003) 112 CA4th 1553, 1563, 5 CR3d 866, 874; *see also ¶ 2:162*);

• Using any provision allowing the licensee an option to purchase in an agreement with a buyer/seller that authorizes the licensee to sell, buy or exchange real estate or a business opportunity for compensation, *except* when the licensee, prior to or coincident with an election to exercise the option to purchase, reveals in writing to the buyer/seller the full amount of the licensee's profit and obtains the buyer's/seller's written consent thereto (Bus. & Prof.C. § 10176(h));

• "Any other conduct, whether of the same or of a different character than specified in [§ 10176], which constitutes fraud or dishonest dealing" (Bus. & Prof.C. § 10176(i); see also Bus. & Prof.C. § 10177(j));

• Obtaining a prospective buyer's signature to an agreement which provides the buyer shall either transact the purchasing, leasing, renting or exchanging of a business opportunity property through the broker obtaining such signature, or pay a compensation to such broker if the property is purchased, leased, rented or exchanged without the broker first having obtained the owner's written authorization to offer such property for sale, lease, exchange or rent (Bus. & Prof.C. § 10176(j));

• Failing to disburse funds pursuant to a loan commitment (*¶ 6:130 ff.*) that has been accepted by the borrower when the broker represents to the borrower that they are either the lender or authorized to issue the commitment on the lender's behalf (Bus. & Prof.C. § 10176(k));

• Intentionally delaying the closing of a mortgage loan for the sole purpose of increasing interest, costs, fees or other charges payable by the borrower (Bus. & Prof.C. § 10176(*l*));

• Violating any provision of law that constitutes a violation of the licensing law applicable to the licensee, as specified (Bus. & Prof.C. § 10176(m)); or

• Knowingly or intentionally misrepresenting the value of real property; moreover, any licensee offering or providing an opinion of value regarding residential real property that is used as the basis for originating a mortgage loan may not have a "prohibited" interest in the property as specified under federal law (see Bus. & Prof.C. § 10177.3(a), (b)).

(2) [2:115] **Incidental improper activities (Bus. & Prof.C. § 10177):** Additionally, a real estate license may be suspended or revoked, its renewal may be delayed, or an applicant may be denied a license, for any of the following conduct by the applicant or licensee (or officer, director or shareholder owning/controlling 10% or more of a corporate licensee):

• Procuring, or attempting to procure, a license or license renewal by fraud, misrepresentation or deceit, or by making any material misstatement of fact in a license application (Bus. & Prof.C. § 10177(a));

• Entering a plea of guilty or no contest to, or being convicted of, a felony or a crime substantially related to a real estate licensee's qualifications, functions or duties (Bus. & Prof.C. § 10177(b)(1); see also *Arneson v. Fox* (1980) 28 C3d 440, 448-449, 170 CR 778, 783 (concluding Bus. & Prof.C. § 10177(b), read in conjunction with Bus. & Prof.C. § 490's "substantially related" requirement, meets due process requirements); *and further discussion at ¶ 2:115.2 ff.*);

(Notwithstanding the above, a license suspended due to a guilty plea must be rescinded and the license reinstated if the guilty plea is withdrawn; see Bus. & Prof.C. § 10177(b)(2)—Department must notify subject licensee of their right to have suspension issue heard as statutorily prescribed.)

- Knowingly authorizing, directing, conniving at or aiding in the publication, advertisement, distribution or circulation of a material false statement or representation concerning the licensee's designation or special education certification, credential, trade organization membership, business, or any business opportunity or property offered for sale (Bus. & Prof.C. § 10177(c));

- Willfully disregarding or violating Bus. & Prof.C. §§ 10000 et seq., 11000 et seq. or DRE rules and regulations (Bus. & Prof.C. § 10177(d); see *Handeland v. Department of Real Estate* (1976) 58 CA3d 513, 518, 129 CR 810, 813);

- Willfully using the term "realtor" or a trade name or insignia of membership in any real estate organization of which the licensee is not a member (Bus. & Prof.C. § 10177(e));

- Acting in a manner that would have warranted denial of an application for a real estate license, having *another license revoked, surrendered or suspended, or receiving a debarment order,* for acts that would be grounds for suspension or revocation of a California real estate license, if the denial, revocation, surrender, suspension, or debarment by the other agency or entity occurred only after giving the licensee/applicant fair notice of the charges, an opportunity to be heard, and "other due process protections … and only upon an express finding of a violation of law by the agency or entity" (Bus. & Prof.C. § 10177(f); see *Berg v. Davi* (2005) 130 CA4th 223, 225, 29 CR3d 803, 804 (attorney disbarment); *Herrera v. Department of Real Estate* (2001) 88 CA4th 776, 778, 106 CR2d 232, 234 (suspension of law license));

- Demonstrating negligence or incompetence in performing an act for which a license is required (Bus. & Prof.C. § 10177(g));

- Failure by a broker to exercise reasonable supervision over its salespersons (or failure by the designated officer under a corporate broker's license to exercise reasonable supervision and control of the corporation's activities for which a real estate license is required) (Bus. & Prof.C. § 10177(h); see *Norman v. Department of Real Estate* (1979) 93 CA3d 768, 776-777, 155 CR 715, 720; *Sandler v. Sanchez* (2012) 206 CA4th 1431, 1434, 142 CR3d 771, 773—designated officer's failure to reasonably supervise corporate employee was ground for suspending/revoking officer's license (¶ *2:48*));

- Using employment by a governmental agency in a capacity giving access to records, other than public records, in a manner that violates the confidential nature of the records (Bus. & Prof.C. § 10177(i));

- Engaging in any other conduct that constitutes "fraud or dishonest dealing" (Bus. & Prof.C. § 10177(j); see also Bus. & Prof.C. § 10176(j); Bus. & Prof.C. § 10177.5—final judgment against licensee for fraud, misrepresentation or deceit with respect to transaction requiring real estate license; and *Grubb Co., Inc. v. Department of Real Estate* (2011) 194 CA4th 1494, 1503-1505, 124 CR3d 894, 901-903—professional licensee's due process rights require proof of misconduct by *clear and convincing* evidence (Commissioner could not discipline licensee under § 10177.5 based on final civil judgment for license-related misconduct that was procured by mere preponderance of evidence));

- Violating any of the terms, conditions, restrictions and limitations in an order granting a "restricted license" (¶ 2:83 ff.) (Bus. & Prof.C. § 10177(k));

- Soliciting or inducing the sale, lease or listing for sale or lease of residential property on the ground (in whole or in part) of loss of value, increase in crime, or decline of the quality of the schools, due to the present or prospective entry into the neighborhood of a person or persons of another race, color, religion, ancestry or national origin (Bus. & Prof.C. § 10177(*l*));

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• Violating the Franchise Investment Law (Corps.C. § 31000 et seq.) or Financial Protection and Innovation Commissioner's regulations relating thereto (Bus. & Prof.C. § 10177(m);

• Violating the Corporate Securities Law of 1968 (Corps.C. § 25000 et seq.) or Financial Protection and Innovation Commissioner's regulations relating thereto (Bus. & Prof.C. § 10177(n);

• Failing to disclose to the buyer, in a transaction in which the licensee is the buyer's agent, the nature and extent of the licensee's direct or indirect ownership interest in the property (including the direct or indirect ownership by a person related to the licensee by blood or marriage, by an entity in which the licensee has an ownership interest, "or by any other person with whom the licensee has a special relationship") (Bus. & Prof.C. § 10177(o));

• Violating the requirements imposed by Bus. & Prof.C. § 10237 et seq. on transactions involving the sale of, or offer to sell, a series of notes secured by an interest in real property (Bus. & Prof.C. § 10177(p)); or

• Violating or failing to comply with the Civ.C. § 2920 et seq. requirements relating to mortgages (Bus. & Prof.C. § 10177(q)).

(a) [2:115.1] **Limitation re corporate brokers:** The Real Estate Commissioner may not suspend or revoke, or deny issuance or delay reissuance of, a corporate real estate broker's license (¶ *2:108*) if:

• the *corporation has not done any of the foregoing prescribed acts,* either directly or through its employees, agents, officers, directors or persons owning/controlling 10% or more of the corporation's stock; *and*

• the corporate officer, director or shareholder who *individually* (not on behalf of the corporation) engaged in the proscribed activity has been *completely disassociated* from any affiliation or ownership in the corporation. [Bus. & Prof.C. § 10177, last para. (abrogating more liberal rule under *Amvest Mortg. Corp. v. Antt* (1997) 58 CA4th 1239, 1246, 68 CR2d 457, 461, that protected corporation's license so long as wrongdoing individual became disassociated from corporation before imposition of discipline, without regard to corporation's involvement in wrongful act)]

(b) [2:115.2] **Limitation re discipline based on criminal conviction:** A real estate license may be denied, suspended or revoked, or its renewal may be delayed, for the applicant's/licensee's conviction of a felony, or a crime if the crime is "substantially related" to the applicant's/licensee's qualifications, functions or duties. [See Bus. & Prof.C. § 10177(b)(1); *and* ¶ *2:115*]

Thus, the Commissioner may not deny, suspend, revoke or delay renewal of a real estate license based on a criminal conviction absent a "reasoned determination" that the applicant's/licensee's conduct was in fact *related to the applicant's/licensee's fitness to engage in the real estate profession*. Discipline may not be imposed merely because of the moral reprehensibility of the underlying conduct. [*Donaldson v. Department of Real Estate of State of Calif.* (2005) 134 CA4th 948, 955-956, 36 CR3d 577, 581-582]

1) Application

• [2:115.3] Revocation of a real estate salesperson's license was not authorized pursuant to Bus. & Prof.C. §§ 490 and 10177(b) because the licensee's misdemeanor conviction for unlawful sex with a minor, however troubling, was not substantially related to his fitness to engage in real estate activities. [*Donaldson v. Department of Real Estate of State of Calif.* (2005) 134 CA4th 948, 955-956, 36 CR3d 577, 581-582]

• [2:115.3a] Revocation of a real estate salesperson's license was not authorized pursuant to Bus. & Prof.C. § 10177(b) after a trial court set aside her misdemeanor hit-and-run conviction nunc pro tunc, allowed her to withdraw her no contest plea and plead to a basic speed law infraction, and dismissed the hit-and-run charge. Although a misdemeanor hit-and-run conviction arguably relates substantially to a licensee's qualifications, functions or duties, "section 10177 does not allow discipline when there has been a dismissal unless the dismissal is based on Penal Code section 1203.4 [i.e., expungement]." [See *Ryan-Lanigan v. Bureau of Real Estate* (2013) 222 CA4th 72, 82, 165 CR3d 582, 590; compare *Skulason v. California Bureau of Real Estate* (2017) 14 CA5th 562, 568-569, 223 CR3d 7, 11-12 (noting § 1203.4, while sometimes inaccurately described as "expungement," is in no way equivalent

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to finding of factual innocence)—Department had no duty to remove from its website public information regarding licensee's three dismissed misdemeanor convictions (*¶ 2:113.1*)]

• [2:115.4] By contrast, a felony conviction for conspiracy to create a false financial picture for a real estate development was substantially related to the licensee's fitness to engage in broker activities, warranting revocation of his broker's license. [*Arneson v. Fox* (1980) 28 C3d 440, 450-452, 170 CR 778, 784-785]

• [2:115.5] Likewise, a licensee's misdemeanor convictions for jeopardizing renter safety and his history of building code violations with the intent to obtain an economic advantage were "substantially related" to his fitness to engage in broker activities, justifying revocation of his broker's license. [*Robbins v. Davi* (2009) 175 CA4th 118, 125-127, 95 CR3d 792, 797-798 (applying 10 CCR § 2910 criteria to determine whether licensee's convictions were "substantially related" to relevant professional qualifications)]

• [2:115.6] And an application for an *unrestricted* real estate salesperson's license was properly denied where the applicant's misdemeanor conviction for domestically abusing his girlfriend was (i) deemed moral turpitude under the then-applicable (former) version of the licensing statute; and (ii) "substantially related" to the qualifications, functions and duties of a salesperson licensee: "[A] conviction involving an unlawful act done with 'the intent or threat of doing substantial injury' is deemed substantially related to the duties of a licensee." [*Donley v. Davi* (2009) 180 CA4th 447, 465, 103 CR3d 1, 16 (applying 10 CCR § 2910 criteria in deciding whether to deny license application)]

2) [2:115.7] **Compare—automatic suspension following incarceration for felony conviction:** A real estate license is suspended *automatically* during any time the licensee is incarcerated after being convicted of a felony, even if the conviction is on appeal. The DRE must notify the licensee of the suspension, however, and of the licensee's right to a specified hearing (below). [Bus. & Prof.C. § 10186.1; see Bus. & Prof.C. § 10186.1(a)]

If, after a hearing before an administrative judge, it is determined the felony for which the licensee was convicted is "substantially related to the qualifications, functions, or duties of a licensee," the Commissioner must suspend the license until the time for appeal has elapsed or until the judgment of conviction is affirmed on appeal or otherwise becomes final, and until further order of the DRE. [See Bus. & Prof.C. § 10186.1(b)]

a) [2:115.8] **Felony convictions involving drug use/sex offenses:** No hearing is required if the conviction is for using dangerous drugs or controlled substances, or for certain sex offenses, in violation of federal or state law. These crimes are "conclusively presumed" to be substantially related to the licensee's qualifications, functions and duties, rendering a hearing unnecessary. However, upon its own motion, or for good cause shown, the Commissioner may decline to impose, or may set aside, the suspension when "it appears to be in the interest of justice to do so …" [Bus. & Prof.C. § 10186.1(c)]

3) [2:115.8a] **Seven-year restriction:** The DRE can only deny a license based on a criminal conviction if the conviction occurred within seven years of the application date. [Bus. & Prof.C. § 480(a)(1)]

Compare: This seven-year limitation does not apply if the applicant was convicted of a serious Pen.C. § 1192.7 felony, or a crime requiring registration per Pen.C. § 290(d)(2), (3), or a felony financial crime that is *directly and adversely* related to a broker's fiduciary qualifications, functions, or duties. [See Bus. & Prof.C. § 480(a)(1)]

a) [2:115.8b] **Applicants subject to formal discipline:** In addition to a criminal conviction, formal discipline by a licensing board in or outside California within seven years of the application date also may disqualify an applicant from a license if the professional misconduct would have been cause for DRE discipline and it is substantially related to a broker's qualifications, functions, or duties. [Bus. & Prof.C. § 480(a)(2)]

Compare: Prior disciplinary action by a licensing board within the previous seven years is not a basis for denying a license if that disciplinary action was a conviction that has been dismissed or expunged as statutorily specified. [Bus. & Prof.C. § 480(a)(2)]

4) [2:115.8c] **Rehabilitated applicants distinguished:** No person may be denied a real estate license on the basis of a criminal conviction, or acts underlying a criminal conviction, if that person has obtained a statutorily-prescribed certificate of rehabilitation, been granted clemency or a pardon by a state or federal executive, or has made a showing of rehabilitation under Bus. & Prof.C. § 482. [See Bus. & Prof.C. § 480(b); *Singh v. Davi* (2012) 211 CA4th 141, 148, 149 CR3d 265, 269 (decided under predecessor statute) (noting Bus. & Prof.C. § 480 general prohibition prevails over

specific Code sections prescribing licensing requirements)—former police officer who met all rehabilitation criteria entitled to broker's license despite prior misdemeanor conviction for theft by false pretenses]

5) [2:115.8d] **Dismissed/expunged convictions distinguished:** No person may be denied a real estate license on the basis of any conviction, or acts underlying the conviction, if the conviction has been dismissed or expunged as statutorily prescribed. [Bus. & Prof.C. § 480(c)]

6) [2:115.8e] **Arrests resulting in infractions, citations or juvenile adjudications distinguished:** The DRE may not deny a license on the basis of an arrest that resulted in a disposition other than a conviction, including an arrest resulting in an infraction, citation or juvenile adjudication. [Bus. & Prof.C. § 480(d)]

(c) [2:115.9] **License renewal delayed; tolling provision:** A decision to delay renewal of a real estate license tolls its expiration until any disciplinary actions pending against the licensee are final or the licensee voluntarily surrenders their license, whichever is earlier. [Bus. & Prof.C. § 10177, last para.]

(3) [2:115.10] **Improper acts affecting "public interest"; criminal/civil offenses involving dishonesty, fraud or deceit (Bus. & Prof.C. § 10087):** A salesperson or broker, or an unlicensed person issued a Bus. & Prof.C. § 10086 "cease and desist" order, may be suspended, barred from any position of employment, management or control, or barred from participating in a licensure examination, for up to 36 months, if the Commissioner finds either of the following (Bus & Prof.C. § 10087):

- Suspension/bar is in the public interest, *and* the salesperson, broker or unlicensed person has committed or caused a violation of the California Real Estate Law (Bus. & Prof.C. § 10000 et seq.), or of a rule or order of the Commissioner, which violation was either known or should have been known to the person or has caused material damage to the public (Bus. & Prof.C. § 10087(a)(1)); *or*

- The salesperson, broker or unlicensed person has been convicted of or pleaded nolo contendere to any crime, or has been held liable in any civil action by final or administrative judgment, if that crime or civil/administrative judgment involved any offense entailing *dishonesty, fraud or deceit*, or any other offense reasonably related to the qualifications, functions or duties of a person engaged in the real estate business (Bus. & Prof.C. § 10087(a)(2); see also Bus. & Prof.C. § 10177(b); *and* ¶ *2:115.2*).

(a) [2:115.11] **Prohibited activities following receipt of § 10087 notice/order:** Persons who receive a notice of intention to issue a Bus. & Prof.C. § 10087 order are *immediately* prohibited from engaging in any business activity involving real estate that is subject to regulation under the California Real Estate Law (Bus. & Prof.C. § 10000 et seq.). [Bus. & Prof.C. § 10087(c)]

Persons actually suspended or barred under § 10087 are prohibited from participating in any capacity in real estate-related activities, including activities involving finance lenders, residential mortgage lenders, banks, credit unions, escrow companies, title companies and underwritten title companies. They also are prohibited from participating in licensure examinations. [Bus. & Prof.C. § 10087(d)]

(b) [2:115.11a] **Reporting requirement:** Licensees must report any of the following to the DRE:

— An criminal complaint, information or indictment charging the licensee with a felony;

— The licensee's conviction of a felony or misdemeanor (including any guilty verdict or guilty or no contest plea);

— Any disciplinary action taken against the licensee by another licensing entity or authority of California or of another state, or by a federal agency. [Bus. & Prof.C. § 10186.2(a)(1)]

The licensee's report must be made in writing within 30 days of the date of bringing the indictment, charging the felony or the date of the conviction or disciplinary action. Failure to make the report is cause for discipline. [Bus. & Prof.C. § 10186.2(a)(2), (b)]

(4) [2:115.12] **Improper publication of real estate-related matter; disclosure of license identification number, etc. (Bus. & Prof.C. § 10140.6):** A licensee is subject to discipline for publishing, distributing or circulating any matter related to any licensed activity that does not include a designation disclosing the fact the licensee is performing acts for which a real estate license is required. [Bus. & Prof.C. § 10140.6(a), (c) ("for sale," "rent," "lease," "open house," and directional signs, as defined, are exempt); see also Bus. & Prof.C. § 10071 (Commissioner's duty to enforce)]

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Licensees also are subject to discipline for failure to disclose their name, license identification number, responsible broker's identity, as statutorily defined (and, if that licensee is a mortgage loan originator (*¶ 2:109.5*), their unique identifier (*¶ 2:109.12*)) on all solicitation materials intended to be the "first point of contact with consumers" (e.g., business cards, stationery, advertising fliers, advertisements on tv, in print or electronic media, "for sale," "rent," "lease," "open house," signs, and other materials designed to solicit the creation of a professional relationship between licensee and consumer), *and on real property purchase agreements* when acting in a manner requiring a real estate license/ mortgage loan originator license endorsement in those transactions. [Bus. & Prof.C. § 10140.6(b)(1), (3); see also Bus. & Prof.C. § 10071 (Commissioner's duty to enforce)]

(a) [2:115.12a] **Change in licensee's surname:** A "natural person" real estate licensee who legally changes the surname in which their license was originally issued may continue to use their former surname for purposes of conducting license-related business so long as both names are filed with the DRE. [Bus. & Prof.C. § 10140.6(b)(2)]

(5) [2:115.13] **Failure to disclose roles in arranging financing for real property transactions (Bus. & Prof.C. § 10177.6):** Real estate agents are subject to discipline for failure to disclose (within 24 hours) their role in arranging financing for a real property sale, lease or exchange. [Bus. & Prof.C. § 10177.6; see also Bus. & Prof.C. § 10071 (Commissioner's duty to enforce); *and discussion at ¶ 2:215.2*]

[2:115.14 - 2:115.19] ***Reserved.***

(6) [2:115.20] **Retaining/compensating unlicensed salesperson/mortgage loan originator (Bus. & Prof.C. § 10137):** A broker's license may be suspended or revoked for retaining or compensating an unlicensed person to perform acts requiring a real estate license (a person retained or compensated as a real estate *salesperson* must be licensed *under the responsible broker* retaining or compensating them). [Bus. & Prof.C. § 10137 (provided, however, that licensed broker may pay commission to out-of-state broker); see also *Sanowicz v. Bacal* (2015) 234 CA4th 1027, 1038-1039, 1041, 184 CR3d 517, 526, 528—although § 10137 prohibits salespersons from accepting compensation from anyone other than brokers under whom they are licensed, or from paying any part of commissions received except "through" those brokers, salespersons may enter into commission-sharing agreements (*¶ 2:280.3*)]

Likewise, a broker's license may be suspended or revoked for retaining or compensating any licensee engaged in any activity for which a mortgage loan originator license endorsement is required, if that licensee does not hold a mortgage loan originator license endorsement (*¶ 2:109.6*). [Bus. & Prof.C. § 10137 (provided, however, that licensed broker may pay commission to out-of-state broker)]

(7) [2:115.21] **Referring customers for compensation (Bus. & Prof.C. § 10177.4):** Further, a real estate license may be suspended or revoked when the licensee claims, demands or receives a commission, fee or "other consideration" (see Bus. & Prof.C. § 10177.4(b)) for referring customers to an escrow agent, structural pest control firm, home protection company, title insurer, controlled escrow company or underwritten title company. [Bus. & Prof.C. § 10177.4(a) (also providing that licensee may not be disciplined for *reporting* violations of Bus. & Prof.C. § 10177.4 unless they had "guilty knowledge of" or also committed or participated in the violation)]

(8) [2:115.22] **Violating prepaid rental listing services regulations (Bus. & Prof.C. § 10167.12):** A real estate broker's license may be suspended or revoked when prepaid rental listing services conducted under the license (*¶ 2:34.5*) violate the provisions of Bus. & Prof.C. § 10167 et seq. or if the broker (or agent acting under the broker) is convicted of a crime substantially related to the qualifications, functions or duties of a prepaid rental listing service licensee. [Bus. & Prof.C. § 10167.12(a)]

(9) [2:115.23] **Failing to pay DRE audit charges in connection with mortgage-related activities (Bus. & Prof.C. § 10232.2):** Brokers who engage in certain mortgage-related activities (Bus. & Prof.C. § 10131(d), (e); *see ¶ 2:26 ff.*) must file prescribed annual reports with the DRE; and a broker who fails to do so must pay the DRE's charges in conducting an audit and preparing its own report (see Bus. & Prof.C. § 10232.2). A broker's license may be suspended, or its renewal may be denied, if the broker does not pay those charges within 60 days of mailing of the DRE's bill. [Bus. & Prof.C. § 10232.2(e)]

[2:115.24] ***Reserved.***

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(10) Violating residential mortgage loan modification laws

(a) [2:115.25] **Preperformance compensation, etc. (Bus. & Prof.C. § 10085.6):** It is illegal in California for anyone, including a real estate licensee, to (i) demand or receive advance fees (¶ *2:31.1*) or any other type of preperformance compensation; (ii) require security as collateral for compensation; or (iii) take a power of attorney from the borrower for any purpose in connection with a residential mortgage loan modification or other form of residential mortgage loan forbearance. A real estate licensee who violates this prohibition can be fined and/or imprisoned for up to one year. [See Bus. & Prof.C. § 10085.6; see also Civ.C. §§ 2944.7 & 2944.8 (authorizing state and local government officials to commence civil actions to recover up to $20,000 for each such violation, as well as additional penalties up to $2,500 for every violation perpetrated against a senior citizen or disabled person); *Matter of Taylor* (Rev.Dept. 2012) 5 Cal. State Bar Ct.Rptr. 221, 226—legislation prohibiting preperformance compensation was designed to prevent loan modification consultants from charging borrowers up-front fees, providing borrowers limited services that fail to help and leaving borrowers worse off than before seeking consultant's services]

(b) [2:115.26] **Preliminary written disclosure requirement (Bus. & Prof.C. § 10147.6):** *Before entering into any fee agreement with the borrower*, real estate licensees who render compensable services in connection with a residential mortgage loan modification or other form of residential mortgage loan forbearance must provide their clients with a statutorily-prescribed written disclosure in *minimum 14-point boldface type,* as follows (Bus. & Prof.C. § 10147.6(a) & Civ.C. § 2944.6(a)):

> "It is not necessary to pay a third party to arrange for a loan modification or other form of forbearance from your mortgage lender or servicer. You may call your lender directly to ask for a change in your loan terms. Nonprofit housing counseling agencies also offer these and other forms of borrower assistance free of charge. A list of nonprofit housing counseling agencies approved by the United States Department of Housing and Urban Development (HUD) is available from your local HUD office or by visiting www.hud.gov."

A real estate licensee who violates the above written disclosure requirement can be fined and/or imprisoned for up to one year. [See Bus. & Prof.C. § 10147.6(c) & Civ.C. § 2944.6(c)]

1) [2:115.27] **Translated copies:** If loan modification services are offered or negotiated in one of the languages specified in Civ.C. § 1632 (i.e., Spanish, Chinese, Tagalog, Vietnamese or Korean), a translated copy of the requisite written disclosure must be provided to the client in that language. A real estate licensee who violates this requirement can be fined and/or imprisoned for up to one year. [Bus. & Prof.C. § 10147.6(b), (c) & Civ.C. § 2944.6(b), (c)]

[2:115.28 - 2:115.29] *Reserved.*

(c) [2:115.30] **Compare—federal law:** Under the Federal Trade Commission's Mortgage Assistance Relief Services Rule, mortgage modification and foreclosure-rescue services generally are prohibited from charging or collecting any advance fees. Indeed, they cannot be paid until they secure a modification—i.e., until the homeowner has a written offer from their lender or servicer that the homeowner decides is acceptable. [See 12 CFR § 1015.5(a)]

1) [2:115.31] **Attorney exemption:** Attorneys who provide mortgage assistance relief services as part of their practice to consumers who reside (or whose dwellings are located) in states where the attorneys are licensed are completely exempt from the federal ban on advance fees provided they (a) comply with state laws and regulations covering the same type of conduct; (b) keep the fees in client trust accounts; and (c) comply with all state laws and regulations applicable to client trust accounts. [See 12 CFR § 1015.7]

However, *California* lawyers apparently cannot take advantage of this exemption because of the federal provision requiring them to comply "with state laws and regulations that cover the same type of conduct" (see Civ.C. § 2944.7 (prohibiting *anyone* from collecting advance fees until they have "fully performed each and every service … contracted to perform"); ¶ *2:115.25*).

(11) [2:116] **Failure to maintain real estate records (Bus. & Prof.C. § 10148):** A broker must retain for three years copies of all "listings, deposit receipts, canceled checks, trust records, and other documents" executed or obtained by them in connection with any transaction for which a real estate license is required. Electronic messages of an "ephemeral nature" need not be retained. [See Bus. & Prof.C. § 10148(a); see also Civ.C. § 1624(d)—electronic messages of an "ephemeral nature" include text messages and instant message format communications unless confirmed in writing as statutorily described]

After notice, the broker's "books, accounts, and records" must be made available for "examination, inspection, and copying" by the commissioner as statutorily prescribed and, "upon the appearance of sufficient cause," are subject to audit without further notice. [Bus. & Prof.C. § 10148(a)]

The license of any broker, salesperson or corporation licensed as a real estate broker may be suspended or revoked if the broker, salesperson or a licensed director, officer, employee or agent of the corporation knowingly "destroys, alters, conceals, mutilates, or falsifies" any of the above "books, papers, writings, documents, or tangible objects." [Bus. & Prof.C. § 10148(e)]

c. [2:117] **Voluntary surrender of license with disciplinary charges pending:** A real estate licensee against whom a disciplinary investigation is pending or an accusation has been filed (Gov.C. § 11503) may petition the Commissioner to *voluntarily surrender* their license. A surrendered licensee may be relicensed only if the Commissioner, after considering all relevant evidence, grants a petition for reinstatement (Gov.C. § 11522). [Bus. & Prof.C. § 10100.2; see also Bus. & Prof.C. § 10152(b)—reinstatement petition must be accompanied by surrendered licensee's fingerprints]

d. [2:117.1] **Settlement in lieu of accusation:** The DRE may enter into a settlement with a licensee or applicant instead of issuing an accusation or statement of issues. The settlement must identify the factual basis for the action being taken and the statutes or regulations violated. All such settlements are "considered discipline" by the DRE. [Bus. & Prof.C. § 10100.4; see Bus. & Prof.C. § 10100.4(a), (b), (d)]

A licensee or applicant who enters into a § 10100.4 settlement may file a timely petition to modify the settlement's terms or for early termination of probation, if applicable. [Bus. & Prof.C. § 10100.4(c)]

e. [2:118] **License/license endorsement suspension, revocation or denial procedure:** Before *suspending or revoking* a real estate license or license endorsement (*¶ 2:109.6*), the DRE must file an "accusation" notifying the holder of the license or license endorsement of the alleged grounds and thereafter must convene a hearing pursuant to Gov.C. § 11500 et seq. [See Bus. & Prof.C. § 10100(a); *Herrera v. Department of Real Estate* (2001) 88 CA4th 776, 778, 106 CR2d 232, 234]

Upon *denial* of an application for a license or license endorsement, the DRE must follow the procedures set forth at Bus. & Prof.C. § 485 et seq. (i.e., file and serve statement of issues, notify applicant, etc.). [See Bus. & Prof.C. § 10100(b)]

(1) [2:118.1] **Statute of limitations (suspension or revocation):** The DRE must file its accusation (Gov.C. § 11503) no later than three years from the occurrence of the alleged grounds for disciplinary action. [Bus. & Prof.C. § 10101]

(a) [2:118.2] **Commencement of limitations period:** The three-year limitations period commences on the *date of occurrence of the grounds* for revocation or suspension. [*Herrera v. Department of Real Estate* (2001) 88 CA4th 776, 779, 106 CR2d 232, 234]

Thus, the exact commencement date turns on the particular ground for discipline (*Herrera v. Department of Real Estate*, supra, 88 CA4th at 780, 106 CR2d at 235):

1) [2:118.3] **Discipline predicated on misconduct:** Where the ground for discipline is the *actual misconduct* of the licensee, the *date of the misconduct* commences the limitations period. [*Herrera v. Department of Real Estate* (2001) 88 CA4th 776, 780, 106 CR2d 232, 235]

2) [2:118.4] **Discipline predicated on conviction, judgment or other regulatory action:** Where, however, the ground for DRE disciplinary action is a *criminal conviction,* a *civil judgment* or *another regulatory agency's disciplinary action*, the three-year limitations period begins to run on the date of the *final official action*. [*Herrera v. Department of Real Estate* (2001) 88 CA4th 776, 780, 106 CR2d 232, 235]

• [2:118.5] Thus, a DRE accusation based on suspension of a broker's law license (Bus. & Prof.C. § 10177(f), *¶ 2:115*) must be filed within three years after the date the broker's law license was suspended (the three-year period does *not* commence on the earlier date of the underlying misconduct). [*Herrera v. Department of Real Estate* (2001) 88 CA4th 776, 780, 106 CR2d 232, 235 (misappropriation of client funds resulted in State Bar suspension of broker's law license and DRE accusation was filed within 3 years of State Bar suspension order)]

• [2:118.6] Where the ground for DRE disciplinary action is a final civil judgment for fraud (Bus. & Prof.C. § 10177.5, ¶ *2:115*), the limitations period commences on the date of the final judgment (not the acts or omissions underlying the judgment). [*California Real Estate Loans, Inc. v. Wallace* (1993) 18 CA4th 1575, 1585, 23 CR2d 462, 468-469]

[2:118.7 - 2:118.9] ***Reserved.***

(2) [2:118.10] **Payment of reasonable investigative and enforcement costs:** Upon the Commissioner's request, any licensee found to have violated the licensing laws may be ordered to pay the reasonable costs of investigating and prosecuting the case filed against the licensee. If the licensee is a corporation or partnership, the order may be made against the licensed corporate entity or licensed partnership. [Bus. & Prof.C. § 10106; see Bus. & Prof.C. § 10106(a), (b)]

Subject to a limited financial hardship exemption, determined in the Commissioner's discretion, the Commissioner may not renew or reinstate the license of any licensee who fails to pay all of the costs ordered. [See Bus. & Prof.C. § 10106(g)(1)]

[2:119] ***Reserved.***

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Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 2. Real Estate Brokers and Listing Agreements

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1. Applicable Law

a. [2:120] **Contractual, agency and statutory obligations:** By executing a brokerage contract, a principal effectively *employs a broker as the principal's agent* to perform brokerage services. Therefore, the broker-principal relationship is governed by both (1) *contract* law (based on the employment agreement) and (2) *agency* law. [*RC Royal Develop. & Realty Corp. v. Standard Pac. Corp.* (2009) 177 CA4th 1410, 1418, 100 CR3d 115, 121; *Horning v. Shilberg* (2005) 130 CA4th 197, 204, 29 CR3d 717, 723; *R.J. Kuhl Corp. v. Sullivan* (1993) 13 CA4th 1589, 1599, 17 CR2d 425, 431]

The duties arising out of general contract and agency law are further supplemented by certain *statutory obligations*, which require brokers to make specific *disclosures* to their principals and other parties to the transaction. Thus, “general principles of agency … combine with the statutory duties created by the Real Estate Law …” [*Wyatt v. Union Mortgage Co.* (1979) 24 C3d 773, 782, 157 CR 392, 397; see *Coldwell Banker Residential Brokerage Co., Inc. v. Sup.Ct. (Salazar)* (2004) 117 CA4th 158, 164, 11 CR3d 564, 569—“Real estate brokers are subject to two sets of duties: those imposed by regulatory statutes, and those arising from the general law of agency” (internal quotes and citation omitted)]

Where no statutory duties are involved, a real estate broker's duties may derive from the general law of agency—i.e., from the agreement between principal (seller or buyer) and agent (broker). [*Padgett v. Phariss* (1997) 54 CA4th 1270, 1279, 63 CR2d 373, 377; *RC Royal Develop. & Realty Corp. v. Standard Pac. Corp.* (2009) 177 CA4th 1410, 1418, 100 CR3d 115, 121—broker's employment may depend upon any lawful condition inserted into agreement]

b. [2:121] **Independent operation of contractual and agency relationship:** The contractual and agency broker-principal relationships are *independent* of each other. Indeed, the law of agency cannot substitute for the law of contracts. Instead, it constitutes an additional, overlapping legal framework that governs the relationship. [*Hall v. Aurora Loan Services LLC* (2013) 215 CA4th 1134, 1140, 155 CR3d 739, 743]

• [2:121.1] For example, although a broker's right to recover compensation turns on the existence of a written agreement (¶ *2:281 ff.*), there can be an enforceable *agency relationship* even in the absence of a written agreement. Consequently, a broker might be held an agent of the seller or buyer even though they have no enforceable compensation claim (because lacking a written agreement). [Civ.C. § 2308; see *Vargas v. Ruggiero* (1961) 197 CA2d 709, 715, 17 CR 568, 570-571]

• [2:121.2] Conversely, depending on the terms of the contract (listing agreement), a broker may have an enforceable compensation claim even though the agency relationship has terminated. [*Century 21 Butler Realty, Inc. v. Vasquez* (1995) 41 CA4th 888, 891-892, 49 CR2d 1, 2-3—exclusive listing agreement expressly gave broker right of compensation "irrespective of agency relationships" so long as property sold within stated term of agreement; *see ¶ 2:355 ff.*]

c. [2:121.3] ***Compare—court-appointed broker acting on court's behalf:*** A broker appointed by a court to help settle a property dispute may be acting as the court's "agent." As such, the broker, while ordered to act in the parties' best interests, does not "advocate" for or "represent" any party. Instead, the broker is "vested" with "limited discretionary authority" to assist the court in resolving the subject dispute (e.g., by marketing and selling property for a price the broker deems appropriate, subject to the court's final approval). In short, the broker functions as an "arm of the court" and is entitled to quasi-judicial immunity with respect to the broker's determinations. [See *Holt v. Brock* (2022) 85 CA5th 611, 623-625, 301 CR3d 412, 421-423 (case of first impression)—quasi-judicial immunity extended to court-appointed broker acting as court's agent in settling partition action between siblings]

2. Agency Law as Applied to Brokers, Generally

a. [2:122] **Nature of "agency":** An "agent" is "one who represents another" (the "principal") in dealings with third persons. Representation by an agent on behalf of a principal is called an "agency." [Civ.C. § 2295; see *Lombardo v. Santa Monica Young Men's Christian Ass'n* (1985) 169 CA3d 529, 541, 215 CR 224, 231; *RSB Vineyards, LLC v. Orsi* (2017) 15 CA5th 1089, 1100, 223 CR3d 458, 467—§ 2295 "makes clear" agent must act for another's benefit *"in dealings with third persons"* (emphasis added)]

In a typical real estate brokerage contract, the prospective seller is the principal and the broker is the agent. But an agency relationship may also arise between broker and buyer, where the buyer (as principal) employs the broker to find and negotiate a purchase of certain real estate on specified terms. [*RC Royal Develop. & Realty Corp. v. Standard Pac. Corp.* (2009) 177 CA4th 1410, 1418, 100 CR3d 115, 121; *R.J. Kuhl Corp. v. Sullivan* (1993) 13 CA4th 1589, 1599-1600, 17 CR2d 425, 431-432; *Salahutdin v. Valley of Calif., Inc.* (1994) 24 CA4th 555, 559, 29 CR2d 463, 464 (buyers retained broker to find home on parcel suitable for subdivision)]

(1) [2:123] **Fiduciary relationship:** Agents stand in a *fiduciary relationship* with their principals. Thus, real estate agents owe their principals the "same obligation of undivided service and loyalty" owed by trustees to their beneficiaries. [*Wyatt v. Union Mortgage Co.* (1979) 24 C3d 773, 782, 157 CR 392, 397; *Warren v. Merrill* (2006) 143 CA4th 96, 109-111, 49 CR3d 122, 131-133—evidence was "more than sufficient to show broker's egregious violation" of duties of loyalty and undivided interest owed to buyer/client; *Roberts v. Lomanto* (2003) 112 CA4th 1553, 1562-1563, 5 CR3d 866, 873]

As fiduciaries, real estate agents must act in the "highest good faith" toward their principals and may not obtain any advantage over the principal in any transaction arising out of the agency relationship. They must make full and complete disclosure of all material facts that might influence their principal's decision to enter into a transaction. [*Wyatt v. Union Mortgage Co.*, supra, 24 C3d at 782, 157 CR at 397; *Ryan v. Real Estate of the Pacific, Inc.* (2019) 32 CA5th 637, 646, 244 CR3d 129, 136 (¶ 2:157.10); *Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 414-415, 98 CR2d 176, 185-186; *see further discussion at ¶ 2:155 ff.*]

(a) [2:123.1] **Impact on right to compensation:** Under agency law, a real estate agent's breach of fiduciary duty may forfeit the right to a commission for even properly performed services—at least where the breach involves intentional disloyalty, bad faith or fraud. [*Ziswasser v. Cole & Cowan, Inc.* (1985) 164 CA3d 417, 424-425, 210 CR 428, 432—sellers' broker's inadvertent failure to disclose loan to buyer for part of purchase price did not warrant forfeiture of commission; *Roberts v. Lomanto* (2003) 112 CA4th 1553, 1570, 5 CR3d 866, 879—no forfeiture of commission where record did not show broker's failure to disclose amount of assignment fee was deliberately deceptive or fraudulent (*discussed further at ¶ 2:157.10 ff.*); compare *In re Mehdipour* (9th Cir. BAP 1996) 202 BR 474, 481, aff'd (9th Cir. 1998) 139 F3d 1303 (applying Calif. law)—10% forfeiture of commission where seller's broker did not fully disclose relationship with and terms of loans made to buyers]

(2) [2:124] **"Special agency":** Real estate brokers are "special agents" because they are authorized to represent the principal only in a *particular transaction*. (Distinguish "general agents," who are empowered to act on behalf of their principals in any or all transactions.) [Civ.C. § 2297]

b. [2:125] **Creation of agency:** As between principal and agent, an agency relationship is *consensual* in nature. As such, it can be created only when it is clear that the principal *intended* to bestow upon a person the status of agent (authority to represent and bind the principal in a given transaction) and the agent, in turn, has *accepted* the appointment. [Civ.C. §§ 2299 ("actual agency" created when agent "is really employed by the principal"), 2307 (agency may be created by "precedent authorization" or "subsequent ratification"); see *Holley v. Crank* (9th Cir. 2005) 400 F3d 667, 673 (citing Rest.2d Agency § 1); *Meyer v. Holley* (2003) 537 US 280, 291, 123 S.Ct. 824, 832—right to control another not itself sufficient to establish principal-agent relationship]

(1) [2:126] **No special formalities:** Nevertheless, no particular formalities are required. An agency relationship can be created without an express agreement and without any obligation to pay agent compensation. [See Civ.C. §§ 2307 (creation of agency "by precedent authorization or by a subsequent ratification"), 2308 (no consideration necessary); *Vargas v. Ruggiero* (1961) 197 CA2d 709, 715, 17 CR 568, 570-571]

(a) [2:126.1] **Compare—right to compensation subject to statute of frauds:** However, although the agency relationship may not be dependent on an express written agreement, the principal's obligation to pay a real estate agent *compensation* must be evidenced by a writing sufficient to satisfy the *statute of frauds* (Civ.C. § 1624(a)(4)). *See ¶ 2:281 ff.*

(2) [2:127] **"Ostensible" agency:** Indeed, insofar as necessary to protect the rights of third parties, an agency relationship can arise whenever the principal intentionally, or by "want of ordinary care, causes a third person to believe another to be their agent who is not really employed by" the principal (so-called "ostensible" agency). [Civ.C. § 2300]

More specifically, an ostensible agency arises when (a) a third person deals with the supposed "agent" under a reasonable belief in the agent's authority; (b) the "principal" sought to be charged, by act or neglect, generated the third person's belief that the agency existed; and (c) the third person is not guilty of negligence in relying on the "agent's" apparent authority. [*Kaplan v. Coldwell Banker Residential Affiliates, Inc.* (1997) 59 CA4th 741, 747, 69 CR2d 640, 643; *see also ¶ 2:242*]

c. [2:128] **Delegation and subagencies:** Unless expressly forbidden by the principal, agents may delegate their powers to another person when either:

• The act to be performed is purely mechanical;

• The act is one that the agent cannot, but the subagent can, lawfully perform;

• It is commonplace to delegate such powers; or

• The principal has expressly authorized such delegation. [Civ.C. § 2349]

(1) [2:129] **Effect:** To the extent an agent's powers are lawfully delegated (¶ 2:128), a subagent represents the principal "in like manner with the original agent"; and the original agent is not responsible to third persons for the subagent's acts. [Civ.C. § 2351; but see *George F. Hillenbrand, Inc. v. Insurance Co. of North America* (2002) 104 CA4th 784, 822-824, 128 CR2d 586, 615-616—§ 2351 does not insulate *corporate* agent from liability for acts of its employees]

(a) [2:130] **Compare—unauthorized delegation:** On the other hand, if a subagent is improperly employed, the principal and subagent have no agency relationship; rather, the agent is deemed the subagent's principal for purposes of agency law. [Civ.C. § 2350]

(2) [2:131] **Application in connection with multiple listing services:** In real estate sales transactions, subagency problems typically arise when the seller's broker uses a "multiple listing service." (Many local brokerage associations create a multiple listing service in which properties are listed for sale by seller's brokers. Participating brokers must agree to share in commissions paid in respect to any multiple listed property. See Civ.C. § 1087, *and ¶ 2:371 ff.*)

Because most listing agreements permit the seller's broker to utilize a multiple listing service (*see ¶ 2:384*), a subagency relationship can arise between the seller and broker representing the buyer. This could create a situation where both buyer and seller have the same "agent" (i.e., the listing broker and the buyer's broker), in turn creating a "dual agency" and its attendant obligations (*¶ 2:139 ff.*). Therefore, most multiple listing services in California provide that a so-called "cooperating broker" (i.e., the buyer's broker) is not a subagent of the seller. Instead, the multiple listing simply creates

an obligation on the part of the seller's broker to share its commission with the cooperating broker and does not offer the cooperating broker a true "subagency."

(a) [2:132] **"Cooperating broker" lacks standing to sue seller for commission:** Moreover, even though utilization of a multiple listing service may create a subagency relationship between the seller and buyer's broker, cooperating brokers ordinarily cannot sue on their own behalf for their expected share of the commission; the cooperating broker is simply an incidental beneficiary of the seller's agreement to pay a commission and thus lacks standing to sue thereon. [See *Colbaugh v. Hartline* (1994) 29 CA4th 1516, 1523-1525, 35 CR2d 213, 216-217]

d. [2:133] **Scope of agent's authority:** The precise scope of a broker's agency authority ordinarily turns on the contract with its principal. [See generally, Civ.C. §§ 2315, 2316; *Lyne v. Bonner* (1954) 129 CA2d 743, 745-746, 277 P2d 941, 943] However, in addition to the authority expressly conferred upon them, agents are clothed with implicit *incidental* authority to do "everything *necessary or proper* and usual, in the ordinary course of business, for effecting the purpose" of their agency. [Civ.C. § 2319 (emphasis added)]

(1) [2:133.1] **Ostensible authority:** Although lacking express contractual authority (or authority incidental thereto, ¶ 2:133), an agent has such "ostensible authority" as the principal, either intentionally or through want of ordinary care, *causes or allows a third person* to believe the agent possesses. [Civ.C. § 2317; *see also* ¶ *2:242*]

(2) [2:134] **Ordinarily, no power to execute contracts for principal:** Generally, absent the principal's *express authorization*, a broker has *no* authority to execute a *contract of sale* on behalf of the principal. [*Lyne v. Bonner* (1954) 129 CA2d 743, 746, 277 P2d 941, 943; see *Holway v. Malloy* (1945) 70 CA2d 317, 319-320, 160 P2d 893, 894-895]

Indeed, under the so-called "equal dignities rule," an agent's authority to enter into a contract must be *in writing* whenever the contract itself is required by the statute of frauds to be in writing (¶ 4:226.1). [Civ.C. § 2309; *Jacobs v. Locatelli* (2017) 8 CA5th 317, 324, 213 CR3d 514, 520]

(3) [2:135] **Limitations on handling funds:** The Real Estate Law and regulations promulgated thereunder also severely restrict the manner in which brokers may handle funds belonging to the parties in a purchase and sales transaction. [See Bus. & Prof.C. § 10145 (generally requiring deposit into trust fund account unless immediately placed into neutral escrow depository); 10 CCR § 2830 et seq.]

[2:136 - 2:137] *Reserved.*

e. [2:138] **Duration of agency:** Unless the listing agreement provides for a shorter term, a real estate agent's duties terminate when the subject matter of the agency (the property) is "sold or otherwise disposed of." Therefore, the agency generally terminates with the close of escrow; and the agent has no post-escrow agency duties to the principal (seller or buyer). [*Robinson v. Grossman* (1997) 57 CA4th 634, 646, 67 CR2d 380, 387; but see *Blickman Turkus, LP v. MF Downtown Sunnyvale, LLC* (2008) 162 CA4th 858, 887, 76 CR3d 325, 348—agent's disclosure duty may continue after agency relationship terminates if it is foreseeable principal will continue to rely on agent for information and agent fails to inform principal no further information will be provided]

Again, however, a broker may have an enforceable right to *compensation* even though the agency has terminated (*see* ¶ *2:355 ff.*).

3. [2:139] **"Dual Agency" Problems:** A "dual agency" (or dual representation") arises when the same salesperson (or same brokerage firm, through different salespersons, ¶ 2:139.1) represents both buyer and seller. In such cases, the broker (and any salesperson acting on the broker's behalf) is a fiduciary for *both* buyer and seller. [See *Horiike v. Coldwell Banker Residential Brokerage Co.* (2016) 1 C5th 1024, 1028, 210 CR3d 1, 2; *Fragale v. Faulkner* (2003) 110 CA4th 229, 235, 239, 1 CR3d 616, 621, 624 & fn. 9]

This scenario raises one of the most serious problems in the real estate brokerage field … because a broker who is agent for both buyer and seller is put in the difficult (if not incongruous) position of being a fiduciary to parties who have directly *competing* interests. [See *Glenn v. Rice* (1917) 174 C 269, 272, 162 P 1020, 1021]

Nevertheless, under narrowly-defined circumstances (¶ *2:140 ff.*), the law permits such dual agencies.

a. [2:139.1] **Salespersons/broker associates:** In carrying out its duties, including those of a dual agent, a broker may act through one or more salespersons or broker associates who operate under the broker's license and supervision. [See Civ.C. § 2079.13(a); Bus. & Prof.C. § 10010.5(a)(5) & (b) (explaining responsible broker's duty to supervise/oversee licensed

acts of its salespersons/broker associates, whether they are independent contractors or employees, and broker's liability for their "actions or negligence"); see also Bus. & Prof.C. §§ 10015.1 & 10015.3 (defining "responsible broker" and "broker associate")]

A salesperson or broker associate, however, does not have an independent agency relationship with the broker's clients. Instead, its agency relationship is derived from the broker's relationship with the clients and, as such, the "[salesperson or broker associate] owes the parties to the transaction the same duties as the broker on whose behalf [the salesperson or broker associate] acts." [See *Horiike v. Coldwell Banker Residential Brokerage Co.* (2016) 1 C5th 1024, 1028, 1037-1038, 210 CR3d 1, 2, 9-10 (interpreting former Civ.C. § 2079.13(b) (now Civ.C. § 2079.13(a), 2nd para.))—listing salesperson who functioned on brokerage's behalf in dual agency transaction "stood in the shoes" of brokerage and owed buyer a disclosure duty "equivalent" to that of the brokerage—i.e., to disclose all facts materially affecting property's value or desirability]

(1) [2:139.2] **Comment:** In *Horiike*, supra, the Cal. Supreme Court acknowledged that in other dual agency cases a plaintiff's allegations may raise difficult questions regarding the scope of a real estate salesperson's fiduciary duties (e.g., if salespeople owe precisely the same duties as their employers, buyers and sellers could be denied the benefit of an exclusive salesperson's undivided loyalty and, worse, salespersons could have a duty to harm their original client by disclosing to the other side confidential information about the client's motivations or the salesperson's beliefs). Nonetheless, the Court concluded former § 2079.13(b) (now Civ.C. § 2079.13(a)), as presently written, "provides no basis for distinguishing between a broker's duty to learn of and disclose all facts materially affecting the value or desirability of the property and its [salesperson's or broker associate's] duty to do the same." Moreover, the Court concluded, "to the extent there is any uncertainty about the scope of a dual agent's fiduciary duties in other contexts," the Legislature is free to resolve the issue "by, for example, adopting legislation to uncouple [salesperson's or broker associate's] duties from those of the brokers they represent." [*Horiike v. Coldwell Banker Residential Brokerage Co.* (2016) 1 C5th 1024, 1041-1042, 210 CR3d 1, 13]

b. [2:140] **Principals' informed consent required:** A real estate agent's fiduciary duty to faithfully represent the interests of the agent's principal includes the duty to make *full disclosure of adverse interests*. This is both a common law and statutory duty (¶ 2:141 ff.). [*Brown v. FSR Brokerage, Inc.* (1998) 62 CA4th 766, 777, 72 CR2d 828, 833; see also *Ryan v. Real Estate of the Pacific, Inc.* (2019) 32 CA5th 637, 646, 244 CR3d 129, 136 (¶ 2:157.10)]

Thus, a broker may properly act as "dual agent" for buyer and seller only with *both parties' informed consent.* [Civ.C. § 2079.16; *Horiike v. Coldwell Banker Residential Brokerage Co.* (2016) 1 C5th 1024, 1028, 210 CR3d 1, 2; see also *McConnell v. Cowan* (1955) 44 C2d 805, 809, 285 P2d 261, 264; *Brown v. FSR Brokerage, Inc.*, supra, 62 CA4th at 768-769, 72 CR2d at 828]

Brokers *violate* the real estate licensing law, and risk discipline, damages liability and a loss of compensation, if they act for more than one party in a transaction without the knowledge and consent of all parties thereto. [Bus. & Prof.C. § 10176(d); see *Brown v. FSR Brokerage, Inc.*, supra, 62 CA4th at 778, 72 CR2d at 834; *and ¶ 2:149 ff.* (remedies for nondisclosure)]

c. [2:141] **Statutory written disclosure statement required:** Seller's and buyer's agents for all real property (including mobilehomes) must provide the seller and buyer with a statutory *written disclosure statement* prescribed by Civ.C. § 2079.16. [Civ.C. § 2079.14(a); see *Brown v. FSR Brokerage, Inc.* (1998) 62 CA4th 766, 777, 72 CR2d 828, 833—"contemplated disclosure is to be in writing" (decided under former law)]

The § 2079.16 statement makes certain disclosures about the agent's fiduciary duties to the parties and about which party or parties to the transaction the agent is representing. The statutory form includes a section describing the effect of a "dual agency" and explaining that brokers and their salespersons and broker associates can legally act as agents for both buyer and seller in a transaction *only with the knowledge and consent* of both buyer and seller. The statutory form also includes a section explaining the seller's and buyer's responsibilities (see Civ.C. § 2079.16). [See *Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 414, 98 CR2d 176, 185 (decided under similar former law)]

It is not enough simply to disclose the fact of dual representation. "The agent must also disclose all facts which would reasonably affect the judgment of each party in permitting the dual representation …" [*Huijers v. DeMarrais* (1992) 11 CA4th 676, 686, 14 CR2d 232, 238 (decided under similar former law)]

(1) [2:142] **Timing:** The statutory scheme times presentation of the disclosure statement in a manner intended to provide the parties with optimum opportunity to make an informed decision whether to retain the broker as agent in the transaction *before* signing an agency agreement. [*Huijers v. DeMarrais* (1992) 11 CA4th 676, 685, 14 CR2d 232, 238 (decided under former law)]

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"We read [the statutes] as a legislative determination that the information required to be disclosed alerts the parties to the potentially harmful consequences of dual representation, so they can make an informed judgment." [*Huijers v. DeMarrais*, supra, 11 CA4th at 686, 14 CR2d at 238-239 (decided under former law)] Thus, the statement must be provided to the parties *early* in the transaction, as follows:

(a) [2:143] **Seller/listing agents:** A "seller's agent" (i.e., the person who has obtained a listing of real property to act as an agent for compensation; Civ.C. § 2079.13(f)) must provide the seller with the statement *before entering into a listing agreement*. [Civ.C. § 2079.14(a); see also Bus. & Prof.C. §§ 10018.03 & 10018.04 (defining "listing agent" as licensee who provides services requiring real estate license for or on behalf of seller per listing agreement, and includes seller's agent who may or may not be listing agent)]

(b) [2:144] **Buyer agents:** A "buyer's agent" (i.e., the agent who represents a buyer in a real property transaction; Civ.C. § 2079.13(n); see also Bus. & Prof.C. § 10018.06 (defining "buyer's agent" as licensee who provides services requiring real estate license for or on behalf of buyer)) must provide the buyer with the disclosure statement "as soon as practicable" before execution of the buyer's offer to purchase; however, if the purchase offer is not prepared by the buyer's agent, the buyer's agent "shall present" the disclosure statement to the buyer *no later than the next business day* after receiving the offer to purchase from the buyer. [Civ.C. § 2079.14(b)]

[2:145] ***Reserved.***

(c) [2:146] **Subsequent assumption of dual agency:** Information about whether an agent represents both buyer and seller may not always be known before the seller signs a listing agreement. Therefore, the Civil Code also provides that the buyer's agent must disclose to the buyer and seller "as soon as practicable" whether that agent represents the buyer only or both buyer and seller. Similarly, the seller's agent must disclose to the seller "as soon as practicable" whether they represent the seller only or both buyer and seller. Thus, a *subsequent* disclosure statement is required when an agent assumes a dual agency relationship with buyer and seller *after* the listing agreement is signed. [Civ.C. § 2079.17(a)-(d) (also stating agent's duty to provide disclosure and confirmation of representation may be performed by broker's real estate salesperson or broker associate); see *Huijers v. DeMarrais* (1992) 11 CA4th 676, 684, 14 CR2d 232, 237 (decided under similar former law)]

[2:146.1 - 2:146.4] ***Reserved.***

(2) [2:146.5] **Seller's/buyer's signed acknowledgment of receipt:** The seller's agent and buyer's agent ordinarily must obtain the seller's and buyer's signed acknowledgment of receipt of the § 2079.16 disclosure statement (the statement includes an acknowledgment section; see Civ.C. § 2079.16). [Civ.C. § 2079.14]

• [2:146.6] *Seller/buyer refuses to sign:* If the seller or buyer refuses to sign the acknowledgment of receipt (¶ 2:146.5), the agent must execute a signed and dated written declaration of the facts of the refusal. [Civ.C. § 2079.15]

(3) [2:147] **Additional written confirmation upon execution of sale contract:** The buyer's agent's relationship (whether acting solely as agent for buyer or as dual agent for both buyer and seller) must be *confirmed* in the purchase and sale contract *or* in a separate writing executed or acknowledged by the seller, buyer and buyer's agent *prior to or coincident with the parties' execution of the contract*. [Civ.C. § 2079.17(a); and see Civ.C. § 2079.17(c) for form of confirmation]

The seller's agent's relationship (whether acting solely as the agent for seller or as dual agent for both buyer and seller) must be confirmed in the purchase and sale contract *or* in a separate writing executed or acknowledged by the seller and seller's agent *prior to or coincident with execution of the contract by the seller.* [Civ.C. § 2079.17(b); and see Civ.C. § 2079.17(c) for form of confirmation]

This separate disclosure and confirmation is *in addition to* the disclosure statement required by Civ.C. § 2079.14 (¶ *2:141*). [Civ.C. § 2079.17(d)] And neither may be deemed a substitute for the other. [See *Huijers v. DeMarrais* (1992) 11 CA4th 676, 685, 14 CR2d 232, 237-238 (decided under former law)—providing Civ.C. § 2079.16 disclosure statement at time purchase contract signed *insufficient*]

(4) [2:148] **Limitation on dual agent's disclosures:** The broad disclosure requirements are limited by two important exceptions: Unless the *seller expressly consents*, a dual agent "may *not*" disclose to the buyer any "confidential information" obtained from the seller. Conversely, a dual agent "may *not"* disclose to the seller any confidential information obtained from the buyer without the express permission of the buyer. [Civ.C. § 2079.21(a), (b)]

Section 2079.21 defines "confidential information" as "facts relating to the client's financial position, motivations, bargaining position, or other personal information that may impact price" (e.g., seller's willingness to accept a price less than the listing price or buyer's willingness to pay a price greater than the price offered). [See Civ.C. § 2079.21(c), (d) (also providing Civ.C. § 2079.21 "does not alter in any way the duty or responsibility of a dual agent to any principal with respect to confidential information other than price"); *Brown v. FSR Brokerage, Inc.* (1998) 62 CA4th 766, 777, 72 CR2d 828, 834 (decided under former law)]

(5) Remedies for nondisclosure

(a) [2:149] **Professional discipline:** Failure to make the requisite dual agency disclosures violates the licensing law (Bus. & Prof.C. § 10176(d); see also Bus. & Prof.C. § 10176(a) & § 10177(o); *and* ¶ *2:114, 2:140*), for which the Real Estate Commissioner may suspend or revoke the agent's real estate license (¶ *2:113*). [*McConnell v. Cowan* (1955) 44 C2d 805, 812-813, 285 P2d 261, 266]

(b) [2:150] **Avoidance of transaction; relief from compensation agreement; damages:** But the consequences are not confined to professional discipline. There is also a *private remedy* on behalf of the aggrieved principal:

"The remedy for a real estate agent's breach of a duty to disclose a dual representation of both buyer and seller is that the principal is *not liable to pay the agent's commission*, and the principal may *avoid the transaction* … It makes no difference that the principal was not in fact injured, or that the agent intended no wrong or that the other party acted in good faith …" [*Huijers v. DeMarrais* (1992) 11 CA4th 676, 686, 14 CR2d 232, 238 (emphasis added); see *McConnell v. Cowan* (1955) 44 C2d 805, 809-810, 285 P2d 261, 264; *L. Byron Culver & Associates v. Jaoudi Industrial & Trading Corp.* (1991) 1 CA4th 300, 305, 1 CR2d 680, 682—"unless both principals know of the dual agency at the time of the transaction, the agent cannot recover a commission from either"]

1) [2:151] **Limitation on avoidance of purchase contract where disclosure statement ultimately provided—relief turns on rescission remedy:** However, a *delayed* disclosure statement, given after the time prescribed by statute (¶ *2:142 ff.*) but *before* the parties signed the purchase contract, does not itself trigger the right to avoid the *purchase contract*. While the principal may be relieved of the obligation to pay a commission, avoidance of the purchase contract turns on the right to a *rescission* remedy (e.g., whether other party to the deal *misrepresented* any material facts). [*Huijers v. DeMarrais* (1992) 11 CA4th 676, 686, 14 CR2d 232, 239—reversed for further findings on whether seller had right to rescind based on buyer's misrepresentation about seller's obligation to pay commission notwithstanding listing broker's noncompliance with statute governing timing of disclosure statement]

Cross-refer: The remedy of rescission in purchase and sale transactions is discussed in detail at ¶ *11:460 ff.*

2) [2:152] **Limitation on avoidance of listing agreement where disclosure statement would be "superfluous" (principal aware of disclosure information):** Moreover, courts have discretion to enforce the listing agreement (obligation to pay agent's commission) notwithstanding the agent's failure to provide the requisite disclosure statement where the principal nonetheless was *aware* of the statutory information:

"We do not mean to say that the failure to provide a disclosure form will always result in a voidable listing agreement. A seller, for example, *who has sufficient knowledge concerning the information contained in the disclosure form may be held to the listing agreement* even though [the seller] did not receive the disclosure form." But a finding that the principal had "considerable knowledge and experience with respect to real estate and other transactions" is "*not* the equivalent to a finding of sufficient knowledge to make the disclosure form superfluous." [*Huijers v. DeMarrais* (1992) 11 CA4th 676, 687, 14 CR2d 232, 239 (emphasis added)]

3) [2:153] **Compare—principal's "acceptance of benefits" immaterial to avoidance of compensation obligation:** That the principal consummated the transaction notwithstanding the broker's nondisclosure of the dual agency and thus received a "financial benefit" from the broker's efforts does not change the rule barring the broker's recovery of a commission. "A bar to recovery is a matter of public policy." [*L. Byron Culver & Associates v. Jaoudi Industrial & Trading Corp.* (1991) 1 CA4th 300, 306, 1 CR2d 680, 683, fn. 4]

[2:153.1 - 2:153.4] ***Reserved.***

4) [2:153.5] **Damages remedy as alternative to rescission:** The aggrieved principal is not confined to a rescission remedy. In the alternative, they may elect to "stand behind" the sale transaction and instead sue the dual agent for

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losses suffered in reliance on the agent's advice, unaware the agent was representing both sides in the deal. But the damages remedy is, of course, limited to whatever monetary loss the principal can prove on account of the agent's misconduct. [*Brown v. FSR Brokerage, Inc.* (1998) 62 CA4th 766, 778, 72 CR2d 828, 834—seller, unaware until after transaction closed that his agent was also representing buyer, could pursue damages cause of action against agent for persuading him to sell for less than asking price on agent's representation "this was the best he was going to get" (triable issue of fact whether buyer in fact would have paid more)]

d. [2:154] **Distinguish—"finders":** As indicated earlier, a "finder" is not held to broker/salesperson licensing requirements and fiduciary standards (¶ 2:37 ff.). If the scope of a broker's employment is *limited to bringing the parties together* so they may negotiate their *own* purchase and sale contract, the broker is a mere "finder" and, upon performance, is entitled to agreed-upon compensation even though the other party is unaware of the finder's employment—i.e., *disclosure* to the other party is not a condition to receipt of the agreed-upon compensation. [*McConnell v. Cowan* (1955) 44 C2d 805, 810-811, 285 P2d 261, 265]

Again, however, a mere "finder" has *no authority to negotiate* and does *not negotiate* terms on which the buyer and seller will deal … so, that, unlike a dual agent, there is no opportunity for the finder to sacrifice either principal's interests to the detriment of the other. The so-called "finder's exception" to the limitations on dual agency does *not* apply where the purported "finder," engaged by both parties, is clothed with some discretion in advising or negotiating the transaction; in such event, they cannot recover compensation from either unless *both* buyer and seller know of the dual agency at the time of the transaction. [See *McConnell v. Cowan*, supra, 44 C2d at 811, 285 P2d at 265—supposed "finder" was in fact a *dual agent* and thus denied compensation because of failure to disclose dual agency]

4. [2:155] **Broker's Agency Duties and Standards of Conduct, Generally:** Standing in a *fiduciary* relationship with their principals, real estate brokers are subject to the same *highest* duty of good faith and fair dealing that is imposed on trustees acting on behalf of their beneficiaries (*see ¶ 2:123*).

More particularly, as fiduciaries for their principals, brokers are bound by a host of specified duties and obligations:

a. [2:156] **Duty of loyalty and good faith:** [*Burch v. Argus Properties, Inc.* (1979) 92 CA3d 128, 131, 154 CR 485, 487]

b. [2:157] **Duty to be honest and truthful:** [*Ward v. Taggart* (1959) 51 C2d 736, 741, 336 P2d 534, 537]

c. [2:157.1] **Duty to investigate and disclose material facts that might affect principal's decision:** Real estate brokers have a *fiduciary* duty to disclose to their principal(s) (including *both* buyer and seller in a "dual agency" situation, *¶ 2:139*) all "*material facts*—that is, all facts which might affect the principal's willingness to enter into or complete a transaction." *Roberts v. Lomanto* (2003) 112 CA4th 1553, 1567, 5 CR3d 866, 876 (emphasis added)]

In this context, "[t]he test of materiality is objective: whether a *reasonable person* in the principal's position would have acted differently had he known the undisclosed facts." [*Roberts v. Lomanto*, supra, 112 CA4th at 1567, 5 CR3d at 876 (emphasis added)]

(1) [2:157.2] **Buyer's agent's fiduciary duty:** The *buyer's* agent's fiduciary duty to disclose material facts to the buyer includes a duty to disclose *reasonably obtainable* material information, which may require the agent to *investigate facts* not directly known to the agent. [*Field v. Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 25-26, 73 CR2d 784, 789-790; see also *William L. Lyon & Assocs., Inc. v. Sup.Ct. (Henley)* (2012) 204 CA4th 1294, 1311, 139 CR3d 670, 683—broker's duty to use reasonable skill and care on buyer's behalf operates independently of statutory/contractual duties owed; *Leko v. Cornerstone Bldg. Inspection Service* (2001) 86 CA4th 1109, 1115-1116, 103 CR2d 858, 863-864—broker's duty to buyer includes obligation to discover and disclose material defects in property]

A buyer's broker who breaches this fiduciary duty may be liable for, among other things, negligence, negligent misrepresentation and actual or constructive fraud (¶ 2:157.3 ff.). [*William L. Lyon & Assocs., Inc. v. Sup.Ct. (Henley)*, supra, 204 CA4th at 1311, 139 CR3d at 683]

• [2:157.3] The failure of a home buyer's broker to investigate and disclose efflorescence, bubbling, blistering and cracking stucco covered up with dark paint supported the buyer's complaint for breach of fiduciary duty, fraud, negligence and negligent misrepresentation. [See *William L. Lyon & Assocs., Inc. v. Sup.Ct. (Henley)* (2012) 204 CA4th 1294, 1311, 139 CR3d 670, 683—broker acting as dual listing agent owed both statutory and (more extensive) common law fiduciary duties to buyer]

• [2:157.4] The failure by an employee of a buyer's broker to disclose property defects observed prior to close of escrow supported the buyer's action for negligent nondisclosure and constructive fraud against the broker. [*Michel v. Moore & Assocs., Inc.* (2007) 156 CA4th 756, 762-763, 67 CR3d 797, 801-803]

[2:157.5] ***Reserved.***

(a) [2:157.6] **When duty arises:** The broker's fiduciary duty to disclose material facts about the property arises upon creation of the principal-broker relationship—*before* the purchase contract is entered into. [*Exxess Electronixx v. Heger Realty Corp.* (1998) 64 CA4th 698, 711, 75 CR2d 376, 385]

(b) [2:157.7] **Verifying information from others:** When *transmitting* material information from the seller (or others) to the buyer, the buyer's broker must either *verify* the accuracy of the information *or disclose* to the buyer that the information has *not been verified*. [*Salahutdin v. Valley of Calif., Inc.* (1994) 24 CA4th 555, 562-563, 29 CR2d 463, 466-467 & fn. 3]

A buyer's broker who accepts material information from others as being true and transmits it to the buyer without verification or disclosing to the buyer that it has not been verified breaches the broker's fiduciary duty and may be liable to the buyer for negligent misrepresentation or "constructive fraud." [*Salahutdin v. Valley of Calif., Inc.*, supra, 24 CA4th at 562-563, 29 CR2d at 466-467 & fn. 3; *Field v. Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 26, 73 CR2d 784, 789]

On the other hand, the "buyer's agent is not required to verify information received from the seller and passed on to the buyer if the buyer understands the agent is merely passing on unverified information." [*Pagano v. Krohn* (1997) 60 CA4th 1, 11, 70 CR2d 1, 6; see *Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 417, 98 CR2d 176, 187-188]

[2:157.8 - 2:157.9] ***Reserved.***

(2) [2:157.10] **Seller's agent's fiduciary duty:** A broker engaged by a property owner to market and sell the owner's property likewise has a *fiduciary* duty to the *seller* (the broker's principal) to disclose all "material facts" (again, meaning those facts that might affect the seller's decision to proceed with the transaction). [*Roberts v. Lomanto* (2003) 112 CA4th 1553, 1563, 5 CR3d 866, 873; see also *Ryan v. Real Estate of the Pacific, Inc.* (2019) 32 CA5th 637, 646, 244 CR3d 129, 136—seller's broker who knew neighbor's extensive remodeling plans would adversely affect value of seller's property had duty to inform seller]

(a) [2:157.11] **Effect of agent also acting as principal in transaction:** The broker's fiduciary duty remains the same even if the broker (or the broker's relative or associate) may also be a principal in the real estate transaction. "In other words, once an agency relationship has been created between the agent and the seller, the agent is not absolved of fiduciary duties merely because [the agent] is also buying or selling as a principal." [*Roberts v. Lomanto* (2003) 112 CA4th 1553, 1563, 1566, 5 CR3d 866, 873, 875 (internal brackets and quotes omitted)]

In this situation, the broker's fiduciary duty to their principal does *not* terminate once the purchase agreement between the seller and the broker (buyer) is executed. [*Roberts v. Lomanto*, supra, 112 CA4th at 1563, 1566, 5 CR3d at 873, 875]

• [2:157.12] Seller executed an agreement to sell his property to his Broker for $11 million. Subsequently, and while still acting as Seller's agent, Broker assigned the purchase agreement to Third Party Buyer with Seller's consent. Broker told Seller that Third Party Buyer was paying her an assignment fee but refused to disclose the amount of the fee or the total price Third Party Buyer had agreed to pay. After the deal closed, Seller learned Third Party Buyer had paid Broker $12.2 million for the property, which included a $1.2 million assignment fee.

Broker's failure to disclose to Seller the details of the assignment transaction deprived Seller of his ability to insist that the assignment fee be paid to him as part of the property purchase price. "In this transaction, [Broker] clearly acted in her best interest and not in the best interest of her principal, in breach of her fiduciary duty to [Seller]." [*Roberts v. Lomanto* (2003) 112 CA4th 1553, 1563, 1568, 5 CR3d 866, 873, 877; *see also* ¶ *2:162 ff.*]

[2:157.13 - 2:157.14] ***Reserved.***

(3) [2:157.15] **Compare—seller's agent's *nonfiduciary statutory duty to buyer:*** The *seller's* agent owes a limited statutory duty of inspection and disclosure to the buyer (Civ.C. § 2079). But, absent "dual agency" situations (*¶ 2:139 ff.*), the seller's agent is not in a fiduciary relationship with the buyer and thus owes *no fiduciary* duties to the buyer. A broker's fiduciary duty of inspection and disclosure is *independent of* and more *extensive* than the § 2079 statutory duty (*¶ 2:173 ff.*). [*Field v. Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 25, 73 CR2d 784, 789; *Michel v. Moore & Assocs., Inc.* (2007) 156 CA4th 756, 762, 67 CR3d 797, 802; see also *Saffie v. Schmeling* (2014) 224 CA4th 563, 568, 168 CR3d 766, 769—brokers owe third parties, including adverse parties in real estate transactions, only those duties imposed by regulatory statutes (i.e., the general obligation of honesty, fairness and full disclosure)]

(4) [2:157.16] **Joint and several liability issues:** The inspection and disclosure duty of the buyer's broker overlaps to some degree with the *seller's* broker's duty of inspection and disclosure owed prospective purchasers (*¶ 2:170 ff.*). And each of those duties may overlap with the statutory duty owed by a *home inspection company* retained by the buyer to conduct an inspection with due care (Bus. & Prof.C. § 7196; *see ¶ 4:350.3*).

When the brokers and home inspection company all breach coextensive duties by failure to discover and disclose the same condition or defect in the property, *each* will be *jointly and severally liable* to the buyer for consequential injury and may pursue equitable indemnity claims among themselves. [*Leko v. Cornerstone Bldg. Inspection Service* (2001) 86 CA4th 1109, 1116, 1119, 103 CR2d 858, 864, 866 (buyers sued seller's and buyers' agents for failure to discover and disclose structural defects from Northridge earthquake; realtors could pursue equitable indemnity claim against home inspection company that allegedly failed to discover and disclose same defects)]

d. [2:158] **Duty to disclose relationship with other party:** [*Smith v. Zak* (1971) 20 CA3d 785, 794-795, 98 CR 242, 248—seller's broker must disclose relationship with buyer even though broker has no financial interest in buyer or the transaction (other than right to commission); see *In re Mehdipour* (9th Cir. BAP 1996) 202 BR 474, 480-481, aff'd (9th Cir. 1998) 139 F3d 1303 (applying Calif. law)—seller's broker breached fiduciary duty by failing fully to disclose unrelated partnership with buyers and that he loaned them part of purchase price; *and ¶ 2:139 ff.* re duty to disclose *dual agency*]

e. [2:159] **Duty to disclose intent to purchase:** [*Batson v. Strehlow* (1968) 68 C2d 662, 675-676, 68 CR 589, 598—seller's broker breaches fiduciary duty by becoming purchaser (or purchasing on behalf of entity in which broker has an interest) without seller's full knowledge and consent]

f. [2:160] **Duty to disclose all offers:** [*Nguyen v. Scott* (1988) 206 CA3d 725, 736, 253 CR 800, 806; *Smith v. Zak* (1971) 20 CA3d 785, 793, 98 CR 242, 246—duty to disclose all offers to buy, in addition to offer accepted]

g. [2:161] **Duty of care and diligence:** Brokers are obligated to exercise reasonable skill and care in the performance of their duties. Holding themselves out as professionals with superior knowledge in real estate transactions, brokers are subject to the standard of care that would be exercised by a reasonably prudent real estate broker or salesperson acting in a similar capacity. [*Wilson v. Hisey* (1957) 147 CA2d 433, 438, 305 P2d 686, 690]

h. [2:162] **Duty to disclose profits:** Absent the principal's consent, profits from a real estate transaction belong to the principal, not the broker. Thus, brokers are not permitted to make any "secret" profits or compensation from or through their agency, and must disclose any and all profits to be received in connection with their agency. [*Roberts v. Lomanto* (2003) 112 CA4th 1553, 1569-1570, 5 CR3d 866, 878-879; *Bate v. Marsteller* (1965) 232 CA2d 605, 616, 43 CR 149, 157; see also Bus. & Prof.C. § 10176(g) (*¶ 2:114*); and 12 USC § 2607—brokers may not receive any "kickback" from transactions involving a "federally related mortgage loan" (*¶ 4:639*)]

(1) [2:162.1] **Subject to disgorgement:** Undisclosed compensation, commissions or profits received by a broker from the broker's agency activities must be *returned* (disgorged) regardless of whether the principal incurred any loss because of the nondisclosure. [*Savage v. Mayer* (1949) 33 C2d 548, 551, 203 P2d 9, 10; *Roberts v. Lomanto* (2003) 112 CA4th 1553, 1570, 5 CR3d 866, 878-879—broker not entitled to retain "secret" assignment fee even though transaction yielded principal full asking price]

A broker is liable for "secret" profits even though the benefits flowed strictly to a third party and the broker did not share in the profits. [*St. James Armenian Church of Los Angeles v. Kurkjian* (1975) 47 CA3d 547, 553, 121 CR 214, 218]

i. [2:163] **Duty to account for monies:** Similarly, brokers must account to their principals for all funds belonging to others which they receive in connection with the real estate transaction; and are prohibited from commingling their own funds with the funds of others. [See Bus. & Prof.C. § 10145 (funds not immediately turned over to principal or placed in neutral escrow depository must generally be placed in trust fund account); 10 CCR §§ 2830-2832, 2835]

j. [2:164] **Statutory disclosure duties:** Aside from the general disclosure obligations inherent in any agency relationship, real estate brokers are subject to several express statutory disclosure requirements. *See* *¶ 2:139 ff.* (dual agency disclosures); *and* *¶ 2:173 ff.*

k. [2:165] **Duty to review instruments:** Every instrument prepared or signed by a real estate *salesperson* which has a "material effect" on the rights or obligations of a party to the transaction must be *reviewed, initialed* and *dated by the broker* employing the salesperson. [10 CCR § 2725(a)]

l. [2:166] **Duty not to discriminate:** Real estate agents also are bound not to engage in discriminatory conduct in connection with real estate brokerage activities. [10 CCR § 2780; see also 10 CCR § 2725—licensed broker has duty to familiarize salespersons with federal and state antidiscrimination laws]

More specifically, brokers are bound by state and federal statutes barring discrimination, including:

- *California Fair Employment and Housing Act* (Gov.C. § 12900 et seq.), which prohibits discrimination with respect to housing (see also Gov.C. § 12956.1—before giving copies of previously-recorded deeds, declarations or governing documents to others, realtor must affix prescribed statement advising any restrictive covenants in said documents that violate state/federal fair housing laws are void and may be removed by submitting "Restrictive Covenant Modification" form, together with copy of attached document with unlawful provision redacted, to county recorder's office pursuant to Gov.C. § 12956.2 (*discussed further at ¶ 3:235.6 ff.*); similarly, when delivering copies of deeds, declarations or governing documents directly to persons holding record ownership interests in property, a "Restrictive Covenant Modification" form must be provided with procedural information for appropriate processing along with said documents (Gov.C. § 129561));

- *Fair Housing Act of 1968* (42 USC § 3601 et seq.), the *federal* statutory scheme prohibiting discrimination in housing;

- *Unruh Civil Rights Act* (Civ.C. § 51 et. seq.), which bans discrimination by a "business establishment" regarding housing accommodations.

Cross-refer: For a comprehensive treatment of unlawful housing discrimination, see Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 2C.

[2:167 - 2:169] ***Reserved.***

5. Specific Disclosure Obligations

a. Inspection and disclosure of condition of property—seller/listing broker's duty to prospective buyers

(1) [2:170] **Common law genesis of statutory duty—"*Easton* investigation and disclosures":** A residential real estate broker's statutory inspection and disclosure obligations (Civ.C. § 2079 et seq., *¶ 2:173 ff.*) derive from the common law duty found to exist in case law. [*Easton v. Strassburger* (1984) 152 CA3d 90, 102, 199 CR 383, 390]

Under *Easton*, brokers have an affirmative obligation to conduct a "reasonably competent and diligent *inspection*" of residential property listed for sale and to "*disclose* to prospective purchasers all facts *materially affecting* the value or desirability of the property that such an investigation would reveal." [*Easton v. Strassburger*, supra, 152 CA3d at 102, 199 CR at 390 (emphasis added); see *Robinson v. Grossman* (1997) 57 CA4th 634, 640, 67 CR2d 380, 383; *Loken v. Century 21-Award Properties* (1995) 36 CA4th 263, 269-270, 42 CR2d 683, 687]

(a) [2:170.1] **Scope of duty and liability:** The *Easton* disclosure duty (as now defined by statute, *¶ 2:173 ff.*) applies to *material facts* affecting the value or desirability of the property and of which the broker is *actually aware* or *should have been aware* by a reasonable inspection. Undisclosed facts are "material" if they would have a significant and measurable effect on the property's market value. [*Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 410, 98 CR2d 176, 182; *Sweat v. Hollister* (1995) 37 CA4th 603, 608, 43 CR2d 399, 402 (disapproved on other grounds by *Santisas v. Goodin* (1998) 17 C4th 599, 609, 71 CR2d 830, 836, fn. 5, and *Brannon v. Sup.Ct. (Crippen)* (2004) 114 CA4th 1203, 1205, 1211, 8 CR3d 491, 492, 496); see also *Holmes v. Summer* (2010) 188 CA4th 1510, 1518-1519, 116 CR3d 419, 424-425—monetary liens and encumbrances may affect value and desirability of residential properties]

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For a breach of the duty to inspect and disclose known and knowable material facts affecting the value of the property, a seller's broker is subject to consequential liability to the buyer on a common law *negligence* or *fraud* theory. [See *Easton v. Strassburger* (1984) 152 CA3d 90, 103, 199 CR 383, 390-391 (residential property that suffered soil subsidence)—seller's broker should have been aware of various "red flags" indicating problems with soil movement and had duty to disclose same to buyer, rendering broker liable to buyer on negligence theory; *Holmes v. Summer* (2010) 188 CA4th 1510, 1528, 116 CR3d 419, 432 (overencumbered residential property)—seller's broker had duty to disclose substantial risk that overencumbered residential property could not be freely transferred, rendering broker potentially liable to buyer on negligence theory; *Lingsch v. Savage* (1963) 213 CA2d 729, 735-740, 29 CR 201, 204-207 (buyers granted leave to amend to allege fraud cause of action)]

1) [2:170.2] **Not legal consequences of factual conditions:** Brokers satisfy their duty to inspect and disclose by informing the buyer of the *facts* affecting desirability or value of the property. It is *not* up to the broker to disclose to the buyer the *legal consequences or ramifications* of the factual nature of realty or offer conclusions as to how those facts may adversely impact value. [*Sweat v. Hollister* (1995) 37 CA4th 603, 608-609, 43 CR2d 399, 402 (disapproved on other grounds by *Santisas v. Goodin* (1998) 17 C4th 599, 609, 71 CR2d 830, 836, fn. 5, and *Brannon v. Sup.Ct. (Crippen)* (2004) 114 CA4th 1203, 1205, 1211, 8 CR3d 491, 492, 496); *Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 412, 98 CR2d 176, 183-184]

- [2:170.3] For example, a buyer who purchases a residence after being informed by the seller's broker the property is located in a flood plain has no actionable nondisclosure claim against the broker for failure also to advise that a city ordinance prevented homes in designated flood plains from being remodeled or enlarged.

  Although the value of the home was adversely affected by the building restrictions, the *fact* that made the property subject to the ordinance (location in a flood plain) was disclosed; it was not necessary for the seller to further disclose the legal disabilities associated with that fact. "It is not the obligation of the seller to research local land use ordinances and advise a buyer as to their effect on the realty." [*Sweat v. Hollister* (1995) 37 CA4th 603, 609, 43 CR2d 399, 402 (disapproved on other grounds by *Santisas v. Goodin* (1998) 17 C4th 599, 609, 71 CR2d 830, 836, fn. 5, and *Brannon v. Sup.Ct. (Crippen)* (2004) 114 CA4th 1203, 1205, 1211, 8 CR3d 491, 492, 496)]
- [2:170.4] Similarly, when a buyer is accurately informed about applicable zoning, the seller's broker need not also advise concerning the detrimental aspects and consequences of specific zoning. Like local ordinances regulating construction in a flood plain, the existence and effect of zoning regulations is information as readily available to buyers as to sellers and seller's agents. [*Sweat v. Hollister* (1995) 37 CA4th 603, 609, 43 CR2d 399, 402 (dictum) (disapproved on other grounds by *Santisas v. Goodin* (1998) 17 C4th 599, 609, 71 CR2d 830, 836, fn. 5, and *Brannon v. Sup.Ct. (Crippen)* (2004) 114 CA4th 1203, 1205, 1211, 8 CR3d 491, 492, 496)]
- [2:170.5] Where a condominium buyer was aware of the "essential facts" concerning moisture intrusion in some of the units, the buyer's broker fulfilled its fiduciary duty to the buyer by disclosing the existence of a pending lawsuit by the homeowners association against the developer and the fact it arose from water intrusion problems at the development. The broker had *no duty* to tell the buyer the lawsuit might adversely affect the value of the buyer's unit. [*Pagano v. Krohn* (1997) 60 CA4th 1, 12, 70 CR2d 1, 7]
- [2:170.6] Likewise, brokers who disclosed to a condo buyer that the project's homeowners association had sued the developer for construction defects and that the litigation had settled were not further bound to investigate and disclose that because of the defects the floor in buyer's unit could not bear the weight of marble. Brokers had no actual knowledge of the details of the lawsuit; and once the buyer was informed of the litigation, the details were within *buyer's* "diligent attention" (she could have examined the court file). [*Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 411, 98 CR2d 176, 183]

[2:170.7] ***Reserved.***

2) [2:170.8] **Not opinions re value:** The common law (and statutory) disclosure duty pertains to material *facts*. It does not include a duty to disclose *opinions* learned from others concerning how the practical ramifications of disclosed facts might adversely impact the property's value. [*Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 411-412, 98 CR2d 176, 183-184—statements in "Broker's Price Opinion" constituted "no more than a vague and

general speculation concerning the possible market value of [buyer's] unit at some unspecified future time," not an additional fact about construction defect litigation that required disclosure; *see also* ¶ *2:170.2*]

3) [2:170.9] **Includes matters of public record:** Although a buyer is deemed to have constructive notice regarding matters of public record, the seller's broker still has a duty to disclose the recorded matters if they affect the value or desirability of the property (e.g., significant liens and encumbrances that may affect free transferability of the property; ¶ *2:170.1*).

Indeed, residential buyers typically do not perform preliminary title searches since sellers generally provide preliminary title reports during escrow; moreover, title reports generally do not disclose current encumbrance balances. Thus, constructive notice of such matters does not mean "a cause of action in tort arising out of failure to disclose will not lie." [See *Holmes v. Summer* (2010) 188 CA4th 1510, 1521-1522, 116 CR3d 419, 426-427]

4) [2:170.10] **No liability to third parties:** The broker's inspection and disclosure obligations run only to the "intended beneficiaries" of the broker's advice—ordinarily, only the *buyer* and *prospective buyers*. No inspection and disclosure duties are owed to third persons who are not parties (or in privity with parties) to the purchase and sale transaction. [*Coldwell Banker Residential Brokerage Co., Inc. v. Sup.Ct. (Salazar)* (2004) 117 CA4th 158, 166, 11 CR3d 564, 570 (citing text)—no broker disclosure duties owed to those with whom broker has no "broker-customer" relationship; *see also* ¶ *2:234.1*]

A broker may be liable to a third party only if they *intended* to supply information about the property for *that party's benefit* and as an *objective* of the particular broker service rendered. [*Coldwell Banker Residential Brokerage Co., Inc. v. Sup.Ct. (Salazar)*, supra, 117 CA4th at 166-167, 11 CR3d at 570-571]

• [2:170.11] Partygoers at Buyer's newly-purchased home were injured and some killed when the home's balcony collapsed from a defective beam that was allegedly not disclosed by Seller's Brokers. Brokers owed no duty to the partygoers and thus were not liable to plaintiffs in their suit for personal injury and wrongful death because the partygoers had *no customer relationship with Brokers* and could *not be classified as "intended beneficiaries"* of the allegedly negligent information provided by Brokers concerning the balcony's defect. [*FSR Brokerage, Inc. v. Sup.Ct. (Blanco)* (1995) 35 CA4th 69, 73-74, 41 CR2d 404, 408—no plaintiffs or their heirs were sellers, buyers or prospective buyers, nor in contractual privity with brokers]

• [2:170.12] While living in his mother's newly-purchased house, plaintiff minor allegedly developed asthma caused by toxic mold in the house that allegedly was not disclosed by Seller's Broker. Plaintiff failed to state a cause of action against Broker because a broker-customer relationship existed only between his mother and Broker. The information supplied by Broker regarding the property was solely for the *mother's* benefit (to guide her in a real estate transaction). "Any benefit to, or effect on, [plaintiff minor] resulted not as an intended objective or purpose of [Broker's] role as broker in the real estate transaction, but rather from [plaintiff's] relationship to [his mother] as buyer of the house." [*Coldwell Banker Residential Brokerage Co., Inc. v. Sup.Ct. (Salazar)* (2004) 117 CA4th 158, 166-167, 11 CR3d 564, 570-571]

(b) [2:171] **Commercial real estate?** The court in *Easton* limited its holding to *residential* property, expressing "no opinion" whether a broker's obligation to conduct an inspection for defects for the buyer's benefit applies to the sale of commercial real estate. [*Easton v. Strassburger* (1984) 152 CA3d 90, 102, 199 CR 383, 390, fn. 8]

Even so, dictum in *Easton* suggests a comparable duty of inspection and disclosure does *not* exist in the *commercial* property arena and that any common law negligence or fraud liability will be limited to the failure to disclose defects of which the broker had *actual knowledge:* "Unlike the residential home buyer who is often unrepresented by a broker, or is effectively unrepresented because of the problems of dual agency …, a purchaser of commercial real estate is likely to be more experienced and sophisticated in his dealings in real estate and is usually represented by an agent who represents only the buyer's interests …" [*Easton v. Strassburger*, supra, 152 CA3d at 102, 199 CR at 390, fn. 8]

Cases postdating *Easton*, construing the now-*statutory* duty of inspection and disclosure (¶ *2:173 ff.*), have *declined* to extend the *Easton* obligation to the sale of commercial properties. [See *Smith v. Rickard* (1988) 205 CA3d 1354, 1360, 254 CR 633, 636; *RSB Vineyards, LLC v. Orsi* (2017) 15 CA5th 1089, 1097-1098, 223 CR3d 458, 464-466 (involving sale of vineyard and residence previously converted into commercial wine-tasting room)—sellers who lacked actual/constructive knowledge of deficiencies in converted building not liable for failure to disclose same; *and* ¶ *2:176*]

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(c) [2:172] **Compare—breach of fiduciary duty:** The *Easton* obligation (as now defined by statute, ¶ 2:173 ff.) applies to sellers' brokers even though they are not in an *agency* relationship with, and hence owe no *fiduciary duties* to, the buyer—i.e., a seller's broker has a duty to inspect and reveal to prospective buyers known or knowable material defects in residential property even though the broker is acting strictly as the seller's agent.

On the other hand, a broker who is the *buyer's agent* (including a "dual agent") is a *fiduciary* for the buyer and may be held negligent as a fiduciary for failing to inspect the property and disclose reasonably discoverable defects to the buyer. These fiduciary duties, incident to the *agency* relationship, are *broader* than the *Easton* duty that runs between broker and a nonclient (*see also ¶ 2:157.1 ff.*). [*Field v. Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 25, 73 CR2d 784, 789; see also *William L. Lyon & Assocs., Inc. v. Sup.Ct. (Henley)* (2012) 204 CA4th 1294, 1311, 139 CR3d 670, 677, 683—broker serving as dual agent owes purchaser not only statutory inspection/disclosure duty but also "higher fiduciary duty" to act with "utmost care, integrity, honesty and loyalty"; compare *Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 415-417, 98 CR2d 176, 186-187 (no breach of fiduciary duty)—having been told by dual agent of construction defect suit and settlement and that condo unit was being purchased "*as is,*" *buyer* had duty to investigate further to determine whether defects would affect her plans to alter unit]

"An agent must exercise reasonable skill and care for the benefit of the principal in the performance of agency duties, and will be liable for any damages suffered by the principal as a result of the agent's negligence … Those duties *may include inspecting the property and disclosing any material defects to the principal*." [*Smith v. Rickard* (1988) 205 CA3d 1354, 1363-1364, 254 CR 633, 638-639 (emphasis added); see *Montoya v. McLeod* (1985) 176 CA3d 57, 64-65, 221 CR 353, 358; see also *Salahutdin v. Valley of Calif., Inc.* (1994) 24 CA4th 555, 562-563, 29 CR2d 463, 466-467 & fn. 3—buyer's broker breaches fiduciary duty to buyer by failing to investigate accuracy of third-party representations broker transmits to buyer or to disclose lack of verification]

The *fiduciary* duty of inspection/disclosure applies both in residential *and commercial* real estate transactions. [See *Smith v. Rickard*, supra, 205 CA3d at 1363-1364, 254 CR at 638-639 (dictum because defendant broker *not* in agency relationship with buyer)]

(2) [2:173] **Statutory inspection and disclosure obligations (Civ.C. § 2079 et seq.)—residential property:** The common law duty of inspection and disclosure under the *Easton* line of authority is now *codified* and clarified by Civ.C. § 2079 et seq. [*William L. Lyon & Assocs., Inc. v. Sup.Ct. (Henley)* (2012) 204 CA4th 1294, 1304, 139 CR3d 670, 677]

(a) [2:173.1] **Impact on common law *Easton* duty and other broker duties:** The statutory scheme includes a statement of legislative intent expressly providing that Civ.C. §§ 2079-2079.6 should be construed as a *definition* of the duty of care found to exist in *Easton* (*¶ 2:170 ff.*) and the *manner of its discharge;* and that the Legislature's purpose was to "codify and make precise" the *Easton* holding. [Civ.C. § 2079.12(a)(4), (b); *Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 412-413, 98 CR2d 176, 184; *Coldwell Banker Residential Brokerage Co., Inc. v. Sup.Ct. (Salazar)* (2004) 117 CA4th 158, 164, 11 CR3d 564, 569]

The statutes are deemed *declarative of the common law* regarding the *Easton* inspection and disclosure duty (effectively "trumping" inconsistent common law regarding this duty). But the Legislature has *not* preempted the court's ability to *interpret* §§ 2079-2079.6; nor does the enactment of these statutes modify or restrict *existing duties* owed by real estate licensees. [See Civ.C. § 2079.12(a)(4) & (b); *Field v. Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 24, 73 CR2d 784, 788; *Robinson v. Grossman* (1997) 57 CA4th 634, 641, 67 CR2d 380, 383 & fn. 3; see *Williams v. Wells & Bennett Realtors* (1997) 52 CA4th 857, 862-863, 61 CR2d 34, 37—pursuant to Civ.C. § 2079.12, neither *Easton* nor statutory scheme changes preexisting law regarding broker's *fraudulent concealment* of material defects *known* to broker but unknown to prospective buyer]

(b) [2:174] **Limited to residential properties and used manufactured homes/mobilehomes:** Civ.C. § 2079 et seq. applies to the sale of residential real property improved with one-to-four dwelling units, or to the sale of used *manufactured homes* (as defined in Health & Saf.C. § 18007) and *mobilehomes* (as defined in Health & Saf.C. § 18008) by brokers or salespersons licensed under the Real Estate Law. [See Civ.C. § 2079(a); Health & Saf.C. §§ 18025(c), 18046(c)]

(Parallel inspection/disclosure obligations apply to the sale of used manufactured homes and mobilehomes by dealers and salespersons licensed under the Mobilehomes-Manufactured Housing Act. See Health & Saf.C. § 18046(d); *and ¶ 2:176.5*.)

1) [2:175] **Certain leases included:** The statutory scheme also applies to (i) *leases* of such property which include an *option to purchase;* (ii) *ground leases* of land on which one to four dwelling units have been constructed; and (iii) *real property sales contracts* (as defined by Civ.C. § 2985, *¶ 4:112*) for such property. [Civ.C. § 2079.1]

2) [2:176] **Not commercial property:** On the other hand, Civ.C. § 2079 et seq. does *not* apply to *commercial real estate* transactions. [Civ.C. §§ 2079, 2079.1; *Smith v. Rickard* (1988) 205 CA3d 1354, 1360, 254 CR 633, 636]

(*But see ¶ 2:172*—dual agent may be liable to buyer on *breach of fiduciary duty* theory.)

[2:176.1 - 2:176.4] ***Reserved.***

(c) [2:176.5] **Which brokers/salespersons:** The duty imposed by Civ.C. § 2079 et seq. applies to real estate brokers and salespersons, licensed under the Real Estate Law, who have a "*written contract with the seller* to find or obtain a buyer" or who act in *cooperation with* such a broker to find and obtain a buyer. Thus, the *seller's/listing agent* (or cooperating agent) bears the statutory obligation of inspection and disclosure. [Civ.C. § 2079(a) (emphasis added); see also Health & Saf.C. § 18046(c)—sale of used manufactured homes or mobilehomes by broker or salesperson licensed under Real Estate Law "shall be subject to" Civ.C. § 2079]

The same inspection/disclosure duty applies to resales of manufactured homes and mobilehomes by dealers and salespersons licensed under the Mobilehomes-Manufactured Housing Act who have a written contract with the seller to find or obtain a buyer or who act in cooperation with others to find and obtain a buyer. [See Health & Saf.C. § 18046(d)]

1) [2:176.6] **Not brokers exclusively representing buyers; broader fiduciary duty distinguished:** The Civ.C. § 2079 statutory duty is imposed solely on *seller's brokers* and cooperating brokers. Brokers who *exclusively represent the buyer* are outside the ambit of § 2079 but owe their principals (buyers) far more *expansive fiduciary duties* of inspection and disclosure (*see ¶ 2:157.1 ff.*). [*Field v. Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 20-21, 73 CR2d 784, 786; see also *Michel v. Moore & Assocs., Inc.* (2007) 156 CA4th 756, 762, 67 CR3d 797, 802—fiduciary duty owed buyer is substantially greater than § 2079 negligence standard of due care (*¶ 2:178 ff.*)]

2) [2:176.7] **Dual agents:** Arguably, the Civ.C. § 2079 inspection/disclosure duty equally applies to a broker representing *both* seller and buyer ("dual agent," *¶ 2:139 ff.*) so long as such a broker has a "written contract with the seller to find or obtain a buyer" as provided by Civ.C. § 2079(a) (¶ 2:176.5). [See *Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 414, 98 CR2d 176, 185]

As a practical matter, however, the point is academic because Civ.C. § 2079.16 incorporates equivalent obligations for dual agents; and those obligations are also part of the broader *fiduciary duties* owed by dual agents to *both* buyer and seller. [*Assilzadeh v. California Fed'l Bank, FSB*, supra, 82 CA4th at 414-415, 98 CR2d at 185-186]

3) [2:176.8] **"Cooperating brokers" subject to § 2079:** A buyer's broker is not a "cooperating broker" within the meaning of Civ.C. § 2079 simply because they helped the seller's broker complete the sale transaction. A cooperating broker encompassed by the statute is one who acts in cooperation with the seller's broker to "*find or obtain a buyer*" (Civ.C. § 2079(a); see also Health & Saf.C. § 18046(d)). Section 2079 was not meant to apply to brokers who *exclusively represent* the buyer as *direct fiduciary*. [*Field v. Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 27, 73 CR2d 784, 790—broker contracted to act as buyer's sole agent in search for residence to purchase, not to find buyer for seller's residence]

[2:176.9 - 2:176.14] ***Reserved.***

(d) [2:176.15] **To whom duty owed:** The duties imposed on brokers under Civ.C. § 2079 are owed *exclusively* to *prospective buyers*, and *not* to other persons who are *not parties to the real estate transaction*. "Only a transferee, that is, the ultimate purchaser, can recover from a broker or agent for breach of these duties." [*Coldwell Banker Residential Brokerage Co., Inc. v. Sup.Ct. (Salazar)* (2004) 117 CA4th 158, 165, 11 CR3d 564, 569; *see also ¶ 2:170.10 ff.*]

Third parties cannot circumvent this duty limitation by alleging that the broker actively concealed or intentionally suppressed facts subject to the Civ.C. § 2079 disclosure requirements. "[A]llegations of willful misconduct are not determinative. The broker's disclosure duty is to the transferee whether the breach is willful or negligent." [*Coldwell Banker Residential Brokerage Co., Inc. v. Sup.Ct. (Salazar)*, supra, 117 CA4th at 168, 11 CR3d at 572 (internal quotes

and citation omitted)—characterizing broker as "actively negligent" does not change analysis or result; *see also ¶ 2:234.1*]

1) [2:176.16] **Compare—homeowners association's standing to sue on members' behalf:** Although not owed any duties itself, the homeowners association for a common interest development is statutorily empowered to pursue its members' claims against real estate agents for breach of fiduciary duty, concealment and intentional misrepresentation in matters concerning damage to the common areas. [See Civ.C. § 5980; *Glen Oaks Estates Homeowners Ass'n v. Re/Max Premier Properties, Inc.* (2012) 203 CA4th 913, 919-922, 137 CR3d 865, 870-872; see also *River's Side at Washington Square Homeowners Association v. Sup.Ct. (River's Side LLC)* (2023) 88 CA5th 1209, 1238, 305 CR3d 532, 555 (order sustaining demurrer without leave to amend reversed)—homeowner's association had standing to pursue its members' claims against individual unit vendors as to defects in common areas]

(e) [2:177] **Nature and scope of duty:** Brokers and salespersons subject to Civ.C. § 2079 (or Health & Saf.C. § 18046(d)) have a two-pronged duty: first, to conduct a "reasonably competent and diligent *visual inspection* of the property"; and second, to "*disclose* to … prospective buyer[s] all *facts materially affecting the value or desirability* of the property that an investigation would reveal." [Civ.C. § 2079(a) (emphasis added); Health & Saf.C. § 18046(d); *Ryan v. Real Estate of the Pacific, Inc.* (2019) 32 CA5th 637, 645, 244 CR3d 129, 135; *Coldwell Banker Residential Brokerage Co., Inc. v. Sup.Ct. (Salazar)* (2004) 117 CA4th 158, 165, 11 CR3d 564, 569; see also *Peake v. Underwood* (2014) 227 CA4th 428, 442, 173 CR3d 624, 636—duty extends only to what reasonably competent and diligent visual inspection of property would reveal (*¶ 2:179.1*); *Furla v. Jon Douglas Co.* (1998) 65 CA4th 1069, 1077-1078, 76 CR2d 911, 915-916—duty encompasses reasonably accurate statement of square footage]

1) [2:177.1] **Legal consequences of apparent defects not within disclosure duty:** The legal ramifications of various factual conditions of the property are not themselves "facts" within the Civ.C. § 2079 disclosure duty. Seller's agents are *not* required to disclose *conclusions as to value* resulting from the factual nature of realty. [*Sweat v. Hollister* (1995) 37 CA4th 603, 608-609, 43 CR2d 399, 402 (disapproved on other grounds by *Santisas v. Goodin* (1998) 17 C4th 599, 609, 71 CR2d 830, 836, fn. 5, and *Brannon v. Sup.Ct. (Crippen)* (2004) 114 CA4th 1203, 1205, 1211, 8 CR3d 491, 492, 496)—broker discharged § 2079 duty by disclosing residence was located in flood plain and was not bound to further disclose that city ordinance precluded remodeling or expansion of flood plain property; *Pagano v. Krohn* (1997) 60 CA4th 1, 12, 70 CR2d 1, 7; *see more detailed discussion at ¶ 2:170.2 ff.*]

2) [2:177.2] **Broker's "good faith" reliance on seller's representations protected:** A seller's agent has no duty under Civ.C. § 2079 to independently verify or disclaim the accuracy of the seller's representations. The post-*Easton* statutory scheme simply requires the seller's agent to act in *good faith* and not to pass the seller's representations on to the buyer without a *reasonable basis* for believing them to be true. [*Robinson v. Grossman* (1997) 57 CA4th 634, 643-644, 67 CR2d 380, 385—seller's broker had no duty to verify seller's representations that stucco cracks were only cosmetic and that leaks causing interior water stains and paint peeling had been repaired]

Once the sellers and their agent make the § 2079 disclosures, "it is incumbent upon the *potential purchasers* to investigate and make an informed decision based thereon." [*Robinson v. Grossman*, supra, 57 CA4th at 644, 67 CR2d at 385 (emphasis added); *Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 413, 98 CR2d 176, 184-185]

3) [2:177.3] **Compare—buyer's broker's broader fiduciary duty:** The duty contemplated by Civ.C. § 2079 does not rise to the level of *fiduciary* obligations owed by brokers to their *clients.* In some contexts, a *buyer's agent's fiduciary duty* of inspection/disclosure may be far more expansive than the "cursory type of visual inspection" Civ.C. § 2079 requires of sellers' brokers to benefit nonclient buyers (*¶ 2:179 ff.*). [*Field v. Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 27, 73 CR2d 784, 790; see also *William L. Lyon & Assocs., Inc. v.Sup.Ct. (Henley)* (2012) 204 CA4th 1294, 1311, 139 CR3d 670, 683—dual listing agent's failure to disclose material defects supported buyer's action for breach of fiduciary duty, fraud, negligence and negligent misrepresentation (*¶ 2:157.3*); *Michel v. Moore & Assocs., Inc.* (2007) 156 CA4th 756, 762, 67 CR3d 797, 802—fiduciary's failure to disclose material information to principal constitutes negligent misrepresentation and constructive fraud (*¶ 2:157.4 & 11:365 ff.*)]

For example, in transmitting information from the seller (or others) to the buyer, the buyer's broker must either verify the information or disclose to the buyer that it has not been verified (*see ¶ 2:157.7*). As stated, this is not within the seller's agent's statutory obligation to the buyer (*see ¶ 2:177.2*).

(f) [2:178] **Standard of care:** In carrying out the Civ.C. § 2079 duty of inspection and disclosure, brokers must exercise the degree of care that would be exercised by "a reasonably prudent real estate licensee." That standard of care is measured by the "degree of knowledge through education, experience, and examination" required to obtain a real estate broker's/salesperson's license (Bus. & Prof.C. § 10000 et seq., *¶ 2:70 ff.*). [Civ.C. § 2079.2; *Michel v. Moore & Assocs., Inc.* (2007) 156 CA4th 756, 763, 67 CR3d 797, 802-803—§ 2079 codifies *negligence* standard of care for "one particular task" imposed on brokers—i.e., seller's agent's obligation to visually inspect property and disclose results to buyer; see also Health & Saf.C. § 18046.1—licensed dealers of used manufactured homes and mobilehomes subject to comparable standard of care vis-á-vis "reasonably prudent [licensed] dealer"]

Also, a broker's or salesperson's obligations pursuant to § 2079 include a duty to comply with DRE regulations "imposing standards of professional conduct. . ." [See Civ.C. § 2079(b)]

[2:178.1 - 2:178.4] ***Reserved.***

(g) [2:178.5] **Form of disclosures:** The inspection disclosures required by Civ.C. § 2079 are to be made on the *agent's portion of the Civ.C. § 1102.6 real estate transfer disclosure statement* (or, with regard to manufactured home/ mobilehome resales, the Civ.C. § 1102.6d transfer disclosure statement) when the property transfer is subject to the § 1102 et seq. disclosure requirements (*see* ¶ *2:185, 4:354 ff.*). If the transfer is not subject to Civ.C. § 1102 et seq. (e.g., sales or transfers between spouses or co-owners, sales or transfers of any portion of property not constituting single-family residential property, and the sale, creation or transfer of leases of any duration except leases with options to purchase or ground leases coupled with improvements; see Civ.C. § 1102.2), a broker's § 2079 inspection disclosures may be made in a separate writing. [Civ.C. § 1102.1(a), (b) & (c)]

(h) [2:179] **Matters outside duty of inspection:** Only a *visual* inspection is required. [Civ.C. § 2079(a); *Field v. Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 24, 73 CR2d 784, 788; see *Wilson v. Century 21 Great Western Realty* (1993) 15 CA4th 298, 308, 18 CR2d 779, 784—absence of steel reinforcement and "J" bolts in foundation *not* discernible by visual inspection and thus outside scope of Civ.C. § 2079 inspection duty; see also *Salahutdin v. Valley of Calif., Inc.* (1994) 24 CA4th 555, 562, 29 CR2d 463, 466, fn. 3—absent "red flags" visible from reasonably diligent visual inspection indicating property was not size represented, § 2079 would not encompass duty to survey property or make sure it was size represented (dictum)]

Further, the requisite visual inspection does *not* include the following:

1) [2:179.1] **Inaccessible areas:** The broker/salesperson has no obligation to inspect "reasonably and normally inaccessible" areas. [Civ.C. § 2079.3; *Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 413, 98 CR2d 176, 184; *Wilson v. Century 21 Great Western Realty* (1993) 15 CA4th 298, 308, 18 CR2d 779, 784-785; see *Peake v. Underwood* (2014) 227 CA4th 428, 443, 173 CR3d 624, 637—no breach of duty where defective subfloors were neither visible nor apparent during reasonable property inspection]

2) [2:179.2] **Off-site areas and public records:** The requisite visual inspection does not include an affirmative inspection of areas *off the site* of the subject property or *public records or permits* concerning *title or use* of the property. [Civ.C. § 2079.3; *Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 413, 98 CR2d 176, 184; see *Padgett v. Phariss* (1997) 54 CA4th 1270, 1282, 63 CR2d 373, 379—Civ.C. § 2079 does not require real estate agents to study court files to see whether property is in litigation; see also *Sweat v. Hollister* (1995) 37 CA4th 603, 609, 43 CR2d 399, 402 (disapproved on other grounds by *Santisas v. Goodin* (1998) 17 C4th 599, 609, 71 CR2d 830, 836, fn. 5, and *Brannon v. Sup.Ct. (Crippen)* (2004) 114 CA4th 1203, 1205, 1211, 8 CR3d 491, 492, 496)—"It is not the obligation of the seller to research local land use ordinances and advise a buyer as to their effect on the realty"]

3) [2:179.3] **Planned development, etc. units:** If the property comprises a unit in a *planned development* (Bus. & Prof.C. § 11003), *condominium* (Civ.C. § 783) or *stock cooperative* (Bus. & Prof.C. § 11003.2), the broker/salesperson is not required to inspect more than the unit offered for sale, *provided* the seller or broker complies with Civ.C. § 4525 et seq. (i.e., the transfer disclosure requirements applicable to *noncommercial/nonindustrial* common interest developments, including providing prospective purchasers with governing documents and notice of any restrictions, assessments or violations, etc.). [See Civ.C. § 2079.3; *Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 413, 98 CR2d 176, 184; *Pagano v. Krohn* (1997) 60 CA4th 1, 9, 70 CR2d 1, 5]

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a) [2:179.4] **No duty to inquire of homeowners' association:** Thus, at least absent facts putting the broker on notice that there might be defects in the common areas, a broker has *no duty* under Civ.C. § 2079 to inquire of a planned unit development's *homeowners' association* regarding common area defects or pending construction defect litigation. [*Padgett v. Phariss* (1997) 54 CA4th 1270, 1282, 63 CR2d 373, 379—pursuant to Civ.C. § 2079.3, "this type of extended inspection is not required"]

b) Application

• [2:179.5] Seller of a condominium unit represented that she knew of no flooding, drainage or grading problems in the development. Seller's Agent represented she knew of nothing to contradict that statement; and further represented that, while other units had experienced moisture intrusion, according to Seller, there were no such problems in Seller's unit.

Having disclosed the "essential facts" about water intrusion in the development, Seller's Agent had no obligation to inspect other units and provide more specific information regarding the water intrusion problems the other units had suffered. [*Pagano v. Krohn* (1997) 60 CA4th 1, 9, 70 CR2d 1, 5—seller's broker "not obligated to disclose the details of water intrusion affecting other specific units in the development absent some reason to believe [buyer's] unit would likely suffer the same fate"]

[2:179.6 - 2:179.9] ***Reserved.***

(i) [2:179.10] **Ordinarily, no disclosure obligations after termination of agency:** A broker's inspection and disclosure obligations are an incident of the agency. Real estate agents' duties (even to their own clients) ordinarily terminate "when the subject matter of agency is sold or otherwise disposed of"—i.e., at the close of escrow. [*Robinson v. Grossman* (1997) 57 CA4th 634, 646, 67 CR2d 380, 387 (internal quotes omitted)]

But this is not an inflexible, automatic rule: Although not common in a straightforward residential purchase and sale transaction, an agent may remain under a duty of disclosure after technical termination of the agency "when it is foreseeable to the agent that the principal will continue to rely on the agent for information and the agent does not inform the principal that no further information will be provided." [See *Blickman Turkus, LP v. MF Downtown Sunnyvale, LLC* (2008) 162 CA4th 858, 887-888, 76 CR3d 325, 348 (quoting Rest.3d Agency § 8.11, comm. "c") (involving complex commercial lease transaction where lessor charged lessee's agent with duty to disclose lessee's deteriorating financial condition after lease had been executed)]

(j) [2:180] **Two-year statute of limitations:** An action against a seller's (or cooperating) broker/salesperson for breach of the Civ.C. § 2079 obligations must be brought within *two years* of the "*date of possession.*" [Civ.C. § 2079.4 (emphasis added); *William L. Lyon & Assocs., Inc. v. Sup.Ct. (Henley)* (2012) 204 CA4th 1294, 1305, 139 CR3d 670, 678]

The "date of possession" triggering commencement of the limitations period is the date of recordation, the date escrow closes, or the date of the buyer's occupancy, *whichever occurs first.* [Civ.C. § 2079.4; compare *William L. Lyons & Assocs., Inc. v. Sup.Ct. (Henley)*, supra, 204 CA4th at 1307-1314, 139 CR3d at 679-685 (contrasting more flexible limitations period for action involving dual listing agent, triggered by dates buyers discovered or should have discovered breach of agent's contractual/fiduciary duties); *Field v. Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 25, 73 CR2d 784, 788 (contrasting more flexible limitations period for action involving broker who exclusively represented buyers, triggered by date buyers discovered or should have discovered broker's fiduciary negligence)]

1) [2:180.1] **Applicable to any action against nonfiduciary brokers arising out of § 2079 duty to inspect/disclose:** The Civ.C. § 2079.4 two-year statute applies to a "legal action for breach of duty imposed by [Civ.C. § 2079 et seq.]." [Civ.C. § 2079.4]

Thus, the statutory two-year bar applies to any cause of action (regardless of the label used) against a *nonfiduciary* broker (i.e., by a nonclient buyer against a seller's or cooperating broker) that arises out of the broker's statutory duty to inspect and disclose. [*Field v. Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 27, 73 CR2d 784, 790, fn. 12; *Loken v. Century 21-Award Properties* (1995) 36 CA4th 263, 272, 42 CR2d 683, 689]

a) [2:180.2] **Actions "sounding in negligence":** Clearly, the two-year statute applies to negligence actions against a seller's broker premised on the broker's negligent inspection and consequent failure to disclose what a diligent

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inspection would have revealed. [See generally, *Williams v. Wells & Bennett Realtors* (1997) 52 CA4th 857, 865, 61 CR2d 34, 39 (distinguishing between negligence and fraud claims)]

1/ [2:180.3] **Including negligent misrepresentation:** Even a *negligent misrepresentation* cause of action (which has its roots in fraud) is subject to the two-year statute if the underlying wrongful conduct stems from the seller's (or cooperating) broker's Civ.C. § 2079 duty to inspect and disclose. [*Loken v. Century 21-Award Properties* (1995) 36 CA4th 263, 273, 42 CR2d 683, 689]

For example, in *Loken*, supra, Seller's Broker represented there were no problems with the house, that it appeared to be in a very structurally sound condition, and the only defect discovered after a "competent and diligent visual inspection" was a cracked driveway. However, evidence at trial showed a cracked slab and significant other cracks and structural problems which Broker failed to discover and disclose, indicating Broker's inspection was at least *negligent* and that there was a failure to disclose what a diligent inspection would have revealed. The essence of Buyer's negligent misrepresentation cause of action was Broker's *negligent actions* in breach of the § 2079 duty to inspect and disclose; thus, "there can be no question that it falls within the two-year limitation period of section 2079.4." [*Loken v. Century 21-Award Properties*, supra, 36 CA4th at 268, 273, 42 CR2d at 686, 689]

2/ [2:180.4] **Actions alleging per se violation of Civ.C. § 1102:** Likewise, a cause of action against a seller's broker alleging a "per se violation" of Civ.C. § 1102 et seq. (requiring a seller's "real estate transfer disclosure statement," a section of which requires the seller's agent to disclose defects found after a visual inspection, ¶ *2:185*) is subject to the Civ.C. § 2079.4 two-year statute because it "sounds in negligence" and *stems from* the Civ.C. § 2079 inspection disclosure duty. [*Loken v. Century 21-Award Properties* (1995) 36 CA4th 263, 274, 42 CR2d 683, 690]

[2:180.5 - 2:180.9] ***Reserved.***

2) [2:180.10] **Inapplicable to intentional fraud actions:** By contrast, the Civ.C. § 2079.4 limitations period does *not* apply to an *intentional fraud* cause of action against a broker premised on the broker's deliberate concealment of material facts *known* to the broker. [*Williams v. Wells & Bennett Realtors* (1997) 52 CA4th 857, 865, 61 CR2d 34, 39]

Reason: In enacting Civ.C. § 2079 et seq., the Legislature made clear it was *not changing* pre-*Easton* law relating to duties owed by real estate agents (Civ.C. § 2079.12, ¶ *2:173.1*). Thus, unaffected by the statutory scheme —including Civ.C. § 2079.4—is preexisting law requiring brokers to disclose defects *known* to the broker but unknown to the prospective buyer, and subjecting brokers to fraudulent concealment liability for a failure to disclose such known facts. [*Williams v. Wells & Bennett Realtors*, supra, 52 CA4th at 862-863, 865, 61 CR2d at 37, 39 (distinguishing *Loken* as premised on broker's *negligent* acts); see also *Peake v. Underwood* (2014) 227 CA4th 428, 444-446, 173 CR3d 624, 638-639—listing agent who knew of prior problems in residence's subflooring and disclosed same to buyer during escrow had no duty "as a matter of law" to disclose additional defects neither visible nor apparent during reasonable property inspection]

3) [2:180.11] **Inapplicable to actions by *client against broker:*** The Civ.C. § 2079 duties run between the *seller's agent* (or cooperating agent) and a *nonclient buyer* (¶ *2:176.5 ff.*). Thus, since the Civ.C. § 2079.4 two-year statute is limited to actions arising out of Civ.C. § 2079, it does *not* apply in suits brought by *clients* against their brokers. [*Field v. Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 20-21, 73 CR2d 784, 786; see also *William L. Lyon & Assocs., Inc. v. Sup.Ct. (Henley)* (2012) 204 CA4th 1294, 1305, 139 CR3d 670, 678—two-year limitations period did not apply to buyers' action against seller's broker acting as dual agent]

a) [2:180.12] **Seller's implied contractual indemnity action against broker:** The Civ.C. § 2079.4 statute of limitations is inapplicable to a *seller's* action for implied contractual indemnity against the seller's broker based upon a breach of duty owed to the seller to properly perform the *broker-client* agreement. [*William L. Lyon & Assocs., Inc. v. Sup.Ct. (Henley)* (2012) 204 CA4th 1294, 1315, 139 CR3d 670, 685—sellers' indemnity action did not accrue until they suffered actual loss through payment; *West v. Sup.Ct. (Willis M. Allen Co.)* (1994) 27 CA4th 1625, 1633-1635, 34 CR2d 409, 413-414—purchasers sued both sellers and brokers but suit against brokers dismissed because barred by § 2079.4]

b) [2:180.13] **Buyer's breach of fiduciary duty action against broker:** Similarly, Civ.C. § 2079.4 does not apply to suits for breach of fiduciary duty against brokers by purchasers whom they exclusively represent. [*Field v. Century 21 Klowden-Forness Realty* (1998) 63 CA4th 18, 20-21, 73 CR2d 784, 786—§ 2079.4 did not bar buyers' suit against their brokers based on brokers' failure to determine extent of easement was substantially more burdensome than represented and acreage was not accurate]

As earlier explained, the *fiduciary* duty of a broker to investigate for a buyer whom the broker exclusively represents does not derive from Civ.C. § 2079 but, rather, is *independent of*, and more expansive than, the seller's broker's *separate nonfiduciary* § 2079 duty (¶ *2:157.2 ff., 2:176.6*). [*Field v. Century 21 Klowden-Forness Realty*, supra, 63 CA4th at 25, 73 CR2d at 789]

Moreover, since suits involving fiduciaries are governed by a more flexible statute of limitations (accrual is measured by the date plaintiff discovers, or should have discovered, the wrongful act, rather than by the fixed two-years-from-possession rule of § 2079.4), "to apply section 2079.4 to fiduciary duties of a buyer's broker would, contrary to the Legislature's express statement of intent [*see* ¶ *2:173.1*], restrict the ability of buyers to obtain redress for duties owed by their own real estate licensees which existed before section 2079.4 was enacted." [*Field v. Century 21 Klowden-Forness Realty*, supra, 63 CA4th at 25, 73 CR2d at 789]

(k) [2:181] **Buyer's duty of care not affected:** Civ.C. § 2079 et seq. does not relieve buyers of the duty to exercise reasonable care to protect themselves. In particular, regardless of the broker's disclosures, buyers cannot turn a blind eye to known facts or facts within their "diligent attention and observation." [Civ.C. § 2079.5; *Furla v. Jon Douglas Co.* (1998) 65 CA4th 1069, 1079, 76 CR2d 911, 916; see *Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 413, 417, 98 CR2d 176, 184, 187—having been told of condo project's construction defect litigation and that her unit was being purchased "*as is*," buyer had duty to investigate whether defects involved in lawsuit would affect her remodeling plans; *Pagano v. Krohn* (1997) 60 CA4th 1, 10, 70 CR2d 1, 5—buyers knew about water intrusion at condo complex and "additional details they fault [seller's broker] for not disclosing … were within their own diligent attention"]

Actionable nondisclosure relates to facts *not discoverable* by the purchasers. By contrast, there is no actionable breach of § 2079 duties with regard to information as readily available to prospective buyers as it is to the seller's brokers. [*Sweat v. Hollister* (1995) 37 CA4th 603, 608-609, 43 CR2d 399, 402 (disapproved on other grounds by *Santisas v. Goodin* (1998) 17 C4th 599, 609, 71 CR2d 830, 836, fn. 5, and *Brannon v. Sup.Ct. (Crippen)* (2004) 114 CA4th 1203, 1205, 1211, 8 CR3d 491, 492, 496)—no duty to disclose existence and effect of city ordinances regulating rebuilding or improvement of house in disclosed flood plain ("That disabilities may exist should be obvious to any buyer")]

1) [2:182] **Question of fact:** Whether the buyer unreasonably failed to protect themself or unjustifiably failed to discover true conditions presents a *factual* issue for resolution by the trier of fact. [See *Furla v. Jon Douglas Co.* (1998) 65 CA4th 1069, 1079, 76 CR2d 911, 917—issue of fact (not determinable by summary judgment) whether true square footage was "obvious and patent" to buyer, thereby making his reliance on seller's broker's representation unjustified]

[2:183 - 2:184] ***Reserved.***

b. [2:185] **Additional seller's transfer disclosure statement re physical condition of residential property:** To further protect residential real estate buyers, a statutory-form "transfer disclosure statement" must be delivered by the seller to the buyer before a purchase and sale contract is executed. The statutory disclosure form contains a checklist for giving notice of existing or potential problems concerning the physical condition of the property and cautions the buyer that, in connection therewith, they may wish to obtain professional advice and/or inspections of the property. [Civ.C. § 1102 et seq.; see Civ.C. §§ 1102.3, 1102.6; *Coldwell Banker Residential Brokerage Co., Inc. v. Sup.Ct. (Salazar)* (2004) 117 CA4th 158, 164-165, 11 CR3d 564, 569; *and* ¶ *4:358 ff.* re exact time for delivery of statement]

(However, only *facts* concerning the condition of the property must be disclosed, *not* the legal ramifications of alleged defects. *See* ¶ *2:170.2 ff.*)

(1) [2:185.1] **Which property transactions:** The statutory disclosure statement requirements apply to any transfer by sale, exchange, real property sales contract (as defined by Civ.C. § 2985, ¶ *4:112 ff.*), lease with option to purchase, other option to purchase, or ground lease coupled with improvements of "single-family residential property." [Civ.C. § 1102(a); see also Bus. & Prof.C. § 10018.08 (defining "single-family residential property" as (i) real property improved with one to four dwelling units, including any leasehold exceeding one year's duration of such, (ii) a unit in a residential stock

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cooperative, condominium or planned unit development, and (iii) mobile/manufactured homes as statutorily specified (below)); *Richman v. Hartley* (2014) 224 CA4th 1182, 1184, 169 CR3d 475, 477 (decided under former law)—transfer disclosure requirements apply even to "mixed-use" properties if they contain up to four dwelling units]

The statutory disclosure requirements also apply to *resales of manufactured homes* (as defined in Health & Saf.C. § 18007) and *mobilehomes* (as defined in Health & Saf.C. § 18008) when offered for sale or sold through a real estate broker pursuant to Bus. & Prof.C. § 10131.6. [Bus. & Prof.C. § 10018.08; see also Health & Saf.C. §§ 18025(c) & 18046(c)—sales of used manufactured homes/mobilehomes by licensed real estate brokers and salespersons subject to Civ.C. § 2079; Civ.C. § 798.74.4 (requirements include use of Civ.C. § 1102.6d Manufactured Home and Mobilehome Transfer Disclosure Statement; ¶ *2:185.3*)]

(2) [2:185.2] **Purpose:** The transfer disclosure statement is intended to enable prospective buyers to rely on the information furnished in deciding whether and on what terms to purchase the property. [See Civ.C. § 1102.6 (Real Estate Transfer Disclosure Statement, Seller's Information); *Calemine v. Samuelson* (2009) 171 CA4th 153, 162, 89 CR3d 495, 502—Civ.C. § 1102 et seq. was enacted to make required disclosures "specific and clear"]

The statutory scheme itself (Civ.C. § 1102 et seq.) is "intended to provide real estate agents *the means* to elicit material information from the seller about the property …, and to deliver that information to the buyer." [*Coldwell Banker Residential Brokerage Co., Inc. v. Sup.Ct. (Salazar)* (2004) 117 CA4th 158, 164, 11 CR3d 564, 569 (emphasis added; original emphasis omitted) (citing Stats. 1985, Ch. 1574, § 2); see also *Richman v. Hartley* (2014) 224 CA4th 1182, 1187, 169 CR3d 475, 479—Legislature intended Transfer Disclosure Law to reduce litigation and disputes pertaining to certain real property sales transactions]

(3) [2:185.3] **Form of transfer disclosure statement:** The basic real estate transfer disclosure statement (for one-to-four-unit residential property) is prescribed by Civ.C. § 1102.6; and the required disclosures are itemized in the "Seller's Information" section of the form. The form also contains an "Agent's Inspection Disclosure," to be used by the *seller's agent* (or the agent who obtained the purchase offer) in making the inspection disclosures required by Civ.C. § 2079. It is the *agent's* responsibility to deliver the § 1102.6 statement to the buyer. [Civ.C. §§ 1102.1(a), 1102.6, 1102.12; see *Robinson v. Grossman* (1997) 57 CA4th 634, 641-642, 67 CR2d 380, 384]

A separate, but parallel, transfer disclosure form is prescribed by Civ.C. § 1102.6d for manufactured home/mobilehome resales. Like the Civ.C. § 1102.6 form (above), it contains a "Seller's Information" section for the requisite disclosures; and an "Agent's Inspection Disclosure" section for the seller's agent (or agent who obtained the purchase offer) to use in making the Civ.C. § 2079 inspection disclosures. [See Civ.C. §§ 1102.1(b) & (c), 1102.6d]

(The California Association of Realtors (C.A.R.) provides preprinted form transfer disclosure statements made in accordance with Civ.C. § 1102 et seq. The forms may be purchased online through C.A.R.'s subsidiary, the REBS Online Store, at *www.car.org*, or by contacting REBS Customer Service at (213) 739-8227.)

(a) [2:185.4] **Agent Visual Inspection Disclosure (AVID) form:** Although not required, brokers and salespersons (for both sellers and/or buyers) sometimes provide buyers of residential property with an AVID form. Its purpose is to formally notify a buyer of specific defects in the property known to the broker or salesperson. The AVID form also provides brokers and salespersons with a written record of the disclosures made. It normally is delivered prior to the close of escrow and may be attached to the Real Estate Transfer Disclosure Statement (¶ *2:185.3*).

(Preprinted AVID forms may be purchased through C.A.R.; *see* ¶ *2:185.3*.)

[2:185.5 - 2:185.9] ***Reserved.***

(4) [2:185.10] **Nonwaivable; effect of noncompliance:** The Civ.C. § 1102 et seq. transfer disclosure requirements are *nonwaivable*—even in an "as is" sale. [Civ.C. §§ 102(c), 1102.1(a) & (b); see also *Richman v. Hartley* (2014) 224 CA4th 1182, 1192, 169 CR3d 475, 483 (noting any attempted waiver is void as against public policy)—"as-is" provision in parties' sale agreement could not, "as a matter of law, operate as a waiver of the Transfer Disclosure Law"]

A property transfer will not be invalidated solely for failure to deliver the requisite disclosure statement. But "any person" (meaning seller *or agent*) who "willfully or negligently" fails to comply with § 1102 et seq. "shall be liable" for the buyer's actual damages. [Civ.C. § 1102.13; but see *Loken v. Century 21-Award Properties* (1995) 36 CA4th 263, 274, 42 CR2d 683, 690—Civ.C. § 2079.4 2-year statute of limitations applies to § 1102.13 damages suit against broker (¶ *2:180.4*)]

(5) [2:186] **No effect on other disclosure obligations:** Although the Legislature intended the Civ.C. §§ 1102.6/1102.6d transfer disclosure statements to be used by both sellers (in making Civ.C. § 1102 et seq. disclosures) and agents (in making Civ.C. § 2079 disclosures), nothing in Civ.C. § 1102 et seq. affects or changes a broker's/salesperson's inspection disclosure obligations pursuant to Civ.C. § 2079. [Civ.C. § 1102.1(a) & (b)]

Nor does Civ.C. § 1102 et seq. affect the parties' and agents' obligations under the law to disclose *any facts materially affecting the value and desirability of the property,* including, but not limited to, the physical conditions of the property and previously received reports of physical inspections noted on the Civ.C. § 1102.6 (or Civ.C. § 1102.6a) disclosure form. [Civ.C. § 1102.1(a) & (b); see *Calemine v. Samuelson* (2009) 171 CA4th 153, 161-162, 89 CR3d 495, 502—Legislature did not intend to alter seller's common law disclosure duty by enacting Civ.C. § 1102 et seq.]

Thus, a seller's agent is not shielded from liability for material nondisclosures affecting the value or desirability of the property simply by delivering the *seller's* Civ.C. § 1102.6 (or Civ.C. § 1102.6d) transfer disclosure statement to the buyer. The agent's obligations under Civ.C. § 2079 et seq. and consequential liability pursuant thereto, exist *independently* of Civ.C. § 1102 et seq. [Civ.C. § 1102.1(a) & (b); see also Civ.C. § 1102.8—specification of items for disclosure in Civ.C. § 1102 et seq. “does not limit or abridge any obligation for disclosure created by any other provision of law or which may exist in order to avoid fraud, misrepresentation, or deceit in the transfer transaction”]

(a) [2:186.1] **Broker's Civ.C. § 2079 inspection disclosures required despite § 1102.2 exemption:** Certain types of transfers are exempt from the Civ.C. § 1102 et seq. real estate transfer disclosure statement requirement (e.g., sales or transfers between spouses or co-owners, sales or transfers of any portion of property not constituting single-family residential property, and the sale, creation or transfer of leases of any duration except leases with options to purchase or ground leases coupled with improvements; see Civ.C. § 1102.2 (“sale” and “transfer” as used herein have their commonly understood meanings); *and ¶ 4:362*). However, these exemption provisions relate exclusively to the *seller's* § 1102 et seq. disclosure obligations and do *not* relieve *brokers* of their *independent* Civ.C. § 2079 inspection disclosure duties. (In a transaction not requiring a Civ.C. § 1102.6 or § 1102.6d transfer disclosure statement, brokers should make Civ.C. § 2079 inspection disclosures in a separate writing; *¶ 2:178.5*.) [See Civ.C. §§ 1102.1(a) & (b), 1102.2]

Cross-refer: The Civ.C. § 1102 et seq. disclosure requirements are discussed in greater detail at *¶ 4:354 ff.*

c. [2:187] **Natural hazard disclosures:** In addition to the Civ.C. § 1102.6 (or Civ.C. § 1102.6d) seller's transfer disclosure statement (re physical condition of the property, ¶ *2:185, 4:354 ff.*), sellers or their agents may have to make certain natural hazard disclosures (¶ 2:187.1 ff.) to prospective buyers. [Civ.C. § 1103 et seq.; Gov.C. §§ 8589.3, 8589.4, 51183.5; Pub.Res.C. §§ 2621.9, 2694, 4136]

(1) General rules

(a) [2:187.1] **Which property:** The Civ.C. § 1103.2 natural hazard disclosure rules apply to sales, exchanges, real property sales contracts as defined in Civ.C. § 2985, leases with options to purchase, any other options to purchase, and ground leases coupled with improvements, of any “single-family residential real property” located in a natural hazard zone (¶ 2:187.2). They also apply to resales of *mobilehomes and manufactured homes* (used for residential purposes) located in a natural hazard zone. [See Civ.C. § 1103(b); Bus. & Prof.C. § 10018.08 (defining “single-family residential real property” as (i) real property improved with one to four dwelling units, including any leasehold exceeding one year’s duration of such, (ii) units in residential stock cooperatives, condominiums or planned unit developments, and (iii) mobile/manufactured homes when offered for sale or sold through real estate brokers per Bus. & Prof.C. § 10131.6)]

Similar disclosure rules under the Government Code and the Public Resources Code apply to other types of property (commercial property included) in a natural hazard zone. [Gov.C. §§ 8589.3, 8589.4, 51183.5; Pub.Res.C. §§ 2621.9, 2694, 4136]

(b) [2:187.2] **Which hazards:** This separate disclosure duty applies when the property is located within a:

- *special flood hazard area* or *area of potential flooding* (shown on an inundation map prepared per Water Code § 6161) (*¶ 2:187.25 ff.*);

- *earthquake fault zone* or *seismic hazard zone* (*¶ 2:187.30 ff.*); or

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- *high or very high fire hazard severity zone* or *wildland fire area* (*¶ 2:187.35 ff.*). [See Civ.C. §§ 1103(c), 1103.2(a) (amended Stats. 2023, Ch. 99; eff. 1/1/24); Gov.C. §§ 8589.3, 8589.4, 51183.5; Pub.Res.C. §§ 2621.9, 2694, 4136]

(c) [2:187.3] **Nonwaivable; effect of noncompliance:** Any waiver of the Civ.C. § 1103 et seq. disclosure requirements is *void as against public policy*. [Civ.C. § 1103(d)]

No transfer subject to the natural hazard disclosure requirements will be invalidated solely because of a failure to make the disclosures. However, any person who "willfully or negligently" violates or fails to perform a duty prescribed by Civ.C. § 1103 et seq. "shall be liable" for the transferee's actual damages resulting therefrom. [Civ.C. § 1103.13; Gov.C. §§ 8589.3(e), 8589.4(e), 51183.5(e); Pub.Res.C. §§ 2621.9(f), 2694(f), 4136(f)]

(d) Who bears disclosure burden

1) [2:187.4] **Earthquake and flood hazards:** With regard to earthquake and flood hazards, the disclosure burden rests principally with the *seller's agent;* but the seller has the disclosure obligation if they are acting without an agent. [See Civ.C. § 1103(c)(1), (2), (4), (5); Gov.C. §§ 8589.3(a), 8589.4(a); Pub.Res.C. §§ 2621.9(a), 2694(a)]

(Interestingly, however, Civ.C. § 1103.3 places the duty to *deliver* the disclosure statement on the *seller* in all cases. *See ¶ 2:187.6*.)

2) [2:187.5] **Fire hazards:** The statutes charge the *seller or* the seller's agent with the burden of disclosing fire hazards. [Civ.C. § 1103(c)(3), (6); Gov.C. § 51183.5(a); Pub.Res.C. § 4136(a)]

3) [2:187.6] **Escrow agents not included:** An *escrow agent* (unless holding a real estate license under the Real Estate Law) is *not* an agent of the seller (or buyer) for purposes of the natural hazard disclosure requirements unless the escrow agent is empowered to so act by express written agreement (in which event, the extent of that agency is governed by the written agreement). [Civ.C. § 1103.11; Gov.C. §§ 8589.3(d)(1), 8589.4(d)(1); Pub.Res.C. §§ 2621.9(e)(1), 2694(e)(1)]

4) [2:187.7] **Multiple agents:** When more than one licensed real estate broker is acting as agent in a transaction subject to Civ.C. § 1103 et seq., the broker *who obtained the offer* (except as otherwise provided in § 1103 et seq.) has the duty of delivering the disclosure statement to the transferee … unless the transferor has given other written delivery instructions. [Civ.C. § 1103.12(a)]

5) [2:187.8] **Agents unable to obtain statement:** If a licensed broker responsible for delivering disclosures under Civ.C. § 1103 et seq. cannot obtain the requisite disclosure document and does not have the transferee's written assurance that the disclosure has been received, the broker must give the transferee written notice of the transferee's rights to the disclosure. [Civ.C. § 1103.12(b) (also requiring broker to keep record of action to effect compliance in accordance with Bus. & Prof.C. § 10148 (*¶ 2:116*))]

[2:187.9] ***Reserved.***

(e) [2:187.10] **Form and timing of disclosures:** The natural hazard disclosures ordinarily must be made through the "Natural Hazard Disclosure Statement" prescribed by Civ.C. § 1103.2. (In transactions subject to Civ.C. § 1103, an alternative Civ.C. § 1102.6a "Local Option Real Estate Disclosure Statement" may be used if it includes substantially the same information and warnings required by Civ.C. § 1103.2.) [Civ.C. § 1103.2(a), (e); Gov.C. §§ 8589.3(c), 8589.4(c), 51183.5(c); Pub.Res.C. §§ 2621.9(c), 2694(c), 4136(d)]

The *seller* of property subject to Civ.C. § 1103 et seq. (*¶ 2:187.1*) must deliver the requisite statement to the buyer (by personal delivery or mail, see Civ.C. § 1103.10) as follows:

- In *sale* transactions, "as soon as practicable" before the transfer of title. [Civ.C. § 1103.3(a)(1)]

- If the property is being sold by a real property sales contract (as defined in Civ.C. § 2985, *¶ 4:112 ff.*), a lease with option to purchase, or a ground lease coupled with improvements, "as soon as practicable before the prospective buyer's execution of the contract." [See Civ.C. § 1103.3(a)(2) (defining "execution" to mean "the making or acceptance of an offer"); *and further discussion at ¶ 4:365 ff.*]

The statutes governing natural hazard disclosures for property not subject to Civ.C. § 1103 et seq. do not set a deadline for delivery of the statement; but, by requiring disclosure to a *prospective* buyer, those statutes make clear the delivery must occur before title is transferred. [See Gov.C. §§ 8589.3(a), 8589.4(a), 51183.5(a); Pub.Res.C. §§ 2621.9(a), 2694(a), 4136(a)]

(f) [2:187.11] **Amendments:** The required disclosures may be amended in writing by the seller or their agent. Any amendment, however, is subject to Civ.C. § 1103.3; i.e., if delivered after execution of the offer to purchase, the buyer has a limited period of time to terminate their offer. [See Civ.C. §§ 1103.3(c), 1103.9]

(g) [2:187.12] **Good faith limitation:** Each disclosure required by Civ.C. § 1103 et seq. and every act performed in making the disclosures "shall be made in good faith"—i.e., "honesty in fact in the conduct of the transaction." [Civ.C. § 1103.7]

(h) [2:187.13] **Exempt transactions:** Several types of sales or transfers are exempt from the Civ.C. § 1103 et seq. natural hazard disclosure requirements (including sales or transfers pursuant to court order, foreclosure sales, sales or transfers between co-owners or spouses, sales or transfers in probate, transfers to or from a governmental entity, and the sale, creation or transfer of any lease of any duration except leases with options to purchase or ground leases coupled with improvements). [See Civ.C. § 1103.1(a)(1)-(10)]

However, transfers not subject to Civ.C. § 1103 et seq. may *nonetheless be subject to other natural hazard disclosure requirements* (including those under Gov.C. §§ 8589.3, 8589.4 and 51183.5; and Pub.Res.C. §§ 2621.9, 2694 and 4136). [Civ.C. § 1103.1(b) & (c) ("sale" and "transfer" as used herein have their commonly understood meanings)]

(i) [2:187.14] **Not preemptive of other disclosure obligations:** The statutory itemization of natural hazards for disclosure "does not limit or abridge any obligation for disclosure created by any other provision of law or that may exist in order to avoid fraud, misrepresentation, or deceit in the transfer transaction." [Civ.C. § 1103.8(a); Gov.C. §§ 8589.3(f), 8589.4(f), 51183.5(f); Pub.Res.C. §§ 2621.9(g), 2694(g), 4136(g); see also Civ.C. § 1103.2(a)—"representations made in this Natural Hazard Disclosure Statement do not constitute all of the seller's or agent's disclosure obligations in this transaction"]

Nor do the Civ.C. § 1103 natural hazard disclosure requirements change a real estate broker's or salesperson's duties pursuant to Civ.C. § 2079. [Civ.C. § 1103.8(b)]

"The Legislature does not intend to affect the existing obligations of the parties to a real estate contract, or their agents, to disclose any fact materially affecting the value and desirability of the property, including, but not limited to, the physical condition of the property and previously received reports of physical inspection noted on the disclosure form provided pursuant to Section 1102.6 or 1102.6a." [Civ.C. § 1103.8(a); *Calemine v. Samuelson* (2009) 171 CA4th 153, 162, 89 CR3d 495, 502]

[2:187.15] ***Reserved.***

(j) [2:187.16] **Effective only between seller/agent and buyer:** The Civ.C. § 1103 natural hazard disclosures operate only between the seller, seller's agent and prospective buyer, and "shall not be used by any other party" (insurance companies, lenders, governmental agencies, etc.) for any purpose. [Civ.C. § 1103.2(g)]

(k) [2:187.17] **Liability for errors, inaccuracies or omissions:** Neither the seller nor any seller's agent or buyer's agent incurs liability for any error, inaccuracy or omission of information delivered pursuant to Civ.C. § 1103 et seq. *provided* (i) the error, inaccuracy or omission was *not within the seller's, seller's agent's or buyer's agent's personal knowledge,* (ii) the error, inaccuracy or omission *was based on information timely provided by public agencies* or others providing information as specified in Civ.C. § 1103.4(c) (¶ *2:187.19*), *and* (iii) *ordinary care* was exercised in obtaining and transmitting the information. [Civ.C. § 1103.4(a)]

1) [2:187.18] **Substitute compliance by public agency:** The delivery of information required to be disclosed under Civ.C. § 1103 et seq. by a public agency or other person providing such information "*shall be deemed to comply*" with Civ.C. § 1103 et seq. and "*shall relieve* the seller, seller's agent, and buyer's agent *of any further duty*" under Civ.C. § 1103 et seq. *with respect to that item of information*. [Civ.C. § 1103.4(b) (emphasis added)]

2) [2:187.19] **Reliance on expert information:** The delivery of a report or opinion prepared by a licensed engineer, land surveyor, geologist, or expert in natural hazard discovery dealing with matters within the scope of their license or expertise "*shall be sufficient compliance*" for purposes of relieving the seller, seller's agent and buyer's agent from

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liability under Civ.C. § 1103.4(a) (¶ *2:187.17*) *if* the information is provided to the prospective buyer pursuant to request, whether written or oral. [Civ.C. § 1103.4(c) (emphasis added); see also Civ.C. § 1103.2(a) (seller's/agent's representation on Natural Hazard Disclosure Statement re good faith selection of, and reliance on, expert's report as "substituted disclosure" pursuant to Civ.C. § 1103.4)]

In responding to such a request, the expert may indicate, in writing, an understanding that the information provided will be used in satisfying the Civ.C. § 1103.2 disclosure requirements and, if so, "shall indicate the required disclosures" (or parts thereof) to which the information being furnished applies. In addition, the expert must determine, among other things, whether the property is in an airport influence area or located within one mile of a mine operation and, if so, provide a statutorily-prescribed notice. [See Civ.C. § 1103.4(c)]

A report delivered pursuant to Civ.C. § 1103.4(c) must be accompanied by a completed and signed Natural Hazard Disclosure Statement (¶ *2:187.10*), but the Disclosure Statement does not change the legal effect of the report. [Civ.C. § 1103.2(f)(1), (2)]

3) [2:187.20] **Relief from further § 1103 disclosure duties:** After sellers or their agents comply with Civ.C. § 1103.2, they "*shall be relieved of further duty"* under § 1103 et seq. *with respect to those items of information*. Neither the seller nor the seller's agent is required to provide notice to the prospective buyer if the information given thereafter becomes inaccurate as a result of governmental action, map revision, changed information, or other act or occurrence, *unless the seller or agent has actual knowledge* that the information has become inaccurate. [Civ.C. § 1103.5(a) (emphasis added)]

If information disclosed pursuant to § 1103 et seq. thereafter is rendered inaccurate because of governmental action, map revision, changed information, or other act or occurrence postdating delivery of the required disclosure, that inaccuracy "does not constitute a violation" of § 1103 et seq. [Civ.C. § 1103.5(b)]

[2:187.21 - 2:187.24] ***Reserved.***

(2) [2:187.25] **Flood hazard area disclosures:** If the property is located within a special flood hazard area designated by the Federal Emergency Management Agency (FEMA), or in an area of potential flooding shown on an inundation map prepared pursuant to Water Code § 6161, the seller's *agent*, or seller if acting without an agent, must disclose that fact to prospective transferees. [Civ.C. § 1103(c)(1) & (2); Gov.C. §§ 8589.3(a), 8589.4(a)]

(a) [2:187.26] **Notice limitation:** The flooding/inundation disclosure duty is triggered only if the seller or seller's agent (i) has *actual knowledge* that the property is within a special flood hazard or inundation area; *or* (ii) the local jurisdiction has compiled a list, by parcel, of properties within the special flood hazard or inundation area and a notice has been posted at the county recorder, county assessor and county planning agency offices identifying the location of the parcel list (i.e., constructive notice). [Civ.C. § 1103(c)(1)(A), (B) & (c)(2); Gov.C. §§ 8589.3(b), 8589.4(b)]

(b) [2:187.27] **Disclosures pursuant to FEMA Letter of Map Revision:** If the Federal Emergency Management Agency (FEMA) has issued a Letter of Map Revision confirming that the property is no longer in a special flood hazard area, the seller or seller's agent may mark "No" on the Natural Hazard Disclosure Statement—even if the map has not yet been updated. A copy of the FEMA letter must be attached to the disclosure statement by the seller or seller's agent. [Civ.C. § 1103.2(c)]

Conversely, if FEMA has issued a Letter of Map Revision confirming that the property *is* in a special flood hazard area and the location of the letter has been posted pursuant to Gov.C. § 8589.3(g), the seller or seller's agent must mark "Yes" on the Natural Hazard Disclosure Statement—even if the map has not yet been updated. A copy of the FEMA letter must be attached to the disclosure statement by the seller or seller's agent. [Civ.C. § 1103.2(d)]

[2:187.28 - 2:187.29] ***Reserved.***

(3) [2:187.30] **Earthquake hazard area disclosures:** If the property is located within an earthquake fault zone designated pursuant to Pub.Res.C. § 2622, or within a seismic hazard zone designated pursuant to Pub.Res.C. § 2696, the seller's *agent*, or seller if acting without an agent, must disclose that fact to potential transferees. [Civ.C. § 1103(c)(4) & (5); Pub.Res.C. §§ 2621.9(a), 2694(a)]

(a) [2:187.31] **Notice limitation:** The earthquake fault/seismic hazard zone disclosure duty is triggered only if (i) the seller or seller's agent has *actual knowledge* that the property is within a delineated earthquake fault zone or seismic

hazard zone; *or* (ii) a map that includes the property has been provided to the city or county pursuant to Pub.Res.C. §§ 2622 or 2696 and a notice has been posted at the county recorder, county assessor and county planning agency offices identifying the location of the map and any information regarding changes to the map received by the county (i.e., constructive notice). [Civ.C. § 1103(c)(4), (5); Pub.Res.C. §§ 2621.9(b), 2694(b)]

(b) [2:187.32] **Ambiguous maps—affirmative disclosure generally required:** If an earthquake fault zone or seismic hazard zone map (or accompanying information) is not of sufficient accuracy or scale for a reasonable person to determine whether the property is in a natural hazard area, the seller or seller's agent must mark "Yes" on the Natural Hazard Disclosure Statement. [Civ.C. § 1103.2(b); Pub.Res.C. §§ 2621.9(d), 2694(d)]

A "No" may be marked by the seller's agent in such circumstances only if the seller attaches a report prepared pursuant to Civ.C. § 1103.4(c) (¶ *2:187.19*) verifying that the property is not in the hazard zone. [Civ.C. § 1103.2(b); Pub.Res.C. §§ 2621.9(d), 2694(d)]

In any event, notwithstanding the ambiguous map, the seller and seller's agent must exercise reasonable care in deciding whether the property in fact is within an earthquake fault/seismic hazard zone. [Civ.C. § 1103.2(b); Pub.Res.C. §§ 2621.9(d), 2694(d)]

[2:187.33 - 2:187.34] ***Reserved.***

(4) Fire hazard property

(a) Required disclosures

1) [2:187.35] **Property in "high" or "very high" fire hazard severity zone:** If the property is located within a "high" or "very high" fire hazard severity zone designated pursuant to Gov.C. § 51178, the *seller or the seller's agent* must disclose to prospective buyers the fact that the property is located within a high or very high fire hazard severity zone and is subject to the Gov.C. § 51182 maintenance requirements (regarding, with respect to occupied dwellings or structures, the property owner's/occupier's duty to clear away surrounding brush, etc., and maintain a specified firebreak ("defensible space of 100 feet") around and adjacent to the structure). [See Civ.C. §§ 1103(c)(3), 1103.2(a) (amended Stats. 2023, Ch. 99; eff. 1/1/24); Gov.C. § 51183.5(a)]

2) Property in "high or very high fire hazard severity zone"

a) [2:187.35a] **Disclosure of fire hardening improvements for pre-2010 homes:** On or after January 1, 2021, if property is located within a "high or very high fire hazard severity zone" (designated under Gov.C. § 51178) and was constructed before January 1, 2010, sellers must provide specific, statutorily prescribed disclosure notices to buyers that include information on "fire hardening" improvements. [Civ.C. § 1102.6f(a)]

b) [2:187.35b] **Disclosure of vegetation management compliance:** On or after January 1, 2021, if property is located within a "high or very high fire hazard severity zone" (designated under Gov.C. § 51178), sellers must provide documentation stating the property complies with state or local vegetation management requirements. [Civ.C. § 1102.19]

3) [2:187.36] **Property in wildland fire area:** Similarly, a *seller* of property located within a state responsibility area determined by the board, pursuant to Pub.Res.C. § 4125 (forests and timber/brush, etc.), *or* the seller's agent, must disclose to prospective buyers the fact that the property is located within a wildland area that may contain substantial forest fire risks and hazards and is subject to the Pub.Res.C. § 4291 maintenance requirements (duties re providing defensible spaces around structures, removing dead/dying wood from trees, shrubs and other plants adjacent to or overhanging buildings, etc.). [Civ.C. § 1103(c)(6); Pub.Res.C. § 4136(a)]

Unless the property is located in a county that has assumed responsibility for prevention and suppression of all fires pursuant to Pub.Res.C. § 4129, the seller must also disclose to prospective buyers that it is not the state's responsibility to provide fire protection services to any building or structure located within the wildlands except where a local agency has so agreed with the Department of Forestry and Fire Protection pursuant to Pub.Res.C. § 4142. [Pub.Res.C. § 4136(b)]

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(b) [2:187.37] **Notice limitation:** The very high fire hazard severity and wildland fire area disclosure obligations are triggered only if (i) the seller or seller's agent has *actual knowledge* that the property is within a very high fire hazard severity zone or wildland fire zone; or (ii) a map that includes the property has been provided to the local agency, city or county pursuant to Gov.C. § 51178 or Pub.Res.C. § 4125 and a notice has been posted at the county recorder, county assessor and county planning agency offices that identifies the location of the map and any information regarding changes to the map received by the local agency or county (i.e., constructive notice). [Civ.C. § 1103(c)(3), (6); Gov.C. § 51183.5(b); Pub.Res.C. § 4136(c)]

(c) [2:187.38] **Ambiguous maps—affirmative disclosure generally required:** If a high/very high fire hazard severity zone or wildland fire area map (or accompanying information) is not of sufficient accuracy or scale for a reasonable person to determine whether the property is in a natural hazard area, the seller or seller's agent must mark "Yes" on the Natural Hazard Disclosure Statement. [Civ.C. § 1103.2(b) (amended Stats. 2023, Ch. 99; eff. 1/1/24); Gov.C. § 51183.5(d); Pub.Res.C. § 4136(e)]

A "No" may be marked by the seller's agent in such circumstances only if the seller attaches a report prepared pursuant to Civ.C. § 1103.4(c) (*¶ 2:187.19*) verifying that the property is not in the hazard zone. [Civ.C. § 1103.2(b); Gov.C. § 51183.5(d); Pub.Res.C. § 4136(e)]

Notwithstanding the ambiguous map, however, the seller and seller's agent are bound to exercise reasonable care in deciding whether the property in fact is within a high or very high fire hazard severity zone or wildland fire area. [Civ.C. § 1103.2(b); Gov.C. § 51183.5(d); Pub.Res.C. § 4136(e)]

d. Disclosures pertaining to listing agreement

(1) [2:188] **Specification of fixed term for exclusive listing agreements:** Any "exclusive agreement authorizing a licensee" to perform licensed brokerage activities for compensation must "contain a definite, specified date of final and complete termination." [Bus. & Prof.C. § 10176(f); *see ¶ 2:114* (noncompliance is ground for license suspension or revocation) *and ¶ 2:379*]

(2) [2:188.1] **Specification of no fixed compensation rate:** Any printed or form listing agreement must contain a statement in at least 10 point boldface type, immediately preceding broker compensation provisions, that real estate broker commissions are not fixed by law; and that commissions are set by each broker and may be negotiable between seller and broker. [Bus. & Prof.C. § 10147.5; *see further discussion at ¶ 2:391 ff.*]

Real estate agents are also precluded from stating or implying that they cannot charge less than the commission quoted to the owner by the agent. [10 CCR § 2785(a)(3)]

e. [2:189] **Other disclosures concerning the property:** Several additional statutory disclosures must be made by sellers and brokers; the more prominent requirements are noted at ¶ 2:191 ff.

• [2:190] **Comment:** Some of these statutes place the disclosure burden on the *seller* (rather than the seller's broker). Even so—at least in regard to residential real estate transactions—they also impact a seller's *broker's* disclosure burdens under the general authority of *Easton* (*¶ 2:170 ff.*) and Civ.C. § 2079 et seq. (*¶ 2:173 ff.*).

(1) [2:191] **Structural pest control report:** "As soon as practical" before transfer of title or execution of the sales contract, the *seller or seller's agent* must deliver to the buyer a copy of a structural pest control inspection report (Bus. & Prof.C. § 8516) upon which a certification in accordance with Bus. & Prof.C. § 8519 may be made, "provided that certification or preparation of a report is a condition of" the purchase contract or a condition of financing the transfer. [See Civ.C. § 1099(a); *see ¶ 4:378 ff.*]

(2) [2:192] **Hazardous materials:** Several statutes require disclosures regarding the presence of hazardous substance (toxic) materials on property to be sold. Briefly:

(a) [2:193] **Hazardous substance release on nonresidential property:** Nonresidential property owners who know, or have "reasonable cause to believe," a release of hazardous substance is located on or beneath the property must—*before the sale*—give the buyer written notice of the condition. [Health & Saf.C. § 78700 (added Stats. 2022, Ch. 257; eff. 1/1/24)]

Noncompliance subjects the owner to "actual damages and any other remedies provided by law." Further, if the owner has actual knowledge of the release of a "material amount" of a hazardous substance and "knowingly and willfully"

fails to give the buyer written notice thereof, the owner is liable for a maximum $5,000 civil penalty for each separate violation. [Health & Saf.C. § 78700 (added Stats. 2022, Ch. 257; eff. 1/1/24)]

(b) [2:194] **Asbestos-containing materials on nonresidential property:** Owners of any *nonresidential* public or commercial building (see Health & Saf.C. § 25919.2) constructed before 1979 who know the building contains asbestos-containing construction materials, must provide all employees working within the building detailed written notifications pursuant to Health & Saf.C. § 25915; or, alternatively, the owner may prepare and distribute notice of an asbestos management plan pursuant to Health & Saf.C. § 25915.1. [See Health & Saf.C. §§ 25915, 25915.1, 25915.2]

[2:195] ***Reserved.***

(c) [2:195.1] **Lead-based paint in residential structures:** "Any person" (seller *or* broker) who knowingly violates these requirements is subject to civil or criminal fines of up to $10,000 per violation and/or imprisonment for up to one year; and may be enjoined. The violator also faces *treble damages liability* to the purchaser in a private civil suit (three times the amount of the purchaser's actual damages caused by the failure to disclose), along with the purchaser's costs, attorney fees and expert witness fees incurred in the civil action. [See 42 USC §§ 3545, 4852d(b); *and discussion at ¶ 4:366.2 ff.*]

[2:195.2 - 2:195.9] ***Reserved.***

(d) [2:195.10] **Toxic mold on nonresidential property:** A seller of *commercial or industrial property* must provide written disclosure to prospective buyers "as soon as practicable" before the transfer of title when the seller *knows of the presence of mold*, whether visible or invisible or hidden, affecting the property, and the mold either exceeds permissible exposure limits (set by Health & Saf.C. § 26103(a), (b) and (c)) or poses a health threat according to Department of Health Services (DHS) guidelines. [Health & Saf.C. § 26140(a); but see also Health & Saf.C. § 26140(d)—disclosure requirements inapplicable until first January 1 or July 1 at least 6 months after DHS adopts requisite standards and guidelines]

Exception: A seller is *exempt* from the above disclosure requirement if the presence of mold was *remediated* according to DHS guidelines. [Health & Saf.C. § 26140(b)]

Cross-refer: Environmental considerations in the purchase and sale of real property (including liability risks for contamination) are separately discussed in *Ch. 5*.

(3) [2:196] **Former federal or state ordnance (military training/munitions) locations:** Sellers of *residential* real property who have actual knowledge of any "former federal or state ordnance locations" within one mile of the property must give written notice thereof "as soon as practicable" before title is transferred. [Civ.C. § 1102.15]

(A "former federal or state ordnance location" is an area identified by a federal or state agency as an area once used for military training purposes which may contain potentially explosive munitions. See Civ.C. § 1102.15.)

(4) [2:197] **Continuing lien securing special tax levy, assessment installments:** When residential property being sold is subject to a continuing lien securing a special tax levy pursuant to the Mello-Roos Community Facilities Act (Gov.C. § 53311 et seq.), or a fixed lien assessment collected in installments to secure bonds issued under the Improvement Bond Act of 1915 (Streets & Highways C. § 8500 et seq.), the seller must make a "good faith effort" to obtain a disclosure notice concerning the taxes (pursuant to Gov.C. § 53340.2) from each local agency levying the tax; and must deliver the notice(s) to the prospective buyer "as long as the notices are made available by the local agency." [See Civ.C. § 1102.6b(a) & (b)]

(a) [2:197.1] **Form of disclosure notice:** The Civ.C. § 1102.6b disclosure requirements may be satisfied by delivering a disclosure notice obtained from a nongovernmental source so long as it includes certain statutorily-required information. [Civ.C. § 1102.6b(d)]

(b) [2:197.2] **Effect of providing proper disclosure notice:** Delivery of a proper disclosure notice to the buyer is "deemed to satisfy" the seller's and their agent's responsibility to inform the buyer about special tax or assessment installments on the property. Moreover, nothing in Civ.C. § 1102.6b imposes a duty to discover special tax or assessment installments, or the existence of any levying district, not actually known to the agents. [Civ.C. § 1102.6b(e)]

(5) [2:198] **Supplemental property tax bills:** A seller of residential real property, or the seller's agent, must also deliver to the prospective buyer a disclosure notice advising that because property tax reassessment is triggered under California law by a change in ownership, the buyer may receive one or two supplemental tax bills depending on when the buyer's loan closes; and that the buyer is responsible for paying the supplemental bills. [Civ.C. § 1102.6c(a)]

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These disclosure requirements may be satisfied by delivering a disclosure notice pursuant to Civ.C. § 1102.6b (¶ 2:197 ff.) that satisfies the § 1102.6c(a) requirements. [Civ.C. § 1102.6c(b)]

(6) Earthquake safety disclosure

(a) [2:199] **Commercial structures:** "As soon as practicable *before the sale*" of any precast concrete or reinforced masonry building having wood frame floors or roofs, built before January 1, 1975 and which is located within any county or city, the *seller or seller's "agent"* must deliver to the purchaser a copy of the "Commercial Property Owner's Guide to Earthquake Safety" (described in Bus. & Prof.C. § 10147). [Gov.C. § 8893.2 (emphasis added)]

(b) [2:199.1] **Residential structures:** Similarly, "as soon as practicable *before the transfer*" of any residential dwelling built prior to January 1, 1960 and which has "one to four living units of conventional light-frame construction," the *seller* must deliver to the buyer a copy of the "Homeowner's Guide to Earthquake Safety" (published pursuant to Bus. & Prof.C. § 10149) "and complete the earthquake hazards disclosure regarding the property" as required by Gov.C. § 8897.2 (specified deficiencies "which may increase a dwelling's vulnerability to earthquake damage"). [Gov.C. § 8897.1(a); see Gov.C. § 8897.1 et seq.]

The *seller* bears the burden of making the requisite disclosures. The seller's *agent's* duty under Gov.C. § 8897.1 et seq. is limited to providing the seller with a copy of the "Homeowner's Guide to Earthquake Safety" for delivery to the prospective buyer (although this does not alter the broker's obligation to disclose known hazards on or affecting the property). [Gov.C. § 8897.5; see also Civ.C. § 2079.8]

[2:199.2 - 2:199.3] ***Reserved.***

(7) [2:199.4] **Knowledge of certain industrial use zoning:** The *seller* of single-family residential real property subject to Civ.C. § 1102 et seq. (one to four dwelling units) who has *actual knowledge* that the property is adjacent to or zoned to allow an industrial use described in Civ.C. § 731a (certain manufacturing, commercial or airport uses), or affected by a nuisance created by such a use, must give written notice of that knowledge "as soon as practicable" before title is transferred. [Civ.C. § 1102.17; see also Civ.C. §§ 1102.6a(d) & 1103.4(c)(1) (city/county-required disclosures re effects of property being within "airport influence area")]

(8) [2:199.5] **Water heater safety certification:** *See discussion at ¶ 4:366.16.*

(9) [2:200] **Occupant death; HIV/AIDS information:** A broker's duty to disclose material facts affecting the condition, value or desirability of the property (¶ 2:170 ff.) may include a duty to disclose the fact of an occupant's death or disease (cf. Civ.C. § 1710.2(c)).

However, *no cause of action* arises against a property owner, or the seller's or buyer's real estate agent, for the failure to disclose to the buyer (a) an occupant's death upon the property or the manner of death where the death occurred *more than three years* before the purchase offer; or (b) that an occupant of the property was living with human immunodeficiency virus (HIV) or died from AIDS-related complications. [Civ.C. § 1710.2(a)] But this provision does not protect the owner or agent from liability for making an *intentional misrepresentation* in response to a buyer's or prospective buyer's direct inquiry concerning deaths on the property. [Civ.C. § 1710.2(d)]

[2:200.1 - 2:200.4] ***Reserved.***

(10) [2:200.5] **Information re proximity of registered sex offenders:** Contracts for the purchase and sale of residential property (one to four dwelling units) must contain a statutorily-prescribed notice advising (i) that law enforcement maintains for public access a data base of locations of registered sex offenders (applicable to contracts entered into on or after 7/1/99 and before 9/1/05); or (ii) that the Department of Justice maintains for public access an "Internet Web site at www.meganslaw.ca.gov" containing the addresses where registered sex offenders reside or the "community of residence and ZIP Code" in which the offenders reside (applicable to contracts entered into on or after 4/1/06). A contract entered into on or after 9/1/05 and before 4/1/06, must contain one or the other of these notices. [See Civ.C. § 2079.10a(a), ¶ 4:366.17 (also applicable to residential leases)]

Upon delivering the Civ.C. § 2079.10a notice to the buyer (or lessor) (by way of the purchase and sale agreement or lease), neither the broker nor seller (or lessor) are required to provide additional information regarding the presence of

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registered sex offenders in the neighborhood. [Civ.C. § 2079.10a(b) (also stating registered sex offenders have no cause of action against disclosing parties based on information in § 2079.10a notice)]

(a) [2:200.6] **Other common law and statutory duties not affected:** Providing the § 2079.10a notice does not, however, alter or relieve brokers and sellers of other common law and statutory duties (including, but not limited to, duties otherwise prescribed by Civ.C. § 1102 et seq. and Civ.C. § 2079 et seq.). [Civ.C. § 2079.10a(c)]

(11) [2:201] **Defects/malfunctions in converted condominiums/common interest developments:** "As soon as practicable" *before title is transferred* for the *first sale* of a unit in a residential condominium, community apartment project or stock cooperative that was *converted* from an existing dwelling, the owner, subdivider, or agent of either must deliver to prospective buyers *either* (a) a written statement listing all "substantial defects or malfunctions" in the unit's and common area's "major systems," *or* (b) a written statement disclaiming knowledge of same (but a disclaimer may be delivered only after the owner/subdivider has *inspected* the unit and common areas and discovered no substantial defects or malfunctions which a reasonable inspection would have disclosed). [Civ.C. § 1134(a)]

(a) [2:202] **Buyer's right to rescind (disclosures postdating execution of purchase contract):** If the disclosure is delivered after execution of a purchase agreement, the buyer has three days (running from the date of personal delivery) (or where the disclosure is mailed, five days running from deposit in the mail) to *terminate* the agreement by delivering written notice of termination to the owner/subdivider or agent. [Civ.C. § 1134(b)—disclosures delivered after execution of purchase agreement must contain statement describing buyer's right, method and time to so rescind]

(b) [2:203] **Consequences of noncompliance:** The transfer of title is not invalidated solely because of a failure to comply with Civ.C. § 1134 (Civ.C. § 1134(f)); but willful noncompliance subjects the offending owner/subdivider or agent to liability for the buyer's "actual damages" caused thereby (Civ.C. § 1134(d)). And, in any event, sellers and agents remain subject to general disclosure duties regarding the condition of the property (¶ *2:170 ff.*). [See Civ.C. § 1134(g)]

[2:204 - 2:206] ***Reserved.***

(12) [2:207] **Smoke detectors:** Sellers of real property containing a single-family dwelling must deliver to the transferee a written statement indicating the property contains an operable smoke detector pursuant to Health & Saf.C. § 13113.8(a) (see also Health & Saf.C. § 13113.7). [Health & Saf.C. § 13113.8(b); but see Health & Saf.C. § 13113.8(d) re exemptions]

The disclosure statement must be included in the receipt for deposit, an addendum attached thereto, or a separate document; and must be delivered "as soon as practicable" before the transfer of title. [Health & Saf.C. § 13113.8(b) & (c)]

(a) [2:208] **No broker duty to monitor compliance:** Except to the extent provided in Health & Saf.C. § 13113.8, real estate agents have no duty (express or implied) to "monitor or ensure compliance" with the statute. [Health & Saf.C. § 13113.8(f)]

(b) [2:209] **Erroneous disclosures; agent's liability:** Generally, an "agent" incurs no liability for the seller's erroneous or inaccurate Health & Saf.C. § 13113.8 disclosures. But that immunity does *not* apply to licensed brokers/salespersons who participate in making the disclosure with "actual knowledge" of its falsity. [Health & Saf.C. § 13113.8(e)]

(c) [2:210] **Noncompliance—exclusive damages remedy:** Noncompliance with Health & Saf.C. § 13113.8 does not invalidate the transfer of title; the sole remedy for failure to comply is a maximum $100 actual damages award, exclusive of court costs and attorney fees. [Health & Saf.C. § 13113.8(g)]

(d) [2:210.1] **Residential transfer disclosure statement certification:** The "seller's information" section of the Civ.C. § 1102.6 residential property transfer disclosure statement includes a seller's certification that the property, at the close of escrow, will be in compliance with Health & Saf.C. § 13113.8 (i.e., it will have operable smoke detectors(s) approved, listed and installed in accordance with the State Fire Marshal's regulations and applicable local standards). [Civ.C. § 1102.6]

(13) [2:211] **Compliance with automatic garage door safety standards:** The "seller's information" section of the Civ.C. § 1102.6 transfer disclosure statement required in residential property transactions (¶ *2:185*) must indicate (among other things) whether the property contains an automatic garage door opener. If applicable, the seller must indicate that the garage door opener may not be in compliance with safety standards relating to automatic reversing devices as set forth in Health & Saf.C. § 19890 et seq. [See Civ.C. § 1102.6]

(14) [2:211.1] **Compliance with pool, window security bar safety standards:** The "seller's information" section of the Civ.C. § 1102.6 residential property transfer disclosure statement also requires the seller to indicate whether the property

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has a swimming pool and window security bars. If applicable, the seller must disclose that a child resistant pool barrier may not be in compliance with safety standards relating to automatic reversing devices set forth in Health & Saf.C. § 19890 et seq. or with pool safety standards contained in Health & Saf.C. § 115920 et seq.; and that window security bars may not have quick-release mechanisms in compliance with the 1995 Edition of the California Building Standards Code. [See Civ.C. §§ 1102.6, 1102.16]

(15) [2:211.2] **Carbon monoxide devices:** The "seller's information" section of the Civ.C. § 1102.6 residential property transfer disclosure statement also requires the seller to indicate whether the property has a carbon monoxide device. If applicable, the seller must disclose that the carbon monoxide device may not be in compliance with the applicable Health & Saf.C. § 13260 et seq. safety standards. [See Civ.C. § 1102.6]

(16) [2:212] **Lawsuits or claims that threaten or affect property:** The seller's information section of the Civ.C. § 1102.6 transfer disclosure statement requires the seller to indicate whether they are aware of any lawsuits by or against the seller, or any Civ.C. §§ 910, 914 claims for damages by the seller, that threaten or affect the property, including any lawsuits or Civ.C. §§ 910, 914 claims alleging a defect or deficiency in the real property or "common areas" (e.g., pools, tennis courts, walkways, etc.). [Civ.C. § 1102.6; see also *Calemine v. Samuelson* (2009) 171 CA4th 153, 162-166, 89 CR3d 495, 502-506—seller's common law disclosure duty extends to *previous* as well as pending lawsuits]

The seller's information section also requires that the seller indicate whether they are aware of any Civ.C. § 900 breach of warranty claims or Civ.C. § 903 breach of enhancement protection agreement claims that threaten or affect the property. [Civ.C. § 1102.6(a)]

(17) [2:213] **Water-conserving plumbing fixtures:** The "seller's information" section of the Civ.C. § 1102.6 transfer disclosure statement requires the seller to indicate whether the property is equipped with water-conserving plumbing fixtures. [Civ.C. § 1102.6]

(18) [2:214] **Room additions, structural modifications, alterations or repairs made by contractors:** On or after July 1, 2024, a seller who accepts an offer for the sale of a single-family residential property within 18 months from the date title to the property was transferred to the seller must disclose to the buyer:

• Any room additions, structural modifications, other alterations, or repairs made to the property by a contractor with whom the seller entered into a contract since the above transfer of title; *and*

• Each such contractor's name and any contact information they provided to the seller. [See Civ.C. § 1102.6h (added Stats. 2023, Ch. 95; eff. 1/1/24)—obligation to provide contractor's name only applies where aggregate price for labor, material and other related items exceeds Bus. & Prof.C. § 7027.2's dollar amount (currently $500)]

The seller's obligation to disclose the room additions, structural modifications, etc., also may be satisfied by providing the buyer with a list of all such changes. [Civ.C. § 1102.6h(b)]

(a) [2:214.1] **Permits:** If the seller obtained permits for any of the room additions, structural modifications, other alterations or repairs, the seller must provide a copy of the permits to the buyer. [Civ.C. § 1102.6h(c)(1)]

If, however, the seller contracted with a third party for the room additions, structural modifications, etc., and was not provided with a copy of the permits, the seller may satisfy the seller's obligation to provide the buyer with copies by (i) informing the buyer that all such information may be obtained from the third party and (ii) providing the buyer with the third party's contact information. [Civ.C. § 1102.6h(c)(2)]

f. [2:214.2] **Disclosures concerning appraisals:** After July 1, 2022, every contract for the sale of single-family residential real property must contain a statutorily prescribed notice specifying that any appraisal of the property is required to be unbiased, objective, and not influenced by improper or illegal considerations (e.g., race, color, religion, gender, sexual orientation, marital status, medical condition, military/veteran status, national origin, etc.). [Civ.C. § 1102.6g]

g. [2:215] **Disclosures concerning loans:** Brokers who, on behalf of their clients, negotiate loans secured by real property (Bus. & Prof.C. § 10131(d), *see ¶ 2:26*) must make several statutory disclosures to the borrower (buyer). [Bus. & Prof.C. § 10240 et seq.; see also 10 CCR § 2840]

(1) [2:215.1] **General requirements:** Broadly, within *three business days* after receipt of a completed loan application *or before* the borrower becomes obligated on the note, *whichever is earlier*, the broker must deliver to the borrower a written statement (in form approved by the Real Estate Commissioner) containing all information required by Bus. & Prof.C. § 10241 (estimated maximum costs and expenses of making the loan, as specified, etc.). [Bus. & Prof.C. §§ 10240(a), 10241]

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The disclosure statement must be personally signed by the borrower and the broker negotiating the loan (or by a licensed salesperson acting for the broker in negotiating the loan); and an "exact copy" must be delivered to the borrower at the time of its execution. The broker must retain on file for three years a "true and correct" copy of the statement as signed by the borrower. [Bus. & Prof.C. § 10240(a); see also Bus. & Prof.C. § 10241.4 re notice concerning balloon payments]

(2) [2:215.2] **Agent's role in arranging financing:** When a real estate agent undertakes to arrange financing for a real property sale, lease or exchange, or when a person or entity arranging financing for such activities undertakes to act as a real estate agent for the property, the agent, person or entity must, within 24 hours, make a *written disclosure* to all parties of those roles and of any related loan transaction. [See Bus. & Prof.C. § 10177.6]

(3) [2:215.3] **Federally-regulated residential mortgage transactions:** When the loan is made in a federally-regulated mortgage transaction in which the principal loan amount exceeds principal loan levels specified in Bus. & Prof.C. § 10245, a real estate broker satisfies the Bus. & Prof.C. § 10240 disclosure requirements if the borrower receives:

• a "good faith estimate" pursuant to the Real Estate Settlement Procedures Act (12 USC § 2601 et seq., *see ¶ 4:639 ff.*) that sets forth the broker's real estate license number and a "clear and conspicuous statement on the face of the document" that the "good faith estimate" does not constitute a loan commitment;

• all applicable disclosures required by the Truth in Lending Act (15 USC § 1601 et seq.); *and*

• if the loan calls for a balloon payment, appropriate balloon disclosures. [See Bus. & Prof.C. § 10249(c)]

In addition, prior to becoming obligated on the loan, the borrower must acknowledge in writing receipt of the "good faith estimate" and all applicable Truth in Lending disclosures. The broker is required to retain for three years a copy of the signed acknowledgment as well as the "good faith estimate" and disclosures acknowledged by the borrower. [Bus. & Prof.C. § 10240(c)]

Cross-refer: The Bus. & Prof.C. § 10240 disclosure obligation and the form of disclosure statement (Bus. & Prof.C. § 10241) are discussed further at *¶ 6:168 ff.*

h. [2:216] **Disclosures concerning broker's relationship to other party or interest in property:** The fiduciary relationship between broker and principal requires the broker to disclose all "material facts" that would affect the principal's decision to buy or sell (*¶ 2:157.1 ff.*); and precludes the broker from obtaining any "secret" advantage over the principal in any transaction arising out of the agency (¶ *2:123, 2:162 ff.*). Consequently, any information regarding the broker's relationship to the other party or the broker's interest in the property must be disclosed at the outset; significantly:

(1) [2:217] **Seller's agent as intended purchaser:** A seller's broker has a fiduciary duty to advise its principal (the seller) of the broker's *intent to become the purchaser* (*¶ 2:159*) *or* of any *relationship* the broker has with the purchaser under which it will *directly or indirectly benefit* from the purchase (*¶ 2:158*). [*Batson v. Strehlow* (1968) 68 C2d 662, 675-676, 68 CR 589, 598; *Smith v. Zak* (1971) 20 CA3d 785, 794, 98 CR 242, 247; *see also ¶ 2:157.11 ff.*]

In effect, a seller's broker may purchase its principal's property *only with the seller's full knowledge and consent*. This rule curbs both *direct* sales to the broker, as well as *indirect* or "*collusive*" sales (where purported third-party purchase is really on behalf of the broker); and extends to sales to the broker's spouse, or an indirect or collusive sale to some other relative of the broker, or the broker's friend, partner, employee or corporation when, because of that relationship, the broker will be directly or indirectly acquiring the property themself. [*Batson v. Strehlow*, supra, 68 C2d at 675-676, 68 CR at 598-599—broker who fails to disclose interest in corporate purchaser cannot retain sales commission; *Smith v. Zak*, supra, 20 CA3d at 794-795, 98 CR at 247-248—seller's broker breached fiduciary duty by purporting to produce "arm's length purchaser" when in fact buyer was broker's close personal friend and broker was actual purchaser]

Additionally, a broker who wishes to purchase the listed property for themself has the burden of proving the fundamental fairness of the transaction and that they acted "with the utmost good faith toward [their] principal." [*Smith v. Zak*, supra, 20 CA3d at 793, 98 CR at 247]

(2) [2:218] **Buyer's broker's interest in property:** Similarly, a broker representing the buyer must disclose to the buyer the nature and extent of the broker's "direct or indirect" ownership interest in the subject property. "The direct or indirect ownership interest in the property by a person *related* to the [broker] by blood or marriage, by an *entity* in which the [broker] *has an ownership interest*, or by any other person with whom the [broker] has a *special relationship* shall be disclosed to the buyer." [Bus. & Prof.C. § 10177(o) (emphasis added), *¶ 2:115*—license suspension, revocation, etc., for nondisclosure]

[2:219 - 2:223] ***Reserved.***

i. [2:224] **Compare—no duty of disclosure between buyer's broker and seller:** Aside from the broad obligation to act fairly and honestly with all parties to a real estate transaction (e.g., no misrepresentations, false promises, etc., *see* ¶ 2:226), neither case law (the "*Easton*" line of authority, *¶ 2:170*) nor statutory law (Civ.C. § 2079, *¶ 2:173*) place the burden on a *buyer's broker* to disclose information to the *seller* … *unless*, of course, the buyer's broker is actually a *dual agent* for *both* buyer and seller (in which event, the dual agency must be disclosed along with delivery of a statutory form disclosure statement, *see* *¶ 2:139 ff.*).

This result makes sense since again, absent a dual agency, there is *no* agency/fiduciary relationship between a seller and a buyer's broker. Moreover, sellers cannot reasonably expect a buyer's broker to disclose information that could *increase* the property's value. [See *Greif v. Sanin* (2022) 74 CA5th 412, 430, 435-436, 284 CR3d 484, 497, 502—where there were "arm's length" negotiations, buyer's broker did not have duty to tell seller purchase price was below fair market value (concluding neither Legislature nor courts recognize such duty)]

(1) [2:224.1] **Comment:** In *Greif,* the buyer's broker did not have a *common law duty* to inform the seller that a $330,000 purchase price for 10 acres of vacant land *in 2012* was well below the land's fair market value. This was so even though the seller was 87 years old, physically infirm, and had cognitive impairments. Instead, the court determined there was no policy justification for placing the burden on buyer's broker to so inform the seller. Indeed, the seller had access to information relevant to its value, he could have researched its fair market value and/or retained a real estate agent to advise and assist him in determining the sales price, yet he chose not to do so. "[I]f the seller chooses not to retain a real estate agent or advisor, the seller is responsible for investigating the value of the Property and determining the sales price." [*Greif v. Sanin* (2022) 74 CA5th 412, 430, 435-436, 284 CR3d 484, 497, 502]

Moreover, in 2012, when the above transaction took place, Civ.C. § 2079.16 (which imposes a *statutory* duty on the buyer's broker to disclose to *both* the buyer and seller all facts known to the agent that materially affect the value of property) did not apply to vacant land. Even so, it is unlikely the buyer's broker would have been liable had the transaction taken place on or after 1/1/2015 (when § 2079.16 was amended to apply to all real property transactions, including transactions involving vacant land). This is because the statutory duty applies only when a property's value is "not known to, or within the diligent attention and observation of, the parties" (Civ.C. § 2079.16, "Buyer's Agent" duties to "the Buyer and the Seller," paragraph (c)). And as *Greif* makes clear, the seller had at his disposal other appropriate means by which to determine his property's fair market value. [*Greif v. Sanin,* supra, 74 CA5th at 427, 435-346, 289 CR3d at 495, 502]

6. Broker's Obligations and Liabilities to Third Parties

a. [2:225] **Responsibility "as a principal" under general agency law:** Pursuant to general agency law, real estate brokers/salespersons are personally responsible to third persons, *as though they were principals*, for acts done in the course of the agency in the following situations (Civ.C. § 2343):

- When, with the broker's consent, credit is given to the broker personally in the transaction (Civ.C. § 2343 subd. 1);
- When the broker enters into a written contract in the name of the broker's principal without a good faith belief they have authority to do so (i.e., in such event, the broker is *personally liable* on the contract as if the broker were acting on the broker's own behalf rather than for the principal) (Civ.C. § 2343 subd. 2);
- When the broker's acts are "wrongful in their nature" (e.g., tortious act perpetrated against third party, *see* *¶ 2:226 ff.*) (Civ.C. § 2343 subd. 3).

(1) [2:225.1] **Measure of damages caused by breach of agent's warranty of authority:** In their capacity as agents, real estate brokers/salespersons *warrant* to all who deal with them that they have the authority to act on behalf of their principals (see Civ.C. § 2342). The detriment caused by a breach of that warranty is deemed to be what could be "recovered and collected" from the broker's/salesperson's purported principal. [Civ.C. § 3318; see also *Kurtin v. Elieff* (2013) 215 CA4th

455, 483-484, 155 CR3d 573, 595-596 (acknowledging § 3318 's general application regardless whether breach is in good faith (Civ.C. § 2342) or bad faith (Civ.C. § 2343))—§ 3318 sets forth precise *amount of liability*]

b. [2:226] **Duty of honesty and fair dealing:** Though not in an agency relationship with third parties, brokers/salespersons owe a broad obligation to act honestly and fairly in dealings with *all* parties to the transaction (e.g., no misrepresentations or false promises to influence, persuade or induce third-party conduct; see generally, Bus. & Prof.C. §§ 10176(a), (b), (i), 10177(j), *¶ 2:114 ff.*). [*Ward v. Taggart* (1959) 51 C2d 736, 741-742, 336 P2d 534, 537; *Nguyen v. Scott* (1988) 206 CA3d 725, 735-736, 253 CR 800, 806; see also *Greif v. Sanin* (2022) 74 CA5th 412, 427, 430, 289 CR3d 484, 495, 497 (acknowledging real estate agents, regardless whether they represent buyer or seller, owe duty of care to third parties, but not with respect to property's fair market value where parties' engaged in "arm's-length" negotiations), *discussed further at* ¶ 2:224 ff.)]

(1) [2:227] **"Secret" profits through deceptive practices:** Thus, a broker is liable to disgorge "secret profits" gained through deception practiced upon a third-party buyer. Even though the broker is not the buyer's agent and therefore breaches no fiduciary duties to the buyer, they violate a real estate agent's statutory obligation to be honest and truthful in their dealings when the broker makes a "secret profit" at the buyer's expense. Such broker holds the profits so obtained as *constructive trustee* for the buyer and is liable to the buyer on an unjust enrichment/quasi-contract theory. [*Ward v. Taggart* (1959) 51 C2d 736, 741-743, 336 P2d 534, 537-539—broker fraudulently represented to buyer he had been given exclusive listing and never presented buyer's first offer to seller but, instead, made "secret profit" by purchasing property at $4,000/acre and then selling to buyer for buyer's second offer of $5,000 (broker liable for $1,000 "secret profit" *plus punitive damages*)]

Similarly, a seller's broker breaches the duty of honesty and fair dealing by failing to transmit a potential buyer's offer to the seller, secretly competing with the buyer for the property, and ultimately purchasing the property for themself. Though the broker does not resell the property to the aggrieved prospective buyer and thus earns no "secret" monetary profit through the deception (as in *Ward*, supra), the law does not permit one "to take advantage of [their] own wrong" (Civ.C. § 3517). Consequently, the broker will be deemed to hold the property in constructive trust for the prospective buyer, who can compel a conveyance by tendering the consideration the broker paid for the property and assuming any obligation still owing to the original seller. [*Nguyen v. Scott* (1988) 206 CA3d 725, 737-741, 253 CR 800, 807-809 (also indicating original *seller* may have *rescission* remedy)]

(2) [2:228] **Concealing pending sale to detriment of interested third party:** A seller's broker who knows a third party holds an unrecorded security interest in the subject property cannot conceal that fact from the prospective buyer, or conceal the impending sale from the holder of the security interest, out of a desire to ensure the deal goes through. The concealment breaches the broker's duty of fairness and renders the broker liable to the third party whose security interest in the property is extinguished by the sale. [*Norman I. Krug Real Estate Investments, Inc. v. Praszker* (1990) 220 CA3d 35, 43-45, 269 CR 228, 231-232 (but damage award should have been reduced to extent holder of security interest was contributorily negligent in failing to record deed of trust)]

"Both the policy of preventing future harm and considerations of moral blame compel the imposition of a duty on the part of a realtor never to allow a desire to consummate a deal or collect a commission to take precedence over [their] fundamental obligation of honesty, fairness and full disclosure toward all parties." [*Norman I. Krug Real Estate Investments, Inc. v. Praszker*, supra, 220 CA3d at 43, 269 CR at 231]

[2:229 - 2:230] ***Reserved.***

c. [2:231] **Statutory duties of disclosure to buyers:** As earlier discussed, sellers' brokers are statutorily bound to make a reasonable investigation of the property and provide prospective buyers with prescribed disclosure statements regarding the physical condition of the property (e.g., Civ.C. §§ 1102 et seq., 1103 et seq., 2079 et seq.). *See ¶ 2:170 ff.*

d. [2:232] **Theories of liability:** Depending on the facts, various theories of recovery are available to third parties aggrieved by a broker's dishonest dealings or other breach of duty:

(1) [2:233] **Constructive trust/quasi-contract/restitution:** Brokers can become "involuntary trustees" of the profits they make through fraudulent misrepresentations. [See *Ward v. Taggart* (1959) 51 C2d 736, 741-742, 336 P2d 534, 537; *Nguyen v. Scott* (1988) 206 CA3d 725, 735, 253 CR 800, 806; *¶ 2:227*]

(2) [2:234] **Negligence:** Brokers are liable to all *parties to the transaction* for injuries resulting from their negligence. [See *Merrill v. Buck* (1962) 58 C2d 552, 562-563, 25 CR 456, 462-463—realtors who undertook to show landlord's house

to prospective tenant for commission were under duty to warn prospective tenant of concealed danger of which they were aware; *Hall v. Aurora Loan Services LLC* (2013) 215 CA4th 1134, 1143, 155 CR3d 739, 745—summary judgment improperly granted where evidence presented triable issue whether listing agents (as well as owners) knew or should have known stairway ladder constituted concealed danger and therefore had duty to warn third parties; see also *Norman I. Krug Real Estate Investments, Inc. v. Praszker* (1990) 220 CA3d 35, 43, 269 CR 228, 231-232, ¶ *2:228* (negligence liability to third-party holder of unrecorded security interest extinguished by sale)]

(a) [2:234a] **Negligence liability arising from listing in multiple listing service:** Brokers and salespersons are subject to statutory negligence liability for inaccuracies in listings placed in a multiple listing service (MLS):

An agent who places a listing or other information in an MLS "shall be responsible for the truth of all representations and statements" made by the agent of which the agent "had knowledge or reasonably should have had knowledge to *anyone injured* by their falseness or inaccuracy." [Civ.C. § 1088(b) (emphasis added); *Furla v. Jon Douglas Co.* (1998) 65 CA4th 1069, 1077, 76 CR2d 911, 916; see also *Saffie v. Schmeling* (2014) 224 CA4th 563, 569-570, 168 CR3d 766, 770—broker's *2006* MLS statement indicating property located in earthquake study zone was declared buildable by licensed geologist following Fault Hazard Investigation and that related report was available to "serious buyers" deemed sufficiently accurate notwithstanding omission of report's *1982* publication date]

1) [2:234b] **MLS' duty to retain agent's information:** An MLS must retain and make accessible on its computer system all listing and other information placed by an agent for at least three years from the date the listing was placed in the MLS. [Civ.C. § 1088(c)]

(b) [2:234.1] **No duty of care to disinterested third parties:** But brokers owe *no* duty of care to third parties who are complete *strangers* to the real estate sale transaction—i.e., those who are not a seller, buyer or prospective purchaser of the property, have no contractual relationship with the broker, and are not intended beneficiaries of information and advice provided by the broker. Consequently, such third parties cannot state a negligence cause of action against the broker. [*Coldwell Banker Residential Brokerage Co., Inc. v. Sup.Ct. (Salazar)* (2004) 117 CA4th 158, 165, 11 CR3d 564, 570; *FSR Brokerage, Inc. v. Sup.Ct. (Blanco)* (1995) 35 CA4th 69, 73-74, 41 CR2d 404, 408; *see also* ¶ *2:170.10 ff.*]

(c) [2:234.2] **Negligence liability arising from failure to obtain seller's permission to disclose confidential information reflecting substantial risk of escrow not closing:** Brokers are not obligated to reveal confidential information *unrelated* to their Civ.C. § 2079.16 affirmative duties (i.e., their affirmative duties of care, honesty, good faith, fair dealing and disclosure, etc.). But a seller's broker's broad obligation to act fairly toward *all* parties (¶ *2:226*) requires them to obtain the seller's permission to disclose confidential information reflecting a substantial risk that escrow will not close:

"The solution to the conflict between the duty to disclose and the duty to maintain client confidentiality is clear. When the duty of fairness to all parties requires the disclosure to the buyer of confidential information reflecting a substantial risk that the escrow will not close, then the seller's real estate agent or broker must obtain the seller's permission to disclose such confidential information to the buyer before the buyer enters into a contract to purchase the property … If the seller is unwilling to consent to the disclosure of confidential information, and the real estate agent or broker nonetheless chooses to undertake representation of the seller, [the real estate agent or broker] does so at the peril of liability in the event the transaction goes awry due to the undisclosed risks involved." [See *Holmes v. Summer* (2010) 188 CA4th 1510, 1526, 116 CR3d 419, 430—broker who failed to obtain seller's permission to disclose substantial risk that overencumbered residential property could not be freely transferred was potentially liable to buyer on negligence theory; ¶ *2:170.1*]

(3) [2:235] **Fraud:** *Any party to the transaction* injured by a broker's affirmative misrepresentations, concealment of material facts or other deceptive conduct can proceed against the broker on a fraud cause of action. [See *Manderville v. PCG & S Group, Inc.* (2007) 146 CA4th 1486, 1497-1498, 55 CR3d 59, 68—brokers misrepresented that property could be subdivided; *Furla v. Jon Douglas Co.* (1998) 65 CA4th 1069, 1077-1078, 76 CR2d 911, 916—broker overstated square footage; *Cory v. Villa Properties* (1986) 180 CA3d 592, 597-598, 225 CR 628, 631—broker misrepresented amount of acreage]

(a) [2:235.1] **Homeowners association's standing to sue on members' behalf:** *See* ¶ *2:176.16*.

Cross-refer: For a detailed discussion of fraud damages, *see Ch. 11*.

(4) [2:236] **Breach of warranty:** *See discussion at* ¶ *2:225.1*.

[2:237 - 2:239] ***Reserved.***

7. [2:240] **Principal's Liability for Broker's Conduct:** Being in an agency relationship with their brokers, sellers or buyers (as the case may be) are subject to liability for the broker's conduct within the scope of a real estate transaction under general principles of agency law:

a. [2:241] **Principal bound by acts within scope of agency authority:** All liabilities that would accrue to the broker, had the broker been acting on the broker's personal account, accrue *to the principal* to the extent they arise out of transactions within the broker's actual *or ostensible* authority. [Civ.C. § 2330]

(1) [2:242] **Acts within "ostensible authority":** Even though a broker has not been expressly empowered to act on the principal's (seller's or buyer's) behalf, an "*ostensible* agency" relationship is created when the principal "intentionally, or by want of ordinary care, *causes a third person to believe*" the broker is their agent in the matter. [Civ.C. § 2300 (emphasis added); see also Civ.C. §§ 2315 (agent has such authority as principal, "actually or ostensibly, confers upon [agent]") & 2317 (ostensible authority "is such as a principal, intentionally or by want of ordinary care, causes or allows a third person to believe the agent to possess")]

An ostensible agency relationship subjects the principal to third-party liability as if an "actual agency" had been created (Civ.C. § 2330, ¶ 2:241) *unless* the third person *knows* the agent has not actually been employed to act on behalf of the principal in the matter. Thus, the principal is bound by the conduct of a broker acting under "ostensible authority" to those third persons who "incurred a liability or parted with value" in the good faith belief the broker was the principal's agent in the matter. [Civ.C. § 2334; see *Kaplan v. Coldwell Banker Residential Affiliates, Inc.* (1997) 59 CA4th 741, 747-748, 69 CR2d 640, 642-643—triable issue of fact whether real estate company franchisor could be liable on ostensible agency theory for independent broker/franchisee's acts and omissions]

(2) [2:243] **Acts beyond agency authority:** On the other hand, a principal is *not* bound by a broker's acts *beyond* the scope of the broker's actual or ostensible authority. [See Civ.C. § 2333—if agent exceeds authority, principal bound by authorized acts "so far only as they can be plainly separated from those which are unauthorized"; *but see ¶ 2:244 ff.* re tortious misconduct in scope of agency relationship]

b. [2:244] **Agent's tortious acts or omissions:** Pursuant to general agency law, principals are also exposed to liability for their brokers' *negligent* acts or omissions:

"[A] principal is responsible to third persons for the *negligence* of [their] agent" in transactions concerning the agency business, "*including wrongful acts* committed by such agent in and as a part of the transaction of such business," *and* for the agent's "*willful omission to fulfill the obligations of the principal*." [Civ.C. § 2338 (emphasis added); but see also Civ.C. § 2339—"principal is responsible for no other wrongs committed by [principal's] agent than those mentioned in [Civ.C. § 2338], unless [principal] has authorized or ratified them, even though they are committed while the agent is engaged in [principal's] service"]

(1) [2:245] **Example—broker misrepresentations:** Thus, principals are liable to third parties for their brokers' *misrepresentations* in a real estate transaction … whether or not the principal was aware the misrepresentation was made and even if the misrepresentation was simply negligent. [*Miller v. Wood* (1961) 188 CA2d 711, 714, 10 CR 770, 772—seller vicariously liable for broker's several misrepresentations inducing purchasers to buy; see *Burkett v. J.A. Thompson & Son* (1957) 150 CA2d 523, 527, 310 P2d 56, 58—seller's broker misrepresented house was not built on "filled land" (seller knew otherwise); *Richard v. Baker* (1956) 141 CA2d 857, 863, 297 P2d 674, 678—seller's broker misrepresented lot's boundary lines; *see also ¶ 4:353*]

The same result obtains even if the wrongdoing broker acted as dual agent for both the seller and aggrieved buyer. "[T]he fact that the broker … in a real estate transaction is the agent for both parties is no defense to an action by one of the parties to hold the other party responsible for misrepresentations with regard to such other party's property made to [the party who brought the action] by the broker …" [*Miller v. Wood*, supra, 188 CA2d at 714, 10 CR at 772—seller's broker's misrepresentations to buyers not chargeable to buyers even assuming broker was also buyers' agent]

[2:246 - 2:249] ***Reserved.***

8. [2:250] **DRE "Consumer Recovery Account":** As discussed, brokers who breach their fiduciary duties or otherwise violate the real estate licensing law are subject to disciplinary action (license suspension/revocation) and to civil liability to parties aggrieved by the misconduct. Additionally, aggrieved persons may have a remedy against the DRE "Consumer Recovery Account" (see Bus. & Prof.C. § 10471 et seq.; 10 CCR § 3100 et seq.), which is funded (in part) from license fees paid by brokers and salespersons.

a. [2:251] **General framework and purpose:** The Real Estate Consumer Recovery Program provides recourse to an "aggrieved person" who is unable to obtain complete satisfaction of a judgment against wrongdoing real estate licensees. The broad purpose is to *protect the public* against losses resulting from misrepresentations and related breaches of fiduciary duty by brokers/salespersons unable to respond to damages awards. [Bus. & Prof.C. § 10471; see *Worthington v. Davi* (2012) 208 CA4th 263, 278, 145 CR3d 389, 400; *Yergan v. Department of Real Estate* (2000) 77 CA4th 959, 966, 92 CR2d 189, 194; *Stewart Title Guar. Co. v. Park* (9th Cir. 2001) 250 F3d 1249, 1252 (applying Calif. law)]

Upon compliance with statutory conditions (¶ *2:255 ff.*), the program permits payment from the Consumer Recovery Account of the amount of the aggrieved person's unpaid judgment up to a statutory maximum dollar limit.

(1) [2:252] **Liability limits:** Notwithstanding the number of aggrieved persons or parcels of real estate involved in a transaction, or the number of judgments against a licensee, the Consumer Recovery Account liability limit for payment applications filed on or after January 1, 1980 through December 31, 2008, is $20,000 for any one transaction and $100,000 for any single licensee; for applications filed on or after January 1, 2009, the liability limit is $50,000 for any one transaction and $250,000 for any single license. [Bus. & Prof.C. §§ 10474(a), (b), 10474.5—pro rata distribution of maximum liability limits in satisfaction of multiple claims against single licensee; *Zinnemann v. Bagnol* (2002) 104 CA4th 656, 659, 128 CR2d 342, 343]

When multiple real estate licensees are involved in a transaction and the individual conduct of two or more of them results in a final judgment, the aggrieved person may seek payment from the Consumer Recovery Account based on the judgment against any of the wrongdoing licensees (subject to the Account's liability limits, above, and provided the claimant has diligently pursued collection efforts against others liable in the transaction, ¶ *2:260*). [Bus. & Prof.C. § 10474(c)]

[2:252.1 - 2:252.4] ***Reserved.***

(2) [2:252.5] **Direct right of recovery limited to "aggrieved persons":** Only an "aggrieved person" has a direct right of recovery against the Consumer Recovery Account. [See Bus. & Prof.C. § 10471(a)—"aggrieved person" who obtains final judgment against defendant licensee may file application for payment from Consumer Recovery Account]

An "aggrieved person" within the meaning of the statute must be a *client* of the wrongdoing licensee or a *member of the general public* whom the recovery statutes were designed to protect. [*Stewart Title Guar. Co. v. Park* (9th Cir. 2001) 250 F3d 1249, 1253 (applying Calif. law); *Middelsteadt v. Karpe* (1975) 52 CA3d 297, 302, 124 CR 840, 844]

By contrast, the Consumer Recovery Account was not established to protect licensees and others who are in a better position than the general public to guard against, and absorb the consequences of, deceitful conduct of real estate licensees. [*Middelsteadt v. Karpe*, supra, 52 CA3d at 302, 124 CR at 844; *Wallace v. Onate* (1991) 2 CA4th 549, 553, 3 CR2d 3, 5-6; see *Stewart Title Guar. Co. v. Park* (9th Cir. 2001) 250 F3d 1249, 1253]

(a) [2:252.6] **Not nonclients or nonconsumers:** Thus, the statutory scheme does not provide recourse for licensees with claims against other licensees. [*Middelsteadt v. Karpe* (1975) 52 CA3d 297, 302, 124 CR 840, 844; *Wallace v. Onate* (1991) 2 CA4th 549, 554, 3 CR2d 3, 6—broker not entitled to recovery from Account for amounts paid to customers for losses sustained as result of fellow licensee's dishonest conduct (*see* ¶ *2:263.8*)]

Nor is a direct right of compensation from the Consumer Recovery Account available to an insurer or like entity "who is not a vulnerable member of the public unable to protect itself from the deceitful conduct of real estate licensees." [*Stewart Title Guar. Co. v. Park* (9th Cir. 2001) 250 F3d 1249, 1253—title insurer not "aggrieved person" eligible for recovery from Account fund (*see* ¶ *2:263.7*)]

(b) [2:252.7] **Broker standing in capacity as principal:** Although denied "aggrieved person" standing in the capacity as real estate licensee, a real estate agent who acts as *principal* with respect to the agent's own property in a transaction and whose conduct does not require a real estate license is not precluded from recovering from the fund simply by virtue

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of the agent's status as licensee. [*Wallace v. Onate* (1991) 2 CA4th 549, 554, 3 CR2d 3, 6; see *Buccella v. Mayo* (1980) 102 CA3d 315, 327, 162 CR 369, 375-376]

(c) [2:252.8] **Compare—subrogation claims:** Under some circumstances, those having no direct right of recovery as an "aggrieved person" may be entitled to payment out of the fund as *assignee* or *subrogee* of other aggrieved persons. *See discussion at ¶ 2:263.5 ff.*

(3) [2:253] **Automatic license suspension:** Payment from the Consumer Recovery Account in settlement of a judgment against a broker, salesperson or person holding a prepaid rental listing service license (*¶ 2:34.5*) results in *automatic suspension* of their license. No further hearing is required; indeed, the Commissioner has a *mandatory duty* to suspend the license (although the judgment debtor licensee may seek judicial review by timely petition for writ of mandate; Bus. & Prof.C. § 10471.5(c)). [Bus. & Prof.C. § 10475; *Rodriguez v. Department of Real Estate* (1996) 51 CA4th 1289, 1300, 59 CR2d 652, 659]

The suspended license will not be reinstated until the judgment debtor licensee has *reimbursed* the Consumer Recovery Account for the full amount of the payment, *plus interest*. [Bus. & Prof.C. § 10475; but see also Bus. & Prof.C. § 10481—repayment to Consumer Recovery Account does not prejudice Commissioner's general authority to take disciplinary action against licensee for violation of Real Estate Law]

(a) [2:253.1] **No infringement of licensee's due process rights:** The Bus. & Prof.C. § 10475 automatic license suspension provision has survived due process challenge … because the statutory scheme builds in three levels of due process protection before a license will be lost (*Rodriguez v. Department of Real Estate* (1996) 51 CA4th 1289, 1299-1300, 59 CR2d 652, 658 (broker licensee)):

- First, since only a judgment creditor with a final judgment is eligible for payment from the Consumer Recovery Account (Bus. & Prof.C. § 10471(a), *¶ 2:256*), the judgment debtor licensee has had the benefit of full procedural safeguards in a court of law;

- The judgment debtor licensee also has the statutory right to notice and an opportunity to submit written argument before the Commissioner rules on a claim for payment from the Consumer Recovery Account (Bus. & Prof.C. § 10471.1(a), (c); 10 CCR § 3106(a); *¶ 2:263*); and

- The judgment debtor licensee has the right to challenge an adverse decision by traditional mandate (Bus. & Prof.C. § 10471.5(c); 10 CCR § 3109). [*Rodriguez v. Department of Real Estate*, supra, 51 CA4th at 1298, 59 CR2d at 657]

(4) [2:254] **DRE subrogated to judgment creditor's rights:** Upon payment from the Consumer Recovery Account, the Real Estate Commissioner "shall be" subrogated to all of the judgment creditor's rights against the judgment debtor; and the judgment creditor "shall assign all of [their] right, title, and interest in the judgment to the commissioner …" [See Bus. & Prof.C. § 10479—amounts recovered by Commissioner on judgment must be deposited back into Consumer Recovery Account]

b. [2:255] **Conditions and procedure:** The Real Estate Law and DRE regulations prescribe detailed conditions and procedures for obtaining payment from the Consumer Recovery Fund (see Bus. & Prof.C. § 10471 et seq.; and 10 CCR § 3100 et seq.). Following is a brief overview:

(1) [2:256] **Final judgment:** The aggrieved person must proceed by application to the Department of Real Estate. An application *cannot* be filed unless and until the claimant obtains against the licensee (a) a *final judgment* (including, but not limited to, a criminal restitution order issued pursuant to Pen.C. § 1202.4(f) or 18 USC § 3663), *or* (b) an arbitration award that includes findings of fact and conclusions of law and has been reduced to a judgment pursuant to CCP § 1287.4. [Bus. & Prof.C. § 10471(a); see *Doyle v. Department of Real Estate* (1994) 30 CA4th 893, 897-898, 36 CR2d 193, 195-196—judgment resulting from settlement agreement and stipulation for entry of judgment satisfies Bus. & Prof.C. § 10471(a) so long as judgment based on fraud; *Yergan v. Department of Real Estate* (2000) 77 CA4th 959, 967-968, 92 CR2d 189, 195-196 (¶ 2:257a); *Worthington v. Davi* (2012) 208 CA4th 263, 280, 145 CR3d 389, 401-402—where arbitrator's factual findings evidenced licensee's clear intent to defraud, award and resulting judgment satisfied § 10471(a) (*¶ 2:257a*)]

A "final judgment" for this purpose includes a federal court judgment but does *not* include judgments rendered by the courts of another state. [Bus. & Prof.C. § 10471(a)]

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(a) [2:257] **Judgment based on fraud/conversion of trust funds in performance of licensed activity:** The Consumer Recovery Account is not a payment recourse for liabilities against judgment debtors who simply happen to hold a real estate license or prepaid rental listing service license. The final judgment must be based upon the licensee's "fraud, misrepresentation, or deceit, made with intent to defraud, or conversion of trust funds" arising directly out of any transaction for which a real estate license or prepaid rental listing service license (¶ *2:34.5*) is required (and not in violation of Bus. & Prof.C. §§ 10137 or 10138, making it unlawful to employ or pay compensation to unlicensed personnel to engage in licensed activities or to perform any licensed activity without a valid real estate license). [Bus. & Prof.C. § 10471(a); see *Froid v. Fox* (1982) 132 CA3d 832, 841, 183 CR 461, 466—Recovery Account not liable for claim based on broker fraud not arising out of licensed activity; *Stout v. Edmonds* (1986) 180 CA3d 66, 70, 225 CR 345, 347 (same); *Buccella v. Mayo* (1980) 102 CA3d 315, 323-326, 162 CR 369, 373-375 (same)]

1) [2:257a] **Evidence of fraud not enough:** Thus, the Consumer Recovery Account is not liable to pay when the final judgment is predicated merely on claims for *professional negligence* and *breach of duty.* This is so notwithstanding evidence the parties were defrauded by a licensee in a real property transaction. "The statute does not ask for proof that the applicant had valid *claims* for fraud; the applicant must demonstrate that it has a valid *judgment* for fraud." [See *Yergan v. Department of Real Estate* (2000) 77 CA4th 959, 968-970, 92 CR2d 189, 196-197 (emphasis in original) —no Consumer Recovery Account liability where judgment was based on settlement agreement expressly limiting recovery to claims for professional negligence and breach of duty; compare *Worthington v. Davi* (2012) 208 CA4th 263, 280, 283, 145 CR3d 389, 401-402, 404—although arbitrator based award and resulting judgment on licensee's breach of fiduciary duty, his factual findings evidencing licensee's clear intent to defraud rendered Consumer Recovery Account liable for resulting damages]

2) [2:257.1] **Within scope of licensee's license:** Further, the statute requires that the final judgment rest on the licensee's performance of acts for which *that license* was required. [Bus. & Prof.C. § 10471(a)]

This language has been narrowly interpreted to mean that the licensee's liability must arise out of activities *within the scope of the licensee's particular license;* and, therefore, the Consumer Recovery Account is *not liable* when the judgment is based on the performance of acts *outside the scope* of the defendant's license. [*Davis v. Harris* (1998) 61 CA4th 507, 511, 71 CR2d 591, 593-594—Recovery Account not required to compensate victims of salesperson's fraud because his liability rested on conduct for which *broker's license* was required and thus was beyond scope of his license (as salesperson)]

(b) [2:258] **Good faith prosecution of underlying complaint:** The judgment against the licensee must be based on the claimant's "conscientious" and "good faith" prosecution of the underlying complaint, meaning that (i) no potentially liable party was "intentionally and without good cause" omitted from the complaint, (ii) no party named in the complaint who otherwise reasonably appeared capable of responding in damages was "intentionally and without good cause" dismissed from the action, and (iii) the claimant "employed no other procedural means contrary to the diligent prosecution of the complaint in order to seek to qualify for the Consumer Recovery Account." [Bus. & Prof.C. § 10471(c)(5)(A)]

Or, if the claimant is proceeding against the Consumer Recovery Account on the basis of a criminal restitution order (¶ *2:256*), the application must state that (i) the claimant has "not intentionally and without good cause" failed to pursue a potentially liable person other than a defendant who is the subject of a criminal restitution order; (ii) the claimant has "not intentionally and without good cause" failed to pursue in a civil damages action all potentially liable persons who otherwise reasonably appeared capable of responding in damages other than a defendant who is the subject of a criminal restitution order; and (iii) the claimant "employed no other procedural means contrary to the diligent prosecution of the complaint in order to seek to qualify for the Consumer Recovery Account." [Bus. & Prof.C. § 10471(c)(5)(B)]

(2) [2:259] **Judgment unsatisfied:** The claimant's judgment against the licensee must be *unsatisfied* (in whole or in part). [Bus. & Prof.C. § 10471(a)—claim against Consumer Recovery Account for "amount unpaid on the judgment that represents an actual and direct loss to the claimant in the transaction"]

(a) [2:260] **Diligent efforts to obtain recovery from judgment debtors:** The Consumer Recovery Account serves as a fund of *last resort*. It is not an alternative to personal satisfaction from the licensee and others liable in the transaction. Consequently, aggrieved persons have no right of recovery against the fund until they have *exhausted all other avenues*

for relief from all of the wrongdoing parties. [*Stewart Title Guar. Co. v. Park* (9th Cir. 2001) 250 F3d 1249, 1252 (applying Calif. law)]

Thus, the claimant must:

• Conduct searches and inquiries with respect to the judgment debtor's assets available to satisfy the judgment (and the application to the DRE must indicate the results of actions taken to have those assets applied to satisfy the judgment) (see Bus. & Prof.C. § 10471(c)(7)(D)); and

• Diligently pursue collection efforts against all other judgment debtors and persons liable in the transaction that is the basis for the underlying judgment (Bus. & Prof.C. § 10471(c)(7)(E)).

(b) [2:261] **No bankruptcy discharge:** Further, recourse against the Consumer Recovery Account is not available if the unsatisfied debt has been *discharged in bankruptcy*. [See Bus. & Prof.C. § 10471(c)(7)(F)—if licensee debtor in pending bankruptcy, claimant may proceed against Consumer Recovery Account only if debt declared nondischargeable by bankruptcy court; see also *Armenta v. Edmonds* (1988) 201 CA3d 464, 466, 247 CR 204, 205—bankruptcy discharge precluded recovery]

Thus, if the licensee files a bankruptcy petition, the burden is on the claimant (judgment creditor) to obtain a *nondischargeable fraud* adjudication from the bankruptcy court (see 11 USC § 523(a)(2), (4) & (c)(1)). The claimant's right to recovery from the Account cannot be perfected *after* a bankruptcy discharge by going back to state court for a “replacement judgment” against the Account. [*Zinnemann v. Bagnol* (2002) 104 CA4th 656, 664, 128 CR2d 342, 347-348—no recovery where default judgment against licensee discharged in bankruptcy was replaced later by judgment obtained solely for recovery against Account]

(3) [2:262] **One-year limitations period:** The claimant's application for payment from the Consumer Recovery Account must be delivered in person, by certified mail, or electronically in a manner prescribed by the DRE, to a DRE office no later than one year after the underlying judgment has become final. [Bus. & Prof.C. § 10471(b), (c)(7)(G) (amended Stats. 2023, Ch. 510; eff. 1/1/24)]

The one-year period commences upon entry of the final judgment without regard to the finality of postjudgment procedures to enforce the judgment. [*Mason v. Department of Real Estate* (2002) 102 CA4th 1349, 1354-1355, 126 CR2d 278, 282—immaterial to running of one-year statute that payment of final judgment against deceased licensee's estate was awaiting probate court approval]

(On the application process and form of application, see Bus. & Prof.C. § 10471(c)-(e).)

(4) [2:263] **Notice to judgment debtor:** The claimant must serve a copy of the application, along with a statutorily-prescribed notice, upon the judgment debtor licensee in the manner prescribed by Bus. & Prof.C. § 10471.1(a), (b) (personal service, certified mail or publication, as specified). The notice advises the licensee of the risk of automatic license suspension (¶ *2:253*) and of the procedure for contesting payment from the Consumer Recovery Account (failure to contest by written response filed within 30 days after service of the notice waives the licensee's right to object and to receive further notice of DRE action taken on the judgment creditor's claim). [See Bus. & Prof.C. § 10471.1(e)]

[2:263.1 - 2:263.4] *Reserved.*

c. [2:263.5] **Assignee and subrogee claims:** Persons having no direct right of recovery against the Consumer Recovery Account (because they are not “aggrieved persons,” ¶ *2:252.5*) may be entitled to collect from the fund as *assignee* or *subrogee* of an aggrieved person. [*Lorenz v. Sauer* (9th Cir. 1987) 807 F2d 1509, 1513 (applying Calif. law)]

(1) [2:263.6] **Subject to conditions on aggrieved person's right of recovery:** But as assignee or subrogee, the claimant “steps into the shoes” of the aggrieved person (assignor/subrogor) and can have no greater right to recover from the fund than the aggrieved person. I.e., if the aggrieved person (assignor/subrogor) is not eligible for relief under the statutory scheme, neither is the assignee/subrogee. [*Stewart Title Guar. Co. v. Park* (9th Cir. 2001) 250 F3d 1249, 1254-1255]

• [2:263.7] Title Insurer insured lenders who loaned money to property owners refinancing existing loans through Mortgage Broker, who also acted as the escrow holder. Broker received funds to pay off the existing liens, but embezzled the funds. When the senior liens were not paid off, the lenders made claims on their policies and Title Insurer paid them off.

Under the terms of the policies, Title Insurer became subrogated to the insured lenders' rights. As subrogee, Title Insurer filed suit and obtained a judgment against Broker, which Broker failed to fully satisfy. Title Insurer's application for payment from the Consumer Recovery Fund for the unsatisfied judgment was *properly denied:*

As "aggrieved persons," the lenders (subrogors) were eligible for relief from the fund only after exhausting all other avenues of relief (*¶ 2:260*) … which they did by obtaining full compensation under their policies. Since the lenders were made whole, they had no viable claim against the Consumer Recovery Account and, hence, there was no claim to which Title Insurer could be subrogated. [*Stewart Title Guar. Co. v. Park* (9th Cir. 2001) 250 F3d 1249, 1254-1255]

• [2:263.8] Broker negligently delivered her clients' checks to another Agent, who in turn fraudulently converted the checks for his own use. Fearful of being sued, Broker paid her clients in full for their losses, obtained assignments from them, sued Agent, and then sought payment of the unsatisfied default judgment from the Consumer Recovery Account (relying on a subrogation theory). Broker's claim was *properly denied* because the *clients* (assignors/subrogors), having been made whole by Broker's payments to them, were not themselves eligible for relief from the fund. (As direct claimants against the fund, they would have been required to pursue collection efforts from *all wrongdoers,* including Broker (*¶ 2:260*); since they were fully compensated by Broker, their potential claims against the Consumer Recovery Account were extinguished.) [*Wallace v. Onate* (1991) 2 CA4th 549, 554-555, 3 CR2d 3, 6]

[2:263.9] ***Reserved.***

(2) [2:263.10] **Assignee/subrogee claimant must be innocent of wrongdoing:** Recognizing that the purpose of the Consumer Recovery Account is to aid *victimized clients* (consumer protection, *¶ 2:251*), case law adds another limitation on the rights of assignees and subrogees against the fund:

Even if otherwise eligible for relief, such claimants will be denied recovery if they in any way participated in or were responsible for the underlying wrongdoing. It is "not in keeping with the purpose of the fund to allow a negligent actor to gain from the fund, even though the wrongdoer had compensated the injured party and had been assigned their rights." [*Stewart Title Guar. Co. v. Park* (9th Cir. 2001) 250 F3d 1249, 1254; see *Lorenz v. Sauer* (9th Cir. 1987) 807 F2d 1509, 1513 (applying Calif. law)—claim rejected because recovery would benefit wrongdoer's bankruptcy estate; *Wallace v. Onate* (1991) 2 CA4th 549, 554, 3 CR2d 3, 6—claim of subrogee broker rejected because she was herself negligent]

d. [2:264] **DRE decision:** The Real Estate Commissioner must render a final written decision on the claim within 90 days after receipt of the claimant's application (absent claimant's agreement to extend the 90-day period); if no decision is made within that period, the claim "shall be deemed to have been denied." [See Bus. & Prof.C. §§ 10471.3 & 10471.5 (notice of decision to claimant and judgment debtor)]

(1) [2:264.1] **Court action on DRE denial of application:** A claimant may contest the Commissioner's denial of a claim by filing a verified application in superior court (below), within six months, for an "Order Directing Payment Out of the Consumer Recovery Account." [See Bus. & Prof.C. §§ 10472, 10472.1, 10473 & 10473.1; *Yergan v. Department of Real Estate* (2000) 77 CA4th 959, 965, 92 CR2d 189, 194 (DRE denial of claim affirmed because underlying judgment not based on fraud, etc. as required by Bus. & Prof.C. § 10471(a))]

If the underlying judgment is from a California *state* court, the application must be filed in the same court. If the judgment is from a *federal* court, the application must be filed in the superior court of any county that would have been the proper venue if the underlying suit had been filed in a California state court, or in the Superior Court of the County of Sacramento. [Bus. & Prof.C. §§ 10471.5(b), 10472(a)]

[2:265 - 2:269] ***Reserved.***

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Chapter 2. Real Estate Brokers and Listing Agreements

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1. Nature of Compensation Arrangement—In General

a. [2:270] **Negotiable; commission the norm:** A real estate agent's compensation is strictly a matter of negotiation between broker and principal; the parties are free to agree to any amount or manner of compensation and may condition the broker's entitlement to compensation on any lawful basis. [*Horning v. Shilberg* (2005) 130 CA4th 197, 204, 29 CR3d 717, 723; *R.J. Kuhl Corp. v. Sullivan* (1993) 13 CA4th 1589, 1599, 17 CR2d 425, 431; *RC Royal Develop. & Realty Corp. v. Standard Pac. Corp.* (2009) 177 CA4th 1410, 1418, 100 CR3d 115, 121—broker's right to compensation may depend upon any lawful condition inserted into agreement]

Nevertheless, real estate brokers are typically paid on a *commission* basis—i.e., a *percentage* of the gross selling price (or, in rental transactions, a percentage of the rent).

b. [2:271] **Agreement arising out of agency/employment relationship required:** The right to compensation as a “broker” is based on an agency or employment *relationship with a third party*. [*Horning v. Shilberg* (2005) 130 CA4th 197, 204, 29 CR3d 717, 723; *see also* ¶ *2:120*]

Additionally, within the context of the agency or employment relationship, the broker's right to compensation arises only from an *agreement* between the principal (buyer/seller) and agent (broker). The agreement is strictly enforced according to its terms. [*Colbaugh v. Hartline* (1994) 29 CA4th 1516, 1524, 35 CR2d 213, 217; *Enea v. Coldwell Banker/Del Monte Realty* (ND CA 1998) 225 BR 715, 717 (applying Calif. law); *and see* ¶ *2:281 ff.* re statute of frauds]

If the agreement does not specifically state the amount of compensation, the broker will be deemed entitled to a “reasonable” commission. [*Beazell v. Schrader* (1963) 59 C2d 577, 580, 30 CR 534, 536]

(1) [2:271a] **Compare—broker acting as principal:** Where a broker agrees to purchase property on the broker's *own behalf*, there is no agency or employment relationship with a third party and thus no entitlement to a commission or other compensation for “brokerage” activities. (As explained at the outset, one cannot be a “broker” in the performance of activities on the broker's *own behalf; see* ¶ *2:21.1*.) Any agreement to pay a purported “commission” or other “broker” compensation in that event is essentially an *agreement to a reduction in the purchase price;* it is not a “brokerage contract.” [*Horning v. Shilberg* (2005) 130 CA4th 197, 204-205, 29 CR3d 717, 723-724—because broker acted as principal in real estate purchase transaction, he was not entitled to broker commission based on broker activities in his suit against seller for breach of purchase agreement]

(2) [2:271.1] **“Listing agreement” not essential:** Typically, the compensation arrangement is set forth in a “listing agreement” (agreement employing the broker, ¶ *2:350 ff.*). But that is not essential. In the absence of a listing agreement, “the right to the commission then depends on the document which *does* set forth the commission agreement, sometimes the real estate sale contract itself, sometimes the escrow instructions.” [*Torelli v. J.P. Enterprises, Inc.* (1997) 52 CA4th 1250, 1254, 61 CR2d 76, 78 (emphasis in original)]

Under certain circumstances, an enforceable right to a commission may even be traced to a seller's signed counteroffer which, because it was not timely accepted, never gave rise to a binding contract as between the seller and buyer. [*Torelli v. J.P. Enterprises, Inc.*, supra, 52 CA4th at 1257, 61 CR2d at 80—having signed counteroffer, seller became bound by implied promise not to deprive broker of benefits of bargain to pay commission; *see* ¶ *2:321, 2:338.1*]

(3) [2:271.2] **Buyer's broker/cooperating broker claims to share of seller's/listing broker's commission:** Even when they are the “procuring cause” of a purchase and sale, neither the buyer's broker nor cooperating brokers have an enforceable right to a share of the commission earned by the seller's broker (under a listing arrangement with the seller) when there is *no written agreement* providing for such an arrangement. [*Enea v. Coldwell Banker/Del Monte Realty* (ND CA 1998) 225 BR 715, 718 (applying Calif. law)—broker who produced actual buyer pursuant to right of first refusal not entitled

to share of seller's broker's commission because no agreement therefor; see also *Colbaugh v. Hartline* (1994) 29 CA4th 1516, 1523, 35 CR2d 213, 216—cooperating broker's right to share of listing broker's commission depends on terms of cooperation agreement]

c. [2:272] **Commission amount—variables:** The commission percentage varies depending on the kind of property and transaction involved (e.g., residential vs. commercial; improved vs. unimproved; lease vs. sale of fee, etc.). Generally, however, brokers within the same community charge approximately the same commission rate for the same kind of property.

The *selling price* might also impact the commission structure, which may vary as the price increases. For example, a residential real estate brokerage commission is typically six percent. However, on extremely expensive (multi-million dollar) homes, the commission may be reduced by a few percentage points.

(1) [2:273] **"Net listings":** Alternatively, the parties might agree to a "net listing" arrangement, pursuant to which the broker is entitled to keep as compensation any amount by which the purchase price exceeds a fixed, agreed-upon amount (*see ¶ 2:366*).

(2) [2:274] **"Sliding-scale" commission structure:** Another creative compensation arrangement fixes the broker's commission percentage on a specified portion of the purchase price (e.g., 6% of the first $2 million), and increases the commission percentage to the extent the purchase price exceeds the stated amount (e.g., 10% on that portion of purchase price exceeding $2 million). This approach may be attractive to sellers because it induces brokers to put forth extra effort to obtain optimum offers.

(3) [2:275] **Leasing transactions:** In most standard commercial lease transactions, the broker's commission is a percentage of the rent, which fluctuates over the term of the lease. Usually, the percentage commission declines during the later years of the lease. However, the commission amount will also depend on whether the transaction involves a "gross" or "net" lease. (*See ¶ 7:33 ff.* for distinction between "gross" and "net" leases.)

(a) [2:275.1] ***Caveat—additional commission triggered by "renewal provision":*** "Renewal provisions" in listing agreements for leases may trigger an *additional commission* based on additional rent paid if the lease is renewed or extended or the rented premises are expanded. [See *John B. Kilroy Co. v. Douglas Furn. of Calif., Inc.* (1993) 21 CA4th 26, 34-35, 25 CR2d 752, 756-757—broker entitled to commission for any modifications or extensions of lease for up to *30 years* where commission schedule stated that if lease contains option rights to renew lease and/or expand premises, commission "shall be calculated as though it was part of the initial lease transaction"]

Counsel representing landlords should watch out for such provisions (they are often buried in the text of the listing agreement and landlords frequently neglect to focus on their effect).

d. [2:276] **Payment:** Commissions are typically paid in full at the closing of the transaction. (*See ¶ 2:394 and 4:578*.) However, with respect to leasehold transactions, a portion of the commission (usually half) is ordinarily payable upon execution of the lease, with the balance due either at the time the tenant takes occupancy or when the tenant is first required to pay rent.

2. [2:277] **Conditions to Payment of Compensation:** Three general conditions must be satisfied before real estate brokers are entitled to compensation from their principals:

• The broker must have a *valid real estate license* (¶ *2:64 ff., 2:278*);

• There must be a *written agreement* between broker and principal sufficient to satisfy the *statute of frauds* (¶ *2:281*); and

• The *specific conditions* of the broker's contract with the principal must have been *satisfied* (¶ *2:305*).

a. [2:278] **Valid real estate license:** Any agreement employing an *unlicensed* party to perform *brokerage services* is *void* and unenforceable. Therefore, an unlicensed real estate agent *cannot recover compensation* for brokerage services. [Bus. & Prof.C. §§ 10130 (unlawful to engage in brokerage activities without license), 10136; *Salazar v. Interland, Inc.* (2007) 152 CA4th 1031, 1033-1034, 62 CR3d 24, 25-26—unlicensed broker not entitled to commissions from company he assisted in purchasing 105,000 AT&T Internet service customers (transaction deemed sale of "business opportunity" requiring broker's license); but see also *Nein v. HostPro, Inc.* (2009) 174 CA4th 833, 847-849, 95 CR3d 34, 46-48 (disagreeing with *Salazar* court's analysis whether *brokerage services* requiring license were actually performed so as to bar unlicensed plaintiff's compensation claim as matter of law)]

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Compare—severable nonbrokerage services compensable: See discussion at ¶ 2:280.10 ff.

(1) [2:279] **Time of licensing:** Section 10136 requires brokers suing for brokerage activity compensation to allege and prove they were licensed "at the time the alleged cause of action [for compensation] arose"—i.e., at the time the *brokerage services were performed.* [Bus. & Prof.C. § 10136; see *Fellow v. Adams* (1969) 274 CA2d 855, 862, 79 CR 633, 637-638; *Cline v. Yamaga* (1979) 97 CA3d 239, 244-245, 158 CR 598, 601—broker's action arises when commission becomes due and payable]

• [2:279.1] For example, a broker was entitled to compensation where, though his license had lapsed at the time a buyer for estate real property had been procured and the sale was confirmed, his license was renewed *before* the sale was consummated. [*Estate of Lopez* (1992) 8 CA4th 317, 324, 10 CR2d 67, 70-71]

• [2:279.2] But compensation was barred where a broker had no license at the time all brokerage services were performed and the sale was consummated. [*Davis v. Chipman* (1930) 210 C 609, 621-623, 293 P 40, 45-46]

(2) [2:280] **"Substantial compliance":** Case law also suggests that technical noncompliance with the licensing law will not bar the recovery of compensation. [See *Schantz v. Ellsworth* (1971) 19 CA3d 289, 293, 96 CR 783, 785—broker held valid license but failed to obtain branch office license (Bus. & Prof.C. §§ 10162 & 10163) or license for use of fictitious business name (Bus. & Prof.C. § 10159.5); *Estate of Baldwin* (1973) 34 CA3d 596, 605, 110 CR 189, 195—fact seller agreed to pay commission to unlicensed corporation under whose name licensed broker conducted brokerage services did not preclude broker from recovering commission where services performed individually and broker was merely doing business under fictitious name]

The licensing law should not be so literally construed as to require exact compliance "if it would transform the statute into an unwarranted shield for the avoidance of a just obligation … Literally, all that section 10136 requires is that the plaintiff prove that he was a duly licensed real estate broker." [*Schantz v. Ellsworth*, supra, 19 CA3d at 292, 96 CR at 785 (internal quotes omitted); see also *Estate of Baldwin*, supra, 34 CA3d at 605, 110 CR at 195]

(3) [2:280.1] **Licensed salesperson must have acted through licensed broker:** A salesperson's license at the time the brokerage services are performed does not itself satisfy the "valid license" prerequisite to compensation. A salesperson may only act under the authority of a licensed broker (¶ *2:35, 2:47 ff.*); and the broker under whose authority the salesperson is acting must itself be a party to the real estate contract. [*Venturi & Co. LLC v. Pacific Malibu Develop. Corp.* (2009) 172 CA4th 1417, 1423-1424, 92 CR3d 123, 128-129, fns. 7 & 8]

• [2:280.2] Finance company that entered into a resort development contract was not entitled to compensation for all services because its manager had only a sales license and, without a broker's license, the company was not entitled to compensation for any broker's services it performed. Although the manager was later employed by a licensed broker, that broker was not a party to the subject real estate contract. [*Venturi & Co. LLC v. Pacific Malibu Develop. Corp.* (2009) 172 CA4th 1417, 1423-1424, 92 CR3d 123, 128-129]

(a) [2:280.3] **Commission-sharing agreements between salespersons:** So long as commissions from the sale of real property are initially paid *through* a licensed broker, salespersons working under the broker may share the commissions pursuant to a commission-sharing agreement. [See Bus. & Prof.C. § 10137—shared commission must be paid through responsible broker]

By the same token, the broker is *not* required to be a party to the agreement. Indeed, by enacting Bus. & Prof.C. § 10137, which restricts the manner in which commissions may be paid (¶ *2:115.20*), "the Legislature did not limit the payee to a licensed broker; instead it required that any such payment be made 'through the broker' thus permitting payments to be made to licensed real estate professionals, whether agents or brokers." [See *Sanowicz v. Bacal* (2015) 234 CA4th 1027, 1030, 1040-1041, 184 CR3d 517, 519-520, 528 (deciding in case of first impression that real estate salespersons may sue fellow salespersons for reneging on their commission-sharing deals)]

(4) [2:280.4] **Compare—sharing commission with unlicensed persons:** It is permissible under the Real Estate Law for a licensed broker to share a commission with unlicensed persons so long as they do not perform any act for which a license is required. [88 Ops.Cal.Atty.Gen. 203 (2005)]

Thus, e.g., an attorney holding a broker's license may represent a seller in a real property transaction in which the seller agrees to pay the attorney's *law firm* a real estate broker commission in lieu of a fee for legal services rendered in the sales transaction *provided* no one in the law firm who does not hold a real estate license performs any acts requiring a real estate license. [88 Ops.Cal.Atty.Gen. 203 (2005); *see also* ¶ *1:148 ff.*]

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(5) [2:280.5] **Compare—"finder's fee" compensation:** The absence of a real estate license is no bar to the recovery of agreed-upon compensation for services performed as a *finder* … so long as the purported "finder" provided no brokerage services in the transaction (played no part in negotiating the details of the transaction, etc., ¶ *2:38*). [*Tyrone v. Kelley* (1973) 9 C3d 1, 11-12, 106 CR 761, 768; *GreenLake Capital, LLC v. Bingo Investments, LLC* (2010) 185 CA4th 731, 736, 111 CR3d 82, 85—one who simply finds and introduces prospective parties to real estate transaction is protected by "finder's exception"]

(a) [2:280.6] **Evaluated on per-transaction basis:** This "finder's exception" is applied on a *transaction-by-transaction basis*. Thus, one who acts as an unlicensed *broker* in some transactions for a principal may nonetheless recover an agreed-upon finder's fee on transactions where they did not cross the line from finder to broker. [*Lindenstadt v. Staff Builders, Inc.* (1997) 55 CA4th 882, 894-895, 64 CR2d 484, 491; see also *Venturi & Co. LLC v. Pacific Malibu Develop. Corp.* (2009) 172 CA4th 1417, 1421, 92 CR3d 123, 127—unlicensed finance company entitled to compensation for portion of contractually agreed-upon activities unrelated to real estate broker services (i.e., finding potential financing sources and providing financial/marketing advice, etc.)]

"[T]he purpose of the broker's licensing statute—the promotion of competency and trust—is not served by denying [unlicensed individual] a finder's fee on transactions where he merely introduced the principals … to one another …" [*Lindenstadt v. Staff Builders, Inc.*, supra, 55 CA4th at 894, 64 CR2d at 491]

[2:280.7 - 2:280.9] ***Reserved.***

(6) [2:280.10] **Compare—compensation for unlicensed person's services *severable from and unrelated to brokerage activities:*** The *doctrine of severability* (Civ.C. § 1599) generally preserves and enforces any *lawful* portion of an unlawful contract to the extent the lawful portion feasibly may be severed; and nothing in the real estate licensing statutes bars the recovery of compensation for services not requiring a real estate license or purports to repudiate the generally applicable doctrine of severability. Accordingly, an unlicensed person can seek compensation for nonbrokerage services to the extent the agreement's provisions for those services are severable from and unrelated to the provisions for brokerage activities. [See *MKB Mgmt., Inc. v. Melikian* (2010) 184 CA4th 796, 802-803, 108 CR3d 899, 904-905; *GreenLake Capital, LLC v. Bingo Investments, LLC* (2010) 185 CA4th 731, 739-740, 111 CR3d 82, 88]

Even if the contract is capable of severance, however, the decision *whether to sever* and enforce the lawful portions providing compensation for nonbrokerage services is a *discretionary* determination for the trial court. [*MKB Mgmt., Inc. v. Melikian*, supra, 184 CA4th at 803, 108 CR3d at 905]

• [2:280.11] An unlicensed management company was entitled to seek compensation from the owner of several apartment buildings for contractually-agreed upon repairs, decorating and general maintenance even though other services provided by the company (offering for lease and leasing units and collecting rents) were noncompensable in the absence of a real estate license. [*MKB Mgmt., Inc. v. Melikian* (2010) 184 CA4th 796, 802-805, 108 CR3d 899, 904-907]

• [2:280.12] An unlicensed company retained to assist a "bridge" lender in identifying and raising financing was entitled to seek compensation for that portion of its services deemed severable from and unrelated to brokerage activities. The company helped the "bridge" lender draft initial documentation to support a revolving credit facility and subsequent credit and security agreement, neither of which provided the "bridge" lender with a direct equity position in the underlying real property; "collateral so remote" from an actual lien on real property is not subject to the strictures of the Real Estate Law." [*GreenLake Capital, LLC v. Bingo Investments, LLC* (2010) 185 CA4th 731, 741-742, 111 CR3d 82, 90-91]

[2:280.13 - 2:280.14] ***Reserved.***

(7) [2:280.15] **Compare—broker assignment of rights to *earned commissions to third-party nonbroker:*** A broker who is licensed when a cause of action for recovery of commissions accrues may *assign* its rights to *earned* commissions to a third-party *nonbroker*. The assignment does not violate public policy requiring broker supervision of nonbroker activities (¶ *2:48*), nor is it void for requiring a defaulting principal to pay a nonbroker for regulated services (¶ *2:64*). This is so because neither the broker nor the assignee has any further duties to the principal, at least with respect to the transactions that gave rise to the earned commissions. [*Schaffter v. Creative Capital Leasing Group, LLC* (2008) 166 CA4th 745,

756-759, 83 CR3d 19, 26-29—broker assigned rights based on good faith belief principal/buyer would default on purchase and dishonor agreement's commission clause, *not* to shirk broker responsibilities]

(a) [2:280.16] **Comment:** Real estate brokers have countless reasons why they would prefer to assign commission claims to third parties rather than file suit on their own behalf. For example, a broker may determine the amount to be gained from successful litigation does not merit the time and effort that would necessarily be expended; or, the broker many not want to get a reputation for suing past or current clients. A broker may make a business judgment that the likelihood of success is outweighed by the possibility of failure. And a broker simply may not want to run the risk of a counterclaim being filed against them. [See *Schaffter v. Creative Capital Leasing Group, LLC* (2008) 166 CA4th 745, 757, 83 CR3d 19, 27, fn. 6]

b. [2:281] **Statute of frauds:** Agreements employing a broker to act in a real estate transaction are subject to the statute of frauds:

> "An agreement authorizing or employing an agent, broker, or any other person to purchase or sell real estate, or to lease real estate for a longer period than one year, or to procure, introduce, or find a purchaser or seller of real estate or a lessee or lessor of real estate where the lease is for a longer period than one year, for compensation or a commission" is invalid unless it, or some note or memorandum thereof, is *in writing*, subscribed by the party to be charged (or by such party's agent). [Civ.C. § 1624(a)(4); *Phillippe v. Shapell Industries, Inc.* (1987) 43 C3d 1247, 1255, 241 CR 22, 24-25]

The primary purpose of the writing requirement is to protect property owners against compensation claims from persons never authorized to act as the owner's intermediary in a real estate transaction. [*Rader Co. v. Stone* (1986) 178 CA3d 10, 21, 223 CR 806, 810] Secondarily, however, the writing requirement also protects brokers who, having been properly employed, perform brokerage services for their principals in good faith. [*Seck v. Foulks* (1972) 25 CA3d 556, 575, 102 CR 170, 181]

Cross-refer: An agreement for the purchase and sale of such property is likewise subject to the statute of frauds (Civ.C. § 1624(a)(3); *Smyth v. Berman* (2019) 31 CA5th 183, 197, 242 CR3d 336, 348). Many of the same principles apply as well to broker compensation agreements. For a detailed discussion, *see ¶ 4:263 ff.*

(The sections at ¶ 2:282 ff. address statute of frauds issues arising solely under broker compensation agreements pursuant to Civ.C. § 1624(a)(4).)

(1) [2:282] **Sufficiency of writing—essential terms:** The written agreement (or written memorandum thereof) need not contain all the terms of the employment contract. But, at a minimum, it must set forth the following essential terms:

• the fact of *employment* of the broker to act in the real estate transaction;

• the broker's *identity;* and

• a sufficiently certain *description* of the property. [See generally, *Woodbridge Realty v. Plymouth Develop. Corp.* (1955) 130 CA2d 270, 274, 278 P2d 713, 715-716; *Rosenbaum v. Rosenbaum* (1967) 257 CA2d 193, 64 CR 632, 636; *Barcelon v. Cortese* (1968) 263 CA2d 517, 525-526, 69 CR 657, 663-664; see also *Rader Co. v. Stone* (1986) 178 CA3d 10, 21-25, 223 CR 806, 810-813; *Phillippe v. Shapell Industries, Inc.* (1987) 43 C3d 1247, 1259, 241 CR 22, 27—where agreement relates solely to specifically described property, principal *not liable* to pay broker commission on purchase of *different* property]

(a) [2:283] **Compare—compensation arrangement:** So long as the requirements set forth at ¶ 2:282 are met, the other terms—including the amount of the broker's compensation, and even the agreement to pay broker compensation—need not be specifically stated in writing. Compensation arrangements and other terms may be shown by extrinsic evidence; and, if there is no evidence as to the amount of compensation, an agreement to pay a "reasonable" commission will be inferred. [*Beazell v. Schrader* (1963) 59 C2d 577, 580, 30 CR 534, 536; *Rader Co. v. Stone* (1986) 178 CA3d 10, 21, 223 CR 806, 810]

(2) [2:284] **Sufficiency of subscription:** The written agreement must be signed by or on behalf of the principal (or the principal's authorized agent) against whom broker compensation is sought. [*Marks v. Walter G. McCarty Corp.* (1949) 33

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C2d 814, 820, 205 P2d 1025, 1029-1030; *Rader Co. v. Stone* (1986) 178 CA3d 10, 21, 223 CR 806, 810; see also *Jacobs v. Locatelli* (2017) 8 CA5th 317, 323, 213 CR3d 514, 518-519 (demurrer to real estate broker's contract-based compensation claim improperly sustained)—written commission agreement signed by alleged agent/owner on behalf of other owners deemed sufficient to satisfy statute of frauds]

(a) [2:285] **Form and placement:** The subscription need not be at the end of the instrument; nor need it be handwritten. The principal's *printed name* satisfies the statute so long as *intended as a signature* (i.e., as an authentication), but not if the name appears simply for identification or some other purpose. [*Rader Co. v. Stone* (1986) 178 CA3d 10, 23, 223 CR 806, 812; see also *Marks v. Walter G. McCarty Corp.* (1949) 33 C2d 814, 820, 205 P2d 1025, 1029—letterhead not sufficient subscription where not adopted as principal's signature]

Moreover, the statute is satisfied even if the signature appears solely on one of a series of papers … so long as, taken together, all the papers relate to the same transaction. "[T]his is enough, as all the papers are to be considered together as forming one contract or memorandum." [*Thompson v. Walsh* (1946) 76 CA2d 188, 194, 172 P2d 745, 749; see *Rader Co. v. Stone*, supra, 178 CA3d at 23, 223 CR at 812]

(b) [2:286] **Timing:** It is not absolutely essential that the writing be executed before brokerage services are performed. The statute is satisfied even if the principal executed the agreement *after* the services were performed or the transaction consummated. [*Hillman v. Koch* (1949) 92 CA2d 163, 166, 206 P2d 434, 436]

(c) [2:286.1] **Validation by ratification:** Although the requisite subscription is absent from a separate written brokerage agreement, the statute of frauds may be satisfied by the principal's subsequent *ratification* thereof—as where the principal consummates a written purchase agreement stating that a broker commission will be paid. [See *Friddle v. Epstein* (1993) 16 CA4th 1649, 1655-1656, 21 CR2d 85, 88-89—by consummating written purchase agreement, which included allegedly separate provision for broker commission, purchasers ratified entire transaction, including broker's fee provision]

(3) [2:287] **Agreements covered:** Civ.C. § 1624(a)(4) is strictly construed to apply to virtually every agreement employing a licensed broker for compensation. Indeed, "[o]nce the statute of frauds applies, its bar against relief is absolute and applies no matter how the unhappy broker styles [their] claim to recover compensation or a commission." [*Westside Estate Agency, Inc. v. Randall* (2016) 6 CA5th 317, 324, 211 CR3d 119, 125]

(a) [2:288] **Licensed broker's "finder's fee" agreements:** An agreement to pay a *licensed broker* compensation for simply *bringing the parties together* (i.e., employing broker as a mere "finder," *¶ 2:37 ff.*) is subject to Civ.C. § 1624(a)(4) even though the broker is not employed to negotiate the terms of the transaction. [*Tenzer v. Superscope, Inc.* (1985) 39 C3d 18, 25-28, 216 CR 130, 133-135]

(Distinguish—equitable estoppel theory of recovery by *unlicensed* "finder"; *see ¶ 2:303*.)

(b) [2:289] **"Hybrid" real estate transactions:** Even though the principal is not contemplating an actual "purchase" or "sale" (or more-than-one-year lease), Civ.C. § 1624(a)(4) also applies to the employment of brokers to handle real estate transactions that effectively accomplish a result similar to a purchase or sale (or more-than-one year lease). For example:

1) [2:290] **Exchanges:** A property owner's agreement authorizing an agent, for compensation, to negotiate the *exchange* of the owner's property for some other parcel must be in writing pursuant to Civ.C. § 1624(a)(4) even though the property is not technically "sold" or "purchased" in the exchange. [*Zimmerman v. Bank of America Nat'l Trust & Savings Ass'n* (1961) 191 CA2d 55, 57, 12 CR 319, 320]

2) [2:291] **Options:** So too, a contract employing a broker for compensation to obtain an *option to purchase* real property must be in writing. Even though the option is not an actual "sale" or "purchase" (it simply grants the optionee the right to buy the property within the option term), it relates to a contract for the sale or purchase of real estate. [*Pacific Southwest Develop. Corp. v. Western Pac. R.R. Co.* (1956) 47 C2d 62, 68, 301 P2d 825, 829; *Barcelon v. Cortese* (1968) 263 CA2d 517, 528, 69 CR 657, 665]

Cross-refer: Options to purchase and preemptive purchase rights are discussed in detail in *Ch. 8*.

(c) [2:292] **Modifications:** Generally, contracts subject to the statute of frauds may only be modified by a written agreement which itself satisfies the statute of frauds. [Civ.C. § 1698(c)] But an oral modification of a brokerage contract is not necessarily voidable:

A *fully executed* oral agreement may modify a written contract (Civ.C. § 1698(b)); and a written listing agreement may be modified pursuant to the law of rescission or novation (Civ.C. § 1698(d)). [See *Realty Corp. of America v.*

Burton (1958) 162 CA2d 44, 56-57, 327 P2d 948, 956—modification of broker commission agreement by written collateral agreement or by supplemental novated oral agreement fully executed]

(d) [2:293] **Compare—commission-sharing agreements:** Civ.C. § 1624 applies to agreements between broker and principal. It does *not* apply to *inter-broker commission-sharing agreements.* [*Westside Estate Agency, Inc. v. Randall* (2016) 6 CA5th 317, 325, 211 CR3d 119, 125; *Grant v. Marinell* (1980) 112 CA3d 617, 621, 169 CR 414, 416]

(4) [2:294] **"Absolute" statute of frauds defense as against brokers (no "equitable estoppel" exception):** Under general contract law, a party may be able to overcome a statute of frauds defense on the basis of "equitable estoppel" (detrimental reliance on oral agreement and resulting "unconscionable injury" or "unjust enrichment"). [*Monarco v. Lo Greco* (1950) 35 C2d 621, 623-624, 220 P2d 737, 739-740—estoppel is proper to avoid unconscionable injury or unjust enrichment that would result from refusal to enforce oral promise]

However, "equitable estoppel" theories of recovery and other equitable remedies (e.g., quantum meruit) generally are *not* available to licensed real estate brokers in actions to recover a commission under an oral employment agreement. [*Phillippe v. Shapell Industries, Inc.* (1987) 43 C3d 1247, 1260-1270, 241 CR 22, 28-35; see also *Westside Estate Agency, Inc. v. Randall* (2016) 6 CA5th 317, 325-326, 211 CR3d 119, 127 (discussing narrow exceptions, including "actual fraud" (¶ 2:301) and ratification (¶ 2:286.1)); *American Int'l Enterprises, Inc. v. FDIC* (9th Cir. 1993) 3 F3d 1263, 1269-1270—statute of frauds barred recovery by broker on oral commission agreement with FDIC]

(a) [2:295] **Rationale:** The real estate licensing requirements compel *strict adherence* to the statute of frauds in connection with broker compensation agreements. [See *Phillippe v. Shapell Industries, Inc.* (1987) 43 C3d 1247, 1260-1269, 241 CR 22, 28-35]

1) [2:296] **Presumed knowledge of law:** Real estate brokers are licensed as such only *after* they have demonstrated a knowledge of the real estate law. Thus, licensed brokers are *presumed* to know that contracted-for commissions are invalid and unenforceable unless the employment agreement is reduced to a writing satisfying the statute of frauds. [*Phillippe v. Shapell Industries, Inc.* (1987) 43 C3d 1247, 1260-1262, 241 CR 22, 28-29—licensed brokers "are conclusively presumed to know the requirements of section 1624"; *American Int'l Enterprises, Inc. v. FDIC* (9th Cir. 1993) 3 F3d 1263, 1270; *Pacific Southwest Develop. Corp. v. Western Pac. R.R. Co.* (1956) 47 C2d 62, 70, 301 P2d 825, 831]

2) [2:297] **Rendition of brokerage services not "unconscionable injury":** Moreover, the mere rendition of brokerage services under an oral agreement does not constitute a detrimental change of position producing "unconscionable injury" for purposes of an equitable estoppel theory of recovery. To give rise to equitable estoppel, the promisee's (broker's) reliance on an oral agreement must be *reasonable:* "[T]he broker's reliance on the oral contract [is] *not reasonable* in light of the broker's presumed knowledge of the requirements of the statute of frauds." [*Phillippe v. Shapell Industries, Inc.* (1987) 43 C3d 1247, 1262, 241 CR 22, 29-30 (emphasis added)—broker's reliance on oral contract not reasonable, "and he therefore suffered no unconscionable injury"; *American Int'l Enterprises, Inc. v. FDIC* (9th Cir. 1993) 3 F3d 1263, 1270; see also *Pacific Southwest Develop. Corp. v. Western Pac. R.R. Co.* (1956) 47 C2d 62, 70, 301 P2d 825, 830-831]

3) [2:298] **Principal's release from compensation obligation not "unjust enrichment" (no quantum meruit recovery):** Similarly, the fact a broker's principal does not pay for the broker's services under an unenforceable oral contract cannot constitute "unjust enrichment" sufficient to support an equitable estoppel. To hold otherwise would conflict with consistent holdings that licensed brokers, who cannot recover under oral agreements invalid under the statute of frauds, are also prohibited from recovery in quantum meruit for the reasonable value of their services. Upholding a quantum meruit theory of recovery in such cases would *frustrate the purpose* of and, indeed, eviscerate if not entirely abrogate Civ.C. § 1624(a)(4). [*Phillippe v. Shapell Industries, Inc.* (1987) 43 C3d 1247, 1263-1264, 241 CR 22, 30-31; see *American Int'l Enterprises, Inc. v. FDIC* (9th Cir. 1993) 3 F3d 1263, 1270; *Beazell v. Schrader* (1963) 59 C2d 577, 582, 30 CR 534, 537]

4) [2:299] **Public policy concerns—consumer protection:** Sound public policy also militates against recognition of a licensed real estate broker's equitable estoppel exception to the statute of frauds. Civ.C. § 1624(a)(4) "can … be characterized as a *consumer protection statute* … [It] manifests a valid legislative intent to protect real estate buyers and sellers from unfounded claims for brokers' commissions … [and] also serves a cautionary purpose. By requiring a writing, the statute serves to emphasize to contracting parties the significance of their agreement. The importance

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of real estate transactions makes this aspect of the statute especially salutary." [*Phillippe v. Shapell Industries, Inc.* (1987) 43 C3d 1247, 1265-1267, 241 CR 22, 31-33; see *Buckaloo v. Johnson* (1975) 14 C3d 815, 827, 122 CR 745, 751 (disapproved on other grounds by *Della Penna v. Toyota Motor Sales, U.S.A., Inc.* (1995) 11 C4th 376, 392-393, 45 CR2d 436, 447, fn. 5)—"[w]e have neither the authority nor the inclination to circumvent that declared policy …"]

(b) [2:300] **No exception for commercial real estate transactions—relative bargaining power irrelevant:** It has been suggested that, at least in the commercial real estate arena, brokers may not be in sufficiently strong bargaining positions to obtain written employment contracts from their principals and, therefore, Civ.C. § 1624(a)(4) should not bar recovery on an oral agreement in such situations because the statute is contrary to industry custom and practice. But § 1624(a)(4) contains *no exception* based on the parties' relative bargaining strengths. "If the Legislature believes that [the statute] is not workable in the real estate marketplace, the Legislature can act accordingly." [*Phillippe v. Shapell Industries, Inc.* (1987) 43 C3d 1247, 1267-1268, 241 CR 22, 33]

Moreover, any judicially-recognized "disparity of bargaining power" exception would unduly complicate resolution of broker compensation disputes. "Even defining bargaining power would be troublesome … [T]o determine whether there was a disparity, a court would likely have to conduct a detailed examination of the parties' respective financial conditions thus creating a need for considerable pretrial discovery and protracted litigation." Further, if bargaining power were relevant, the parties (who ordinarily desire certainty in their financial dealings) would not know at the time of entering into an oral agreement whether it would be an enforceable contract. Each party would have to speculate whether they possessed some quality that created an imbalance in bargaining power. "To hold that the validity of a commission agreement depends on relative bargaining power would lead to great uncertainty … [and] unnecessary complexities." [*Phillippe v. Shapell Industries, Inc.*, supra, 43 C3d at 1268, 241 CR at 34]

In any event, the statute provides *no exception for commercial transactions*. "An unequivocal statute must take precedence over mere custom. Indeed, the widespread custom of not using written contracts in real estate transactions was apparently a reason why section 1624[(a)(4)] was enacted in the first instance." [*Phillippe v. Shapell Industries, Inc.*, supra, 43 C3d at 1269, 241 CR at 35]

(c) [2:301] **"Actual fraud" exception:** Notwithstanding the "absolute" statute of frauds defense as against brokers (¶ 2:294 ff.), the statute of frauds does not bar a licensed broker's action against the principal for "*actual fraud*." But the "actual fraud" theory permits the recovery of broker compensation under an invalid oral agreement only where the broker can demonstrate they *reasonably relied on the principal's misrepresentations*. [*Phillippe v. Shapell Industries, Inc.* (1987) 43 C3d 1247, 1269-1270, 241 CR 22, 35]

1) [2:302] **"Reasonable reliance" requirement narrowly construed:** Ordinarily, a broker will be hard-pressed to show *justifiable* ("reasonable") reliance: Given the broker's presumed knowledge of the real estate law and the statute of frauds (¶ 2:296), a broker's reliance on an oral promise to pay a commission or to execute the requisite writing at a later date "cannot be sufficiently reasonable to support an action for fraud." [*Phillippe v. Shapell Industries, Inc.* (1987) 43 C3d 1247, 1270, 241 CR 22, 35; *American Int'l Enterprises, Inc. v. FDIC* (9th Cir. 1993) 3 F3d 1263, 1270; see also *Westside Estate Agency, Inc. v. Randall* (2016) 6 CA5th 317, 327, 211 CR3d 119, 128—absent principal's "actual fraud" (¶ 2:301), fact broker is licensed forecloses possibility it *reasonably relied* on unwritten contract]

This is not to say there are no types of oral promises on which brokers can reasonably rely (e.g., broker might reasonably rely on principal's representation that the necessary contract has in fact been executed). [See *Owens v. Foundation for Ocean Research* (1980) 107 CA3d 179, 183-184, 165 CR 571, 573 (disapproved on other grounds by *Tenzer v. Superscope, Inc.* (1985) 39 C3d 18, 29-31, 216 CR 130, 136-137, and by *Applied Equipment Corp. v. Litton Saudi Arabia Ltd* (1994) 7 C4th 503, 521, 28 CR2d 475, 485, fn. 10)—principal represented his authorization was in writing when in fact it was not]

Although no definitive list of such promises has been identified, it clearly is *narrowly-defined:* "We believe … that a licensed broker's reliance can be reasonable *only in rather limited circumstances*." [See *Phillippe v. Shapell Industries, Inc.* (1987) 43 C3d 1247, 1270, 241 CR 22, 35 (emphasis added)—whether broker's reliance is reasonable "must be determined on the facts of each case"]

(d) [2:303] **Compare—unlicensed real estate "finders":** Because they are *not* presumed to have knowledge of the real estate licensing law (and, hence, the statute of frauds), *unlicensed real estate finders* (i.e., unlicensed persons who simply act as *intermediaries* in bringing buyer and seller together but who do *not negotiate* the terms of the transaction,

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¶ *2:37 ff.*) may rely on an equitable estoppel or quantum meruit theory to recover commissions under an oral agreement. [*Tenzer v. Superscope, Inc.* (1985) 39 C3d 18, 28, 216 CR 130, 135; see *Phillippe v. Shapell Industries, Inc.* (1987) 43 C3d 1247, 1260-1261, 241 CR 22, 28-29—"[w]e believe the distinction between licensed brokers and unlicensed finders remains valid"]

But even "finder's fee agreements" between a *licensed* broker and principal are subject to Civ.C. § 1624(a)(4). [*Tenzer v. Superscope, Inc.*, supra, 39 C3d at 25-28, 216 CR at 133-135; see *Phillippe v. Shapell Industries, Inc.*, supra, 43 C3d at 1258, 241 CR at 26, fn. 6]

[2:304] ***Reserved.***

c. [2:305] **Satisfaction of contract terms (conditions precedent):** The parties are free to make the duty to pay broker compensation dependent on the satisfaction of any lawful conditions. [*Blank v. Borden* (1974) 11 C3d 963, 969, 115 CR 31, 34; *John B. Kilroy Co. v. Douglas Furn. of Calif., Inc.* (1993) 21 CA4th 26, 35, 25 CR2d 752, 757; see also *RealPro, Inc. v. Smith Residual Co., LLC* (2012) 203 CA4th 1215, 1220, 138 CR3d 255, 259—offer to purchase property at full listing price did not trigger broker's right to commission where other conditions precedent to payment not met (¶ *2:315 & 2:334*)]

Most listing agreements, however, condition the payment of compensation on (1) the broker's procurement of a "ready, willing and able" buyer; and/or (2) actual consummation of the purchase and sale transaction. [See *Won Shil Park v. First American Title Co.* (2011) 201 CA4th 1418, 1423-1424, 136 CR3d 684, 689-690—nonbinding preliminary communications between broker and potential buyer and initial price memorandums between seller and buyer not sufficient]

While brokerage contracts are typically executed between the seller and broker, the same rules apply when the buyer employs a broker to find particular property and negotiate a purchase on specified terms (*see* ¶ *2:327*); i.e., the contract may make the buyer's duty to pay a commission contingent on the satisfaction of any lawful conditions—ordinarily, (1) the buyer's entry into a binding contract for purchase, and/or (2) actual consummation of the purchase. [*RC Royal Develop. & Realty Corp. v. Standard Pac. Corp.* (2009) 177 CA4th 1410, 1418, 100 CR3d 115, 121 (citing text); see also *R.J. Kuhl Corp. v. Sullivan* (1993) 13 CA4th 1589, 1600-1601, 17 CR2d 425, 432]

➪ [2:306] ***PRACTICE POINTER:*** Counsel who draft or review brokerage agreements for their clients (prospective sellers or buyers, as the case may be) should be sure the agreement carefully enumerates express, lucid and detailed conditions precedent to the client's obligation to pay a commission. The conditions should be as extensive as possible so as to protect the client from liability to pay a commission if no closing occurs (*see* ¶ *2:307 ff.*).

(1) "Procurement" of "ready, willing and able" buyer as condition precedent

(a) [2:307] **Procuring cause:** A condition precedent requiring the broker to "procure" a "ready, willing and able" buyer is satisfied only if the broker is the "*procuring cause*." That is a question of fact in each case. [*Colwell Co. v. Hubert* (1967) 248 CA2d 567, 577, 56 CR 753, 760-761]

The broker does not necessarily have to consummate the transaction (the word "procure" does not itself imply formal consummation). Broadly, the broker is a "procuring cause" if they originate a series of events which, without any break in continuity, result in the intended transaction. [*Colwell Co. v. Hubert*, supra, 248 CA2d at 577, 56 CR at 760-761; *Rose v. Hunter* (1957) 155 CA2d 319, 323, 317 P2d 1027] Stated another way, the broker must put in motion a chain of events which, without a break in continuity, are the proximate cause of the transaction. [*Nelson v. Mayer* (1954) 122 CA2d 438, 445, 265 P2d 52, 56]

The broker may even be the "procuring cause" when a sale is not completed (*Estate of Lopez* (1992) 8 CA4th 317, 320-321, 10 CR2d 67, 68). *See* ¶ *2:316 ff.*

1) [2:308] **Distinguish—exclusive listing agreements:** "Procuring cause" issues only arise under listing agreements which actually require the broker to "*procure*" or "*produce*" a buyer. In contrast, under a true "*exclusive* right to sell" listing agreement, the broker is entitled to a commission *regardless of who procures the buyer* (*see* ¶ *2:355*).

(b) [2:309] **Ready, willing and able buyer—conclusive presumption:** Listing agreements often require the broker to procure a "ready, willing and able" buyer. Such conditions may complicate broker compensation agreements because the phrase defies precise definition.

Some cases hold it is conclusively presumed as between seller and broker that the buyer is in fact "ready, willing and able" simply upon execution of an "unconditional" contract to sell. [*Beazell v. Kane* (1954) 127 CA2d 593, 595, 274 P2d 224, 225; *Deeble v. Stearns* (1947) 82 CA2d 296, 299, 186 P2d 173, 175—"execution of a contract of sale by the owner of real property is conclusive proof that he was satisfied as to the qualifications of the purchaser and of his ability to perform the contract, thus rendering the owner liable for the payment of the broker's commission"]

1) [2:310] **Risk for sellers:** Such a conclusive presumption can make it *extremely risky for sellers* to condition the duty to pay broker compensation strictly on the broker's procuring a "ready, willing and able" buyer. The following scenarios are illustrative:

• [2:311] At least under the *Beazell* and *Deeble* line of authority, a seller would arguably be obligated to pay the broker's commission when a buyer executes an *unconditional* contract to purchase but *fails to consummate the transaction* (i.e., neither "ready" nor "able" to close). [See *Twogood v. Monnette* (1923) 191 C 103, 107, 215 P 542, 543—absent specific agreement to the contrary, broker "has earned his commission" by producing a person "ready, willing, and able to purchase the property on terms satisfactory to the seller" regardless of whether sale is ever consummated]

• [2:312] Likewise, the seller might be bound to pay a broker's commission when a buyer who executes a *conditional* purchase contract subsequently *waives* or *satisfies* all contingencies but then *fails to close the deal* (i.e., unable or unwilling to consummate the purchase).

• [2:313] Similarly, under such an agreement, the broker might earn the right to a commission upon the seller's accepting an unconditional offer (or a conditional offer that subsequently becomes unconditional) even though the occurrence of later events makes the closing impossible (e.g., condemnation of all or part of the property). [See *Jauman v. McCusick* (1913) 166 C 517, 521-522, 137 P 254, 255-256—purchase agreement secured by broker was subsequently abandoned without broker's fault; *Caine v. Briscoe* (1926) 78 CA 660, 670, 248 P 774, 778—seller's acceptance of buyer estopped seller from denying buyer's ability or willingness to complete contract of sale; *Deeble v. Stearns* (1947) 82 CA2d 296, 299, 186 P2d 173, 175—buyers repudiated contract of sale after seller approved contract and accepted deposit; *Turner v. Waldron Realty* (1962) 209 CA2d 376, 382-383, 25 CR 771, 775-776—broker procured buyer on terms acceptable to seller but deal never consummated; *Green v. Linn* (1962) 210 CA2d 762, 766-767, 26 CR 889, 892—owner prevented consummation of deal]

➪ [2:314] ***PRACTICE POINTER:*** *Avoid* these risks. The better practice for sellers is to include as an additional condition to broker compensation the *actual consummation* of the purchase and sale transaction (*see ¶ 2:315*).

(2) [2:315] **Closing as condition precedent:** Optimally, from the seller's perspective, the listing agreement should condition payment of a broker's commission on *actual consummation* of the transaction (as evidenced by a *conveyance* of title and the buyer's *payment of the purchase price*). Such an arrangement protects against the risks discussed at ¶ 2:310 ff. because the seller's obligation to pay the broker is triggered only by a "done deal." [*Estate of Lopez* (1992) 8 CA4th 317, 321, 10 CR2d 67, 68-69; see *RealPro, Inc. v. Smith Residual Co., LLC* (2012) 203 CA4th 1215, 1220, 138 CR3d 255, 259 (listing agreement authorized commission at "close of escrow")—no commission due where seller rejected full listing price offer, was entitled to and did counter-offer and sale never occurred (*¶ 2:334*); *Cochran v. Ellsworth* (1954) 126 CA2d 429, 440-441, 272 P2d 904, 910-911 (contract provided for commission "in the event of consummation of the sale")—no commission due where payment of purchase price and conveyance of title never occurred]

"Generally …, a real estate broker has earned [their] commission when [the broker] has brought to the vendor a purchaser who is ready, willing and able to buy the property … It is not necessary for the sale to be completed …" However, this rule does not apply "where the broker's contract specifies additional conditions on the payment of commission." Where the listing contract "provides for a commission only upon completion of the sale, the broker's cause of action does not arise … until the sale is completed." [*Estate of Lopez*, supra, 8 CA4th at 320-321, 10 CR2d at 68-69; see also *R.J. Kuhl Corp. v. Sullivan* (1993) 13 CA4th 1589, 1600-1601, 17 CR2d 425, 432—same rule with respect to brokerage contracts between *buyer* and broker]

(3) [2:316] **Compare—commission obligation despite seller's conduct precluding sale:** Ordinarily, the seller cannot escape liability to pay broker compensation by purposefully frustrating a sale or making a sale impossible. [See generally, *Howard v. Gitlen & Assocs., Inc. v. Ameri* (1989) 208 CA3d 90, 96-97, 256 CR 36, 39 (collecting cases); *Sullivan v. Dorsa* (2005) 128 CA4th 947, 960, 27 CR3d 547, 556—"there is no doubt about the soundness of the general principle [that] a

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seller may be liable for preventing a broker from performing under an exclusive listing agreement"] Such conduct is likely to breach the *seller's* covenants in the listing agreement (*see ¶ 2:317 ff.*).

Exception: But this principle cannot override a *categorical statutory bar* to broker compensation liability. For example, by statute, there is no liability to pay broker commissions associated with an action to partition real property by sale if the sale is not consummated, for whatever reason [CCP § 873.745 (incorporating limitations on broker compensation payable for private real property sales in decedents' estates, Prob.C. § 10160); *Sullivan v. Dorsa*, supra, 128 CA4th at 956-960, 27 CR3d at 553-556; *see* ¶ *2:346, 2:433 ff.*]

(a) [2:317] **Seller's breach of express covenant:** Many listing agreements expressly bar the seller from withdrawing the property from the market or rendering the property unmarketable during the term of the agreement. A seller who breaches such provisions may be liable to pay the commission even though a sale consequently cannot be completed. [*Blank v. Borden* (1974) 11 C3d 963, 970-972, 115 CR 31, 34-36—"withdrawal-from-sale" provision gave broker right to 6% commission on stipulated sale price (not a void "penalty" provision); *Baumgartner v. Meek* (1954) 126 CA2d 505, 511-513, 272 P2d 552, 556; compare *Howard v. Gitlen & Assocs., Inc. v. Ameri* (1989) 208 CA3d 90, 97, 256 CR 36, 39—seller's settlement of litigation not an act withdrawing property from market so as to render seller liable for commission; *see also ¶ 2:399*]

(b) [2:318] **Seller's breach of implied covenant of good faith and fair dealing:** Even in the absence of such an express covenant, the seller's interference with the broker's ability to complete its undertaking (procuring a satisfactory buyer and/or consummating the sale) may *breach the implied covenant of good faith and fair dealing* (obligating both parties generally not do anything that would preclude the other party from realizing the benefits of its bargain; *see ¶ 4:275.5*). An owner who breaches the implied covenant may nonetheless be liable for the broker's commission. [*Stromer v. Browning* (1966) 65 C2d 421, 424-425, 55 CR 18, 20; see *Colwell Co. v. Hubert* (1967) 248 CA2d 567, 575-576, 56 CR 753, 759-760—owner's affirmative conduct in preventing broker from performing agency contract breached implied covenant for which broker had damages remedy]

"A prospective seller … owes a duty to the broker not to act arbitrarily or in bad faith to prevent consummation of the transaction where the broker has found a prospective buyer who is ready, able, and willing to purchase the property, and the prospective buyer and the prospective seller have agreed upon the terms and conditions of the sale … [¶] Under such circumstances, if a sale is not consummated because the seller, acting arbitrarily or in bad faith, prevented consummation, the broker is entitled to [the broker's] commission even though [their] contract provides that payment shall be made out of the proceeds of the sale … or upon successful completion of the escrow …" [*Stromer v. Browning*, supra, 65 C2d at 424-425, 55 CR at 20; see also *Coulter v. Howard* (1927) 203 C 17, 23, 262 P 751, 753-754—"consummation of sale" condition is subject to constraint that "law requires of the vendor good faith and the doing of no intentional act to discourage, embarrass, or prevent the completion of the purchase"]

1) Application

a) [2:319] **Repudiation of agreement:** The broker is entitled to a commission where the seller, without cause, *repudiates the listing agreement* (*Daum v. Sup.Ct. (Yuba Plaza, Inc.)* (1964) 228 CA2d 283, 287-288, 39 CR 443, 446) or *repudiates the sale agreement* with a buyer procured by the broker (*Coulter v. Howard* (1927) 203 C 17, 25, 262 P 751, 754).

b) [2:320] **Refusal to accept satisfactory offer:** Similarly, the broker is entitled to a commission where the seller refuses to accept an offer on terms consistent with those set forth in the listing agreement. [*Collins v. Vickter Manor, Inc.* (1957) 45 C2d 875, 881, 306 P2d 783, 787]

[2:320.1] **Comment:** An offer that varies in only immaterial respects from the terms stated in the listing agreement may satisfy the broker's duty to procure a buyer as a condition to compensation; and likewise, if the seller executes a purchase agreement on terms that vary from those stated in the listing agreement, the seller will be deemed to have accepted the changed terms, thus entitling the broker to a commission. [*Lathrop v. Gauger* (1954) 127 CA2d 754, 767-768, 274 P2d 730, 738-739] (Indeed, this is a typical scenario … because sellers commonly accept an offer for less than the price designated in the listing agreement.)

c) [2:321] **Sale behind broker's back after rejected seller's counteroffer:** So too, a broker may be entitled to an agreed-upon commission when buyer and seller are *brought together by the broker* and, after expiration of a

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seller's counteroffer containing the agreement to pay a commission, enter into direct negotiations and *consummate a sale on substantially the same terms* as set out in the expired counteroffer.

Having agreed to pay a commission that was memorialized in the counteroffer, the seller cannot thereafter, consistent with the implied covenant of good faith, escape paying the commission by making a deal with the buyer (procured by the broker) on substantially the same terms as contemplated in the counteroffer. The omission of a provision for the broker's commission in the final agreement negotiated directly between buyer and seller is the "functional equivalent of a with-fault repudiation of the entire sale" (as in *Coulter v. Howard* (1927) 203 C 17, 25, 262 P 751, 754; ¶ *2:319*). [*Torelli v. J.P. Enterprises, Inc.* (1997) 52 CA4th 1250, 1256-1257, 61 CR2d 76, 79-80]

"While no writing may have expressly prohibited [Seller] from entering into direct negotiations with [Buyer], the implied covenant of good faith meant that [Seller] still had no right to use those negotiations to deprive [Broker] of [Broker's] commission for having found [Buyer] in the first place." [*Torelli v. J.P. Enterprises, Inc.*, supra, 52 CA4th at 1257, 61 CR2d at 80—"it is hard to imagine a more blatant example of an attempt to cheat a broker out of a commission than the case before us"]

2) [2:322] **Implied covenant also runs between *buyer and broker:*** The same result may obtain where the principal is a *buyer:* Consummation of the purchase as a condition to the buyer's duty to pay a commission will be *excused* when the buyer breaches the implied duty of good faith and fair dealing by purposefully failing to complete the purchase contract. [*R.J. Kuhl Corp. v. Sullivan* (1993) 13 CA4th 1589, 1601, 17 CR2d 425, 432; *see* ¶ *2:329*]

(4) [2:323] **Buyer/seller "satisfaction" as condition precedent:** The broker might fully perform by "procuring" a ready, willing and able buyer and yet face a potential barrier to compensation because of a "satisfaction" clause in the purchase and sale agreement. Nonetheless, as between the parties to the transaction, and insofar as a "satisfaction" clause impacts the broker's right to compensation, an implied "reasonableness" standard will be read in:

A condition that hinges the commission obligation on either party's "satisfaction" with the purchase/sale contract or other terms surrounding the sale does not make that party's obligation illusory or permit that party to withdraw from the transaction at their pleasure. "A contractual provision for performance to the satisfaction of one of the parties ordinarily calls for such performance as would be satisfactory to a reasonable person"; and the party to whom performance is tendered cannot claim "arbitrarily, unreasonably or capriciously" that they are not satisfied in order to evade liability. [*Collins v. Vickter Manor, Inc.* (1957) 45 C2d 875, 881-883, 306 P2d 783, 788; see also *R.J. Kuhl Corp. v. Sullivan* (1993) 13 CA4th 1589, 1600, 17 CR2d 425, 431-432]

[2:324] *Reserved.*

3. Compensation to Buyer's Broker

a. [2:325] **Seller's obligation:** Sellers are *rarely* obligated to pay a commission to the *buyer's broker*. Indeed, such a scenario could only arise in two situations:

- When there is a written agreement between seller and buyer's broker that satisfies the statute of frauds and specifically obligates the seller to pay a broker's commission; or

- When the seller has opened the door to a *subagency* relationship through a listing agreement with the seller's own broker (*see* ¶ *2:131 ff.*).

(1) [2:326] **No third-party beneficiary obligation:** There is no apparent California authority that would permit a buyer's broker to claim a commission as against the seller on a theory the buyer's broker is a third-party beneficiary of the listing agreement between seller and seller's broker. Even under a multiple listing agreement, the buyer's broker is more likely to be deemed a mere "cooperating broker" with no standing to sue the seller for a commission (Civ.C. § 1087). [See *Colbaugh v. Hartline* (1994) 29 CA4th 1516, 1523-1525, 35 CR2d 213, 216-217; *and* ¶ *2:132*]

b. Buyer's obligation

(1) [2:327] **Express buyer-broker agreement:** Buyers are of course liable for a broker's commission to the extent they expressly *agree* to same. Typically, this occurs (if at all) pursuant to a contract under which the buyer employs the broker to *locate* specified property and negotiate for its purchase on the buyer's terms. [See *R.J. Kuhl Corp. v. Sullivan* (1993) 13 CA4th 1589, 1600, 17 CR2d 425, 432]

(a) [2:328] **Conditions to payment, generally:** Like sellers and brokers, buyers and brokers may structure the compensation arrangement on any lawful basis. Generally, however, unless the contract provides otherwise, the buyer's broker earns its commission upon the buyer's entry into a binding contract for a purchase meeting the terms specified in the brokerage contract *regardless whether the sale is consummated*. [*R.J. Kuhl Corp. v. Sullivan* (1993) 13 CA4th 1589, 1600, 17 CR2d 425, 432; see also *RC Royal Develop. & Realty Corp. v. Standard Pac. Corp.* (2009) 177 CA4th 1410, 1419-1422, 100 CR3d 115, 122-124—buyer's obligation to pay broker's commission became fixed at time buyer entered purchase agreement with seller, *not* when escrow closed (once entered into, agreement by its terms vested buyer with equitable title and beneficial interest, triggering obligation to pay commission); *Schaffter v. Creative Capital Leasing Group, LLC* (2008) 166 CA4th 745, 751-753, 83 CR3d 19, 22-24—broker earned its commissions when investment company "buyer" *entered* preconstruction condominium purchase agreements (agreements clearly provided commissions were payable on close of escrow *or* buyer's default, and buyer defaulted when it refused to close escrow solely due to properties' insufficient appreciation)]

(b) [2:329] **Consummation of purchase condition subject to implied covenant of good faith and fair dealing:** So too, like sellers and brokers, buyers and brokers can agree to condition the commission obligation upon actual *consummation* of the purchase contract. But in that event, the buyer is likewise subject to the *implied covenant of good faith and fair dealing:* i.e., the buyer, as principal, "cannot in these circumstances refuse to perform under the purchase contract and thereby obtain an economic advantage unfairly derived from the broker's services. To do so violates the implied covenant of good faith and fair dealing and *excuses* the non-occurrence of the condition," in turn obligating the buyer to pay a commission based on the price that would have obtained had the buyer not backed out. [*R.J. Kuhl Corp. v. Sullivan* (1993) 13 CA4th 1589, 1593, 17 CR2d 425, 427 (emphasis in original)—buyer's broker fully performed by finding suitable property and negotiating sale contract but buyer thereafter thwarted completion of purchase transaction by effectively "selling" his contract right to purchase entire parcel and retaining option to purchase one-half]

(2) [2:330] **Implied promise and third-party beneficiary theories of recovery:** Buyers generally have no obligation to pay a broker's commission *absent a specific written agreement* on the subject between buyer and buyer's broker. However, there is a significant exception:

Where the buyer retains the broker to locate property that meets the buyer's specifications and the owner agrees to the offered price, the buyer becomes liable to *complete the transaction*. Notwithstanding the absence of a written agreement between buyer and broker, if the buyer subsequently defaults or otherwise breaches the purchase agreement, they are liable for the broker's commission on the alternative theories that:

- The buyer's broker is a *third-party beneficiary of the purchase agreement* between buyer and seller; and/or

- The law *implies a promise* by the buyer to *consummate the transaction* upon execution of the purchase agreement, and a breach of the purchase agreement therefore *breaches the buyer's implied promise to the broker*. [*Chan v. Tsang* (1991) 1 CA4th 1578, 1583, 3 CR2d 14, 17; *Donnellan v. Rocks* (1972) 22 CA3d 925, 931, 99 CR 692, 696]

(a) [2:331] **Application:** In *Chan*, supra, Buyer and Broker had an oral arrangement whereby Broker was to procure property for Buyer to purchase. Buyer ultimately executed a written purchase agreement with Seller which, *under Seller's acceptance portion*, required *Seller* to pay a broker's commission. Though the property met Buyer's specifications, Buyer ultimately breached the agreement without cause.

The court held that, under these facts, Buyer *impliedly promised* to complete the transaction *and* Buyer's Broker was a "*third party beneficiary of the purchase agreement* between Buyer and Seller," rendering Buyer liable to Broker for the commission Broker would have received from Seller had Buyer performed. [*Chan v. Tsang* (1991) 1 CA4th 1578, 1587, 3 CR2d 14, 19 (relying on *Donnellan v. Rocks*, supra)]

(b) [2:332] **Comment:** Both *Chan* and *Donnellan* relied on out-of-state authority (see *Chan v. Tsang* (1991) 1 CA4th 1578, 1585-1587, 3 CR2d 14, 18-19); and both have since come under serious criticism:

• Significantly, the *Chan* court did not address the *statute of frauds;* nor did the court explain why a buyer's broker can claim a commission on an implied promise theory (where there is no written employment agreement) while a *seller's* broker cannot.

• Additionally, *Chan* did not expound on the third-party beneficiary theory of recovery; nor distinguish other authority rejecting third-party beneficiary standing by a buyer's broker *against the seller*.

Nonetheless, *Chan* and *Donnellan* have not been overruled and, thus, present potentially serious problems for prospective buyers (¶ *2:333*).

➪ [2:333] ***PRACTICE POINTER:*** Historically at least, many buyers were not hesitant to breach a purchase agreement because they had little concern with the consequences. Their thinking was that the seller was not likely to sue for the breach or, in the event of suit, not likely to prevail. This conclusion rested on the theories that (i) many sellers are simply reluctant to incur the time and expense of suing, (ii) in any event, if the property is worth more than the contract price, the seller will not have suffered any cognizable damages, and/or (iii) if the buyer bargained for a liquidated damages provision (¶ *4:310 ff.*), the buyer could breach the contract and only suffer the forfeiture of a minimal deposit. (*See* ¶ *11:101 ff.* re seller's damages for buyer's breach of purchase agreement.)

Buyer's counsel should be mindful of *Chan* when advising their clients on a contemplated breach. *Chan* suggests buyers could conceivably be liable to their brokers even though the buyer is *not required to pay damages to the seller* (or even if the purchase contract contains a valid liquidated damages clause). Thus, a buyer's decision to renege on a purchase contract could risk far more in liability than seemingly inconsequential exposure on the seller's claim.

c. [2:334] **Seller's broker's obligation (commission-splitting):** A seller's broker has no obligation to *share* its commission with the buyer's broker in the absence of an *agreement* providing for such an arrangement (¶ *2:271.2*). The fact the listing agreement gives the seller's broker the *authority* to "cooperate with" other brokers and divide its commission accordingly does not give the buyer's broker any enforceable right to a share of the commission; such language simply leaves the seller's broker free, *if it so chooses*, to split its commission with other brokers. [*Enea v. Coldwell Banker/Del Monte Realty* (ND CA 1998) 225 BR 715, 718 (applying Calif. law)—listing broker not required to split commission with broker for buyer exercising right of first refusal; see also *RealPro, Inc. v. Smith Residual Co., LLC* (2012) 203 CA4th 1215, 1220, 138 CR3d 255, 259—listing broker not required to split commission with buyer's broker despite agreement to do so where all conditions precedent to payment not met]

4. [2:335] **Right to Compensation Where Sale Consummated After Expiration of Listing Agreement:** Most listing agreements contain (or *should* contain) a specific *expiration* date. Indeed, certain "exclusive listing agreements" must state a definitive term (*see* ¶ *2:379*). However, expiration of the listing agreement before the actual closing does not necessarily bar the broker's entitlement to a commission:

a. [2:336] **Offer accepted during term, but closing occurs after expiration of term:** The broker is clearly entitled to compensation under a listing agreement that expressly provides for a commission *so long as the offer is accepted* (or an acceptable offer is *procured*) before the end of the listing term. [*Walter v. Libby* (1945) 72 CA2d 138, 142-143, 164 P2d 21, 23; *Wilson v. Roppolo* (1962) 207 CA2d 276, 280-281, 24 CR 437, 439]

(Even in the absence of such a provision, courts are unlikely to excuse sellers from their broker compensation obligation so long as the offer is procured within the term of the listing agreement. *See* ¶ *2:307* re satisfaction of condition that broker procure a "ready, willing and able" buyer.)

(1) [2:337] **Commission earned when property "sold":** Most listing agreements state the broker has earned their commission once the property is "sold." However, "sold" does not necessarily mean the transaction must be consummated (as evidenced by a conveyance of title and payment of the purchase price). "Sold" ordinarily means a "transaction for the transfer of real property from a seller to a buyer" and includes a real property sales contract within the meaning of Civ.C. § 2985 (i.e., an agreement in which one party agrees to convey real property title to another upon satisfaction of specified conditions set forth in the contract and that does not require conveyance of title within one year from date of contract's formation). [Bus. & Prof.C. § 10018.10; see also Civ.C. § 2079.13(*l*); *Leonard v. Fallas* (1959) 51 C2d 649, 652-653, 335 P2d 665, 668; *and* ¶ *2:382*]

b. Seller's improper conduct

(1) [2:338] **Intentional delay (breach of implied covenant):** As discussed, sellers impliedly promise under a listing agreement not to do anything that will prevent their brokers from realizing the benefit of the broker's bargain (implied covenant of good faith and fair dealing, *¶ 2:318*). Therefore, a seller cannot avoid the obligation to pay a commission by intentionally, arbitrarily or in bad faith thwarting or delaying execution of a purchase agreement until expiration of the listing agreement term. [*Herz v. Clarks Market* (1960) 179 CA2d 471, 474-475, 3 CR 844, 846; see also *California Auto Court Ass'n v. Cohn* (1950) 98 CA2d 145, 149, 219 P2d 511, 514]

(2) [2:338.1] **Direct negotiations with buyer procured by broker on same terms (breach of implied covenant):** Nor can a broker's right to a commission be defeated by the fact the seller dealt directly with a buyer procured by the broker, and on substantially the same terms, after expiration of both the listing agreement and the seller's subsequent counteroffer that had again memorialized the commission arrangement. [*Torelli v. J.P. Enterprises, Inc.* (1997) 52 CA4th 1250, 1252, 61 CR2d 76, 77]

“The [seller's] promise to pay *the broker* a commission did not die with the expiration of the counteroffer *to the buyer*. When the seller signed the counteroffer, it became bound by an implied promise not to deprive the broker of the benefits of the bargain to pay the commission. The law does not allow a broker to be cheated out of [their] commission by the simple artifice of entering into direct negotiations and making substantially the same bargain, albeit without the commission.” [*Torelli v. J.P. Enterprises, Inc.*, supra, 52 CA4th at 1252, 61 CR2d at 77 (emphasis in original)]

(3) [2:339] **Waiver of time limit:** Sellers who repeatedly encourage their broker to continue marketing the property after expiration of the listing term and does not object to the broker's continuing brokerage efforts may be held to have waived the listing agreement time limit, or be deemed to have granted an extension of time, thus remaining bound by the obligation to pay a commission up until the time of sale. [*Kraemer v. Smith* (1960) 179 CA2d 52, 57, 3 CR 471, 474]

c. [2:340] **“Safety clause”:** Most listing agreements contain a “safety clause,” which essentially provides a grace period for entitlement to a commission.

Typically, the safety clause gives the broker the right to a commission if the owner sells the property (1) within a certain period of time after expiration of the listing term (2) to a party whom the broker has “negotiated with” or “introduced to the property” or “shown the property to.” (In practice, the second condition respecting the particular buyer varies among listing agreements.)

(1) [2:341] **“Procuring cause”:** Courts may read in a requirement that the broker be the “procuring cause” of the sale (*¶ 2:307*) even if the safety clause does not explicitly so require. [See *Wright & Kimbrough v. Dewees* (1921) 52 CA 42, 45-46, 197 P 957, 958]

On the other hand, if the safety clause only requires “negotiation” or “introduction” by the broker, the broker need not prove they were the procuring cause. [*Leonard v. Fallas* (1959) 51 C2d 649, 652-653, 335 P2d 665, 668; *Delbon v. Brazil* (1955) 134 CA2d 461, 464, 285 P2d 710, 712]

➪ ***PRACTICE POINTERS***

• [2:342] Safety clauses usually require that the broker deliver to the seller a list of prospective buyers whose offers could trigger the clause. The broker is typically required to provide this list to the seller within a certain number of days following expiration of the listing term (although anyone who has already submitted a written offer to the seller is usually deemed included within the safety clause even if not identified on the broker's list). In turn, any prospective buyer who is not on the list is deemed outside the scope of the safety clause.

Provisions like these which explain the mechanics and define the parameters of the safety clause are of course beneficial for both seller and broker, as they minimize the potential for dispute over sales postdating expiration of the listing agreement that will trigger the broker's entitlement to a commission. Clearly, the shorter the time period for the broker to provide the requisite list, the better for the seller.

• [2:343] In addition, be sure to strive for *clarity* when drafting a safety clause. Triggering language such as “negotiate with,” “introduced the property to a prospective buyer” or “shown the property to a prospective buyer” is unfortunately ambiguous and difficult to define. (For example, has a broker “shown” the property if the buyer simply participated in a

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crowded open house and never spoke with the broker? Has the broker "negotiated with" a prospective buyer who merely inquires if there is any flexibility in the listed purchase price? Has the broker "introduced" such buyers to the property?)

From the seller's perspective, it makes better sense to define the "safety clause" obligation by a readily ascertainable standard. At a minimum, the broker should be required to be the "procuring cause" and, optimally, the safety clause should be triggered only if the buyer submitted a written offer during the listing term. Remember, safety clause terms, like all provisions in a listing agreement, are *negotiable*. Seller's counsel should negotiate for provisions that will ensure maximum protection for their clients.

(2) [2:344] **Impact on subsequent listing agreement:** Any continuing "safety clause" obligation under an expired listing agreement will impact the seller's commission exposure under a new (second or subsequent) listing agreement. In other words, a safety clause could theoretically expose unwary sellers to *double commission* liability.

➪ [2:345] ***PRACTICE POINTER:*** Appropriate language in the subsequent listing agreement can avoid this trap. Sellers contracting with a new broker should be sure to include a provision excluding commission liability on account of a sale to any buyer who might be subject to the safety clause under a prior listing agreement.

5. [2:346] **Preemptive Statutory Rules in Probate Sales/Partition Proceedings:** Real property sales in probate administrations are subject to special statutory rules that also govern the amount and allocation of broker commissions (Prob.C. § 10160 et seq.). The same broker commission statutes also apply to sales in *partition* proceedings (CCP § 873.745). In these transactions, the broker's right to a commission and the amount thereof are *founded on statute, not contract*. [*Melikian v. Aquila, Ltd.* (1998) 63 CA4th 1364, 1369, 1371, 74 CR2d 739, 742, 743; *Sullivan v. Dorsa* (2005) 128 CA4th 947, 956, 27 CR3d 547, 553]

This subject is separately addressed at ¶ *2:430 ff.*

6. [2:347] **Prior Court Approval Required in Bankruptcy Cases:** A broker is not entitled to compensation for the sale of real property in a bankruptcy estate *unless* the bankruptcy trustee or debtor in possession *obtained prior court approval* to employ the broker. [11 USC § 327(a); *In re Haley* (9th Cir. 1991) 950 F2d 588, 590; *Enea v. Coldwell Banker/Del Monte Realty* (ND CA 1998) 225 BR 715, 719]

[2:348 - 2:349] ***Reserved.***

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Chapter 2. Real Estate Brokers and Listing Agreements

E. Listing Agreements

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4. [2:424] Copy of Listing Agreement to Principal(s)

[2:350] The employment contract between seller and broker is commonly (and statutorily) known as a "listing agreement." (Again, however, a separate "listing agreement" is not essential to a broker's right to recover compensation, so long as the arrangement is memorialized in a written document that satisfies the statute of frauds; *¶ 2:271.1*.)

The California Association of Realtors (C.A.R.), as well as most larger brokerage companies, provides a variety of preprinted form listing agreements that can be purchased online through C.A.R.'s subsidiary, the REBS Online Store, at *www.car.org*, or by contacting REBS Customer Service at (213) 739-8227. The parties, however, are free to enter into any kind of listing agreement they desire. [*Blank v. Borden* (1974) 11 C3d 963, 972, 115 CR 31, 36, fn. 8; *Leonard v. Fallas* (1959) 51 C2d 649, 652, 335 P2d 665, 668]

Agreements between prospective *buyers* and brokers are rare. Occasionally, however, buyers enter into formal agreements with brokers to locate particular property meeting the buyer's specifications (*¶ 2:327*); this is commonly known as an "exclusive authorization to locate property."

1. Types of Listing Agreements

a. [2:351] **In general:** A "listing agreement" is statutorily defined as "a written contract between a seller of real property or a business opportunity and a real estate broker by which the broker has been authorized to sell the real property or find or obtain a buyer, including rendering other services for which a real estate license is required to the seller pursuant to the terms of the agreement." [Bus. & Prof.C. § 10018.14; Civ.C. § 1086(f); *McAvoy v. Hilbert* (2009) 172 CA4th 707, 712, 91 CR3d 437, 441; see also *Hall v. Aurora Loan Services LLC* (2013) 215 CA4th 1134, 1140, 155 CR3d 739, 743—property owner's legal relationship with agent is created and defined by listing agreement]

(1) [2:352] **Statutory classifications:** Bus. & Prof.C. § 10018.14 recognizes three types of listing agreements, each distinguished from the other by the conditions that must be satisfied for the broker to earn a commission. A "listing agreement" may be either:

• An "exclusive right to sell listing agreement" (¶ *2:355*);

• A "seller reserved listing agreement" (¶ *2:358*); or

• An "open listing agreement" (¶ *2:360*).

(2) [2:353] **Nonstatutory types:** However, the statutory listing agreements are not exclusive. The parties may negotiate any other type of listing they desire (*see* ¶ *2:364 ff.*). [*Metzenbaum v. R.O.S. Associates* (1986) 188 CA3d 202, 210, 232 CR 741, 745, fn. 1]

(3) [2:354] **Construction of agreement—title not dispositive:** Indeed, neither the Bus. & Prof.C. § 10018.14 definitions nor the title used in the agreement are dispositive of the parties' true rights and obligations. [*Metzenbaum v. R.O.S. Associates* (1986) 188 CA3d 202, 210, 232 CR 741, 745, fn. 1 (decided under former law)]

For example, a so-called "exclusive right to sell" does *not* grant the broker the right to *sell* the property or the right to *execute contracts* on the seller's behalf. Rather, it simply grants the broker a right to compensation upon the happening of certain events. Thus, the *contents* of a listing agreement, not the label used, prevail in interpreting contracts for broker compensation; and courts will construe the parties' rights and obligations by looking to the "four corners of the document" (see generally, Civ.C. § 1639). [*Howard Gitlen & Associates, Inc. v. Ameri* (1989) 208 CA3d 90, 95, 256 CR 36, 38 (decided under former law); *Metzenbaum v. R.O.S. Associates*, supra, 188 CA3d at 210, 232 CR at 745, fn. 1 (decided under former law); see also *Colbaugh v. Hartline* (1994) 29 CA4th 1516, 1524, 35 CR2d 213, 217 (decided under former law)—cooperating broker has no right to proceed against seller for commission absent provision in listing agreement conferring such right]

b. [2:355] **Exclusive right to sell listing agreement:** An "exclusive right to sell listing agreement" grants the seller's agent, for a specified period of time, the exclusive right to sell, find or obtain a buyer for the real property. The seller's agent is entitled to the agreed compensation if, during the specified period of time, the property is sold, "no matter who effected the sale," or when the seller's agent receives and presents to the owner any enforceable offer "from a ready, able and willing buyer on terms that are authorized by the listing agreement or accepted by the owner." [Bus. & Prof.C. § 10018.15—agreement may provide for compensation to seller's agent if property sold within specified period after agreement's termination; *Century 21 Butler Realty, Inc. v. Vasquez* (1995) 41 CA4th 888, 891, 49 CR2d 1, 2 (decided under former law)]

An exclusive listing agreement must contain a *specific term* (Bus. & Prof.C. § 10176(f), ¶ *2:379*).

(1) [2:356] **Commission liability for *any sale during exclusive term:*** Again, an "exclusive" listing agreement does not actually empower the broker to "sell" the property or execute a sale contract for the owner. But even if the sellers have the right to terminate the agency relationship before the agreement's stated expiration date, that does not terminate the broker's right to compensation. Under an "exclusive right to sell listing agreement," the broker earns the right to the specified commission if a sale occurs during the listing term *regardless of who sold the property or procured the buyer*. [*Century 21 Butler Realty, Inc. v. Vasquez* (1995) 41 CA4th 888, 892, 49 CR2d 1, 3 (decided under former law); *Howard Gitlen & Associates, Inc. v. Ameri* (1989) 208 CA3d 90, 94-95, 256 CR 36, 38 (decided under former law)—broker under "exclusive right to sell" listing entitled to commission even if property *sold by owner* during listing term]

➪ [2:357] ***PRACTICE POINTER:*** This feature, of course, puts sellers at an obvious disadvantage: They will be liable for the broker's commission even if the broker has nothing to do with procuring the buyer or consummating the transaction.

c. [2:358] **Seller reserved listing agreement:** A "seller reserved listing agreement" is identical to an "exclusive right to sell listing agreement" (¶ *2:355*) *except* "[c]ompensation is not owed to the seller's agent if the owner sells the property directly and not through any other broker." [Bus. & Prof.C. § 10018.16—agreement may provide for compensation to seller's agent if property sold, other than directly by seller, within specified period after agreement's termination; see *E.A. Strout Western Realty Agency, Inc. v. Gregoire* (1950) 101 CA2d 512, 515-516, 225 P2d 585, 587 (decided under former law)]

Seller reserved listing agreements must also contain a specified term (Bus. & Prof.C. § 10176(f), ¶ *2:379*).

➪ [2:359] ***PRACTICE POINTER:*** A seller reserved listing agreement may be more desirable for sellers than an exclusive right to sell listing agreement because the sellers are released from any commission obligation if they sell the property

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without broker involvement. However, to ensure optimum protection, the listing agreement should precisely define what constitutes a "direct sale by the owner."

For example, absent clear provision to the contrary, an owner will be liable for the broker's commission under a reserved listing agreement when the owner sells the property directly to a person whose name was furnished to the seller by the broker even though the broker was not the "procuring cause." [*Leonard v. Fallas* (1959) 51 C2d 649, 652, 335 P2d 665, 668 (decided under former law)]

d. [2:360] **Open listing agreement:** An "open listing agreement" grants "no exclusive rights or priorities" to the seller's agent; and a commission is payable to the seller's agent only if that agent "obtains and presents to the owner an enforceable offer from a ready, able, and willing buyer on the terms authorized by the listing agreement, which is accepted by the owner, before the property is otherwise sold either through another licensee or by the owner directly and before the listing agreement expires by its terms or is revoked by the seller's agent or the owner." [Bus. & Prof.C. § 10018.17; *McAvoy v. Hilbert* (2009) 172 CA4th 707, 712, 91 CR3d 437, 442 (decided under former law)]

(1) [2:361] **Revocable at seller's will:** Unlike "exclusive right to sell" and "seller reserved" listing agreements, an "open listing agreement" need not specify a definite date for termination. [Bus. & Prof.C. § 10176(f); *Summers v. Freeman* (1954) 128 CA2d 828, 830-831, 276 P2d 131, 133] Indeed, the owner may effectively revoke an open listing agreement any time before the broker has obtained a buyer. . . and this is so regardless of the effort and expense the broker may have incurred before the termination. [*Tetrick v. Sloan* (1959) 170 CA2d 540, 545-546, 339 P2d 613, 616-617 (decided under former law)]

(2) [2:362] **Opportunity for optimum marketing exposure without enhanced commission liability:** An open listing agreement also gives the seller the opportunity to enter into as many open listings as they desire and thus optimize marketing exposure without risking "double commission" liability. An open listing seller's agent is entitled to a commission only if that *particular agent* is the *first* to obtain a ready, willing and able buyer. [*Marks v. Rowley* (1951) 102 C2d 619, 621, 228 P2d 29, 31 (decided under former law); *People v. National Ass'n of Realtors* (1981) 120 CA3d 459, 477-478, 174 CR 728, 737 (decided under former law)]

➪ [2:363] ***PRACTICE POINTER:*** Nonetheless, in practice, open listing seller's agents might not be as committed to marketing the property as they would if granted an "exclusive." Knowing someone else could step in and claim the commission by producing a satisfactory buyer during the listing term, an open listing seller's agent may be tempted not to exert time and energy that could, theoretically at least, go uncompensated. Sellers eager to close a deal as expeditiously as possible should keep this in mind when weighing the pros and cons of "exclusive" vs. "open" listing agreements.

e. [2:364] **"Hybrid" listings agreements:** Again, the parties are not limited to the foregoing types of listings agreements. They can modify any of the standard listing arrangements to suit their particular idiosyncrasies.

(1) [2:365] **Example—"exclusive" with exceptions:** For example, sellers often grant an exclusive right to sell, but exclude from the listing agreement specific persons or entities (or their employees or family members), reserving the right to sell to such persons/entities without liability to pay a commission. This might occur where the seller does not insist on an exclusive agency listing agreement but nonetheless knows of certain identifiable prospective buyers.

The seller may also want to exclude from the listing agreement any buyers obtained from a specified marketing source or publication.

f. [2:366] **Net listings agreements:** A net listing agreement is not a traditional form of listing agreement but, rather, is a method of measuring the broker's compensation. Under a net listing agreement, the broker's commission is based on an amount by which the purchase price exceeds a designated price (e.g., broker entitled to commission on that portion of purchase price that exceeds $1 million). [*Haigler v. Donnelly* (1941) 18 C2d 674, 678, 117 P2d 331, 334; *Smith v. Zak* (1971) 20 CA3d 785, 795, 98 CR 242, 248]

A net listing agreement can be incorporated into any kind of listing agreement.

➪ [2:367] ***PRACTICE POINTER:*** In negotiating a net listing agreement, bear in mind the seller's broker's inherent *conflict of interest:* i.e., the seller often relies heavily (if not exclusively) on the seller's broker in determining the best listing ("asking") price, as well as an acceptable selling price; and a seller's broker whose commission depends on bringing in the highest possible offer might be motivated to inflate a realistic asking price. This could stymie an expeditious sale.

g. [2:368] **"Pocket listings"; "one-party listings," etc.:** Although lacking any statutory definition, there are several atypical listing arrangements which the industry describes by common labels such as "pocket listing" or "one-party listing":

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(1) [2:369] **Pocket listing:** Historically, a "pocket listing" has not actually been a written listing agreement (and, hence, has been voidable as violating the statute of frauds, ¶ 2:281 ff.). Rather, the term has simply been broker nomenclature for situations where a seller orally advises a broker that it might be willing to enter into a listing agreement if the broker can procure a buyer for a particular price. [See *PLS.Com, LLC v. Nat'l Ass'n of Realtors* (9th Cir. 2022) 32 F4th 824, 830 (acknowledging "pocket listings" historically were marketed through face-to-face communications, telephone calls or email]

Because pocket listings have not been legally binding on brokerage contracts, their obvious danger from a broker's perspective has been that the seller will simply refuse to sign a compensation agreement once the broker has found a buyer.

Notwithstanding the foregoing, in 2017 demand for pocket listings "skyrocketed" and, as a result, a group of real estate agents created PLS. PLS was a nationwide "pocket listing" database *outside* the National Association of Realtors (NAR) and its affiliated regional MLS system. PLS allowed sellers to choose how much information to share and included listings anywhere in the United States. It was open to any agent who wished to join, and agents who did join were charged less than they were by traditional MLSs. By 2019, PLS had 20,000 members who were "cooperating to sell billions of dollars of residential real estate listings nationwide." PLS's "competitive" edge caused significant concern among several regional MLSs and the NAR, resulting in the NAR adopting a policy meant to maintain the market dominance of its affiliated MLS system and, specifically, to exclude PLS. As a result, PLS listings declined and PLS ultimately exited the market and initiated antitrust litigation. [See *PLS.com, LLC v. Nat'l Ass'n of Realtors*, supra, F4th at 830-831, 843 (holding PLS adequately alleged antitrust injury)—district court's dismissal of PLS's complaint reversed and remanded for further proceedings consistent with 9th Circuit's opinion]

(2) [2:370] **One-party listing:** A "one-party listing" (or "one-party showing") in broker parlance refers to situations where a broker has one specific party (or any other finite number of parties) interested in the seller's property. The seller might not be inclined to go through the effort of marketing its property (or may want to quietly market the property to a select group of prospective buyers). In this scenario, the broker is given a listing agreement limited to a specified number of specifically-identified prospective buyers.

h. [2:371] **Multiple listing service:** A "multiple listing service" (MLS) is not itself a listing agreement. Rather, the listing agreement may permit the broker to utilize an MLS—i.e., a "facility of cooperation" of real estate agents (and appraisers) operating through an intermediary by which the agents establish express or implied contracts for compensation between agents that are MLS participants in accordance with its MLS rules regarding listed properties in a listing agreement; a multiple listing service does not itself act as broker/salesperson in the transaction. [Civ.C. § 1087]

(1) [2:372] **Seller authorization required:** A listing may not be placed in a multiple listing service without the seller's *express authorization*. [Civ.C. § 1088(a)]

(2) Effect on compensation

(a) [2:373] **Open listings agreements:** If an open listing is placed in a multiple listing service, the total compensation the owner is obligated to pay goes to the seller's agent only if that agent obtains and presents to the owner an enforceable offer from a ready, able, and willing buyer on the terms authorized by the listing agreement, which is accepted by the owner before the property is otherwise sold either through another licensee or by the owner directly and before the listing agreement expires by its terms or is revoked by the seller's agent or the owner. [Bus. & Prof.C. § 10018.17; *see* ¶ 2:360]

1) [2:373.1] **Disputes between cooperating brokers:** Disputes over which cooperating broker "procured" the sale are generally submitted to a committee of the local Board of Realtors for resolution by arbitration proceedings. [See *Colbaugh v. Hartline* (1994) 29 CA4th 1516, 1523, 35 CR2d 213, 216, fn. 1 (decided under former law)]

(b) [2:373.2] **Exclusive listings:** Where an exclusive listing utilizes a multiple listing service, the seller is only obligated to pay a commission to the *seller's* broker (*see ¶ 2:355 ff.*). The cooperating brokers' right to compensation turns on agreement, if any, with the listing broker. [See *Colbaugh v. Hartline* (1994) 29 CA4th 1516, 1525, 35 CR2d 213, 217 (decided under former law)]

Absent an express agreement between the seller's broker and cooperating brokers, the cooperating brokers have *no right* to a share of the seller's broker's commission. [*Colbaugh v. Hartline*, supra, 29 CA4th at 1525, 35 CR2d at 217

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(decided under former law); see *Enea v. Coldwell Banker/Del Monte Realty* (ND CA 1998) 225 BR 715, 717-718 (applying former Calif. law); *and further discussion at* ¶ *2:271.2, 2:334*]

[2:374] ***Reserved.***

2. [2:375] **Strict Construction Against Brokers:** Ordinarily, a listing agreement is presented *by the broker* to the seller for signature; and, typically, brokers utilize a preprinted form (which, nonetheless, is negotiable and can be modified; *see* ¶ *2:377 ff.*). Consequently, courts strictly construe ambiguities in a listing agreement *against the broker*. [See generally, Civ.C. § 1654—uncertainties interpreted "most strongly against the party who caused the uncertainty to exist"; *E.A. Strout Western Realty Agency, Inc. v. Gregoire* (1950) 101 CA2d 512, 517, 225 P2d 585, 588—where listing agreement is drafted by broker, "we must in construing it apply to it the rule … that its terms are to be taken most strongly against [the broker]"; *Coleman v. Mora* (1968) 263 CA2d 137, 144, 69 CR 166, 169 (broker inserted word "agency" between words "exclusive" and "listing" in listing agreement caption)—"A contract prepared by a broker that is claimed to give an exclusive right to sell has been construed narrowly as against the broker"; *Century 21 Butler Realty, Inc. v. Vasquez* (1995) 41 CA4th 888, 891, 49 CR2d 1, 2—where broker prepares listing agreement, uncertainty "relating to the commission should be construed in favor of the seller"]

3. [2:376] **Preparation and Review of Listing Agreement:** In many real estate transactions, seller's counsel's first involvement occurs after the listing agreement has been signed and an offer presented. Nonetheless, if given the opportunity, seller's counsel can provide an invaluable service for their clients in preparing, or at least reviewing, a proposed listing agreement.

➪ [2:377] ***PRACTICE POINTER—TACTICAL APPROACH*:** Counsel who have occasion to prepare or review a listing agreement should approach the task with two general points in mind:

• Standard preprinted broker form listing agreements are just that—a *broker's* standardized form. They do not include much in the way of benefits or protections for the seller.

• By the same token, unlike institutional lenders' form loan documents and many other standardized industry forms, broker listing agreements are highly *negotiable*. While the commission percentages tend to remain stable on a community-wide basis, the intense marketing competition in the real estate industry gives sellers plenty of bargaining room on other issues. Sellers, of course, should strive to provide their brokers with maximum motivation and incentive; nonetheless, there is no reason why those incentives cannot be made compatible with seller protections.

The sections at ¶ *2:378 ff.* analyze the most common provisions found in listing agreements, and suggest some additional provisions and negotiating tactics for a seller's protection.

a. [2:378] **Type of listing:** While the label given a listing agreement is not determinative of the parties' rights and obligations (¶ *2:354*), affixing a title that correctly reflects the type of listing contemplated fosters clarity and precision.

(Of course, a precise title may not be possible where the arrangement is a hybrid that does not fall into any single traditional category; ¶ *2:364 ff.*)

b. [2:379] **Term of listing:** Any "*exclusive right to sell*" or "*seller reserved*" listing agreement *must* "contain a definite, specified date of final and complete termination." [Bus. & Prof.C. § 10176(f)—noncompliance is ground for license suspension or revocation; *Dale v. Palmer* (1951) 106 CA2d 663, 666-668, 235 P2d 650, 651-652 (decided under former law)—noncompliance renders listing agreement void; but see *Nichols v. Boswell-Alliance Const. Corp.* (1960) 181 CA2d 584, 589, 5 CR 546, 549 (decided under former law)—although noncomplying broker was not entitled to "anticipatory damages" after subdivider's repudiation, he was entitled to compensation for "executed" aspects of agreement; *Schaffter v. Creative Capital Leasing Group, LLC* (2008) 166 CA4th 745, 754, 83 CR3d 19, 24 (decided under former law)—courts have "uniformly rejected *Dale v. Palmer's* harsh rule" when brokers seek *earned* commissions]

Compare: A fixed termination date is not required for open listings or any other kind of nonexclusive listing arrangement. [*Summers v. Freeman* (1954) 128 CA2d 828, 830-831, 276 P2d 131, 133; *see* ¶ *2:361*]

➪ [2:380] ***PRACTICE POINTER:*** Successful negotiation over an exclusive listing termination date requires a recognition of the seller's and broker's competing interests.

• The seller, of course, normally will prefer to keep the term shorter, facilitating a change in brokers if the property is not being marketed aggressively or properly.

• The broker, on the other hand, has an equally strong interest in maximizing the listing term because it will invest a fair amount of time, effort and advertising money in initially getting the property exposed to prospective buyers … for which the broker will expect to be compensated. (Brokers subjected to a relatively short exclusive listing, like brokers under an open listing, are likely not to put forth their best marketing efforts on the assumption those efforts might not pay off; *see ¶ 2:363*.)

(1) [2:381] **Calendar date as measuring rod:** The better practice is to specify a particular *calendar date* of expiration, rather than a term measured by days, weeks or months. (The latter approach invites dispute over such matters as whether the first day should be counted; whether the time period is measured from the date of the agreement or the date of its execution, etc. Conversely, a fixed calendar date leaves no room for confusion.)

(2) [2:382] **Minimizing disputes over entitlement to commission following posttermination "sale" (definition of when property "sold"):** Most listing agreements provide that the broker is entitled to a commission if the property is "sold" during the listing term. This language could generate dispute with regard to whether the requisite "sale" occurred before or after termination of the listing agreement.

Real estate lawyers typically think of "sold" as implying the conveyance of title and payment of the purchase price. But in connection with *listing agreements,* a "sale" includes, among other things, "a real property sales contract within the meaning of [Civ.C.] Section 2985…" (see Bus. & Prof.C. § 10018.10; Civ.C. § 2079.13(*l*), *and* ¶ 2:337). In other words, the broker may earn the right to a commission simply by obtaining a "ready, willing and able" buyer before expiration of the listing term … no matter when the deal is actually consummated (¶ *2:307, 2:335*).

It follows that sellers contemplating an *actual closing* (or some scenario other than a "sale" as defined by Bus. & Prof.C. § 10018.10 and Civ.C. § 2079.13(*l*)) within the listing term as the event triggering the commission obligation must clearly so provide in the listing agreement.

[2:383] ***Reserved.***

c. [2:384] **Multiple listing/subagency provision:** Particularly in residential property sale transactions, brokers urge their sellers to agree to list the property in a "multiple listing service" (Civ.C. § 1087). Generally, sellers should react favorably to such provisions, as a multiple listing service optimizes the market exposure by motivating other brokers to show the property (multiple listing cooperating brokers who produce a buyer will share in the seller's/listing broker's commission; *see ¶ 2:371 ff.*).

(1) [2:385] **Subagency pitfalls:** By the same token, sellers should try to avoid any language suggesting that a *subagency* relationship between seller and *buyer's broker* can be created; *see ¶ 2:131*.

(2) [2:386] **Confidentiality concerns:** Some multiple listing provisions permit the seller's/listing broker to report the ultimate sale price and terms to other local realty board members. Some sellers may want that information kept confidential, in which event the language should be modified accordingly. (Indeed, if confidentiality is important, a full-blown provision to that effect should be added to the listing agreement, as well as any purchase and sale agreement.)

d. [2:387] **Owner representations:** Listing agreements often include several affirmative seller representations concerning the physical condition of the property, condition of title and other matters pertaining to the seller's and seller's broker's disclosure obligations (*¶ 2:170 ff.*).

While brokers are justified in wanting assurances sellers will meet their disclosure obligations, sellers should be wary of making representations in a listing agreement *unless they have made an independent investigation* of the facts represented.

(1) [2:388] **"Marketable title" representation:** For example, form listing agreements commonly contain a seller's representation that the seller holds "marketable title." Unless the seller *actually knows* they hold marketable title, such a representation can be risky: If title is in fact unmarketable, the seller might have a claim under their title insurance policy (*see ¶ 3:95 ff.*) … but could also be liable to pay a broker's commission (if the broker procures a "ready, willing and able" buyer) on a sale that falls through because of the defect in title.

(2) [2:389] **Representations re physical condition of property:** The seller's statutory disclosure obligations regarding the physical condition of the property run in favor of the *buyer*—*not* the broker (see Civ.C. § 1102.3; ¶ *2:185, 4:354 ff.*). Since the seller is not required by law to make such representations to the broker, they should be avoided in a listing agreement. Indeed, including such representations can only enhance the potential for a broker's claim against the seller.

e. [2:390] **Commission rate and time for payment:** Failure to specify a commission rate or other amount of compensation does not affect the validity of the listing agreement (¶ *2:283*). But, to promote certainty and protection for the seller, prudence suggests the *commission rate* and *time for payment* be clearly stated (otherwise, the broker will be entitled to a "reasonable commission"—an amount unknown to the seller at the outset of the transaction; ¶ *2:283*).

(1) [2:391] **Compensation amount:** While standardized commission rates are generally the norm in particular communities, there is *no statutory or regulatory* commission structure; the amount of broker compensation is entirely *negotiable* between the parties.

(a) [2:392] **Mandatory notice in residential property listing agreements:** Indeed, this point must be included in a listing agreement for the sale of residential real estate:

Any *printed* or *form* listing agreement for the sale of *residential* real property (containing no more than four residential units or for the sale of a mobilehome) must include the following statement in 10-point boldface type immediately preceding any provision relating to broker/salesperson compensation (Bus. & Prof.C. § 10147.5(a)):

> "Notice: The amount or rate of real estate commissions is not fixed by law. They are set by each broker individually and may be negotiable between the seller and broker." [Bus. & Prof.C. § 10147.5(a)]

(b) [2:393] **No preprinted amount in residential property listing agreements:** Further, the amount or rate of broker compensation *cannot be preprinted* in a listing agreement for the sale of such residential property. [Bus. & Prof.C. § 10147.5(b)]

(2) [2:394] **Timing:** As discussed earlier, unless the agreement expressly provides otherwise, the seller's broker may claim the right to a commission simply upon the broker's *procurement* of a "ready, willing and able" buyer before expiration of the listing term … no matter when the deal closes (*see* ¶ *2:307 ff.*). Therefore, sellers will receive maximum protection on their broker compensation obligation if the agreement specifies the commission is *not to be paid unless and until a closing occurs* (*see also* ¶ *2:397 ff.*).

(3) [2:395] **Method of payment:** Brokers prefer that the listing agreement state (a) the commission is to be paid out of the sale proceeds, directly from the escrow; and/or (b) the broker is "irrevocably assigned" an interest in the sale proceeds (up to the amount of the specified commission).

➪ [2:396] ***PRACTICE POINTER:*** From the seller's perspective, including these provisions in a listing agreement is *risky:*

- Such language might effectively create a third-party beneficiary right in the escrow instructions and, hence, to the sale proceeds.

- Additionally, a number of events could occur between the signing of the listing agreement and the closing which might conceivably justify the seller's refusal to pay all or part of the commission. But a provision granting the broker an irrevocable right to their commission from the sale proceeds will leave the seller with little leverage over the broker when it comes time to settle a commission dispute.

In any event, a separate escrow instruction is usually delivered by the seller to the escrow holder specifically directing the disbursement of the commission from the sale proceeds (*see* ¶ *4:578 ff.*). Consequently, there seems no reason why the listing agreement should contain an assignment of the sale proceeds.

f. [2:397] **Conditions to compensation:** Provisions specifying the conditions under which the broker earns the right to a commission are among the most important in any listing agreement.

Depending on the type of listing (open, exclusive right to sell, exclusive agency, etc., ¶ *2:351 ff.*), the conditions to payment will, of course, vary. However, it is always beneficial for the seller to require *as many conditions as possible*.

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➪ [2:398] ***PRACTICE POINTER:*** Again, sellers obtain optimum protection by a condition requiring not only that the broker "procure" a "ready, willing and able" buyer, but *also* the *actual consummation* of the transaction (i.e., transfer of title and payment of purchase price). *See ¶ 2:307 ff.*

g. [2:399] **Withdrawal from sale:** Brokers are not likely to invest optimum marketing efforts if they perceive a risk the seller might subsequently take the property off the market (thus thwarting the broker's right to compensation for services performed). Consequently, most listing agreements provide that if the seller withdraws the property from sale or otherwise takes it off the market or renders the property unmarketable during the listing term, the broker will nonetheless be entitled to a commission (based on the price that otherwise could have been obtained).

Such "withdrawal-from-sale" provisions generally are enforceable even if the broker cannot prove they could have procured a "ready, willing and able" buyer (*¶ 2:317*). [See *Blank v. Borden* (1974) 11 C3d 963, 970-972, 115 CR 31, 34-36; *Baumgartner v. Meek* (1954) 126 CA2d 505, 511-512, 272 P2d 552, 556; *but see also ¶ 2:316* re statutory bar exception]

(Even in the absence of such a provision, the broker might have a claim for compensation based on breach of the seller's implied covenant of good faith and fair dealing. *See ¶ 2:318*.)

h. [2:400] **Broker's obligations:** Many preprinted form listing agreements do not impose any specific obligations on the broker. But there is no reason why such provisions cannot be added and, from the seller's perspective, that approach makes good sense.

Depending upon what the client expects from the broker, some or all of the following broker covenants should be considered:

(1) [2:401] **Advertising:** A provision requiring the broker to engage in specified advertising *at broker expense*. It may even be advisable to set forth a specific marketing plan and/or to itemize specific publications (newspapers, circulars, etc.) in which the property will be advertised, as well as the frequency of such advertisements.

(a) [2:402] **Outdoor advertising regulations:** On the right to utilize outdoor advertising for the sale, lease or exchange of real property, see Bus. & Prof.C. § 5272 and Civ.C. §§ 712 & 713.

Significantly, notwithstanding local ordinances on the subject, property owners or their agents are entitled to display on the owner's property, and on property owned by others with their consent, signs that are reasonably located, in plain view of the public, of reasonable dimension and design and which do not adversely affect traffic or public safety, for purposes of advertising:

• that the property is for sale, lease or exchange;

• directions to the property;

• the owner's or agent's name, address and telephone number. [Civ.C. § 713 (but subject to authority of local government and others to limit or regulate display or placement of advertising signs on private or public rights-of-way)]

(2) [2:403] **Meetings and reports:** A provision requiring the broker to attend periodic sales meetings (with client) and/or prepare periodic sales reports.

(3) [2:404] **Escrow and title:** A provision requiring the broker to supervise escrow and title procedures.

(4) [2:405] **"Open house":** A provision requiring the broker to conduct periodic "open houses" (usually for residential property sales only).

(5) [2:406] **"Good faith efforts":** A provision requiring the broker generally to take all "good faith" steps necessary to market the property in an expeditious manner.

(6) [2:407] **Identifiable salesperson:** A provision requiring that a specific salesperson (or salespersons) be the agent(s) to market the property.

➪ [2:408] ***PRACTICE POINTER:*** A listing agreement is between the seller and the party holding a *broker's* license; it is not an agreement between the seller and a specific *salesperson* (i.e., a real estate licensee acting under the authority of one who holds a broker's license, *¶ 2:35*). Therefore, at least where the identity of the salesperson is important to the seller, it may be prudent also to provide that the listing agreement *terminates* if a designated salesperson is no longer employed by the broker or otherwise not utilized as marketing agent for the property.

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i. [2:409] **Broker's interest in forfeited deposit:** Preprinted form listing agreements often provide that if the buyer breaches its purchase agreement and the seller is thereby entitled to retain all or any portion of the buyer's deposit, the broker will be entitled to some interest in the deposit (usually half) as compensation from the aborted sale.

➪ [2:410] ***PRACTICE POINTER:*** From the seller's perspective, this is an extremely *undesirable* provision. There are at least two good reasons why the broker should *not* share in any portion of a buyer's forfeited deposit:

• First of all, the *seller*—*not* the broker—is the party who suffers the bulk (if not all) of the damages when a buyer breaches the purchase agreement. (The seller has held the property off the market; incurred additional carrying charges for mortgage payments, taxes, insurance and other operating expenses; and perhaps incurred title and escrow charges.)

On the other hand, the broker has not necessarily incurred any direct out-of-pocket loss. (To the extent the broker is out-of-pocket from an aborted sale—e.g., advertising expense—a provision requiring the seller simply to reimburse that (or some lesser) amount will usually be fairer than giving the broker a far heftier "windfall" through a share of the forfeited deposit.)

• More fundamentally, the broker simply has *not done its job*: The seller contracted with the broker for the procurement of a buyer *who would close*—not simply for a *prospective* buyer whose forfeited deposit might not be sufficient to compensate for the seller's loss.

With these points in mind, it makes sense to *strike* any provision giving the broker an interest in a buyer's forfeited deposit. Indeed, seller's counsel should consider *adding* a provision specifically stating the broker is *not entitled to any portion* of a forfeited deposit *or other money damages* the seller recovers from a breaching buyer.

j. [2:411] **Broker indemnification:** Brokers frequently want to include a provision requiring the seller to *indemnify* the broker for any breach of the *seller's* obligation to make statutorily-required disclosures to the buyer. Again, the *seller's* disclosure obligations run to the *buyer*—*not* the broker (¶ *2:185, 4:354 ff.*); hence, it makes no sense for sellers to increase their liability exposure by expanding their disclosure obligations to include the broker.

➪ [2:412] ***PRACTICE POINTER:*** This can be a difficult subject to negotiate, since the broker is likely to contend it has an independent obligation of disclosure to the buyer (¶ *2:170 ff.*) and its knowledge about the property will be based largely upon the accuracy of the seller's disclosures to the broker. Theoretically, this is a legitimate position. Nonetheless, to the extent the broker incurs liability to a buyer because of the seller's affirmative misrepresentations to the broker, the broker will have a common law remedy against the seller (fraud, deceit, etc.) irrespective of any indemnification provision.

Moreover, an indemnification provision opens up the seller to potential *strict liability* to the broker irrespective of fault; e.g., the broker conceivably could have knowledge about a defect in the property that is *unknown to the seller*. (Clearly, the seller should not become obligated to indemnify the broker for a liability as to which the seller bears no responsibility.) Therefore, under no circumstances should the seller ever indemnify the broker for the *broker's failure* to disclose a defect of which the *seller was unaware*.

k. [2:413] **Lock box:** Residential real estate brokers often use a "lock box" on the property—i.e., a device whereby cooperating agents who subscribe to a multiple listing service can obtain access to the property when the seller's/listing broker is unavailable. (A lock box containing a key to the property is left on site and all subscribing agents have a master key, or combination, to the box.)

Not all sellers are amenable to use of a lock box; and it may or may not be advisable in a given instance. (Relevant factors include the general security of the neighborhood, the presence of valuables in the residence, and the owner's general desire for privacy and unannounced visits *versus* the enhanced marketing exposure that a lock box procedure might present.) Seller's counsel should carefully point out the pros and cons and review the procedures with the client before the client agrees to such a provision.

➪ [2:414] ***PRACTICE POINTER:*** Also consider the *liability* risks. The seller's broker may insist upon a specific exemption from liability for damage caused by other brokers' access.

l. [2:415] **Broker's powers and authority:** Creating an agency relationship, a listing agreement generally confers on the broker (agent) the power to do "everything necessary or proper and usual, in the ordinary course of business" in order to effect the purpose of the agency. [Civ.C. § 2319 subd. 1; *see* ¶ *2:133 ff.*] Therefore, those acts which the seller wants excluded from the broker's "ordinary" powers should be addressed by specific "exception" language in the agreement.

For example, seller's counsel might suggest a provision stating the broker has no authority to make representations to prospective buyers concerning any aspect of the property; and/or that the broker is precluded from executing documents on the seller's behalf or accepting deposits. (However, the latter exclusion is actually superfluous, since brokers are precluded by law from accepting monies or executing documents on a principal's behalf unless the listing agreement specifically permits same. *See ¶ 2:134 ff.*)

m. [2:416] **Arbitration of disputes:** As with contracts generally, it may be advisable to include a provision requiring that any dispute under the listing agreement be resolved by arbitration (in lieu of litigation). (*See ¶ 4:485 ff.* for detailed discussion of pros and cons of arbitration vs. litigation.)

(1) [2:417] **Statutory formalities:** "Whenever any contract or agreement between principals and agents in real property sales transactions, including listing agreements … contains a provision requiring *binding arbitration* of any dispute between the principals and agents in the transaction," the contract or agreement must comply with the following standards (CCP § 1298(b) (emphasis added)):

(a) [2:418] **Conspicuous title:** The provision calling for binding arbitration *must be clearly titled* "ARBITRATION OF DISPUTES." [CCP § 1298(b); *McAvoy v. Hilbert* (2009) 172 CA4th 707, 711-712, 91 CR3d 437, 441]

(b) [2:419] **Conspicuous typeface:** A binding arbitration provision in a printed listing agreement must be set out in at least 8-point bold or contrasting red type; and if included in a typed listing agreement, it must be set out in capital letters. [CCP § 1298(b); *McAvoy v. Hilbert* (2009) 172 CA4th 707, 711-712, 91 CR3d 437, 441]

(c) [2:420] **Affirmative assent; notice of consequences:** The parties must affirmatively assent to the arbitration clause (separately initialed). [CCP § 1298(c); *McAvoy v. Hilbert* (2009) 172 CA4th 707, 711, 713, 91 CR3d 437, 440, 441—arbitration provision in open listing agreement unenforceable because, among other things, not initialed by both parties; but see *Grubb & Ellis Co. v. Bello* (1993) 19 CA4th 231, 238-241, 23 CR2d 281, 283-285—arbitration provisions enforceable by broker who did not initial against seller (client) who *did* initial (mutuality of arbitration obligation not required)]

Further, a statutory notice of the effect of binding arbitration must be included immediately before the line or space provided for the parties to indicate their assent or nonassent and immediately following the arbitration provision. If the notice is included in a printed listing agreement, it must be set out in at least 10-point bold type or in contrasting red print in at least 8-point bold type; and if included in a typed listing agreement, it must be set out in capital letters. [See CCP § 1298(c); *McAvoy v. Hilbert*, supra, 172 CA4th at 713, 91 CR3d at 442—open listing agreement for sale of woodworking business, together with real property upon which business operated, constituted "real property sales transaction" subject to CCP § 1298 disclosure requirements]

Cross-refer: The statutory requirements concerning arbitration provisions in real estate purchase and sale contracts (including the effect of preemptive federal law) are discussed in greater detail at *¶ 4:490 ff.*

➪ [2:421] ***PRACTICE POINTER—SCOPE OF ARBITRATION OBLIGATION*:** If arbitration is selected as the acceptable method of dispute resolution, make certain that the listing agreement *limits the scope to disputes between broker and principal*. Be alert for language in some listing agreements purporting to require arbitration of disputes concerning "any resulting transaction." Such provision conceivably could be interpreted as requiring arbitration in disputes with a tenant, a buyer or any other third party.

On the other hand, bear in mind that if a dispute with the seller's/listing broker also involves the buyer and/or buyer's broker and the arbitration provision is limited as discussed above, the seller could find itself arbitrating with its broker and *simultaneously litigating* with the buyer and/or its broker.

In any event, this issue should be *thoroughly discussed* with the client.

n. [2:422] **"Boilerplate" provisions:** Most listing agreements include several "standardized" or "boilerplate" provisions found in contracts generally. These deserve the same careful consideration that should be given in connection with the preparation of a purchase and sale agreement. [See, e.g., *Hasler v. Howard* (2004) 120 CA4th 1023, 1027, 16 CR3d 217, 220—listing agreement's attorney fees clause (providing for prevailing party recovery of fees arising from any action between principal and broker "regarding the obligation to pay compensation" to broker) not broad enough to authorize fee recovery for broker who prevailed in principal's action against broker for fraud, breach of fiduciary duty and breach of duty to disclose dual agency; *and ¶ 4:513* (further discussion of attorney fee clauses), *4:527* ("integration" clauses), *4:534* ("severability" clauses), *4:540* ("further acts" clauses), *4:544* ("choice of law" clauses)]

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➪ [2:423] ***PRACTICE POINTER:*** Again, bear in mind that all provisions presented by the broker are *negotiable* and sellers should insist on *striking or modifying* any and all conditions, representations, etc. that appear unduly onerous or which otherwise might undermine optimum protection for the seller.

4. [2:424] **Copy of Listing Agreement to Principal(s):** Real estate licensees must deliver a copy of the listing agreement to their principal(s) as soon as reasonably practicable after the signature(s) is/are obtained. The copy may be provided electronically as statutorily defined if the parties have agreed to conduct the transaction by electronic means. [Bus. & Prof.C. § 10142] But the licensee's failure to comply will not necessarily affect the validity of the agreement. [See *Pivardiere v. Mercurio* (1955) 137 CA2d 808, 810-811, 290 P2d 908, 910; *Summers v. Freeman* (1954) 128 CA2d 828, 832, 276 P2d 131, 133-134]

[2:425 - 2:429] ***Reserved.***

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Cal. Prac. Guide Real Prop. Trans. Ch. 2-F

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 2. Real Estate Brokers and Listing Agreements

F. Special Rules in Probate Sales

1. [2:431] Estate Representative's Authority to Enter Listing Agreement
   a. [2:432] Limitation on “exclusive” listings
2. [2:433] Broker Compensation Upon Sale Confirmation Governed by Statute
   a. [2:433.1] Same rules applicable in partition proceedings
   b. [2:434] “Reasonable compensation” fixed by court
   c. [2:435] Prerequisites to compensation liability
   d. [2:436] Limitation on commission to nonexclusive broker
   e. [2:437] Allocation of commissions where multiple brokers/bids involved

[2:430] Sales of real property in a decedent's estate (i.e., pending probate administration) are subject to exhaustive rules set forth in the Probate Code (Prob.C. § 10300 et seq.). Among other things, the personal representative for the estate must have the *power to sell* (Prob.C. § 10000); and, unless the personal representative is properly exercising powers granted under the Independent Administration of Estates Act (see Prob.C. § 10503), title may not pass until the sale is reported to and *confirmed by the probate court* (Prob.C. § 10308).

1. [2:431] **Estate Representative's Authority to Enter Listing Agreement:** The Code empowers the personal representative to contract with a licensed real estate broker to secure a purchaser for real property in the decedent's estate (who, in turn, may associate other licensed brokers for this purpose and utilize a multiple listing service) and, pursuant thereto, to agree to pay a commission out of the sale proceeds. [Prob.C. § 10150(a)(1) & (b)]

a. [2:432] **Limitation on “exclusive” listings:** The personal representative may agree to an “exclusive right to sell” listing (¶ *2:355*) *only with prior court permission*; and, in any event, cannot contract for broker exclusives exceeding a 90-day term (but additional 90-day extensions may be granted with court permissions). [Prob.C. § 10150(c)]

2. [2:433] **Broker Compensation Upon Sale Confirmation Governed by Statute:** Broker compensation for sales in probate proceedings is governed exclusively by *statute*—not by contract. Entitlement to a commission and the amount therefore are *fixed by the court* pursuant to Prob.C. § 10160 et seq. [*Estate of Lopez* (1992) 8 CA4th 317, 321, 10 CR2d 67, 69]

The approval and allocation of broker commissions is often the most complicated aspect of a real property sale confirmation in probate proceedings. This is especially so when *multiple brokers* have been involved in the sale process and when the sale is confirmed to an “*overbidder*” (the “overbidding” process at a probate sale confirmation hearing permits persons other than the party whose offer is presented to the court for confirmation to step in as purchaser by “outbidding” the original offer; see Prob.C. § 10311).

A detailed discussion of the many statutory rules on the subject is beyond the scope of this Practice Guide. However, the significant points are overviewed at ¶ 2:433.1 ff.

a. [2:433.1] **Same rules applicable in partition proceedings:** The statutory rules governing broker compensation in probate also apply to broker commissions upon a sale in partition proceedings: The entitlement to and amount of broker commissions in an action to partition property by sale “shall be fixed by the court and divided or limited in the manner provided for private

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sales of real property in decedents' estates.” [CCP § 873.745; see *Sullivan v. Dorsa* (2005) 128 CA4th 947, 956, 27 CR3d 547, 553—pursuant to Prob.C. § 10160 (¶ *2:435*), no broker commission may be awarded on unconsummated sale in partition action; *Melikian v. Aquila, Ltd.* (1998) 63 CA4th 1364, 1369, 74 CR2d 739, 742]

b. [2:434] **“Reasonable compensation” fixed by court:** Notwithstanding a listing agreement to pay a specified commission, broker compensation payable out of a decedent's estate (or upon a partition sale) is *limited* to such amount as the *court*, in its discretion, deems to be “reasonable compensation” for the broker's services to the estate. [See Prob.C. §§ 10150(b), 10161 & 10160.5; *Estate of Lopez* (1992) 8 CA4th 317, 321, 10 CR2d 67, 69 (probate sale); *Melikian v. Aquila, Ltd.* (1998) 63 CA4th 1364, 1369, 74 CR2d 739, 742 (partition sale)]

c. [2:435] **Prerequisites to compensation liability:** Moreover, *no* broker commission is payable by the estate *unless* (i) an actual sale is made, (ii) the sale is confirmed or approved by the court when required, and (iii) the *sale is actually consummated* (title transferred and purchase price paid to estate). [Prob.C. § 10160; *Sullivan v. Dorsa* (2005) 128 CA4th 947, 956-957, 27 CR3d 547, 554—§ 10160 “has the effect of creating a broad bar to contractual recovery by any broker based on an unconsummated sale”]

d. [2:436] **Limitation on commission to nonexclusive broker:** A broker *not* acting under an *exclusive right to sell* listing agreement is entitled to a commission (or other compensation) in probate (or partition) sales *only* where they:

• *Produce the original bid* returned to the court for confirmation; *or*

• *Produce the successful overbidder* to whom the sale is confirmed. [Prob.C. § 10161(b); *Melikian v. Aquila, Ltd.* (1998) 63 CA4th 1364, 1369, 74 CR2d 739, 742]

e. [2:437] **Allocation of commissions where multiple brokers/bids involved:** An agreement among cooperating brokers to divide court-awarded compensation among themselves will be given effect by the probate court according to its terms. [Prob.C. § 10168] But, in the absence of such agreement, the allocation of compensation among several brokers involved in the decedent's estate real property sale (or where more than one bid is involved) is governed by detailed statutory rules. [Prob.C. § 10162 et seq.]

The various scenarios requiring allocation of commissions and application of the governing rules are probably best understood by reference to examples contained in the California Law Revision Commission's official comments to Prob.C. § 10162 et seq. (explained in detail in Ross & Cohen, *California Practice Guide: Probate* (TRG), Ch. 13).

Cross-refer: For a comprehensive discussion of the real property sale procedures in probate administrations (including the Probate Code rules governing broker listing agreements and compensation), see Ross & Cohen, *Cal. Prac. Guide: Probate* (TRG), Ch. 13.

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Cal. Prac. Guide Real Prop. Trans. Ch. 3-A

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 3. Title Insurance

A. Nature of Title Insurance

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  - c. [3:19.3] Incorporation by reference

1. Overview

a. [3:1] **Statutory definition:** "Title insurance" is statutorily defined as "insuring, guaranteeing or indemnifying owners of real or personal property or the holders of liens or encumbrances thereon or others interested therein against loss or damage suffered by reason of: (a) [l]iens or encumbrances on, or defects in the title to said property; (b) [i]nvalidity or unenforceability of any liens or encumbrances thereon; or (c) [i]ncorrectness of searches relating to the title to real or personal property." [Ins.C.

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§ 12340.1; *Hovannisian v. First American Title Ins. Co.* (2017) 14 CA5th 420, 429, 221 CR3d 883, 891; *First American Title Ins. Co. v. XWarehouse Lending Corp.* (2009) 177 CA4th 106, 113, 98 CR3d 801, 806-807; see also *Dollinger DeAnza Assocs. v. Chicago Title Ins. Co.* (2011) 199 CA4th 1132, 1145, 131 CR3d 596, 604—title insurance insures against losses resulting from differences between actual title and record title as of date title is insured]

(1) [3:1.1] **Operates as indemnity agreement:** Essentially then, a title insurance policy is a contract to indemnify persons with an interest in real property (the insureds) against losses incurred because of a defect in the status of title or liens or encumbrances that may affect the title as *reported* by the title company when the policy is issued (*¶ 3:11*). [See *Dollinger DeAnza Assocs. v. Chicago Title Ins. Co.* (2011) 199 CA4th 1132, 1145, 131 CR3d 596, 604-605—title insurer does not *guarantee title but* agrees only to pay losses resulting from, or to cause removal of, cloud on title within policy provisions; *Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1191, 54 CR2d 84, 89—title "policy expressly provides merely that the insurer will pay any loss or damage suffered by the insured from any omitted defect not excluded by the terms of the policy" (internal quotes omitted); *Radian Guaranty, Inc. v. Garamendi* (2005) 127 CA4th 1280, 1293, 26 CR3d 464, 472—"insuring … against risk of loss associated with an undisclosed senior lien falls squarely within the statutory definition of title insurance"; *and ¶ 3:4.2*]

b. Purpose and effect

(1) [3:2] **Researching status of title:** The only certain and correct way to determine the status of title (who holds record title to an interest in real property, and the existence of impediments to title) is to conduct a search of the land records by reviewing the grantor-grantee index in the office of the county recorder for every county where any part of the property is located. Conceivably, the search could be conducted by any party to a sales transaction or any party's counsel (attorneys in some states in fact provide this service).

(2) [3:2.1] **Indemnifying losses from title defects and liens:** In California, parties look to title insurance companies to determine the status of title. But a title insurance policy does *not guarantee* title; nor is it a legal determination or representation of how title is held (*¶ 3:4*). Indeed, title insurance *only* protects against the possibility that liens or other instruments not found in a title search or disclosed in a preliminary report may nonetheless exist: "The records pertaining to real property are complex and encumbrances may be missed by even the most thorough search. Title insurance is an acknowledgment that errors may have been made." [*Radian Guaranty, Inc. v. Garamendi* (2005) 127 CA4th 1280, 1289, 26 CR3d 464, 469-470; *Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1191, 54 CR2d 84, 89; see also *Quelimane Co., Inc. v. Stewart Title Guaranty Co.* (1998) 19 C4th 26, 41, 77 CR2d 709, 717 (noting title insurance *indemnifies* insured against losses resulting from defects in or encumbrances on title)—"A title insurer issues title insurance on the basis of … the quality of its own investigation into … public records concerning the status of the title. … The degree of risk is therefore largely within the control of the insurer"]

Preliminarily, note these distinctions in functions:

(a) [3:3] **Preliminary title report:** The title company's report on the status of title (called a "preliminary title report" or "preliminary report") is *not* itself an insurance policy and will not support a cause of action against the title company. It is simply an *offer* of insurance on the reported terms or, stated another way, an *inducement* for the prospective insured to purchase title insurance and a means by which the insurer may state in advance the precise risk it will assume. [Ins.C. § 12340.11; *2,022 Ranch, L.L.C. v. Sup.Ct. (Chicago Title Ins. Co.)* (2003) 113 CA4th 1377, 1382, 7 CR3d 197, 201, fn. 2 (citing text) (disapproved on other grounds by *Costco Wholesale Corp. v. Sup.Ct.* (2009) 47 C4th 725, 739, 101 CR3d 758, 769); *Rosen v. Nations Title Ins. Co.* (1997) 56 CA4th 1489, 1499-1500, 66 CR2d 714, 720; *see Form 3:A; and detailed discussion at ¶ 3:200 ff.*]

➪ [3:3.1] ***PRACTICE POINTER:*** A preliminary title report will be amended by the title insurer if it discovers, prior to issuance of the title policy, that an exception to title was inadvertently omitted or a new exception arose after issuance of the report.

(b) [3:4] **Report and policy not determinative of title:** *Neither* a preliminary report nor a title insurance policy is a *legal determination* or *representation* of how title is held. "[N]o reliance should ever be placed on a preliminary report or a policy of title insurance to show the condition of title. … This is because any title search or examination is performed by the insurer solely for the purpose of seeking to evaluate its underwriting decision in issuing the policy, not for the

benefit of the insured." [*Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1191-1192, 54 CR2d 84, 89 (internal quotes and citations omitted)]

1) [3:4.1] **Condition of title to be insured:** A preliminary report simply states the condition of title that a title company is willing to insure. A preliminary report is *not a representation* of the condition of title; indeed, the proffered insurable condition may or may not reflect the true condition of record title. [*Southland Title Corp. v. Sup.Ct. (Nye)* (1991) 231 CA3d 530, 537-538, 282 CR 425, 429; see also *Soifer v. Chicago Title Co.* (2010) 187 CA4th 365, 373, 114 CR3d 1, 7—title insurers prepare preliminary reports to limit their own risk by locating and excluding coverage items; *Lee v. Fidelity Nat'l Title Ins. Co.* (2010) 188 CA4th 583, 596, 115 CR3d 748, 758 (same)]

The *only* representation made by the issuance of a preliminary report is that a policy of title insurance will subsequently be issued insuring title in the condition described in the preliminary report. [*Southland Title Corp. v. Sup.Ct. (Nye)*, supra, 231 CA3d at 538, 282 CR at 430; *Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1192-1193, 54 CR2d 84, 90]

2) [3:4.2] **Duty to indemnify:** Likewise, a title insurance policy is simply a contract to *indemnify* against loss caused by defects in title or encumbrances on title not excluded by the terms of the policy; the insurer is obligated to indemnify the insured against losses due to the occurrence of specified contingencies and to provide payment of expenses for the defense against certain claims. [*Golden Security Thrift & Loan Ass'n v. First American Title Ins. Co.* (1997) 53 CA4th 250, 258-259, 61 CR2d 442, 446-447; *Vournas v. Fidelity Nat'l Title Ins. Co.* (1999) 73 CA4th 668, 675, 86 CR2d 490, 495; see also *Hovannisian v. First American Title Ins. Co.* (2017) 14 CA5th 420, 429, 221 CR3d 883, 890-891 (citing *Golden Security Thrift* with approval)—insurance company's obligation to indemnify insured depends upon nature of risks covered by policy]

3) [3:4.3] **No negligence/negligent misrepresentation action against insurer:** A title insurance policy is *not a representation* that title is in any particular condition or that the contingency insured against will not occur. Accordingly, when an insured contingency occurs, *no action for negligence or negligent misrepresentation* will lie against the insurer based solely on the title policy. [*Golden Security Thrift & Loan Ass'n v. First American Title Ins. Co.* (1997) 53 CA4th 250, 258, 61 CR2d 442, 447; *Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1191, 54 CR2d 84, 89; *Southland Title Corp. v. Sup.Ct. (Nye)* (1991) 231 CA3d 530, 537, 282 CR 425, 429]

Indeed, an insured has *no* separate claim against a title insurer based on negligence. [See *Vournas v. Fidelity Nat'l Title Ins. Co.* (1999) 73 CA4th 668, 676-677, 86 CR2d 490, 496, *discussed at ¶ 3:411 ff.*]

(3) [3:5] **Other benefits:** An important incidental benefit of title insurance is that, through the process of obtaining the policy, an insured is able to learn about (and work with a title officer to eliminate some) title issues regarding the property. For example, title defects which inadvertently still remain of record can be removed with the help and direction of a title company.

(4) [3:6] **Practical considerations:** Insurance coverage for a potential defect in title does *not itself remove* the defect or "guarantee" its removal; hence, title insurance may not be sufficient to adequately satisfy a client's needs.

Illustration: Assume, as buyer's counsel, you discover a potential title defect and a title insurer is willing to insure against loss that may result therefrom. At first glance, the availability of insurance might seem to remedy the client's concerns. However, if you believe the potential title defect could risk significant loss to your client, the client (buyer) may prefer not to purchase the property rather than purchase it with a title policy indemnifying against the potential loss. There are three basic reasons:

(a) [3:7] **Costs exceeding policy limit:** A title insurance policy has a *policy limit* (usually equal to the amount of the purchase price for the property). Buyers typically incur costs in addition to the purchase price (e.g., cost of title policy, closing costs, attorney fees, loan fees and interest, property taxes, and liability and casualty insurance premiums); those amounts in excess of the policy limit are *not recoverable* under the policy. Hence, even assuming a hefty policy limit, potential title defects which ripen into actual defects could leave the buyer out-of-pocket for substantial sums.

This issue is particularly important where the subject of the purchase and sale is raw (unimproved) land. In such transactions, the buyer often incurs substantial *postclosing costs* in obtaining subdivision, building and other development permits. These costs which exceed the purchase price—and thus exceed the policy limit—cannot be recouped under a title insurance policy.

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(b) [3:8] **Delay and cost of delay:** Similarly, notwithstanding title insurance coverage, if a potential title defect ripens into an actual third party claim against the insured, the insured will suffer delays and perhaps consequential economic loss. While the title insurer is litigating or otherwise trying to resolve the title defect, the insured might not be able to use, occupy or develop the property. Because the insured usually incurs carrying costs for the property (taxes, mortgage payments, insurance, etc.), any delay will result in the insured bearing expenses in excess of the policy limit.

(c) [3:9] **Aggravation and expense of policy claims:** Finally, even when title insurance covers a title defect that has ripened into a third party claim, the insured invariably will suffer the aggravation and expense of making a claim under the policy. Effective pursuit of a title policy claim usually involves the retention of attorneys and perhaps other experts, running up additional fees.

➪ [3:10] ***PRACTICE POINTER:*** It follows that counsel should always make their own, independent evaluation of the likelihood that potential title defects will ripen into third party claims. Explain the repercussions to your clients and analyze whether, from the clients' perspective, it makes practical sense to proceed with the transaction notwithstanding the procurement of a title insurance policy.

c. [3:11] **Postinsurance defects:** Traditionally, a title policy has insured title only in the condition *stated in the preliminary report*—i.e., only as to defects, liens or encumbrances in *existence as of the date the policy takes effect*. Title insurance generally does not insure against future events: "It is not forward looking. It insures against losses resulting from differences between actual title and the record of title as of the date title is insured." [*Quelimane Co., Inc. v. Stewart Title Guaranty Co.* (1998) 19 C4th 26, 41, 77 CR2d 709, 717; *Magna Enterprises, Inc. v. Fidelity Nat'l Title Ins. Co.* (2002) 104 CA4th 122, 126, 127 CR2d 681, 684]

This distinction sets title insurance apart from other kinds of insurance. Whereas other types of policies generally protect against matters that arise during a specified period after issuance of the policy, title insurance typically indemnifies the insured only from matters affecting or burdening title *at the time the policy is issued*. With a conventional title policy, "[t]here is *no implied agreement to go beyond the conditions existing at the time the policy is issued and to assume a general liability to indemnify against future encumbrances*." [*Rosen v. Nations Title Ins. Co.* (1997) 56 CA4th 1489, 1499, 66 CR2d 714, 720 (emphasis in original; internal quotes and citation omitted); see *Radian Guaranty, Inc. v. Garamendi* (2005) 127 CA4th 1280, 1291, 26 CR3d 464, 471 (contrasting "backward-looking" risk insured by title insurance with "forward-looking" risk insured by mortgage guaranty insurance)]

d. [3:12] **Standard practice in purchase and sale transactions:** Despite its inherent limitations (¶ 3:11), title insurance can (and generally should) be obtained when anyone is acquiring an interest in real property.

With respect to purchase and sales transactions, it is standard—and *always necessary*—for a buyer to require the issuance of a policy of title insurance concurrent with (and as a condition of) the closing, insuring that title is held in the buyer's name (*see ¶ 4:404 ff.*). Additionally, it is standard—and *always necessary*—for a buyer's *lender* (including the seller in a seller-financed sale) to require a policy of title insurance insuring the priority of its lien interest in the property (*see Ch. 6*).

e. [3:13] **Attorney's role:** An attorney representing buyer or seller in a purchase and sale transaction has four general tasks in connection with title issues and title insurance:

(1) [3:14] **Procure and review preliminary report:** As a first step, make certain that a preliminary report is promptly ordered from the designated title company. Counsel will need to review *both* the preliminary report *and* the *recorded documents* set forth as *exceptions to title*.

(As later discussed, a preliminary report simply sets forth a brief description of the exceptions to title; it does *not* necessarily describe the legal effect, or even the salient terms, of the exception(s) being reported. *See* ¶ *3:210, 3:236 ff.*)

(2) [3:15] **Ascertain requisite policy and endorsements:** Because different policies and endorsements are available, counsel must determine which type best satisfies the client's needs. *See detailed discussion at ¶ 3:75 ff.*

(3) [3:16] **Address removal of title defects:** To the extent feasible, it is always better practice to cure (remove) a potential title defect than simply purchase insurance coverage against the possibility of a claim. (As indicated, a title policy does not itself *remove* title defects and might not cover all of the insured's losses flowing from the defect; *see ¶ 3:6 ff.*) Thus, it is incumbent upon counsel to determine whether apparent defects can be cleared by recording additional documents or taking other appropriate steps.

(4) [3:17] **Verify issuance of title policy:** At the closing, counsel should verify that the appropriate policy is being issued in accordance with the parties' agreement and instructions to the title company.

If there are errors, immediately notify the insurer and return the policy along with instructions about the corrections that need to be made and the date by which the corrected policy should be redelivered.

2. [3:18] **Insurable Interests:** Title insurance may be obtained for the protection of many types of interests in property—including fee, leasehold, easement, and mineral and lienhold interests. Conceivably, any property interest within the chain of title is insurable.

[3:18.1 - 3:18.4] ***Reserved.***

3. [3:18.5] **Duration of Coverage (Policy Term):** A title insurance policy is uniquely different from liability and health insurance policies in that it has a one-time premium and remains in effect for so long as the insured owns the insured property. The purchaser (insured) cannot cancel the policy and switch to another carrier without forfeiting the premium. [*Wolschlager v. Fidelity Nat'l Title Ins. Co.* (2003) 111 CA4th 784, 789, 4 CR3d 179, 183; *Kleveland v. Chicago Title Ins. Co.* (2006) 141 CA4th 761, 764, 46 CR3d 314, 316]

4. [3:19] **Policy Interpretation:** As a contract of insurance, a title policy is interpreted pursuant to the general rules governing the interpretation of contracts. [*Rosen v. State Farm Gen. Ins. Co.* (2003) 30 C4th 1070, 1074, 135 CR2d 361, 363; *Dollinger DeAnza Assocs. v. Chicago Title Ins. Co.* (2011) 199 CA4th 1132, 1145, 131 CR3d 596, 605; see also *First American Title Ins. Co. v. XWarehouse Lending Corp.* (2009) 177 CA4th 106, 114, 98 CR3d 801, 808—ordinary rules of contractual interpretation apply even though insurance contracts have special features]

First and foremost therefore, title policies are construed according to the parties' mutual intention at the time the contract was formed. And, to the extent possible, that intent is to be inferred solely from the policy's express provisions. [See Civ.C. § 1639; *Rosen v. State Farm Gen. Ins. Co.* (2003) 30 C4th 1070, 1074, 135 CR2d 361, 363; *Havstad v. Fidelity Nat'l Title Ins. Co.* (1997) 58 CA4th 654, 659-660, 68 CR2d 487, 490; see also *Wolschlager v. Fidelity Nat'l Title Ins. Co.* (2003) 111 CA4th 784, 789, 4 CR3d 179, 183—by accepting policy without objection, insured is bound by policy provisions whether or not read or understood]

a. [3:19.1] **Construction favoring insured:** So as to protect the insured's reasonable expectations, coverage provisions are generally construed broadly in favor of the insured, while exceptions and exclusions are generally construed narrowly against the insurer. [*Montrose Chem. Corp. of Calif. v. Admiral Ins. Co.* (1995) 10 C4th 645, 667, 42 CR2d 324, 335; *Rosen v. Nations Title Ins. Co.* (1997) 56 CA4th 1489, 1497, 66 CR2d 714, 718; but see also *Elysian Invest. Group, LLC v. Stewart Title Guaranty Co.* (2002) 105 CA4th 315, 324-325, 129 CR2d 372, 379—policy *exclusions* cannot be interpreted to create coverage that does not otherwise exist]

Further, because there is little (if any) negotiation between insurer and insured (i.e., the contract of insurance is not a product of equal bargaining strengths), ambiguities are construed against the insurer and consistent with the insured's reasonable expectations. [*Montrose Chem. Corp. of Calif. v. Admiral Ins. Co.*, supra, 10 C4th at 667, 42 CR2d at 335; *White v. Western Title Ins. Co.* (1985) 40 C3d 870, 881, 221 CR 509, 513; see also *Lee v. Fidelity Nat'l Title Ins. Co.* (2010) 188 CA4th 583, 587, 115 CR3d 748, 751—title insurer could not avoid liability based on covered property's ambiguous legal description since risk of proper description was assumed by insurer]

b. [3:19.2] **Compare—unambiguous provisions:** However, courts will not "rewrite" an insurance contract to give a different meaning to clear and unambiguous terms ("plain meaning rule"). "If the policy language is clear and explicit, it governs." [See *Rosen v. State Farm Gen. Ins. Co.* (2003) 30 C4th 1070, 1074, 1078, 135 CR2d 361, 363, 366; *Lee v. Fidelity Nat'l Title Ins. Co.* (2010) 188 CA4th 583, 597, 115 CR3d 748, 759—while insured's objectively reasonable expectations may be considered in resolving ambiguous policy provisions, they cannot be relied upon to create ambiguity where none exists]

Thus, provisions not reasonably susceptible of conflicting interpretations, that are clear and unambiguous, will not be construed otherwise against the insurer. [*Montrose Chem. Corp. of Calif. v. Admiral Ins. Co.* (1995) 10 C4th 645, 666-667, 42 CR2d 324, 334; *First American Title Ins. Co. v. XWarehouse Lending Corp.* (2009) 177 CA4th 106, 115, 98 CR3d 801, 808—when policy terms are "plain and explicit" courts do not indulge in "forced construction" that fastens liability on insurance company it did not assume; see also *RNT Holdings, LLC v. United Gen. Title Ins. Co.* (2014) 230 CA4th

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1289, 1299-1301, 179 CR3d 175, 184-185—provisions expressly terminating insurer's liability following mortgage's reconveyance and excluding liens "created, suffered, assumed or agreed to" by insured precluded lender from recovering on its breach of contract claim; *Golden Security Thrift & Loan Ass'n v. First American Title Ins. Co.* (1997) 53 CA4th 250, 256-257, 61 CR2d 442, 445-446—coverage for parcel's "dimensions" could not be reasonably construed to include its "area" ("acreage")]

c. [3:19.3] **Incorporation by reference:** Like contracts in general, a title insurance policy may include provisions that are not physically a part of the policy so long as they are sufficiently incorporated by reference. A document is effectively incorporated by reference if the reference is "clear and unequivocal" and called to the attention of the other party who consented to it, and the terms of the incorporated document were known or easily available to the parties at the time the contract was made. [*Kleveland v. Chicago Title Ins. Co.* (2006) 141 CA4th 761, 765, 46 CR3d 314, 316; *see also* ¶ *3:208.5 ff.*]

Cross-refer: For a more detailed treatment of the principles governing interpretation of insurance policies, see Croskey, Heeseman, Ehrlich & Klee, *Cal. Prac. Guide: Insurance Litigation* (TRG), Ch. 4.

[3:20 - 3:24] ***Reserved.***

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Cal. Prac. Guide Real Prop. Trans. Ch. 3-B

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 3. Title Insurance

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1. [3:25] **Types of Title Companies:** Three distinct types of title companies perform title services: (a) title insurers; (b) underwritten title companies; and (c) abstract companies.

Some title services may be performed by all three types of companies; others may only be performed by a specific type of title company. (The term “title company” is used generally in this Practice Guide to refer to any of the three foregoing companies.)

a. [3:26] **Title insurer:** A “title insurer” is statutorily defined as “any company issuing title policies as insurer, guarantor or indemnitor.” [Ins.C. § 12340.4]

(1) [3:27] **Services—exclusive authority to issue title policy:** A title insurer is the *only* type of title company permitted to issue policies of title insurance. [See Ins.C. §§ 12340.3, 12340.4 & 12390 (mortgage insurance; ¶ 3:48)]

Title insurers may also perform title searches and prepare preliminary reports which form the basis of title policies. In that capacity, however, they must be licensed as an underwritten title company. [See Ins.C. § 12389.5; *and ¶ 3:28*]

b. [3:28] **Underwritten title company:** An “underwritten title company” is a corporation in the business of preparing title searches, title reports, certificates and abstracts of title that are the basis of title policies. It also may engage in the escrow business and act as an escrow agent by satisfying specific statutory requirements (¶ 4:567 ff.). [See Ins.C. §§ 12340.5, 12389]

Every person engaged in the business of preparing title searches, title examinations, title reports, and certificates of abstracts of title, upon which a title insurer writes title policies, must be *licensed as an underwritten title company* in compliance with the licensing requirements of Ins.C. § 12389 et seq. [Ins.C. § 12389.5]

Unless it is also a certified title insurer (*¶ 3:62*), an underwritten title company may *not* issue a title insurance policy. [See Ins.C. §§ 12340.4, 12340.5, 12389 & 12390]

(1) [3:29] **“Underwriting agreement”:** An underwritten title company performs a title examination and prepares a preliminary report (as opposed to a title insurer performing such functions) pursuant to an “underwriting agreement” with the title insurer that will issue the title policy. An underwriting agreement sets forth the duties and liabilities of each of the two entities with respect to the title report and policy.

c. [3:30] **Abstract company:** An “abstract company” prepares “abstracts of title”—i.e., a written representation, intended to be relied upon by the person contracting for it, listing all recorded documents that impart constructive notice with respect to

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the chain of title to a parcel of property. [Ins.C. § 12340.10; *Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.* (2009) 171 CA4th 1356, 1389, 124 CR3d 271, 301]

An abstract of title is *not* a title policy and an abstract company may *not* issue a policy of title insurance. [Ins.C. § 12340.10; see also Ins.C. §§ 12340.3, 12340.4 & 12390]

(1) [3:31] **Preliminary report distinguished:** Whereas a "preliminary report" sets forth the conditions under which a title company is willing to insure property (¶ *3:200 ff.*), an abstract of title is an *actual representation* as to all of the documents which are recorded and impart constructive notice (Ins.C. § 12340.10); hence, an abstractor is exposed to far greater liability in connection with its title searches than is a title insurer or an underwritten title company (*see* ¶ *3:211 ff.*). [See generally, *Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1190, 54 CR2d 84, 88]

(2) [3:32] **Abstractor's duties and liabilities:** An abstractor has a duty to report all matters affecting an insured's interest in property that are readily discoverable by making a diligent search of the public records. Its failure to report all such matters exposes the abstractor to liability in tort (negligence) for all damages proximately resulting therefrom. [*Contini v. Western Title Ins. Co.* (1974) 40 CA3d 536, 545-546, 115 CR 257, 263; *Southland Title Corp. v. Sup.Ct. (Nye)* (1991) 231 CA3d 530, 536, 282 CR 425, 429; see also *Soifer v. Chicago Title Co.* (2010) 187 CA4th 365, 372, 114 CR3d 1, 6—person who contracts and separately pays for "abstract of title" receives all rights associated therewith and may rely upon express representations contained therein]

In contrast, because neither a preliminary report nor a title policy constitutes a representation that title contingencies will not occur (¶ *3:4 ff.*), no action for negligence or negligent misrepresentation lies against a title insurer based solely on its preliminary report or title insurance policy. [*Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1191, 54 CR2d 84, 89; *Southland Title Corp. v. Sup.Ct. (Nye)* (1991) 231 CA3d 530, 537-538, 282 CR 425, 429-430; see also *Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.* (2009) 171 CA4th 1356, 1389, 124 CR3d 271, 301—statutes governing abstracts of title and preliminary reports are intended to relieve title insurers from liability for negligent preparation of preliminary reports]

(3) [3:33] **Comment:** The work of early abstract companies (i.e., the search and compilation of records affecting property) was the genesis of the current title insurance business. Today, however, there are few abstract companies in California and their use is limited. (Abstract companies are more readily used outside California.)

In practice, title companies now perform functions similar to those of an abstractor when issuing a chain of title guarantee or other similar guarantee. (*See* ¶ *3:41*.)

[3:34] ***Reserved.***

2. Title Company Functions

a. [3:35] **Title insurance:** The primary function of title companies is to search the chain of title to property and issue title insurance or "title policies" (only a *title insurer* may issue a policy of title insurance; *see* ¶ *3:26 ff.*). Again, the fundamental purpose of title insurance is to provide protection to an owner of an interest in property against loss due to certain title defects, liens and encumbrances affecting the property (¶ *3:1 ff.*).

In purchase and sale transactions, two title policies are typically issued: one insuring the *owner's* (*buyer's*) interest; and the other insuring the lien priority of the new *lender's* deed of trust.

(1) [3:35.1] **No agency relationship with insured:** In its capacity as a title insurer, a title company is *not the agent* of its insured. Therefore, whatever duty a title insurer may have with respect to searching the chain of title is *not* imputed to the insured. [*Marriage of Cloney* (2001) 91 CA4th 429, 438-439, 110 CR2d 615, 622—title insurer's knowledge regarding seller's identity and state of his title to property irrelevant to whether insured had constructive notice of prior lien on property when purchased]

b. Other title services

(1) [3:36] **Guarantees:** Title insurers (but *not* underwritten title companies) may issue "guarantees." [Ins.C. §§ 12340.4, 12340.5] Guarantees provide information regarding title to property and insure the accuracy of that information.

There are many types of guarantees. These are some of the more commonly-used ones:

(a) [3:37] **Trustee's sale guarantee:** A "trustee's sale guarantee" insures trustees and beneficiaries under deeds of trust against loss due to an irregularity in a trustee's (foreclosure) sale. In particular, it insures (up to the amount of liability of the guarantee) against:

• loss occasioned by the vesting of title other than as shown;

• incorrect names and addresses of persons who recorded requests for copies of notices of default and notices of sale;

• incorrect names and addresses of other persons entitled to receive copies of notices of default and notices of sale;

• incorrect names and addresses of state taxing agencies entitled to receive copies of notices of default and notices of sale;

• the property being located in a judicial district other than as shown; and

• incorrect information regarding newspapers for publication of notices.

A trustee's sale guarantee also provides an insured with information as to certain rights and limitations under the Servicemembers Civil Relief Act (50 USC § 3901 et seq.) and the Federal Tax Lien Act of 1966 (26 USC § 545 et seq.).

(b) [3:38] **Judgment and tax lien guarantee:** This guarantee lists all judgment and tax liens in a particular person's name for a particular county and insures against loss due to the existence of any judgment or tax liens not listed on the guarantee.

(c) [3:39] **Property search guarantee:** A "property search guarantee" protects against loss arising from the existence of property held by a person in a particular jurisdiction other than the property reported in the guarantee. An insurer generally searches the county assessment rolls, and sometimes the county recorder's index, in preparing this type of guarantee.

(d) [3:40] **Litigation guarantee:** A "litigation guarantee" is used in connection with a lawsuit affecting property, such as a judicial foreclosure, partition or quiet title action. It insures against loss due to incorrectness of the vesting, description of property and names of necessary defendants.

(e) [3:41] **Chain of title guarantee:** A "chain of title guarantee" lists all documents in the public records affecting a particular piece of property since the original government grant or as of another particular date (selected by the insured) and insures against loss resulting from the existence of any other such documents. It includes the names of the parties and recording information with respect to the documents.

(f) [3:42] **Mechanic's lien guarantee:** This guarantee insures against loss due to the existence of any notices of completion, notices of cessation of labor, notices of nonresponsibility, mechanic's liens and *lis pendens* which are recorded after a certain date and not reported in the guarantee.

(g) [3:42.1] **Conditions of title guarantee:** This guarantee provides customers with a product that is similar to a Preliminary Report except it does not contemplate issuance of a title insurance policy.

(2) [3:43] **Gratuitous title services:** Customer service departments of most title companies provide attorneys with certain title services at no charge.

For example, most title companies will disclose by telephone the current vesting of a particular piece of property. A copy of the last-recorded deed will then be sent to the attorney for a nominal fee. Also, depending on counsel's or the client's relationship with the title company, the company may be willing to make specific title investigations without charge (e.g., determining whether there is a tax delinquency respecting a particular piece of property). (*See also* *¶ 3:69*.)

➪ [3:44] ***PRACTICE POINTER:*** These gratuitous services (¶ 3:43) do *not* constitute insurance and create *no* liability on the part of the title company if the information turns out to be incomplete or inaccurate.

(3) [3:45] **Title company as escrow agent:** Title insurers and underwritten title companies may perform escrow services (*see* *¶ 4:567 ff.*). But as an escrow agent, a title company derives its duties from the *escrow instructions;* it does not, under the cloak of performing escrow functions (e.g., disbursing funds and recording documents), thereby become a fiduciary for the purchaser (or any other party to the sale transaction) for purposes of searching the land records or transmitting information regarding title. [*Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1193-1194, 54 CR2d 84, 91; see also *Vournas v. Fidelity Nat'l Title Ins. Co.* (1999) 73 CA4th 668, 674-675, 86 CR2d 490, 484-495—in its capacity

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as escrow holder, title insurer owed no duty to beneficiaries of trust (seller) to discover or disclose need for beneficiary consent to convey]

(4) [3:46] **Title company as trustee of deed of trust:** Also, title insurers and underwritten title companies may—and regularly do—act as trustees of deeds of trust.

A title insurer's or underwritten title company's duties as trustee are specified in the deed of trust. Typically, the trustee's duties are limited to taking the steps necessary to foreclose the deed of trust (when a default occurs) and, upon satisfaction of the secured debt, reconveying the deed of trust. [See *Vournas v. Fidelity Nat'l Title Ins. Co.* (1999) 73 CA4th 668, 677, 86 CR2d 490, 496-497; *and detailed discussion of deeds of trust at ¶ 6:336 ff.*]

(5) [3:47] **Title company as trust company:** Title insurers are not authorized to engage in trust business. [See Stats. 1996, Ch. 1063, § 83 (repealing Ins.C. § 12392, which authorized title insurers to engage in trust business)]

However, trust companies may be controlled by or under common control with a title insurer. [See Fin.C. § 1285]

(6) [3:48] **Other functions:** Title companies are *not* authorized to engage in all types of business. Some of the other functions they may properly perform are identified in Ins.C. §§ 12390 (insuring (i) "identity, due execution, and validity of any note or bond secured by mortgage," (ii) "identity, due execution, validity and recording of any such mortgage," and (iii) "identity, due execution and validity of evidences of indebtedness") and 12391 (authorizing insurers to (i) act as registrar or transfer agent of California, of any California subdivision or district, or of any private or public corporation, (ii) transfer or countersign evidences of indebtedness, and (iii) transfer or countersign stock certificates).

(a) [3:49] **No "multiline" insurance authority:** Title insurers are authorized to write only a *single line* of insurance; i.e., they are "monoline" insurers, prohibited from "transacting" any class of insurance other than title insurance. [Ins.C. § 12360]

Conversely, mortgage guaranty insurers—themselves also "monoline" insurers—are prohibited from transacting title insurance or any class of insurance other than that for which their certificate of authority permits. [Ins.C. § 12640.10; see *Radian Guaranty, Inc. v. Garamendi* (2005) 127 CA4th 1280, 1285-1286, 26 CR3d 464, 467-468—mortgage guaranty insurer that did not hold certificate of authority to transact title insurance prohibited from selling insurance to lenders for losses due to undisclosed property liens]

3. [3:50] **Choosing a Title Company:** As with businesses generally, title companies vary in their level of competence, range of services and pricing. To assist consumers, the Insurance Commissioner publishes an educational brochure on title insurance (see Ins.C. § 12406.5), which can be accessed online at the Commissioner's website (*www.insurance.ca.gov*) (click on "Consumers," "Information Guides," "Residential Series").

a. Relevant factors

(1) [3:51] **Skill of title officers and counsel:** The quality of a title company's work is an essential issue in selecting a title company. The more knowledgeable the title officers and the company's in-house counsel, the better the title company is able to identify and understand the title risks and find a solution. In addition, the likelihood of problems, expense and delay as the transaction progresses is a direct product of the quality of the title company's work at the *beginning* of its title search.

(2) [3:52] **Responsiveness:** Purchase and sale transactions often must close within a limited period of time. It is thus important to use a title company (and title officer) able to perform its duties within the desired timeframe; the officer's availability at critical times in the transaction can be a significant factor.

(3) [3:53] **Title company's underwriting philosophy:** It may be necessary to "shop" for a title company willing to insure against a particular title defect or risk. Some may be less averse than others to insure over a particular lien or kind of lien; and some may be more willing than others to work with a customer to find a solution to an unusual or difficult title problem.

➪ [3:54] ***PRACTICE POINTER:*** It is important to identify title problems early in the transaction and determine whether the title company can resolve the matter to the parties' satisfaction. In this way, if the title company cannot resolve a title issue, the parties will have the leeway to move on to a new company.

(4) [3:55] **Size and assets:** Also consider the title company's size and financial stability. A title company must have enough resources to adequately perform its duties and sufficient assets to cover policy claims.

(5) [3:56] **Rates:** Price is naturally a relevant factor. Although rates are somewhat standardized within the industry, they may vary—especially for unusual endorsements and other special requests.

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(One of the purposes of the statutorily-required Department of Insurance title insurance brochure (¶ *3:50*) is to inform consumers about competing rates and services, and available discounts.)

(6) [3:57] **Location:** Original documents must be hand-delivered to the title company. Hence, the proximity of the company's branch office to the parties (and their attorneys) may be of importance.

(7) [3:58] **Escrow services:** As noted in *Ch. 4*, it is sometimes beneficial to use a title company that can also handle the escrow (*see* ¶ *4:568, 4:572*).

(8) [3:59] **Continuity of relationships:** Many attorneys prefer to use one or a few select title companies for all of their clients' transactions. Establishing and maintaining an ongoing relationship with a title company and its officers, in-house counsel, customer service representatives and management can result in better and quicker services (and sometimes more favorable pricing).

Similarly, it may be advantageous to work with a particular title officer (regardless of the title company with which the officer is affiliated). Indeed, because the title officer is typically the person who keeps the title work moving along, the officer used is often as important (perhaps *more* important) than the title company itself.

[3:59.1 - 3:59.4] ***Reserved.***

b. [3:59.5] **Buyer's Choice Act (sale of foreclosed property):** The Buyer's Choice Act (Civ.C. § 1103.20 et seq.) prohibits a lender under a deed of trust (or its agents, employees, etc.) from requiring, either directly or indirectly, as a condition to the sale of foreclosed residential real property, that the buyer purchase title insurance covering the property from a particular title insurer. [See Civ.C. § 1103.22(a), (b)]

The Act does *not* prohibit the buyer from agreeing to accept a particular title insurer recommended by the lender so long as the buyer is first provided written notice of the right to make an independent selection. [Civ.C. § 1103.22(a)]

(1) [3:59.6] **Penalties for violation:** A seller who violates the Act's provisions is liable to the buyer for an amount equal to three times all charges made for the title insurance. In addition, any person who violates the Act is deemed to have violated their license law and is subject to discipline by their licensing entity. [Civ.C. § 1103.22(c)]

4. Regulation of Title Industry

a. Applicable regulations

(1) [3:60] **State regulation:** The California Insurance Commissioner has general regulatory authority over the title insurance business. [See Ins.C. § 12340 et seq.; 10 CCR §§ 2555-2556.2] Title companies must file their policy forms and rates with the Commissioner and must establish classifications of coverage and services to be used as the basis for determining their rates. [Ins.C. §§ 12401.1, 12401.2]

(2) [3:61] **Limited federal regulation:** Pursuant to the McCarran-Ferguson Insurance Regulation Act (15 USC App. §§ 1011-1015), insurance companies are subject to federal regulation *only* to the extent they are *not regulated by state law*. (The Act supersedes earlier authority holding broadly that federal regulations could be applied to insurance companies conducting activities across state lines (*United States v. South-Eastern Underwriters Ass'n* (1944) 322 US 533, 64 S.Ct. 1162 (superseded by statute as stated in *Barnett Bank of Marion County, N.A. v. Nelson* (1996) 517 US 25, 40, 116 S.Ct. 1103, 1112).)) [See 15 USC § 1012; *Commander Leasing Co. v. Transamerica Title Ins. Co.* (10th Cir. 1973) 477 F2d 77, 83, 89—"title insurance" companies are in the "business of insurance" within meaning of Act and thus exempt from federal antitrust law when their business is regulated by law of state where alleged violations occurred]

Because the California Insurance Commissioner regulates the title insurance business (¶ *3:60*), California title insurers are subject to very little federal regulation.

Cross-refer: For a more detailed discussion of federal regulation of the insurance industry, see Croskey, Heeseman, Ehrlich & Klee, *Cal. Prac. Guide: Insurance Litigation* (TRG), Ch. 14.

b. Certification/authority

(1) [3:62] **Title insurer:** A title insurer may not issue a policy of title insurance until it has received a certificate from the Insurance Commissioner authorizing it to transact the business of title insurance. To become certified, the company must

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comply with all of the Commissioner's regulations—including several financial requirements (many of which are ongoing). [Ins.C. §§ 12350 et seq. (capital and guarantee fund requirements), 12370 et seq. (finances and investments, including title insurance surplus fund), 12380 et seq. (unearned premium reserve and reserve for unpaid losses and loss expense)]

(2) [3:63] **Underwritten title companies:** An underwritten title company must obtain a license from the Insurance Commissioner to conduct title services. Among other things, licensing (or relicensing) requires the company to satisfy specified financial criteria. [See Ins.C. §§ 12389-12389.2]

(3) [3:63.1] **Title marketing representatives:** A "title marketing representative" is an individual employed by a title insurer, underwritten title company or controlled escrow company whose primary duty is to market, offer, solicit, negotiate or sell title insurance. A person may not be so employed in California unless the person holds a valid certificate of registration issued by the Insurance Commissioner (renewable every three years). To become certified, the person must comply with a statutorily-mandated application process. [See Ins.C. § 12418 et seq.]

c. Fees and charges

(1) [3:64] **Policy rates:** As indicated, title companies must file their schedules of rates with the Insurance Commissioner (¶ 3:60). Each schedule must set forth the entire charge for each type of policy and specify that portion of the charge based on work performed by an underwritten title company. In general, the effective date of a particular title company's rates cannot be earlier than the 30th day following the Commissioner's receipt of that company's rate schedule. [See Ins.C. § 12401.1]

Notwithstanding the above, the effective date of a title company's *new* rate may be *earlier* than the 30th day *if:* (a) the new rate is *lower* than the existing rate; (b) the earlier effective date is set forth in the company's filing of its rate schedule with the Commissioner (above); *and* (c) the new rate has been publicly displayed and made available to the public *prior* to its effective date. [Ins.C. § 12401.71; *Villanueva v. Fidelity Nat'l Title Co.* (2021) 11 C5th 104, 113, 276 CR3d 209, 215—"file and use" regulatory approach "allows entities to implement their filed rates without the need for formal prior approval"]

(a) [3:64.1] **Unfiled rates:** Consumers who are charged unfiled rates can sue their title insurers under the Unfair Competition Law (Bus. & Prof.C. § 17200 et seq.; *see* ¶ 3:400 ff.). Title insurers who charge unfiled rates do not have statutory immunity under the rate-filing statutes (see Ins.C. § 12414.26—immunity for acts done, actions taken, or agreements made pursuant to Ins.C. § 12401 et seq. or Ins.C. § 12402 et seq.). Moreover, the Insurance Commissioner does not have exclusive jurisdiction over unfiled-rate claims. [*Villanueva v. Fidelity Nat'l Title Co.* (2021) 11 C5th 104, 110-111, 116-117, 126, 133-134, 276 CR3d 209, 213, 217-218, 226, 232 (concluding administrative proceedings are not ratepayer's exclusive remedy for unfiled rate charges)]

(2) [3:65] **Prohibited commissions and rebates:** Title companies may *not* pay commissions and rebates to an owner, lessee or mortgagee of an interest in property, or to any such person's agent, representative, attorney or employee, for the referral of title insurance business. [See Ins.C. §§ 12404-12406; see also 12 USC § 2607(a) (same under Real Estate Settlement Procedures Act, *¶ 4:639*)]

Nor may title companies pay commissions for the solicitation or negotiation of title services. [Ins.C. § 12408.5]

(Consumer information concerning unlawful commissions and rebates, and how to report suspected violations, is among the subjects addressed in the statutorily-required Department of Insurance title insurance brochure (*¶ 3:50*).)

(a) [3:65.1] **Penalties:** A title company's payment of proscribed commissions or rebates (*¶ 3:65*) is punishable by monetary penalties (ranging from $5,000 to *five times* the amount of the commission or unlawful rebate) and/or restriction or suspension of its certificate of authority or license (*¶ 3:62 ff.*). [Ins.C. § 12409]

(b) [3:65.2] **"Commercial bribery" offense:** An employee of a title insurer, underwritten title company or controlled escrow company who pays a commission, compensation "or other consideration" to a real estate licensee for the placement or referral of title insurance business is guilty of "commercial bribery." The offense is punishable by imprisonment (up to one year) and/or a $10,000 fine for each such transaction. [Pen.C. § 641.4(a) & (b)]

(c) [3:65.3] **Compare—discounts related to value of services performed:** Title company pricing arrangements offering discounts for title insurance services do *not* constitute "kickbacks" in violation of the Real Estate Settlement Procedures Act (12 USC § 2601 et seq., *see* *¶ 3:65*), so long as the discounts are related reasonably to the value of services actually performed. [*Lane v. Residential Funding Corp.* (9th Cir. 2003) 323 F3d 739, 744-745]

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(3) [3:66] **Preliminary reports and other information:** Title insurers and underwritten title companies must charge a reasonable fee for a preliminary report. Subject to the limited exception noted at ¶ 3:68, a preliminary report *cannot* be furnished free of charge. [Ins.C. § 12404.1]

(a) [3:67] **Minimum charge for preliminary report:** The fee must have a "reasonable relation" to the cost of producing the report. At a minimum, it must equal the fee for a standard owner's policy having the lowest amount of liability (as set forth in the company's rate schedule). However, the preliminary report fee may be used to offset the amount of the title policy premium (indeed, this is standard practice). [Ins.C. § 12404.1]

(b) [3:68] **Limited waiver:** The fee may be waived by a title company having a uniform practice of waiving fees for all customers under the same circumstances, *provided* either:

- The policy is sought in connection with a transaction which is not consummated; or
- The title insurer cannot issue the policy without including a certain exception (lien or encumbrance) and another title insurer subsequently issues a policy without the exception. [Ins.C. § 12404.1]

(c) [3:69] **Other no-cost information:** Notwithstanding the fees they charge for preliminary reports (¶ 3:66 ff.), title insurers and underwritten title companies may provide the following information to customers without charge:

- the name of the record owner of property;
- the legal description of property;
- the status of real property taxes;
- recording information for a deed of trust; and
- photocopies of recorded deeds, plats and maps. [Ins.C. § 12404.1]

d. [3:70] **Right to refuse issuance of title policy:** Like insurers generally, title insurers have no duty to do business with or issue a policy of title insurance to any applicant. Absent legislative mandate, an insurer generally has the right to select the risks it will insure. [*Quelimane Co., Inc. v. Stewart Title Guaranty Co.* (1998) 19 C4th 26, 43, 77 CR2d 709, 718]

(1) [3:71] **Compare—conspiracy in restraint of trade:** But title insurers who *conspire* to refuse coverage for particular risks may be violating state or federal antitrust laws; *see ¶ 3:410*.

[3:72 - 3:74] ***Reserved.***

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California Practice Guide: Real Property Transactions | September 2024 Update
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Chapter 3. Title Insurance

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6. [3:162] ALTA Residential Limited Coverage Mortgage Modification Policy

1. [3:75] **Overview:** Most title insurers use policies that have been standardized through efforts of the California Land Title Association (CLTA) and the American Land Title Association (ALTA).

The most common of the CLTA and ALTA policy forms are the CLTA Standard Coverage Owner's Policy, CLTA Standard Coverage Loan Policy, ALTA Owner's Policy and ALTA Loan Policy. These standard policies have the following four components:

— Title Page (which lists the Covered Risks);

— Exclusions From Coverage;

— Schedule A, which identifies the amount of insurance, the insured and the property covered by the policy; and

— Schedule B, which lists Exceptions From Coverage and Conditions and defines the policy's terms and claims procedures.

a. Scope of common CLTA/ALTA coverage

(1) [3:76] **CLTA Standard Coverage Policies:** The CLTA Standard Coverage Owner's Policy (hereafter “CLTA Owner's Policy”) insures the purchaser of property. The CLTA Standard Coverage Loan Policy (hereafter “CLTA Loan Policy”) insures the lender facilitating the purchase of property. *See* ¶ 3:92 ff.

• ***FORM:*** CLTA Owner's Policy, *see* Form 3:B.1; CLTA Loan Policy, *see* *Form 3:B.2*.

(2) [3:77] **ALTA Loan Policy:** The ALTA Loan Policy is customarily used by lenders to insure title where no purchase is involved. This policy protects only the *lender's* property interests (*¶ 3:130 ff.*). [*Siegel v. Fidelity Nat'l Title Ins. Co* (1996) 46 CA4th 1181, 1186, 54 CR2d 84, 85, fn. 2]

• ***FORM:*** ALTA Loan Policy, *see* *Form 3:C*.

(3) [3:78] **ALTA Owner's Policy:** Separate ALTA coverage is available for a property owner by way of the ALTA Owner's Policy (*¶ 3:130 ff.*).

• ***FORM:*** ALTA Owner's Policy, *see* *Form 3:D*.

(4) [3:79] **CLTA/ALTA Homeowner's Policy:** An expanded CLTA/ALTA title insurance policy is available for owner-occupied, one-to-four family residences or condominium units. The CLTA/ALTA Homeowner's Policy offers coverage for certain matters that have not been covered under standard title policies, including certain matters *outside the public records* and various *postpolicy* occurrences (*¶ 3:150 ff.*).

• ***FORM:*** CLTA/ALTA Homeowner's Policy, *see* *Form 3:E*.

(5) [3:80] **ALTA Expanded Coverage Residential Loan Policy—Assessments Priority:** An expanded ALTA lender's policy is available for loans secured by residential properties, insuring the lender for losses similar (though not identical) to those covered by the CLTA/ALTA Homeowner's Policy (*¶ 3:160 ff.*).

• ***FORM:*** ALTA Expanded Coverage Residential Loan Policy—Assessments Priority, *see* *Form 3:F*.

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(6) [3:80.1] **ALTA Residential Limited Coverage Mortgage Modification Policy:** An ALTA mortgage modification policy is available for loans secured by residential properties, protecting the lender from loss or damage occasioned by modification of the mortgage (*¶ 3:162*).

• ***FORM:*** ALTA Residential Limited Coverage Mortgage Modification Policy, *see Form 3:G.*

b. [3:81] **Basic differences between CLTA and ALTA coverage:** The fundamental difference between CLTA and ALTA coverage is that CLTA coverage basically insures only the title as shown by the *"public records."* Most off-record matters affecting title are excluded from coverage since the insured ordinarily can inspect the premises to discover these defects. (However, a CLTA policy also covers a few matters not of record, such as forgery and lack of delivery.) [See *Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1186, 54 CR2d 84, 85, fn. 2; *Elysian Invest. Group, LLC v. Stewart Title Guaranty Co.* (2002) 105 CA4th 315, 317-318, 129 CR2d 372, 374, fn. 1]

The ALTA policies, on the other hand, are "extra coverage, extra premium" policies that insure against losses from many risks excluded by the CLTA policies. The insurer undertakes these extra risks by assuming the insured's responsibility to inspect the property and, in some cases, to review a survey. [See *Siegel v. Fidelity Nat'l Title Ins. Co.*, supra, 46 CA4th at 1186, 54 CR2d at 85, fn. 2; *Elysian Invest. Group, LLC v. Stewart Title Guaranty Co.*, supra, 105 CA4th at 317-318, 129 CR2d at 374, fn. 1—ALTA insures against off-record defects, including rights of parties not in possession, boundary line discrepancies/conflicts and area shortages]

(1) [3:82] **Application:** Thus, a CLTA policy reflects and primarily insures matters of record. If the title company erroneously missed a recorded lien or encumbrance (or if it has elected not to report a particular recorded lien or encumbrance), the policy insures against any loss by reason of that unreported lien or encumbrance of record.

In contrast, when issuing an ALTA policy, the title insurer goes beyond the public record and fundamentally insures that there are no "off-record" matters that would adversely affect the insured's interest. For example, ALTA coverage would insure against encroachments, unrecorded rights of way, prescriptive rights, and unrecorded leases; and would also insure the boundaries of the property based on a current survey. (However, an ALTA coverage policy will occasionally be issued with a "survey exception.")

(2) [3:83] **Comment:** With the distinctions described at ¶ 3:81 ff. in mind, CLTA coverage may be viewed as designed for owners who actually *inspect* the property (and thus are able to visually determine whether there are any off-record matters with which they need be concerned). ALTA coverage, on the other hand, may be viewed as designed for lenders (or owners) who elect *not* to inspect the property (and thus would necessarily need broader coverage).

c. [3:84] **Purchasing ALTA Owner coverage:** As noted, there are separate ALTA policies for lenders and owners (*¶ 3:77 ff.*). In many transactions involving the sale of fully-completed structures (and, particularly, single family residential properties), Californians elect not to purchase ALTA coverage (the ALTA Owner's Policy).

(1) [3:85] **Factors militating against ALTA coverage:** Essentially, there are two practical reasons why owners opt not to purchase ALTA coverage:

• **Cost:** ALTA coverage is more expensive (and usually requires a survey, which also increases the cost).

• **Delay:** The required survey may take several weeks, interfering with the parties' desired closing date.

[3:86 - 3:87] ***Reserved.***

➪ [3:88] ***PRACTICE POINTER:*** In evaluating whether an owner should purchase ALTA coverage (instead of the CLTA Standard Coverage Owner's Policy), apply common sense. Make an inspection of the property, and then ask yourself whether it appears anyone may have an off-record claim to use, possess or enjoy the premises. If so, obtaining ALTA coverage may be the wisest course of action.

ALTA coverage also may be necessary if it looks like a driveway on the subject premises is being used by neighboring landowners, if structures appear to be encroaching upon the property to be purchased or, conversely, if structures on the subject property may be encroaching upon neighboring property. Moreover, when boundary lines appear to be unclear, a survey with ALTA coverage is advisable.

d. [3:89] **Coverage for environmental remediation and protection of the land:** The CLTA and ALTA policies provide limited coverage for environmental remediation or protection of the land (*see* ¶ 3:107, 3:115 & 3:133 re "Covered Risk" No. 5).

(1) [3:90] **Coverage by ALTA endorsement:** In addition to the coverage provided under the CLTA and ALTA policies (¶ 3:89), an *Environmental Protection Lien Endorsement*, insuring against recorded violations of environmental statutes, may be purchased (*see ¶ 3:262*).

Cross-refer: Environmental clean-up liability is discussed in detail in *Ch. 5*.

➪ [3:91] ***PRACTICE POINTER:*** In choosing a title insurance policy appropriate for your transaction, consider whether idiosyncrasies about the particular property may require additional or unique coverage beyond that available under the standard policies. Be sure to keep in mind that expanded coverage may be obtained by purchasing endorsements (*¶ 3:245 ff.*). And, whenever there is concern about the most suitable type of coverage, it is wise to consult with an "advisory title officer" or in-house attorney at the title company.

2. CLTA Policies

• ***FORMS:*** CLTA Owner's Policy and CLTA Loan Policy; *see Forms 3:B.1 and 3:B.2.*

a. [3:92] **Owner's policy:** Subject to specified Exclusions, Exceptions and Conditions, the CLTA Owner's Policy insures an *owner* against loss or damage arising from the following matters:

(1) [3:93] **Incorrect vesting:** An insured owner is protected against loss resulting from title to the property not being vested in the name of the person stated in the policy.

(2) [3:94] **Defects, liens and encumbrances, subject to specified "exceptions":** An insured is protected against loss occasioned by defects, liens or encumbrances affecting title; but that coverage is significantly *modified* by the "*exceptions*" listed in the policy.

The policy gives examples of defects, liens and encumbrances. "Encumbrances" also are defined by statute to include taxes, assessments and all liens on real property (Civ.C. § 1114). And a "lien" is defined by statute as "a charge imposed upon specific property, by which it is made security for the performance of an act" (CCP § 1180). [See *Elysian Invest. Group, LLC v. Stewart Title Guaranty Co.* (2002) 105 CA4th 315, 320-321, 129 CR2d 372, 376 (noting "encumbrance" also has been defined as "any right to, or interest in, land which may subsist in another to the diminution of its value, but consistent with the passing of the fee" (internal quotes omitted)); *Stockton Mortg., Inc. v. Tope* (2014) 233 CA4th 437, 449, 183 CR3d 186, 195 (citing *Elysian* with approval)—notice of abatement action referencing property's substandard condition did not affect title and therefore did not constitute defect, lien or encumbrance]

(3) [3:95] **Unmarketable title:** The CLTA Policy insures against loss due to "unmarketable title." Unmarketable title is defined in the policy as any "alleged or apparent matter that would permit a prospective purchaser or lessee of the Title or a lender on the Title to be released from the obligation to purchase, lease or lend if there is a contractual condition requiring the delivery of marketable title." (CLTA owner's Policy, Conditions, 1. Definition of Terms, item "p.")

(a) [3:96] **Impact on market value distinguished:** Unmarketability of title does *not* refer to physical conditions that only decrease the *value* of property. Marketability of *title* and the market value of the property itself are *separate and distinct*. [*Mellinger v. Ticor Title Ins. Co. of Calif.* (2001) 93 CA4th 691, 696, 113 CR2d 357, 361 (ALTA Residential Policy); see *Elysian Invest. Group, LLC v. Stewart Title Guaranty Co.* (2002) 105 CA4th 315, 324, 129 CR2d 372, 379 (CLTA policy)]

A loss occasioned by "unmarketability of title" is insured only if the defect affects legally recognized rights and incidents of ownership. "One can hold perfect title to land that is valueless; one can have marketable title to land while the land itself is unmarketable." [*Hocking v. Title Ins. & Trust Co.* (1951) 37 C2d 644, 651, 234 P2d 625, 629; *Elysian Invest. Group, LLC v. Stewart Title Guaranty Co.*, supra, 105 CA4th at 324, 129 CR2d at 379; see also *Dollinger DeAnza Assocs. v. Chicago Title Ins. Co.* (2011) 199 CA4th 1132, 1149, 131 CR3d 596, 608—"good title" means owner has legal and equitable title to all land]

• [3:97] Title is not rendered "unmarketable" by an inability to use real property for contemplated building purposes due to a subdivider's *local ordinance violations*. [*Hocking v. Title Ins. & Trust Co.* (1951) 37 C2d 644, 651-652,

234 P2d 625, 629-630; *Elysian Invest. Group, LLC v. Stewart Title Guaranty Co.* (2002) 105 CA4th 315, 324, 129 CR2d 372, 379 (inability to use as second dwelling unit garage that had been converted without permits); see also *Stockton Mortg., Inc. v. Tope* (2014) 233 CA4th 437, 448, 183 CR3d 186, 195—notice of abatement action referencing property's substandard condition did not render title "unmarketable"]

• [3:98] *Hazardous materials* affecting market value are not a defect rendering title unmarketable. [*Lick Mill Creek Apts. v. Chicago Title Ins. Co.* (1991) 231 CA3d 1654, 1660-1662, 283 CR 231, 234-236—environmental clean-up costs not covered by CLTA policy]

• [3:99] An *encroachment* can represent both a physical condition (affecting only market value) and a possible *adverse interest* in the property (affecting marketable title). Whether an encroachment renders title unmarketable turns on "whether a reasonable purchaser, knowing that a third party might claim an interest in the property, would nevertheless proceed with the transaction." [*Mellinger v. Ticor Title Ins. Co. of Calif.* (2001) 93 CA4th 691, 695-696, 113 CR2d 357, 361—whether 20-foot street encroachment rendered title unmarketable was jury question (*see* ¶ *3:102*)]

• [3:100] The existence of *fraud* in the chain of title is not a title defect rendering title unmarketable. [*Mortgage Assocs., Inc. v. Fidelity & Dep. Co. of Maryland* (2002) 105 CA4th 28, 37, 129 CR2d 365, 371—insured's losses incurred upon sale of overvalued properties resulted from fraudulent loan scheme rather than title defect]

• [3:101] Title is not rendered unmarketable simply because an insurer fails to include in its title report a notice of merger duly recorded by a city pursuant to the Subdivision Map Act against contiguous land parcels owned by the insured. Although the notice may restrict the insured's ability to *sell* a portion of the merged land absent compliance with applicable regulations, it does not cast doubt on *ownership* of the land. [*Dollinger DeAnza Assocs. v. Chicago Title Ins. Co.* (2011) 199 CA4th 1132, 1152, 131 CR3d 596, 610]

(b) [3:102] **Question of fact vs. question of law:** Marketability of title may properly be decided as a matter of law where the uncertainty is too trivial to put the insured's title in reasonable doubt or to expose the insured to any more than nominal damages (see *Mertens v. Berendsen* (1931) 213 C 111, 115-116, 1 P2d 440, 441-442—2-to-7/8-inch encroachment) or, conversely, where the uncertainty is so substantial (such as a competing claim to ownership of the entire parcel) that it is unnecessary to submit the question to the trier of fact. [See *Mellinger v. Ticor Title Ins. Co. of Calif.* (2001) 93 CA4th 691, 695-697, 113 CR2d 357, 360-362—20-foot street encroachment "arguably could have dissuaded someone from purchasing the property" and thus was question of fact for jury]

(4) [3:103] **Lack of right of access:** Also insured by the CLTA Policy are losses arising from the lack of a *right* of access to and from the property. This does not mean a lack of "physical or practical access" but, rather, the absence of a *legal right* to access the property in some way, no matter how impractical, difficult or expensive. [*Magna Enterprises, Inc. v. Fidelity Nat'l Title Ins. Co.* (2002) 104 CA4th 122, 125-127, 127 CR2d 681, 683-685]

"A right of access can be different from practical or physical access. If the insured property is landlocked, it has no right of access. If the insured property is contiguous to a public road but so steeply sloped as to make physical access impractical or extremely expensive, it still has a right of access." [*Magna Enterprises, Inc. v. Fidelity Nat'l Title Ins. Co.*, supra, 104 CA4th at 126-127, 127 CR2d at 684 (internal quotes omitted)]

• [3:104] Access coverage was not triggered where the location of a building and fence and differences in elevation between the insured's abutting parcels rendered physical access to one of the parcels difficult or impractical. The insured's ownership of the abutting parcel nonetheless gave it a *right* of access. [*Magna Enterprises, Inc. v. Fidelity Nat'l Title Ins. Co.* (2002) 104 CA4th 122, 127-128, 127 CR2d 681, 685]

• [3:105] Access coverage for two contiguous lots comprising a single buildable site was not triggered because the allegedly "landlocked" lot 2 had access by traversing lot 1. [*Havstad v. Fidelity Nat'l Title Ins. Co.* (1997) 58 CA4th 654, 661, 68 CR2d 487, 491 (dictum)]

• [3:106] *Access thwarted by governmental permit process?* It is unsettled whether access coverage would be triggered (whether the insured would lack a "right of access") if a governmental entity has lawfully prohibited or failed to grant the insured access to its property from other property it owns. [See *Magna Enterprises, Inc. v. Fidelity Nat'l Title Ins. Co.* (2002) 104 CA4th 122, 128, 127 CR2d 681, 685, fn. 1 (noting but not deciding issue because no evidence that City could or would prohibit access from insured's abutting parcel if it were insured's only access)]

(5) [3:107] **Violations or enforcement of laws, ordinances, permits or governmental regulations:** The CLTA owner's policy also insures against violations or enforcement of laws, ordinances, permits, or governmental regulations (including

those relating to building and zoning), but only to the extent the violation or enforcement described in an official Enforcement Notice identifies a restriction, regulation or prohibition relating to (i) the occupancy, use, or enjoyment of the land; (ii) the character, dimensions or location of an improvement on the land; (iii) the subdivision of the land; or (iv) environmental remediation or protection of the land.

(6) [3:107.1] **Enforcement of governmental forfeiture, police, regulatory, or national security power:** Similarly, the CLTA owner's policy insures against the enforcement of a governmental forfeiture, police, regulatory, or national security power, but only to the extent of the enforcement described in an official Enforcement Notice.

(7) [3:107.2] **Exercise of eminent domain power:** The CLTA owner's policy also insures against an exercise of the eminent domain power, but only to the extent the exercise is described in an Enforcement Notice or the taking occurred and is binding on a purchaser for value without knowledge (BFP).

(8) [3:107.3] **Enforcement of PACA-PSA Trust:** The enforcement of a PACA-PSA Trust is insured against, but only to the extent the enforcement is described in an Enforcement Notice.

(9) [3:107.4] **Fraudulent conveyances and fraudulent, preferential or voidable transfers:** The CLTA owner's policy also insures against title being vested other than as stated in the policy, or being defective, or because a court order has provided an alternative remedy, due to the avoidance of a prior transfer of title that constituted a fraudulent conveyance, fraudulent transfer, preferential transfer, or voidable transfer, as defined. Likewise, the policy insures against any such issue where the instrument vesting title constitutes a preferential transfer due to the failure to timely record same in the Public Records after its execution and delivery to the insured, or because recordation of the instrument in the Public Records failed to impart notice of its existence to a BFP.

(10) [3:107.5] **Defects, liens or encumbrances included in "Covered Risks 1 through 9":** Finally, the CLTA owner's policy insures against any defects, liens or encumbrances included in "Covered Risks 1 through 9" (¶ 3:93 ff.) that were created, attached, filed or recorded in the public records subsequent to the policy's date and prior to the recordation of the deed or other instrument vesting title in the public records.

[3:108 - 3:114] ***Reserved.***

b. [3:115] **Lender's Policy:** Subject to specified Exclusions, Exceptions and Conditions, the CLTA Loan Policy insures a *lender* against loss or damage arising from the same matters insured in favor of an owner (i.e., matters 1 through 8, see ¶ 3:93 ff.) … *plus* the following:

(1) [3:116] **Invalidity or unenforceability of insured's lien:** The CLTA Loan Policy insures a lender against loss due to the invalidity or unenforceability of the lien of the insured's deed of trust upon title to the property. (However, this does *not* mean the policy insures enforceability of any *particular provision* in the deed of trust.)

Examples of the covered risks include, but are not limited to, insurance against loss caused by:

— forgery, undue influence, duress, incompetency, incapacity or impersonation;

— failure of a person or entity to have authorized a transfer or conveyance;

— insured's deed of trust not being properly authorized, created, executed, witnessed, sealed, acknowledged, notarized or delivered;

— failure to perform those acts necessary to create an insured's deed of trust by lawful electronic means;

— a document having been executed under a falsified, expired, or otherwise invalid power of attorney;

— insured's deed of trust not having been properly filed, recorded, or indexed in the public records, including by electronic means;

— a defective judicial or administrative proceeding; or

— the invalidity or unenforceability of the insured's deed of trust due to repudiation of an electronic signature by a person that executed the deed of trust because said signatured was invalid under applicable electronic transactions law.

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(2) [3:116.1] **Lack of priority:** The CLTA Loan Policy insures a lender against loss due to the lien of the insured's deed of trust lacking priority as security for certain components of the indebtedness (e.g., principal amount disbursed, interest, reasonable foreclosure expenses, etc.) over any other lien or encumbrance on title.

In addition the policy insures the lender against loss due to the lien of the insured's deed of trust lacking priority as security for each advance of secured loan proceeds over (i) any statutory lien for service, labor, material, or equipment, as defined, and (ii) any assessment liens for street improvements under construction or completed at the policy's date.

(3) [3:117] **Invalidity or unenforceability of assignment of lien:** The CLTA Loan Policy also protects a lender against loss occasioned by the invalidity or unenforceability of any *assignment* of the insured's lien shown on the policy, or the failure of the assignment shown on the policy to vest title to the insured's lien in the named assignee free and clear of all liens.

(4) [3:118] **Fraudulent conveyances and fraudulent, preferential or voidable transfers:** The CLTA loan policy insures a lender against loss due to the invalidity, unenforceability, lack of priority, or avoidance of the lien of the insured's deed of trust, or the effect of a court order providing an alternative remedy, based on the avoidance of a prior transfer of title that constituted a fraudulent conveyance, fraudulent transfer, preferential transfer, or voidable transfer, as defined.

Likewise, the policy insures against any such issue where the lien of the insured's deed of trust constitutes a preferential transfer due to the failure to timely record same in the public records after its execution and delivery to the insured, or because recordation of the deed of trust in the public records failed to impart notice of its existence to a BFP.

(5) [3:119] **Defects, liens or encumbrances included in covered risks:** Finally, the CLTA loan policy insures against any defects, liens or encumbrances included in the above covered risks (¶ 3:115 ff.) that were created, attached, filed or recorded in the public records subsequent to the policy's date and prior to recordation of the insured's deed of trust in the public records.

[3:120 - 3:129] ***Reserved.***

3. ALTA Policies (ALTA Loan Policy and ALTA Owner's Policy)

FORMS

- ALTA Loan Policy, *see Form 3:C.*
- ALTA Owner's Policy, *see Form 3:D*.

a. [3:130] **Distinction between lender's and owner's coverage:** Like the CLTA loan and owner's policies (¶ 3:76), the distinction between the ALTA Loan Policy and the ALTA Owner's Policy is that the former deals with the priority of the lender's trust deed, whereas the latter deals with the owner's title. The two coverages are similar, though not identical (e.g., the ALTA Loan Policy covers risks, exclusions and conditions specifically related to the lender's insured lien, and includes a section for listing matters affecting the property that the insurer covers subject to the terms and conditions of any subordination provision in the matters).

b. [3:131] **Applicability of ALTA Loan Policy to purchase and sale transactions:** Because almost every purchase and sale transaction involves some type of financing, the lender invariably requires title insurance protecting the priority of the lien of its deed of trust. The specific terms and conditions of a lender's policy are of little concern to the seller strictly in its capacity as seller; but the lender's policy becomes of great importance to sellers (and their counsel) in a seller-financed transaction.

An expanded ALTA loan policy insuring the lender for losses similar (though not identical) to those covered by the CLTA/ALTA Homeowner's Policy is also available. *See ¶ 3:160.*

c. [3:132] **Scope of coverage:** The general nature of ALTA policy coverage is specified in the title pages. As stated therein, the policies protect against loss due to several enumerated factors, subject to specified Exclusions, Exceptions and Conditions. And the insurer pays the costs, attorney fees and expenses incurred in defense of any matters insured against by the policies, but only to the extent provided in the Conditions.

d. [3:133] **Matters insured:** The ALTA Owner's Policy insures against the same risks as the CLTA Owner's Policy (*see* ¶ 3:93 ff.*,* Risks 1 through 10).

The ALTA Loan Policy insures against the same risks as the CLTA Loan Policy (see ¶ 3:115 ff., Risks 1 through 14).

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[3:134 - 3:149] ***Reserved.***

4. [3:150] **CLTA/ALTA Homeowner's Policy:** The CLTA/ALTA Homeowner's Policy offers broader coverage for *owner-occupied* one-to-four family residences or condominium units. The policy is *not* available, however, for commercial properties or where the insured is not a “Natural Person” or “Estate Planning Entity.”

FORM: CLTA/ALTA Homeowner's Policy, *see Form 3:E.*

a. [3:151] **Matters insured:** Subject to deductibles and limitations, the CLTA/ALTA Homeowner's Policy insures against 33 “covered risks,” including loss or damage arising from several of the risks covered in the CLTA and ALTA Policies (e.g., incorrect vesting, defects, liens or encumbrances of title, lack of access rights, violations or enforcement of laws, ordinances, permits or governmental regulations, as specified, etc.; ¶ 3:93 ff.).

[3:152 - 3:159] ***Reserved.***

5. [3:160] **ALTA Expanded Coverage Residential Loan Policy—Assessments Priority:** An expanded ALTA lender's policy is available for loans secured by residential properties. The “ALTA Expanded Coverage Residential Loan Policy—Assessments Priority” insures the lender for losses similar (though not identical) to those covered by the CLTA/ALTA Homeowner's Policy (*¶ 3:151*).

FORM: ALTA Expanded Coverage Residential Loan Policy—Assessments Priority, *see Form 3:F.*

a. [3:161] **“Short form” also available:** An ALTA “Short Form Expanded Coverage Residential Loan Policy—Assessments Priority” also is available. Except as otherwise provided in its Schedule “B” and any addendums attached thereto, the short form incorporates by reference all of the long form policy's terms, exclusions and conditions but, unlike the long form, describes the property only by a street address (rather than a legal description) and contains only a minimal identification of the parties, dates and amount of insurance and mortgage.

6. [3:162] **ALTA Residential Limited Coverage Mortgage Modification Policy:** An ALTA mortgage modification policy is available for loans secured by one-to-four family residences or condominiums. Subject to specified exclusions, the “ALTA Residential Limited Coverage Mortgage Modification Policy” protects the lender from loss or damage caused by the invalidity or unenforceability of the mortgage lien on title due to the mortgage's modification and by the mortgage lien's lack of priority over defects in or liens or encumbrances on title due to such modification.

• ***FORM:*** ALTA Residential Limited Coverage Mortgage Modification Policy, *see Form 3:G.*

[3:163 - 3:199] ***Reserved.***

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California Practice Guide: Real Property Transactions | September 2024 Update
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Chapter 3. Title Insurance

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1. In General

a. [3:200] **Statutory definition:** A "preliminary report" is statutorily defined as "reports furnished in connection with an application for title insurance" and an offer "to issue a title policy subject to the stated exceptions set forth in the reports and such other matters as may be incorporated by reference therein." [Ins.C. § 12340.11; *Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1190, 54 CR2d 84, 88]

• ***FORM:*** Preliminary Report, *see Form 3:A*.

(1) [3:201] ***Offer to issue title policy—no liability thereon:*** A preliminary report is *neither* an "abstract of title" *nor* a representation as to the condition of title to property. Rather, it is simply an *offer to issue a title policy* (upon stated terms and conditions), which the prospective insured may or may not accept; hence, a preliminary report does *not* subject the title company to any liability (¶ 3:32). [Ins.C. §§ 12340.10 & 12340.11; *2,022 Ranch, L.L.C. v. Sup.Ct. (Chicago Title Ins. Co.)* (2003) 113 CA4th 1377, 1382, 7 CR3d 197, 201, fn. 2 (citing text) (disapproved on other grounds by *Costco Wholesale Corp. v. Sup.Ct.* (2009) 47 C4th 725, 739, 101 CR3d 758, 769); see also *Stockton Mortg., Inc. v. Tope* (2014) 233 CA4th 437, 452-453, 183 CR3d 186, 199-200—notice of abatement action referenced in preliminary report did not subject title company to liability; *Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.* (2009) 171 CA4th 1356, 1389, 124 CR3d 271, 301—reference to deed restrictions in preliminary reports did not constitute representation as to properties' condition; *Marriage of Cloney* (2001) 91 CA4th 429, 438-439, 110 CR2d 615, 622, fn. 8—title insurer is simply selling product]

(a) [3:201.1] **Compare—conditions of title guarantee:** A conditions of title guarantee provides customers with a product that is similar to a preliminary report except it does not contemplate issuance of a title insurance policy. Guarantees generally are discussed at *¶ 3:36 ff.*

b. [3:202] **Purpose:** A preliminary report is used internally by a title company to evaluate the risks it is willing to assume under a title policy; and, as an "offer" to issue a title policy, it is also given to a prospective insured to facilitate issuance of the policy. The report shows the conditions under which an insurer is willing to insure title (Ins.C. § 12340.11). Accordingly, it lists the title company's standard exclusions, exceptions, and conditions and stipulations to coverage, as well as specific coverage exceptions for those items affecting title to the subject property. [*Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1192, 54 CR2d 84, 89; *Rosen v. Nations Title Ins. Co.* (1997) 56 CA4th 1489, 1499-1500, 66 CR2d 714, 720]

A preliminary report enables prospective buyers to assess the nature and extent of the risks presented in connection with owning an interest in a piece of property; by the same token, the report is not a "guarantee" against other risks not listed on the report. Therefore, the preliminary report provides an initial "laundry list" of title exceptions. In many instances, sellers, buyers and their counsel can work with the title company to clean up and eliminate certain matters which might otherwise be excluded from policy coverage.

c. [3:203] **Not a substitute for title insurance:** Counsel are often asked by their clients why title insurance should be purchased when a preliminary report offers them the benefit of the title company's work regarding the state of title. There is *rarely* a situation when any party should rely solely on a preliminary report (in lieu of a title insurance policy) in consummating a purchase and sale transaction; the reasons are threefold:

(1) [3:204] ***Not insurance coverage:*** Again, a preliminary report provides *no* insurance coverage (*¶ 3:201*).

(2) [3:205] ***Not conclusive of condition of title:*** The report is not conclusive on the legal state of title; nor does it embody the title company's representations regarding the condition of title. It simply contains the title company's conclusions as to the state of title. A title officer may easily have missed a recorded lien or encumbrance or other title defect. Thus, any given preliminary report could be erroneous; i.e., there may be objectionable title exceptions *even though not indicated on a preliminary report*. By statute (Ins.C. §§ 12340.10, 12340.11), insureds may *not rely* on a preliminary report to show the condition of title. [*Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1192-1193, 54 CR2d 84, 89-90; *Southland Title Corp. v. Sup.Ct. (Nye)* (1991) 231 CA3d 530, 537-538, 282 CR 425, 429; *Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.* (2009) 171 CA4th 1356, 1389, 124 CR3d 271, 301]

> "[A] party who fails to obtain title insurance and instead relies on a preliminary report … showing no encumbrances *does so at his own peril* and cannot thereafter maintain an action against the insurer when an undisclosed lien comes to light." [*Siegel v. Fidelity Nat'l Title Ins. Co.,* supra, 46 CA4th at 1185, 54 CR2d at 85 (emphasis added); see also *Lee v. Fidelity Nat'l Title Ins. Co.* (2010) 188 CA4th 583, 596, 115 CR3d 748, 758—insurers cannot be held liable for negligence in connection with preliminary reports since reports themselves are merely inducements to purchase title policies; *Soifer v. Chicago Title Co.* (2010) 187 CA4th 365, 367-368, 114 CR3d 1, 2—real estate investor could not recover for errors in title company's statement regarding condition of title absent title insurance policy or purchase of "abstract of title"]

(3) [3:206] **Vesting issues:** A preliminary report does not necessarily deal with the steps and documents required to properly and lawfully vest title in the buyer's name.

d. [3:207] **Contents:** A preliminary report contains the date of issuance of the report, the type of policy desired, the interest to be insured, the vesting of the property, the legal description of the property, the specific matters affecting the property which the insurer is not willing to insure, the standard preprinted exclusions and exceptions to coverage, and the title insurer's requirements for issuance of the policy. (*See Form 3:A*.)

e. [3:208] **Supplements or amendments:** Because a preliminary report is not binding on the insurer (*¶ 3:201*), it may be modified—by supplements and/or amendments—at any time prior to issuance of the policy. Often, modifications of proposed coverage are made in response to a customer's request to eliminate a matter excepted from coverage, or in response to the title company's discovery of a new matter affecting title prior to issuance of the policy. For its own protection, a title company usually updates its initial search immediately before issuing the policy and modifies its offer of title insurance accordingly.

[3:208.1 - 3:208.4] ***Reserved.***

f. [3:208.5] **Contract created upon insured's acceptance:** The preliminary report stands only as an offer to issue a title policy on the specified terms and conditions up *to the point it is accepted* by the insured. Upon the insured's approval and acceptance of the terms and conditions set forth in the preliminary report, a *binding contract* is created between the insured and title insurer based on those stated terms and conditions *and* any materials incorporated in the preliminary report by reference (*see ¶ 3:19.3*). [*Wolschlager v. Fidelity Nat'l Title Ins. Co.* (2003) 111 CA4th 784, 789-790, 4 CR3d 179, 183-184; *Kleveland v. Chicago Title Ins. Co.* (2006) 141 CA4th 761, 764, 46 CR3d 314, 316]

➪ [3:208.6] ***PRACTICE POINTER:*** Materials "incorporated by reference" could be a trap for the unwary. Because a typical preliminary title report incorporates by reference the *terms of the title policy* to be issued based on the report, it is *crucial* that the *policy* be reviewed carefully *before* accepting the report. Otherwise, your clients may find that they have inadvertently given up certain rights against the title insurer. [See *Wolschlager v. Fidelity Nat'l Title Ins. Co.* (2003) 111 CA4th 784, 790, 4 CR3d 179, 183-184]

g. [3:209] **Counsel's role:** Buyer's counsel is typically asked to review the preliminary report and determine whether the seller can convey title acceptable to the buyer. However, it behooves seller's counsel to review the report as well to determine what steps must be taken and what documents must be prepared to vest title in the buyer. For these reasons, it is advisable to order the preliminary report as early as possible in the transaction, allowing sufficient time within which to arrange for necessary documentation.

➪ [3:210] ***PRACTICE POINTERS:*** Counsel should review a preliminary report with the following points in mind:

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- **Not conclusive of title exceptions:** *A preliminary report only briefly identifies and describes the title exceptions*. The title exception descriptions in the report are written by a title officer and can be misleading, incomplete or incorrect. Thus, the *only way* to properly review exceptions to title is to *examine the recorded documents* described in the preliminary report.

- **Plotting easements, etc.:** A preliminary report (and the recorded documents) often provides only a "metes and bounds" description of easements and rights of way, which is difficult (and sometimes impossible) for counsel to locate on a map. Thus, it may be beneficial to have the title company "plot" any easements or rights of way on an attached drawing of the subject property; in this way, lawyer and client can quickly and easily determine whether easements might impact the buyer's intended use of the property.

- **Utility liens:** By statute, a public utility may create a lien for unpaid utility charges (on separately metered residential property) by recording a certificate of delinquency in the county where the subject property is located (see Pub.Util.C. §§ 10009.6, 10016, 12811.1). However, the lien does not arise until recordation of the certificate. [Pub.Util.C. § 12811.1]

2. Other Documents Compared

a. [3:211] **Abstracts of title:** An "abstract of title" is a written representation intended to be relied upon by the person contracting for it, listing all recorded documents that impart constructive notice with respect to title to a particular piece of property. [Ins.C. § 12340.10; *Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1190, 54 CR2d 84, 88; *Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.* (2009) 171 CA4th 1356, 1389, 124 CR3d 271, 301; see also *Soifer v. Chicago Title Co.* (2010) 187 CA4th 365, 372, 114 CR3d 1, 6—person who contracts and separately pays for "abstract of title" receives all rights associated therewith and may rely upon express representations contained therein]

A preliminary report, in contrast, is only a representation as to the *conditions under which* an insurer will *issue a title policy* (an *offer* to insure on specified terms); it is not a representation as to all recorded documents affecting the property, and does not create any of the duties or responsibilities associated with the preparation and issuance of an abstract of title. [Ins.C. §§ 12340.10, 12340.11; *Siegel v. Fidelity Nat'l Title Ins. Co.,* supra, 46 CA4th at 1190, 1193, 54 CR2d at 88, 90; *Southland Title Corp. v. Sup.Ct. (Nye)* (1991) 231 CA3d 530, 537, 282 CR 425, 429; *Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.*, supra, 171 CA4th at 1389, 124 CR3d at 301]

(As earlier noted, abstracts of title are rarely used in California; ¶ *3:33*.)

(1) [3:212] **Statutory distinction:** Although preliminary reports were always intended to be distinguished from abstracts of title, preparers of preliminary reports were at one time subject to an abstractor's liability. [*White v. Western Title Ins. Co.* (1985) 40 C3d 870, 883-884, 221 CR 509, 515-516; and see *Hawkins v. Oakland Title Ins. & Guaranty Co.* (1958) 165 CA2d 116, 124-127, 331 P2d 742, 746-748—setting forth prerequisites to title report preparer's negligence liability]

Responding to this confusion, the California Legislature enacted Ins.C. §§ 12340.10 and 12340.11, providing distinct statutory definitions of the two documents. (In fact, the name "preliminary report" was changed from "preliminary title report" to further distinguish the two … although preliminary reports are still commonly referred to as "preliminary title reports.") [See *Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1191, 54 CR2d 84, 89; *Southland Title Corp. v. Sup.Ct. (Nye)* (1991) 231 CA3d 530, 535-536, 282 CR 425, 428, fn. 4; see also *Soifer v. Chicago Title Co.* (2010) 187 CA4th 365, 370-371, 114 CR3d 1, 4-5 (explaining relevant statutory provisions)]

(a) [3:213] **Compare—abstractor duties pursuant to contract:** Although they owe no statutory abstractor's duty, title insurers may *contractually agree* to be bound by an abstractor's duties and responsibilities (i.e., to undertake a thorough search of the records and disclose all impediments to title). In that case, the title insurer's written report is an abstract of title pursuant to contract, and the insurer is exposed to professional negligence liability if the report is negligently prepared (*see* ¶ *3:214*). [*Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1194, 54 CR2d 84, 91]

However, *no contract* to provide abstractor services is created simply from a title insurer's agreement to prepare a preliminary report and furnish an ALTA or CLTA policy. Nor can such an agreement arise from mere custom and practice (to hold otherwise would render Ins.C. §§ 12340.10 and 12340.11 "meaningless" and "lead to the improper reliance on the insurer's preliminary report the legislature intended to foreclose"). [See *Siegel v. Fidelity Nat'l Title Ins. Co.*, supra, 46 CA4th at 1195, 54 CR2d at 91-92]

(2) [3:214] **Abstractor's liability:** An abstractor has a duty to search the public records and report all defects, liens and encumbrances discoverable by the exercise of reasonable diligence. [*White v. Western Title Ins. Co.* (1985) 40 C3d 870, 883, 221 CR 509, 515]

An abstractor may be held liable in contract or tort for failing to diligently search the public records and list on the abstract *all* matters imparting constructive notice. In its capacity as an abstractor, a title company's tort liability may exceed the title policy limits. [*Stagen v. Stewart-West Coast Title Co.* (1983) 149 CA3d 114, 118, 196 CR 732, 734; see also *Barthels v. Santa Barbara Title Co.* (1994) 28 CA4th 674, 678, 33 CR2d 579, 581—Civ.C. § 3333 measure of damages applies to abstractor's negligence liability]

(a) [3:215] **Third party exposure:** Except to the limited extent noted at ¶ 3:215.1 ff., an abstractor's potential liability runs only to the person contracting for the abstract.

1) [3:215.1] **Breach of contract liability on third party beneficiary theory:** A third party might have a contract cause of action on third party beneficiary principles; but the third party claimant would have to demonstrate the abstract was expressly made for the claimant's benefit. Where the abstractor had no knowledge of the third party's interest in the property at the time the contract was performed, the third party is at best an "incidental beneficiary" and thus has no ground for recovery on the contract. [*Stagen v. Stewart-West Coast Title Co.* (1983) 149 CA3d 114, 119, 196 CR 732, 734-735]

2) [3:215.2] **Tort liability as professional supplier of information "for guidance of others":** Professional suppliers of information "for the guidance of others" in their business transactions are exposed to tort liability (misrepresentation) to those who are harmed by justifiable reliance upon the supplier's misinformation. Conceivably, a third party may state a tort cause of action against an abstractor on this theory. However, *intent to influence* the particular party is a threshold issue in such cases; in its absence, the abstractor incurs no tort liability even though the claimant may have relied on a misrepresentation to the claimant's detriment and notwithstanding that such reliance may have been reasonably foreseeable. [See Rest.1st Torts § 552; *Stagen v. Stewart-West Coast Title Co.* (1983) 149 CA3d 114, 121-122, 196 CR 732, 736-737]

(3) [3:216] **Compare—title company's liability (post-1981 reports):** By comparison, title companies are free to except any matter from coverage and incur no liability therefor, even if a matter is excluded because of the company's negligence. *See ¶ 3:225*.

b. [3:217] **Property profile:** A "property profile" is similar to a preliminary report in that both state the vesting of the property, the deeds of trust encumbering the property, the unpaid taxes and assessments, and the property's legal description. However, unlike a preliminary report, a property profile does not reflect *all* types of recorded documents and is usually provided at no (or minimal) cost. Also, a policy of title insurance will not be issued based on a property profile (i.e., it is not an "offer" to issue a policy on stated terms and conditions).

• [3:217.1] **Comment:** A property profile is not a substitute for a preliminary report as a step toward obtaining title insurance. However, property profiles are often used instead of a preliminary report by persons who are not interested in obtaining title insurance but merely want to know about vesting and monetary liens (e.g., as part of an asset search). Some title insurers have made their property profiles available online.

c. [3:218] **Binders and commitments:** "Binders" and "commitments" are similar to preliminary reports in that all three are furnished in connection with an application for a title insurance policy. Also, like a preliminary report (*¶ 3:202*), binders and commitments may not be construed as a representation of the condition of title to property; they are simply representations as to the terms under which a policy may be issued. [Ins.C. § 12340.11]

However, binders and commitments differ from preliminary reports in that they *obligate* an insurer to issue a policy of title insurance.

(1) [3:219] **Binders:** A binder is an agreement to provide insurance and provides *temporary coverage until the policy is issued*. Unless otherwise provided in the binder, the terms of the proposed policy are implied in the binder.

(a) [3:220] **When used:** Typically, binders are obtained by purchasers of property who intend to resell within the period of time stated in the binder. In such case, the title insurance policy will be issued to the person or entity to whom the property is to be resold. The cost of obtaining a binder to provide coverage for the initial purchaser and the person to whom the property will be resold is less than what it would cost to obtain two policies of title insurance.

(b) [3:221] **Lapse of binder:** If a policy is not issued to the subsequent (proposed) purchaser within the period stated in the binder, some title companies will issue the policy to the person who purchased the binder; others will simply allow the binder to lapse.

(2) [3:222] **Commitment:** A commitment is a title company's binding agreement to issue a policy of insurance. Unlike a binder, it does *not* provide an insured with temporary coverage; rather, it obligates an insurer to issue an individual (or entity) a specified policy in a specified amount upon satisfaction of the conditions described in the commitment.

Commitments are typically used to facilitate the close of a real estate transaction; i.e., the parties can review the commitment before the closing to make certain the policy will be precisely in the form they anticipate. (Even though there may be additional matters to be attended to prior to the closing, the parties will at least know that the specific terms of the title policy are agreed to and resolved.)

➪ [3:223] ***PRACTICE POINTER:*** The status of title matters may change between the date of the commitment and the date the title policy is issued; e.g., a tax payment may have become delinquent. The length of this "gap" period and perhaps other circumstances may sometimes warrant obtaining an *updated* commitment.

[3:224] ***Reserved.***

3. [3:225] **Title Company's Liability:** As discussed at ¶ 3:211 ff., a preliminary report is not an abstract of title and, therefore, is not a representation as to matters affecting title (¶ *3:201, 3:211*). A title company may determine in its sole discretion the conditions under which it is willing to insure title. [*Sala v. Security Title Ins. & Guarantee Co.* (1938) 27 CA2d 693, 702-703, 81 P2d 578, 581-582]

Accordingly, a title company may elect to except from coverage any matter affecting title and will not be subject to liability therefor—even if the matter is omitted because of the title company's negligence. [See *Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.* (2009) 171 CA4th 1356, 1389, 124 CR3d 271, 301; *Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1192-1193, 54 CR2d 84, 89-90—title insurer not liable for alleged negligent failure to disclose recorded judgment lien in preliminary report; *Southland Title Corp. v. Sup.Ct. (Nye)* (1991) 231 CA3d 530, 537-538, 282 CR 425, 429-430—title company not liable for alleged negligent failure to reflect recorded flood control easement in preliminary report]

4. Issuance of Preliminary Report

a. [3:226] **Title company search:** The first step in preparing a preliminary report is to search the public records for documents imparting "constructive notice" with respect to the subject property.

(1) [3:227] **"Plant" and "starters":** Generally, title officers do not have to comb public records in county recorders' offices every time they conduct a search. Title companies create and maintain their own current records of matters affecting property in "plants"—i.e., internal mechanisms for accumulating and organizing information they need to perform title searches. Some title companies have their own plants, while others share plants. [See *Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1188, 54 CR2d 84, 87, fn. 4]

A title company usually creates its plant files by engaging experienced personnel to review, report, post and index pertinent documents in the public records and transfer the information to its own records. [See *Siegel v. Fidelity Nat'l Title Ins. Co.*, supra]

(a) [3:228] **Plant components:** Plants usually contain lot books, a general index, arb books, and tax records (all discussed at ¶ 3:230 ff.); most of these files are computerized.

(b) [3:229] **Commencement of search:** To begin a search, a title company first checks its plant to determine whether an earlier search was performed for the particular property. The company will use information obtained from an earlier search and conduct a new search only from the date of the earlier search to the date of the present request.

(2) [3:230] **Lot books:** Lot books are indexed by the legal descriptions of subdivided lots or divided parcels. They list all of the public records affecting the lots or parcels, as well as any other information maintained by the title company (such as prior reports). [See *Bank of America Nat'l Trust & Sav. Ass'n v. Giant Inland Empire R.V. Center, Inc.* (2000) 78

CA4th 1267, 1274, 93 CR2d 626, 630—"lot book report represents a snapshot of raw data that appears in the files of the particular branch of the title company" (internal quotes omitted)]

(3) [3:231] **General index:** A general index contains public records affecting persons and the property they own. For example, pending litigation, name changes, marital settlements and general settlement agreements, bankruptcy orders, abstracts of judgments, powers of attorney, trust agreements, and corporate and partnership documents affecting property are maintained in a general index.

Because the property affected by these public records is not always identified by a particular description (other than by who owns it), a general index is an alphabetical index of persons' names. A general index is therefore reviewed in addition to lot books. [See *Bank of America Nat'l Trust & Sav. Ass'n v. Giant Inland Empire R.V. Center, Inc.* (2000) 78 CA4th 1267, 1274, 93 CR2d 626, 630—lot book report "does not reveal anything having to do with the official index, the grantor/grantee index, or anything that tracks the names of any parties" (internal quotes omitted)]

(4) [3:232] **Arb books:** Title companies assign arbitrary (arb) numbers to large parcels described by metes and bounds, rather than by reference to a recorded subdivision map. The arb books contain lists of all parcels with arbitrary numbers and all documents affecting such parcels.

(5) [3:233] **Tax records:** Title companies maintain files on all taxes and assessments levied on properties. However, because property is often identified differently by tax assessors than by the county recorder's office, title companies have to keep separate records of taxes and assessments.

Assessment records, but not property tax records, are usually kept in title company plants (¶ *3:228*). Therefore, a title company's search will also include a search of the tax assessor's records.

b. [3:234] **Title examination:** After completion of a search, a title officer reviews the documents and other information found during the search and compiles a preliminary report showing the condition under which the company is willing to insure title.

c. [3:235] **Underwriting/risk analysis:** A title officer analyzes the risks posed by the liens, encumbrances and defects found in the company's search and usually decides to exclude them from coverage (they are listed as exceptions to coverage). At that point, the buyer must decide whether to suspend going forward with the transaction until the impediment to title is removed (*see* ¶ *3:238 ff. and 4:327*). [See *Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1188, 54 CR2d 84, 87]

Sometimes, if a defect is insignificant and the risk is low, the title company will elect not to except the item from coverage.

[3:235.1 - 3:235.4] ***Reserved.***

d. [3:235.5] **Underlying documents:** Copies of public documents found during the search to prepare the preliminary report (¶ *3:226 ff.*) are sometimes included with the preliminary report. Other times, however, the underlying documents are sent later because of delay in getting them copied at the county recorder's office. (If there is any urgency, counsel should arrange with the insurer for expedited transmission of the documents by messenger, overnight mail or fax (although some older documents have become so faded over time that fax transmission would not be advisable).)

(1) [3:235.6] **Cover page re unlawful restrictive covenants to be added:** Before giving a copy of a previously-recorded deed, declaration or governing document to any person (including persons holding ownership interests of record in property), title companies (as well as county recorders, realtors, etc.) must affix a prescribed cover page or stamp advising that any restrictive covenants in the document violating state/federal fair housing laws are void and may be removed by recording a "Restrictive Covenant Modification" form, together with a copy of the attached document with the unlawful provision redacted. The cover page or stamp must also advise that the "Restrictive Covenant Modification" form can be obtained from the county recorder's office and may be available on its internet website or from the party who provided the document. [See Gov.C. §§ 12956.1, 12956.2—title companies (as well as county recorders, realtors, etc.) also may record Restrictive Covenant Modification forms]

(a) [3:235.7] **Additional responsibilities:** Beginning July 1, 2022, if a title company (escrow company, real estate broker, etc.) has *actual knowledge* that a declaration, governing document, or deed being directly delivered to a person who holds or is acquiring an ownership interest in property includes a possible unlawfully restrictive covenant, the title company (escrow company, real estate broker, etc.) must notify the person of the covenant's existence and their ability to have it removed through the restrictive covenant modification process. Moreover, if requested before the close of escrow, the title (or escrow) company directly involved in the pending transaction must assist in preparing the Restrictive Covenant Modification. However, the title (or escrow) company has no liability associated with the recordation of a

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Restrictive Covenant Modification that contains modifications not authorized by Gov.C. § 12956.2 on behalf of the requester. [Gov.C. § 12956.2(a), (f) (setting forth sample Restrictive Covenant Modification form); see also Gov. C. § 12956.3 (requiring each county recorder to establish restrictive covenant program to assist in redacting "unlawfully restrictive covenants" as statutorily specified); Gov.C. § 27388.2 (authorizing county recorders to charge $2.00 fee for recording first page of specified real estate documents for purposes of implementing § 12956.2 restrictive covenants program)]

5. Insured's Review of Preliminary Report

a. [3:236] **Scope of review:** Upon receiving a preliminary report, prospective insureds should review:

- the vesting of the property (among other things, be sure to verify that the *name* of the proposed vested title holder *exactly matches* the buyer's name in the purchase and sale documents);
- The legal description of the property (among other things, verify that it is identical to the description shown on any survey that has been obtained);
- whether there are any third party claims to ownership;
- whether any defects, liens and/or encumbrances affect or prevent the desired use of the property; and
- whether there are any restrictions on ownership. [See *Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.* (2009) 171 CA4th 1356, 1389-1390, 124 CR3d 271, 301—purchaser who receives and reads (or should have read) preliminary report revealing existence of deed restriction has *actual notice* of its existence and is on inquiry notice of its nature]

Prospective insureds also should review all *documents* underlying the reported defects, liens and encumbrances, etc. (*see* ¶ *3:235.5 ff.*). Likewise, even though the title company's preprinted exceptions cannot be altered, they should be reviewed to determine if there is reason to do something further—e.g., a personal inspection of the property in the case of a CLTA Policy. Additionally, prospective insureds should review the title company's requirements for issuance of the policy to determine what must be done to procure it. And finally, before accepting the company's offer, they should review the proposed *policy* itself (*see* ¶ *3:208.5 ff.*).

b. [3:237] **Exceptions for items affecting property:** A preliminary report lists all recorded title defects, liens and encumbrances, etc., affecting the subject property that the title company will not insure. Recorded title exceptions, including the corresponding recorded documents, should always be reviewed and evaluated to determine whether they are acceptable to the insured.

Some of the exceptions rarely pose a substantial risk to insureds and thus, as a general rule, will be acceptable. They include, for example:

- general and special city and/or county taxes which are liens not yet payable;
- the lien of supplemental taxes (if any) assessed pursuant to Division 1, Chapter 3.5 of the Revenue & Taxation Code;
- utility easements (depending on their location and whether the insured intends to build over such easements); and
- covenants, conditions and restrictions (unless they affect or prevent the intended use of the property).

c. [3:238] **Clearing title exceptions:** Typically, a prospective insured and title officer will work together to eliminate unacceptable exceptions from coverage. Monetary items, such as taxes and liens, may be paid off prior to the closing and other items may be eliminated or subordinated to the insured's interest in the property. These matters need to be negotiated with the title company and, quite often, the other party to the transaction.

(1) [3:239] **Bonding around or indemnifying against unacceptable exceptions:** If neither party is willing to pay off a monetary lien or if the title company is unwilling to remove a particular item as an exception, the insured may be able to

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procure an endorsement from the title company covering the item by posting a bond to secure payment of the lien, or by providing either the buyer's or seller's indemnity to the title insurer for loss due to the matter. (*See* *¶ 3:290 ff.*)

➪ [3:240] ***PRACTICE POINTER:*** The better approach to eliminating unacceptable title exceptions is to take care of the underlying defects (paying off liens, etc.) rather than seeking to have the insurer simply remove the exceptions from the report. Uncorrected defects may lead to future claims that, even if covered by the title policy, will require time and perhaps litigation to resolve.

[3:241 - 3:244] ***Reserved.***

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Cal. Prac. Guide Real Prop. Trans. Ch. 3-E

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 3. Title Insurance

E. Policy Endorsements

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8. [3:262] Environmental Violations

1. [3:245] **Nature and Use of Endorsements:** Endorsements are additional policy provisions that alter title coverage. Most endorsements increase or expand coverage. They are available at varying prices, depending on the extent of the risk assumed by the title insurer in giving a particular endorsement. Endorsements often provide a cost-effective way to address issues that may otherwise impede a transaction.

a. [3:246] **Part of policy:** Endorsements are attached to and made a part of the title policy. If there is a conflict between the terms of an endorsement and the body of the title policy, the *endorsement* terms control. [*Continental Cas. Co. v. Phoenix Const. Co.* (1956) 46 C2d 423, 431, 296 P2d 801, 805]

b. [3:247] **When issued:** Endorsements may be issued simultaneously with issuance of a title insurance policy or after issuance of the policy. In any event, an insured ordinarily must take the initiative in requesting desired endorsements. A title company is not responsible for offering or otherwise recommending their use. [Cf. *Pabitzky v. Frager* (1985) 164 CA3d 401, 403, 210 CR 426, 427]

c. [3:248] **Types of endorsements:** Endorsements are often used to vitiate a title risk not otherwise protected by the policy. There are many standard CLTA or ALTA form endorsements procured for a variety of typical title risks. However, a title company will often create special endorsements to accommodate title risks unique to a particular parcel.

A few of the more commonly used endorsements are discussed briefly in the sections at ¶ 3:255 ff. (The endorsement forms are not replicated in this Practice Guide but may be obtained from California Land Title Association, P.O. Box 13968, Sacramento, CA 95853-3968; see also *www.clta.org.*)

➪ [3:249] ***PRACTICE POINTER:*** Don't be shy about requesting a special endorsement and using creativity to structure one that will cover peculiar title risks. Theoretically, there are as many endorsements available as there are title risks. Where necessary, it can be worth the time and effort to work with the title officer and title company's counsel to draft a “homespun” endorsement.

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d. [3:250] **Endorsements compared to unreported items:** A title insurer that is aware of, but willing to insure against, a potential title defect can accomplish fundamentally the same goal by two different methods: (1) The potential defect can be disclosed on the title policy, but an endorsement issued insuring against any loss arising therefrom; or (2) alternatively, the company may simply elect not to report the item on the policy.

[3:251 - 3:254] ***Reserved.***

2. [3:255] **Covenants, Conditions, Restrictions and Encroachments:** The Form "100 series" of endorsements provides enhanced protection against loss or damage arising out of covenants, conditions, restrictions and encroachments.

3. [3:256] **Mechanic's Liens:** CLTA policies do not insure loss arising from prior unrecorded mechanic's liens. For that reason, the Form "101 series" endorsements are often used in conjunction with CLTA policies where there is partially completed, recently completed or planned construction.

4. [3:257] **Easements:** The Form "103 series" of endorsements includes endorsements that provide enhanced protection against loss or damage arising out of the use, maintenance or encroachment of easements, as well as against loss of use of an easement for ingress and egress.

5. [3:258] **Designation of Improvements, Address:** The CLTA Form 116-06 endorsement insures a lender under an ALTA policy against loss or damage due to inaccuracy of the title company's assurances as to the description of the type of improvement located on the property, the street address of the property, and the location and dimensions of the property.

a. [3:259] **Not "area" or acreage:** The endorsement insuring the correct *dimensions* of the property, however, does *not* provide coverage for a shortage of "area" (as where the policy accurately describes the length of the parcel's boundaries but erroneously states the total acreage). "Dimensions" and "area" are discrete concepts; the former refers to *linear measures* of the sides or base of a geometric object, whereas the latter encompasses the product of the dimensions. [*Golden Security Thrift & Loan Ass'n v. First American Title Ins. Co.* (1997) 53 CA4th 250, 257, 61 CR2d 442, 445-446]

Moreover, the endorsement assures only the accuracy of the policy's warranty of dimensions *according to those records that impart constructive notice under the recording laws*. A parcel's parameter dimensions are used in public records under the recording laws to impart constructive notice, but its *area is not*. [*Golden Security Thrift & Loan Ass'n v. First American Title Ins. Co.*, supra, 53 CA4th at 257, 61 CR2d at 446, fn. 5—no coverage under endorsement for shortage in acreage encompassed within accurately stated boundaries (policy noted 2.06 acres but actual area was 1.36 acres)]

6. [3:260] **Modification of Deed of Trust; Additional Loan Advances:** Although title insurance for deed of trust modifications rarely involves a purchase and sale transaction, loan modifications may be of concern to a buyer who obtains a development or construction loan. For example, a lender whose loan is secured by an existing deed of trust may agree to advance additional funds to the borrower secured by the same lien and trust deed (often referred to as either an "equity advance" or "equity financed" loan). To protect against other liens or interests in the property that may intervene between the date of the original deed of trust and the advancement of funds, the Form "122 series" of endorsements may be used.

7. [3:261] **Assignment of Deed of Trust:** A CLTA Form 104-06 endorsement provides the assignee of a lender under an ALTA policy with protection against loss or damage resulting from invalidity of the assignment, subsisting tax and assessment liens, matters affecting the validity or priority of the lien of the deed of trust, and federal tax liens or bankruptcy proceedings. The endorsement also includes a creditors' rights exclusion with respect to claims arising out of the assignment transaction.

8. [3:262] **Environmental Violations:** The standard form CLTA and ALTA policies include limited coverage for environmental remediation or protection of the land (¶ 3:89). Also available for purchase are "Environmental Protection Lien Endorsements" (ALTA Endorsement Nos. 8.1, 8.1-06 and 8.2-06 respectively) that insure against recorded violations of environmental statutes.

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[3:263 - 3:289] ***Reserved.***

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California Practice Guide: Real Property Transactions | September 2024 Update
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Chapter 3. Title Insurance

F. Alternatives to Endorsements

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     - (1) [3:303] Prerequisites
     - (2) [3:304] Exception—recordation of “notice of preservation of interest”

1. [3:290] **General Concerns:** The practical implications of purchasing property with an appropriate title insurance endorsement must be considered. Like other parts of a title policy, an endorsement simply provides *insurance* against the potential risk created by the purported defect, lien or encumbrance; it does *not eliminate* title defects (*see* ¶ *3:6 ff.*). Though your client may be willing to buy property insured for title defects, the *next buyer* or a *future lender* might back out or decline to make the loan (as the case may be) notwithstanding the availability of title insurance.

For example, assume a purchase and sale transaction is entirely seller-financed (no institutional lender). The seller is probably willing to accept insurance against any existing title defect because, in all likelihood, the seller already accepted title insurance

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for the same defect at the time of the original purchase. However, when the buyer attempts to refinance at a later date, an institutional lender may have more stringent requirements. Frequently, lenders refuse to make a loan even if title insurance is available to cover a particular defect … because lenders are interested in the certainty of clear title vested in the borrower's name; their concerns are not satisfactorily ameliorated by the comfort of a claim against the title insurer, which takes time and money to pursue.

Thus, endorsements to title insurance policies should be used when a particular title defect, lien or encumbrance *cannot be removed or cured*. It follows that the first (and best) recourse is to attempt to *eliminate* the problem—and hence the risk—by obtaining appropriate releases or recording appropriate documents. Some of the possible approaches are noted at ¶ 3:291 ff.

2. Possible Approaches

a. [3:291] **Indemnification agreement:** One method of resolving title matters (at least as between buyer and seller) is to have the seller (or another person or entity) *indemnify* the purchaser against loss arising from the matter which the title insurer will not insure. Alternatively, the seller can agree to indemnify the insurer against loss arising from a matter in exchange for elimination of the matter as an exception from coverage. (These indemnities can, of course, be secured or unsecured.)

b. [3:292] **Surety bond:** A title company will sometimes eliminate an exception to coverage if it is provided with a *surety bond* that serves as security for payment of any lien. For instance, if there is a mechanic's lien of record, the seller can procure a bond insuring the title company against loss due to the lien.

Cross-refer: For a detailed treatment of surety bonds, see Croskey, Heeseman, Ehrlich & Klee, *Cal. Prac. Guide: Insurance Litigation* (TRG), Ch. 6I.

c. [3:293] **Security impound:** Another approach is to impound a certain amount of money with the title company as security against loss. Under such an arrangement, the title company is permitted to use the impounded funds to pay off a monetary lien at its discretion.

d. [3:294] **Subordination:** Sometimes, an insured may be protected by *subordinating* a lien or encumbrance to the insured's interest in the property. Although subordination does not remove the lien of record, it makes the lien "junior" to the insured's interest and, therefore, the insured's interest is not impacted.

Cross-refer: For further discussion of subordination of liens, *see ¶ 6:450 ff.*

3. [3:295] **Termination of Rights With Passage of Time:** By statute, certain recorded interests in property terminate with the passage of time. Specifically, the Marketable Record Title Act (MRTA, Civ.C. § 880.020 et seq.) provides for the removal of liens of "ancient" (expired) deeds of trust, unexercised options, powers of termination, unperformed contracts and abandoned easements. Obviously, if a recorded interest has ceased to exist by reason of MRTA, it is not a cloud on title and need not be a concern in the procurement of title insurance. [See *Schelb v. Stein* (2010) 190 CA4th 1440, 1445, 119 CR3d 267, 270—MRTA was enacted to make real property more freely alienable and marketable; *Manhattan Loft, LLC v. Mercury Liquors, Inc.* (2009) 173 CA4th 1040, 1055, 93 CR3d 457, 467 (same)]

a. [3:296] **Expired deeds of trust:** The lien of a deed of trust *expires*, and is not enforceable by a power of sale (¶ *6:514 ff.*), *10 years* after the final maturity date or last date set for payment or other performance if that date is "*ascertainable from the recorded evidence of indebtedness.*" [Civ.C. § 882.020(a)(1) (emphasis added); *Schelb v. Stein* (2010) 190 CA4th 1440, 1446, 119 CR3d 267, 271]

When the final maturity date or last date fixed for payment or other performance is *not* ascertainable from the recorded evidence of indebtedness, the lien of a deed of trust expires *60 years* after recordation of the deed. [Civ.C. § 882.020(a)(2)]

Expiration of the lien of a deed of trust pursuant to Civ.C. § 880.020 et seq. is equivalent in legal effect to a reconveyance, release or other discharge of the security interest (¶ *6:406 ff.*). [Civ.C. § 882.030; see *Schelb v. Stein,* supra—expiration of deed of trust renders it unenforceable by any means and is equivalent for all purposes to a certification of satisfaction, reconveyance, release, etc.]

(1) [3:297] **"Ascertainable from the recorded evidence of indebtedness":** The 10-year rule applies only when the final maturity date or last date fixed for payment (or other performance) is "ascertainable from the *recorded evidence of indebtedness*" (Civ.C. § 882.020(a) (emphasis added))—meaning the *recorded deed of trust itself* or the underlying *recorded promissory note*, but *not* some other later-recorded document that is not "evidence of the indebtedness." Thus,

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the 60-year rule will apply if the final maturity date or last date set for payment (or other performance) is ascertainable only by reference to an *unrecorded document* (such as an unrecorded promissory note). [See Calif. Bill Analysis, AB 2624, Sen. 6/27/06; *Miller v. Provost* (1994) 26 CA4th 1703, 1709, 33 CR2d 288, 290-291; *Nicolopulos v. Sup.Ct. (Bourgeois)* (2003) 106 CA4th 304, 310-311, 130 CR2d 626, 630-631; *Schmidli v. Pearce* (2009) 178 CA4th 305, 316, 100 CR3d 343, 351—"recorded evidence of indebtedness" is synonymous with deed of trust]

(a) [3:297.1] **10-year rule not triggered by notice of default recorded after recorded evidence of indebtedness:** According to the legislative history, Civ.C. § 882.020(a) purposefully uses the phrase "ascertainable from the *recorded evidence of indebtedness"* in place of the former "ascertainable *from the record"* to provide certainty as to the expiration date of the lien, preventing subsequent items from becoming part of the "record" that would alter the expiration date of the lien under the MRTA. This effectively codifies prior case law holding that once the beneficiary of a deed of trust becomes entitled to claim the 60-year rule (because the maturity date is not stated in the recorded deed of trust or other recorded evidence of the underlying obligation), the beneficiary does not lose that entitlement simply by filing a notice of default that specifies the final maturity date of the underlying debt (*Ung v. Koehler* (2005) 135 CA4th 186, 203-204, 37 CR3d 311, 322-324). [See Calif. Bill Analysis, AB 2624, Sen. 6/27/06; *Schmidli v. Pearce* (2009) 178 CA4th 305, 316, 100 CR3d 343, 351—by replacing "record" with "recorded evidence of indebtedness," Legislature sought to ensure that filing default notice would not trigger 10-year statute]

(b) [3:297.2] **Comment:** It seems apparent that, as amended eff. 1/1/07 to substitute the phrase "ascertainable from the *recorded evidence of indebtedness*," the statute effectively trumps prior case law concluding that any recorded document containing the due date of the note secured by the deed of trust will suffice to trigger the 10-year rule (i.e., *Slintak v. Buckeye Retirement Co., L.L.C., Ltd.* (2006) 139 CA4th 575, 585, 43 CR3d 131, 138 (interpreting former statute)). [See *Schmidli v. Pearce* (2009) 178 CA4th 305, 311, 315-316, 100 CR3d 343, 347, 350-351 (applying and interpreting former Civ.C. § 882.020, determining retroactivity of amended statute and declining to follow *Slintak*)—amended § 882.020 confirms a default notice is *not* part of record from which loan's maturity date can be ascertained]

(c) [3:297.3] **Actual knowledge or notice:** Actual notice or knowledge is *not* sufficient to trigger Civ.C. § 882.020(a)'s 10-year period. [*Trenk v. Soheili* (2020) 58 CA5th 1033, 1043-1044, 273 CR3d 184, 191-192—although trust beneficiary had "clear and actual notice" of maturity date based on "direct privity" and "familial relationship" with original party to underlying promissory note, 60-year period applied because note was not recorded]

(2) [3:298] **Extension by recordation of "notice of preservation of interest":** A secured party may *preserve* its otherwise expired security interest (preventing termination under the 10-year/60-year rules, ¶ 3:296 ff.) by recording a "notice of intent to preserve the interest" (deed of trust) *before expiration of the interest* under Civ.C. § 882.020(a)(1) or (2). [Civ.C. § 880.310]

A timely recorded Civ.C. § 880.310 notice extends the secured party's interest in the deed of trust for 10 years, running from the date of recordation. [Civ.C. § 882.020(a)(3); *Slintak v. Buckeye Retirement Co., L.L.C., Ltd.* (2006) 139 CA4th 575, 586, 43 CR3d 131, 138-139—§ 882.020(a)(3) extension is "*one-time only* provision" (emphasis added)]

(3) [3:298.1] **Extension by filing lis pendens:** Similarly, the secured party's interest is extended if an "action" to enforce, establish or clear title is commenced and a lis pendens (¶ *11:600 ff.*) recorded within the Civ.C. § 882.020(a) period. [Civ.C. § 880.260; *Manhattan Loft, LLC v. Mercury Liquors, Inc.* (2009) 173 CA4th 1040, 1055, 93 CR3d 457, 467 (citing text)]

Although Civ.C. § 880.260 is silent about how long the extension lasts, it has been "harmonized" by case law with the Civ.C. § 882.020(a)(3) extension provision (¶ 3:298): i.e., under Civ.C. § 880.260, the commencement of a title action and recording of a lis pendens extends the secured party's interest for *10 years*. [*Slintak v. Buckeye Retirement Co., L.L.C., Ltd.* (2006) 139 CA4th 575, 586, 43 CR3d 131, 138-139; *Manhattan Loft, LLC v. Mercury Liquors, Inc.*, supra, 173 CA4th at 1055, 93 CR3d at 467-468]

However, the "action" triggering a Civ.C. § 880.260 extension must be the commencement of suit in a court of law; an arbitration proceeding will not suffice because it will not support the recording of a lis pendens. [*Manhattan Loft, LLC v. Mercury Liquors, Inc.*, supra, 173 CA4th at 1055-1056, 93 CR3d at 468—general CCP statutes governing lis pendens override § 880.260 to extent it states "action" includes arbitration proceeding]

[3:298.2 - 3:298.4] ***Reserved.***

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(4) [3:298.5] **Equitable defenses to application of 10-year/60-year rules:** The MRTA expressly does not limit the application of waiver, estoppel, laches and other equitable principles; in an appropriate case, therefore, various equitable defenses may preclude reliance on the 10-year or 60-year rules. [Civ.C. § 880.030; *Nicolopulos v. Sup.Ct. (Bourgeois)* (2003) 106 CA4th 304, 311-312, 130 CR2d 626, 631-632—party urging trust deed lien had expired (even though applicable 60-year limit was still running) failed to prove basis for estoppel or laches defense to reliance on 60-year rule]

(5) [3:299] **Compare—*extinguished lien of deed of trust:*** The lien of a deed of trust may be *extinguished* when the statute of limitations under which a judicial action may be brought to enforce the principal obligation secured by the deed has run. [Civ.C. § 2911; *Robin v. Crowell* (2020) 55 CA5th 727, 744, 270 CR3d 25, 36]

(a) [3:299.1] **Impact on foreclosure rights:** Extinguishment of the lien precludes enforcement of the lien, but does *not* necessarily bar enforcement of the *entire instrument creating the lien*. [*Ung v. Koehler* (2005) 135 CA4th 186, 196, 37 CR3d 311, 317]

Thus, while expiration of the applicable statute of limitations may extinguish the lien of a deed of trust and bar a *judicial* foreclosure action, Civ.C. § 2911 does *not* extinguish a power of sale conferred on the trustee by the deed of trust—i.e., a *nonjudicial* foreclosure under the power of sale may still proceed (*¶ 6:415 ff.*). [*Nicolopulos v. Sup.Ct. (Bourgeois)* (2003) 106 CA4th 304, 309, 130 CR2d 626, 630; see also *Robin v. Crowell* (2020) 55 CA5th 727, 750, 270 CR3d 25, 40-41—Civ.C. § 2911 does not limit trustee's time to exercise power of sale]

This fact distinguishes Civ.C. § 2911 *extinguishment* of the lien from Civ.C. § 882.020 *expiration* of the lien (the latter bars enforcement by power of sale, *¶ 3:296*). [*Nicolopulos v. Sup.Ct. (Bourgeois)*, supra, 106 CA4th at 309-310, 130 CR2d at 630]

Thus, until the trust deed lien *expires* under Civ.C. § 882.020 (*¶ 3:296 ff.*), the possibility of a nonjudicial foreclosure constitutes a cloud on title and will be a concern in obtaining title insurance.

(b) [3:299.2] **Effect of completed judicial foreclosure action:** The power of sale in a deed of trust does not survive a judicial foreclosure sale. After property is sold in connection with a judicial foreclosure action, the trustee no longer holds any title to convey to a subsequent buyer. Thus, a senior lienholder cannot rely on Civ.C. § 882.020 to conduct a subsequent trustee's sale to nonjudicially foreclose against a junior lienholder once Civ.C. § 2911's statute of limitations has expired. [See *Robin v. Crowell* (2020) 55 CA5th 727, 750-754, 270 CR3d 25, 41-44—senior lienholders who initiated judicial foreclosure under deed of trust and purchased property at resulting sale were time-barred from bringing subsequent quiet title action against junior lienholder who was omitted from prior foreclosure action]

[3:299.3 - 3:299.4] *Reserved.*

(6) [3:299.5] **Compare—enforceability of Family Code judgment after expiration of security interest:** Enforceability of a Family Code judgment secured by real property is *not affected* by expiration of the security interest under Civ.C. § 882.020(a): "MRTA expressly is confined to security interests in real property. Nothing in its language addresses the enforceability of the underlying obligation secured by the deed of trust or note on real property." [See *Schelb v. Stein* (2010) 190 CA4th 1440, 1447-1448, 119 CR3d 267, 272-273—Family Code judgments remain enforceable until paid in full or otherwise satisfied per Fam.C. § 291]

Quite the contrary, a Family Code judgment secured by real property remains fully enforceable even after the security interest has expired: "[W]e conclude that [Fam.C.] section 291 does not bar the expiration of an instrument securing a family law judgment. We also conclude that the underlying family law judgment [is] not rendered unenforceable by the terms of MRTA." [*Schelb v. Stein*, supra, 190 CA4th at 1449, 119 CR3d at 273—family law judgment awarding W equalizing payment in form of note/trust deed against H's real property remained enforceable under § 291 notwithstanding expiration of note/trust deed under MRTA]

Cross-refer: The enforcement of family law judgments and orders is discussed in detail in Hogoboom & King, *Cal. Prac. Guide: Family Law* (TRG), Ch. 18.

b. [3:300] **Unexercised options:** A recorded option to purchase real property expires of record six months after its expiration date, provided that date is ascertainable from the recorded instrument, *or* if no expiration date is set forth or ascertainable from the recorded instrument, then six months following the date the instrument was recorded, unless another instrument extending the option is recorded before such expiration. [Civ.C. § 884.010; see also Civ.C. § 884.020—recorded option ceases to operate as constructive notice once it expires of record]

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Cross-refer: Options are treated in depth in *Ch. 8*.

[3:300.1 - 3:300.4] ***Reserved.***

c. [3:300.5] **Powers of termination:** A condition subsequent to fee simple title in the form of a *power of termination* (right of reentry, possibility of reverter or any other reversionary interest held by the grantor, see Civ.C. §§ 885.010, 885.020, *and ¶ 4:92.1*) may expire by the passage of time or because it has become obsolete, as explained at ¶ 3:300.6 ff. [Civ.C. §§ 885.030, 885.040]

Expiration of a power of termination makes the power unenforceable and effectively quitclaims the power to the fee simple owner. It also terminates and renders unenforceable (by damages, injunctive relief or any other means) the restriction to which the fee simple estate was subject. [See Civ.C. § 885.060; *Severns v. Union Pac. R.R. Co.* (2002) 101 CA4th 1209, 1220-1221, 125 CR2d 100, 109 & fn. 7—grantor's successors in interest barred from reclaiming property under deed's reversionary clause that had expired pursuant to Civ.C. § 885.030 (¶ 3:300.6)]

(1) [3:300.6] **Recorded powers:** A power of termination *of record* expires at the *later of* (i) 30 years after recordation of the instrument evidencing the power of termination, *or* (ii) 30 years after recordation of the last notice of intent to preserve the power of termination, *or* (iii) 30 years after recordation of an instrument evidencing the power of termination or of a notice of intent to preserve the power, if the instrument or notice is recorded within 30 years after the date either was last recorded. [Civ.C. § 885.030; *Severns v. Union Pac. R.R. Co.* (2002) 101 CA4th 1209, 1220, 125 CR2d 100, 108-109—1901 recorded power of termination (condition subsequent to fee title providing for return of fee to grantors/assigns if grantee railroad ceased for 6 months to use property as right of way) expired by operation of law, vesting fee simple absolute in grantee/successors in interest, because notice of intent to preserve future interest never recorded]

(2) [3:300.7] **Obsolete powers:** A power of termination also expires if it has become "obsolete." It is obsolete if *either* (i) the restriction to which the fee simple is subject is of "no actual and substantial benefit" to the holder of the power, *or* (ii) enforcement of the power would not effectuate the purpose of the restriction to which the fee simple is subject, *or* (iii) enforcement of the power would be "otherwise inequitable" because of changed conditions or circumstances. [See Civ.C. § 885.040]

d. [3:301] **Unperformed sale contracts:** A recorded contract for the sale of real property terminates at the *later* of:

- Five years after the conveyance date specified in the contract or, if no specified conveyance date, five years after the last date specified in the contract for satisfaction of the conditions set forth therein; *or*

- If there is a recorded extension of the contract (within the periods noted above), five years after the date for conveyance provided in the extension or, if no specified conveyance date, five years after the last date provided in the extension for satisfaction of the conditions set forth in the contract. [Civ.C. § 886.030(a)]

These time periods may be waived or extended, but *only* by an instrument recorded *before expiration* of the prescribed times. [Civ.C. § 886.030(b)]

e. [3:302] **Abandoned easements:** Record title is cleared of an "abandoned easement" by court order pursuant to Civ.C. § 887.010 et seq.

(1) [3:303] **Prerequisites:** All of the following conditions must be satisfied for a period of 20 years immediately preceding commencement of the action to establish such abandonment:

- The easement is not used at any time;

- No separate property tax assessment is made of the easement or, if made, no taxes have been paid on the easement; and

- No instrument creating, reserving, transferring or otherwise evidencing the easement is recorded. [See Civ.C. §§ 887.040, 887.050]

(2) [3:304] **Exception—recordation of "notice of preservation of interest":** An easement is *not* abandoned if the owner either:

- Records a notice of intent to preserve the easement within 20 years preceding commencement of the action to establish the abandonment; or

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• After commencement of the action to establish the abandonment and before judgment in the action is entered, records a "late" notice of intent to preserve the easement upon payment into court of the property owner's litigation expenses attributable to the abandonment action; the late notice of intent effectively extinguishes the statutory abandonment cause of action. [Civ.C. §§ 887.060, 887.070]

[3:305 - 3:309] ***Reserved.***

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Chapter 3. Title Insurance

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1. Prerequisite Notifications to Insurer

a. [3:310] **Two-stage notices:** To trigger title policy liability for a covered loss or damage, the insured is obligated, by the terms of the policy, to give the insurer two separate notices:

(1) [3:311] **"Prompt" notice of claim:** First, the insured must *"promptly" notify* the insurer *in writing* upon learning of any litigation or other matter that may cause loss or damage covered by the policy or cause the insured's interest in the property to become unmarketable. [See CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2); and ALTA Policies (*Forms 3:C & 3:D*)]

(2) [3:312] **Proof of loss or damage:** Additionally, the insurer may, at its option, require as a *condition of payment* that the insured submit to the insurer a *signed* proof of loss. The proof of loss must describe the defect, lien, encumbrance, adverse claim, or other matter insured against that constitutes the basis of the loss or damage; and, to the extent possible, must state the basis of calculating the amount of the loss or damage. [See CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2); and ALTA Policies (Forms 3:C & 3:D)]

b. [3:313] **Delay risks reducing insurer's liability:** If the insurer is prejudiced by the failure of the insured to provide prompt notice (¶ 3:311), the insurer's liability to the insured under the policy is reduced to the extent of the prejudice. [See CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2); and ALTA Policies (Forms 3:C & 3:D); *and* ¶ 3:364]

(1) [3:314] **Only if delayed notice prejudicial:** The policy liability continues notwithstanding delayed notice of claim *unless* the insurer was *prejudiced* by the delay. Prejudice is not presumed from the insured's breach of a notice provision; rather the *insurer* has the burden of proving *actual* prejudice resulted. [*Moe v. Transamerica Title Ins. Co.* (1971) 21 CA3d 289, 302, 98 CR 547, 555]

c. [3:315] **Liberal construction in favor of insured:** In most cases, an insured may not seek a policy recovery against the insurer for failure to perform its duties under the policy unless and until the insured has submitted its statement of proof of loss or otherwise complied with the notice requirements. [*Paulfrey v. Blue Chip Stamps* (1983) 150 CA3d 187, 199-200, 197 CR 501, 508—"In no event could an insured fail to keep his/her part of the bargain in the first instance [filing a claim and proof of loss], and thereafter seek recovery for breach of a duty to pay"]

However, title policies, like all insurance contracts, are construed, to the extent reasonable, to give insureds the benefit of their bargain (*see ¶ 3:19 ff.*). Accordingly, notice provisions are liberally interpreted in favor of the *insured*—i.e., strict adherence to a notice provision is not required unless the insurer is *substantially* prejudiced by the insured's noncompliance (and "substantial" prejudice is likely to be difficult to prove). [See *Lagomarsino v. San Jose Abstract & Title Ins. Co.* (1960) 178 CA2d 455, 458-461, 3 CR 80, 82-83]

d. [3:316] **Exception—denial of coverage:** The insured's contractual duty to notify the insurer *ceases* if and when the insurer *denies coverage*. In that event, noncompliance with a notice provision is no bar to recovery under the policy. [*Samson v. Transamerica Ins. Co.* (1981) 30 C3d 220, 238, 178 CR 343, 354]

2. [3:317] **Insurer's Obligations and Rights:** Generally, an insurer under a title insurance policy has a duty to *indemnify and defend* the insured and pay authorized attorney fees and costs incurred by the insured. In turn, it also has certain concomitant rights under the policy.

Cross-refer: The sections at ¶ 3:318 ff. summarize the title insurer's basic rights and duties under a policy of title insurance. For a comprehensive treatment of insurer contractual rights and obligations under any liability policy (title insurance included), see Croskey, Heeseman, Ehrlich & Klee, *Cal. Prac. Guide: Insurance Litigation* (TRG).

a. [3:318] **Duty to indemnify:** A title policy insurer is bound to indemnify the insured for the insured's actual loss (up to policy limits) suffered as a result of matters covered by the policy. This duty is *exclusive* of the insurer's obligation to defend the insured and pay authorized attorney fees and costs. [See CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2); and

ALTA Policies (*Forms 3:C & 3:D*); *First American Title Ins. Co. v. XWarehouse Lending Corp.* (2009) 177 CA4th 106, 113, 98 CR3d 801, 807—in California, title insurance is indemnity contract under which insurer is obligated to indemnify insured against losses sustained from occurrence of specific contingency]

(1) [3:319] **Loss or damage prerequisite:** The occurrence of a contingency under the policy does not itself trigger the duty to indemnify. The insurer is liable to the insured only if the "contingency" results in a *loss or damage*. [See CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2); ALTA Policies (*Forms 3:C & 3:D*); *Lawrence v. Chicago Title Ins. Co.* (1987) 192 CA3d 70, 75, 237 CR 264, 266-267]

Example: Insured lender discovers the existence of a deed of trust which is prior to the lien of its deed of trust. That alone does not trigger title policy liability to Insured. There is no "loss" or "damage" to be indemnified under the policy if Insured is repaid the entire amount of its loan (including its costs). (*See ¶ 3:373 ff.*)

b. [3:320] **Duty to defend:** An insurer also has a duty to provide a defense, at the insurer's cost and without unreasonable delay, upon the insured's written request in connection with any lawsuit initiated by a third person asserting a claim covered under the policy. [See CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2) and ALTA Policies (*Forms 3:C & 3:D*)]

(1) [3:321] **Triggered by notice of claim:** The duty to defend arises as soon as the insurer receives notice of a claim or interest insured under the policy. At that point, the insurer must decide whether to provide a defense (ascertain whether claim is covered or not covered) even though the indemnification obligation often is not determined until the claim is resolved. [*CNA Cas. of Calif. v. Seaboard Sur. Co.* (1986) 176 CA3d 598, 605-606, 222 CR 276, 279; see also *Liberty Nat'l Enterprises, L.P. v. Chicago Title Ins. Co.* (2013) 217 CA4th 62, 76, 157 CR3d 664, 675—insurer's duty to defend arises when it becomes aware of, or third party suit pleads, facts giving rise to potential coverage under insuring agreement (*¶ 3:323*)]

(a) [3:322] **Notwithstanding both covered and noncovered claims:** The scope of a title insurer's duty to defend turns on the policy language (i.e., the duty is limited to "only those stated causes of action alleging matters insured against by [the] policy"; see CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2) and ALTA Policies (Forms 3:C & 3:D); *Manneck v. Lawyers Title Ins. Corp.* (1994) 28 CA4th 1294, 1301, 33 CR2d 771, 775-776).

Nonetheless, an insurer's duty to defend applies even to noncovered claims so long as *any one* of the claims against the insured is potentially covered by the policy (*¶ 3:323*). [*Gray v. Zurich Ins. Co.* (1966) 65 C2d 263, 275-276, 54 CR 104, 112; see also *Liberty Nat'l Enterprises, L.P. v. Chicago Title Ins. Co.* (2013) 217 CA4th 62, 76, 157 CR3d 664, 675; *Rosen v. Nations Title Ins. Co.* (1997) 56 CA4th 1489, 1497, 66 CR2d 714, 718]

(b) [3:322.1] **Broader than duty to indemnify:** An insurer's duty to defend is *broader* than its duty to indemnify … because the duty to defend grows out of the *insured's reasonable expectations* pursuant to the policy. The duty to defend must therefore be determined *before* resolution of the insurer's duty to indemnify. [*Jarchow v. Transamerica Title Ins. Co.* (1975) 48 CA3d 917, 943-944, 122 CR 470, 488-489 (overruled on other grounds by *Soto v. Royal Globe Ins. Corp.* (1986) 184 CA3d 420, 434, 229 CR 192, 200)]

Whether the claim is valid is irrelevant. The purpose of title insurance is to protect the insured's title against *all* undisclosed claims covered by the policy. [*Jarchow v. Transamerica Title Ins. Co.*, supra]

(c) [3:323] **Triggered by potential liability:** The insurer's duty to defend arises when it becomes aware of facts giving rise to *potential liability* under the policy. Thus, the insured is entitled to a defense at insurer expense so long as the facts —either as expressed or implied in the third party complaint (lawsuit against the insured) or as learned from other sources —give rise to a *potentially covered* claim. [*Waller v. Truck Ins. Exchange, Inc.* (1995) 11 C4th 1, 19, 44 CR2d 370, 378; *Rosen v. Nations Title Ins. Co.* (1997) 56 CA4th 1489, 1496, 66 CR2d 714, 718; see also *Liberty Nat'l Enterprises, L.P. v. Chicago Title Ins. Co.* (2013) 217 CA4th 62, 76, 157 CR3d 664, 675—determination whether insurer has duty to defend "usually is made in first instance" by comparing complaint's allegations with policy terms]

1) [3:323.1] **Compare—no potential coverage under policy terms:** By the same token, the insurer's duty to defend is not absolute. It is measured by the nature and kinds of risks covered by the insurance policy (*¶ 3:322*). [*Waller v. Truck Ins. Exchange, Inc.* (1995) 11 C4th 1, 19, 44 CR2d 370, 379]

When the claim is unambiguously outside the scope of policy coverage (i.e., there is *no potential* coverage), the insurer has *no duty to defend.* [*Liberty Nat'l Enterprises, L.P. v. Chicago Title Ins. Co.* (2013) 217 CA4th 62, 80-81, 157 CR3d 664, 678-679]

• [3:323.2] There was no potential coverage, and thus no duty to defend an insured owner, where the insured's alleged *tortious conduct in acquiring title* did not involve title defects and therefore did not fall within the policy's insuring clause. [*Liberty Nat'l Enterprises, L.P. v. Chicago Title Ins. Co.* (2013) 217 CA4th 62, 80-81, 157 CR3d 664, 678-679]

• [3:323.3] There was no potential coverage, and thus no duty to defend an insured lender, in an action filed by foreclosure sale purchasers who did not learn about a preexisting title defect until after they bought the subject property without warranty. Moreover, their only potential claim against the lender was for misrepresentations for which there was no liability under the policy. [*Hovannisian v. First American Title Ins. Co.* (2017) 14 CA5th 420, 436, 221 CR3d 883, 897]

• [3:323.4] There was no potential coverage, and thus no duty to defend an insured lender, where the alleged title defect occurred after escrow closed and the policy only covered defects in existence as of the closing. [*Rosen v. Nations Title Ins. Co.* (1997) 56 CA4th 1489, 1497-1498, 66 CR2d 714, 718-719]

• [3:323.5] There was no potential coverage, and thus no duty to defend an insured owner, where the claim did not concern title to any land described in the policy or a denial of access to covered land. [*Havstad v. Fidelity Nat'l Title Ins. Co.* (1997) 58 CA4th 654, 661-662, 68 CR2d 487, 491]

(2) [3:324] **Insurer's right to select defense counsel:** The insurer has the right to select counsel of its choice to represent the insured on covered claims (subject to the insured's right to object for "reasonable cause"). [See CLTA Standard Coverage Policies (Forms 3:B,1 & 3:B.2); and ALTA Policies (*Forms 3:C & 3:D*)]

(a) [3:325] **Same counsel for multiple insureds:** The insurer may provide one attorney to represent two insureds (i.e., both an insured lender and insured owner under a policy) *unless* the insureds' interests conflict. In the latter case, *separate* counsel for each insured must be furnished. [*Spindle v. Chubb/Pacific Indem. Group* (1979) 89 CA3d 706, 713, 152 CR 776, 780]

(b) [3:326] **Same counsel for insured and insurer:** Likewise, the insurer may select the same counsel to represent *both* insurer and insured in a third party suit—*unless* insurer and insured have conflicting interests. In the event of conflicting interests (as where the insurer undertakes the defense with a reservation of rights; ¶ 3:327), the insurer generally *must* retain *separate* counsel to represent the insured. [See Civ.C. § 2860 (defining independent counsel requirement)]

Cross-refer: For a comprehensive discussion of the independent counsel requirement (commonly referred to as the "*Cumis* counsel" obligation), see Croskey, Heeseman, Ehrlich & Klee, *Cal. Prac. Guide: Insurance Litigation* (TRG), Ch. 7B.

(c) [3:326.1] **Tripartite attorney-client relationship:** When the insurer retains counsel to defend its insured, a tripartite attorney-client relationship arises among the insurer, insured and counsel. As a result, confidential communications between either the insurer or the insured and counsel are protected by the attorney-client privilege, and both the insurer and insured are holders of the privilege. In addition, counsel's work product does not lose its protection when it is transmitted to the insurer. [*Bank of America, N.A. v. Sup.Ct.* (*Pacific City Bank*) (2013) 212 CA4th 1076, 1083, 151 CR3d 526, 531]

(3) [3:327] **Defense with reservation of rights:** The insurer breaches its duty to the insured, and may incur extracontractual ("bad faith") liability, if it refuses to defend a covered third party claim. Thus, in doubtful cases (where coverage questions and hence the duty to defend are unclear), the insured may choose to defend the third party claim on a "reservation of rights" basis—in effect, furnishing a defense *with the proviso* that the insurer does not thereby concede policy liability or waive the right to assert coverage defenses (nonliability) against the insured at a later date.

A defense with a reservation of rights does not bind the insurer to a judgment against the insured and may entitle the insurer to recover the cost of the defense if it is ultimately determined the insurer did not have a duty to defend. [*Val's Painting & Drywall, Inc. v. Allstate Ins. Co.* (1975) 53 CA3d 576, 585-586, 126 CR 267, 272]

(a) [3:328] **Compare—coverage defenses waivable by defense without reservation of rights:** Coverage defenses *known* to the insurer are *waived* when it defends an action *against its insured without* a reservation of rights. [See *Miller v. Elite Ins. Co.* (1980) 100 CA3d 739, 755, 161 CR 322, 330; compare *Dollinger DeAnza Assocs. v. Chicago Title Ins. Co.* (2011) 199 CA4th 1132, 1153-1154, 131 CR3d 596, 611-612—waiver principle inapplicable to title insurer that initially accepted *first-party* claim without reservation of rights but then denied coverage (title insurer provided only

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first-party, not *liability,* coverage; waiver could not be invoked to create coverage where none existed and for which no exception applied)]

(b) [3:329] **Procedure—nonwaiver agreement or unilateral notice to insured:** An effective reservation of rights defense may be interposed pursuant to either a "nonwaiver agreement" with the insured (i.e., a reservation of rights expressly agreed to by insurer and insured) or a unilateral notice to the insured (i.e., reservation of rights by insurer's notice to insured without insured's consent). [*Val's Painting & Drywall, Inc. v. Allstate Ins. Co.* (1975) 53 CA3d 576, 586, 126 CR 267, 272-273]

1) [3:330] **Unilateral reservation of rights over insured's objection:** Arguably, an insurer's unilateral reservation of rights should be ineffective if the insured objects—i.e., the insurer must elect either to assume the defense unconditionally (thereby waiving coverage defenses) or refuse to defend (thereby risking breach of its duty to defend and potential "bad faith" liability). [*Val's Painting & Drywall, Inc. v. Allstate Ins. Co.* (1975) 53 CA3d 576, 586, 126 CR 267, 273]

However, there is authority to the contrary: Coverage defenses are not waived even when the insured objects to being defended on a reservation of rights basis, absent grounds of *estoppel* (insured's detrimental reliance on insurer's conduct reasonably leading insured to believe insurer was relinquishing its rights). [*Val's Painting & Drywall, Inc. v. Allstate Ins. Co.*, supra, 53 CA3d at 587, 126 CR at 273; see also *Walbrook Ins. Co. Ltd. v. Goshgarian & Goshgarian* (CD CA 1989) 726 F.Supp. 777, 783]

2) [3:331] **Compare—settlement without insured's consent:** Notwithstanding the foregoing, if an insurer who defends a third party action under a reservation of rights settles the action without the insured's consent, the insurer will not be reimbursed for the amount of the settlement. [*Val's Painting & Drywall, Inc. v. Allstate Ins. Co.* (1975) 53 CA3d 576, 588, 126 CR 267, 274]

[3:331.1 - 3:331.4] ***Reserved.***

(4) [3:331.5] **Prosecution of actions distinguished:** In addition to its duty to provide a defense upon request (¶ *3:320*), an insurer has the *right* to institute and prosecute any action or proceeding necessary or desirable to establish title or the lien of the insured deed of trust, or otherwise to prevent or reduce loss or damage to an insured. [See CLTA Standard Coverage Policies (Forms 3:B.1 and 3:B.2); ALTA Loan Policies (Forms 3:C & 3:D); *Bank of America, N.A. v. Sup.Ct.* (*Pacific City Bank*) (2013) 212 CA4th 1076, 1093-1094, 151 CR3d 526, 539—title insurer may, among other things, undertake quiet title, declaratory relief or probate action to eliminate defects or perfect insured's title]

(a) [3:331.6] **Tripartite attorney-client relationship:** The same tripartite attorney-client relationship that arises when an insurer retains counsel to *defend* its insured (¶ *3:326.1*) results when the insurer retains counsel to *prosecute* an action on behalf of the insured. Indeed, "[w]hether a title insurer is defending an action or prosecuting one, the object of protecting the integrity of the insured's title is the same." [*Bank of America, N.A. v. Sup.Ct.* (*Pacific City Bank*) (2013) 212 CA4th 1076, 1095-1096, 151 CR3d 526, 540-541 (noting standard title policies include insurer's "right" to initiate litigation to protect insured's title)]

c. [3:332] **Duty of good faith and fair dealing:** A covenant of good faith and fair dealing is implied in every contract, including insurance (and title insurance) policies. The implied covenant obligates the insurer (as well as the insured, ¶ *3:354*) not to do anything that will interfere with the rights of the other party to the contract to receive the benefits of the agreement. [*Gruenberg v. Aetna Ins. Co.* (1973) 9 C3d 566, 574, 108 CR 480, 484]

Thus, incident to the implied covenant, all insurers are obligated to promptly investigate, prosecute, defend, settle and/or pay claims under the policy; failure to do so (without "proper cause") risks both breach of contract and *extracontractual* (tort) damages to the insured. [*Archdale v. American Int'l Specialty Lines Ins. Co.* (2007) 154 CA4th 449, 467, 64 CR3d 632, 657, fn. 19; see also *Dollinger DeAnza Assocs. v. Chicago Title Ins. Co.* (2011) 199 CA4th 1132, 1155-1156, 131 CR3d 596, 613—claim for breach of implied covenant not maintainable unless benefits are in fact due under policy (insured's cause of action lacked merit as "matter of law" where title policy provided no coverage for claims based on city's notice of merger]

Cross-refer: For a detailed discussion of the insurer's "bad faith" liability, see Croskey, Heeseman, Ehrlich & Klee, *Cal. Prac. Guide: Insurance Litigation* (TRG), Chs. 12C & 13.

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[3:333 - 3:334] ***Reserved.***

d. [3:335] **Right to correct defects, liens, encumbrances, etc., by lawsuit or otherwise:** A title insurer may, at its own cost, initiate any action or proceeding, or "do any other act" to "establish" the insured's interest in the subject property or prevent loss or damage to the insured. In other words, instead of paying the insured under the policy, the insurer may seek to rectify or remove defects, liens, encumbrances, etc., affecting the insured's interest in the property. [See CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2); and ALTA Policies (*Forms 3:C & 3:D*)]

Any action or proceeding commenced by the insurer under the policy may, at the insurer's option, be brought in the name of the insurer or insured. [See CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2); and ALTA Policies (*Forms 3:C & 3:D*)]

(1) [3:336] **Impact on duty to indemnify:** If successful in its effort to cure the covered defect, lien or encumbrance, etc., the insurer generally will not be liable to indemnify its insured with respect to the matter. (This is a natural consequence of the policy terms, since there should no longer be any "loss" or "damage" suffered by the insured; *see ¶ 3:319*.)

However, the result may be otherwise if the insurer takes an *unreasonable amount of time* in attempting to correct the defect, lien or encumbrance, etc. In that event, the insurer may be liable to the insured for actual damages sustained by the insured during the period in which the insured litigated or pursued a settlement with respect to the particular matter. [*Nebo, Inc. v. Transamerica Title Ins. Co.* (1971) 21 CA3d 222, 228-229, 98 CR 237, 241; see also CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2), and ALTA Policies (*Forms 3:C & 3:D*)—"If the Company exercises its rights under Condition 5.b., *it must do so diligently*" (emphasis added)]

(2) [3:337] **Insurer rights reserved:** By exercising its right to initiate an action or proceeding under the policy, the insurer does *not* thereby admit liability or waive any policy provision. [See CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2); and ALTA Policies (*Forms 3:C & 3:D*)]

e. Right to pay or settle claim

(1) [3:338] **Payment of claim:** Instead of indemnifying and/or defending its insured on a covered claim, the insurer has the option of paying the claim as follows:

• Under an owner's policy, it may pay the insured owner the amount of the policy liability (plus authorized costs and attorney fees incurred by the insured); and

• Under a lender's policy, it also may "purchase the indebtedness" by paying the insured lender the outstanding loan amount (plus authorized costs and attorney fees incurred by the insured). [See CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2); and ALTA Policies (*Forms 3:C & 3:D*)]

(a) [3:339] **Terminates policy liability:** The insurer's payment of the full amount of the policy limit terminates its obligations and liability under the policy—including any obligation to defend, prosecute or continue litigation in connection with the claim. [See CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2); and ALTA Policies (*Forms 3:C & 3:D*)]

(2) [3:340] **Settlement of claim:** Alternatively, in the event of a claim under the policy, the insurer may elect to *settle* with the insured claimant or with third party claimants on the insured's behalf. [See CLTA Standard Coverage Policies (Form 3:B.1 & 3:B.2); and ALTA Policies (*Forms 3:C & 3:D*)]

(In certain circumstances, an insurer has an affirmative *duty* to settle third party claims. See detailed discussion in Croskey, Heeseman, Ehrlich & Klee, *Cal. Prac. Guide: Insurance Litigation* (TRG), Ch. 12B.)

(a) [3:341] **Terminates policy liability:** A settlement with the insured or a third party claimant terminates the insurer's liability under the policy with respect to the settled matter. [See CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2); and ALTA Policies (*Forms 3:C & 3:D*)]

(3) [3:342] **Subrogation rights:** Upon paying and settling an insured's claim, the insurer is subrogated and entitled to the rights of the insured. [See CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2); ALTA Policies (Forms 3:C & 3:D)]

[3:343 - 3:349] ***Reserved.***

3. Insured's Obligations

a. [3:350] **Reasonable assistance:** An insured is bound by the policy to provide all reasonable assistance requested by its insurer (at insurer expense) in the prosecution or defense of proceedings and actions permitted or required under the policy. [See CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2); and ALTA Policies (*Forms 3:C & 3:D*)]

(1) [3:351] **Noncooperation risks termination of liability:** To the extent the insurer is *prejudiced* by the insured's failure to cooperate, the insurer's liability under the policy *terminates.* [See CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2); and ALTA Policies (*Forms 3:C & 3:D*)]

However, as with termination of liability on account of failure to give requisite notice or proof of loss (*¶ 3:314*), the *insurer* has the burden of proving it suffered actual prejudice by reason of the insured's noncooperation. [*Clemmer v. Hartford Ins. Co.* (1978) 22 C3d 865, 881-883, 151 CR 285, 293-295 (overruled on other grounds by *Ryan v. Rosenfeld* (2017) 3 C5th 124, 134-135, 218 CR3d 654, 662)]

(2) [3:352] **Exception—denial of coverage:** The insured's duty to assist and cooperate terminates upon the insurer's denial of coverage. [*Samson v. Transamerica Ins. Co.* (1981) 30 C3d 220, 238, 178 CR 343, 354]

b. [3:353] **Examination under oath; production of records:** An insured who makes a policy claim may be required to submit to an examination under oath by an authorized representative of the insurer and to produce all records, in whatever medium maintained, including books, ledgers, checks, memoranda, correspondence, reports, e-mails, disks, tapes and videos reasonably related to the claim. The insured also is bound, upon insurer request, to grant its insurer written permission to examine, inspect and copy all the foregoing documentation in a third party's custody or control that reasonably relates to the claim. Noncompliance with these obligations *terminates* the insurer's liability under the policy as to the particular claim. [CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2); see also ALTA Policies (Forms 3:C & 3:D)]

c. [3:354] **Duty of good faith and fair dealing:** The insurance contract contains a *mutual* implied covenant of good faith and fair dealing, binding the *insured* as well as the insurer (*¶ 3:332*). Pursuant thereto, the insured owes a duty to *reasonably cooperate* with the insurer (and vice-versa) in furnishing known information pertinent to a claim under the policy. [*Samson v. Transamerica Ins. Co.* (1981) 30 C3d 220, 240, 178 CR 343, 355-356]

Cross-refer: The insured's duty of good faith and fair dealing and consequences of its breaching the implied covenant are discussed in detail in Croskey, Heeseman, Ehrlich & Klee, *Cal. Prac. Guide: Insurance Litigation* (TRG), Ch. 12A.

[3:355 - 3:359] ***Reserved.***

4. [3:360] **Two-Year Statute of Limitations:** An action against an insurer "founded upon" a title insurance policy must be commenced within *two years* following *accrual* of the cause of action. [CCP § 339(1)—referring to "action founded upon a contract, obligation or liability, evidenced by a certificate, or abstract or guaranty of title of real property, or by a policy of title insurance"; *Smeaton v. Fidelity Nat'l Title* (1999) 72 CA4th 1000, 1003, 85 CR2d 591, 592; *65 Butterfield v. Chicago Title Ins. Co.* (1999) 70 CA4th 1047, 1053, 83 CR2d 40, 43-44]

a. [3:361] **"Accrual" of cause of action—"discovery" rule:** The insured's cause of action under a title policy "shall not be deemed to have accrued until the *discovery* of the loss or damage …" [CCP § 339(1) (emphasis added)]

Thus, the insured must file suit within two years of *discovering* "the *potential* loss which *may* be incurred if the title is not as represented in the policy." [*65 Butterfield v. Chicago Title Ins. Co.* (1999) 70 CA4th 1047, 1061, 83 CR2d 40, 49 (emphasis in original; internal quotes omitted); *Tabachnick v. Ticor Title Ins. Co.* (1994) 24 CA4th 70, 77, 29 CR2d 59, 63]

(1) [3:362] **Limitation—issuance of policy as minimum prerequisite:** Most "discoveries" of loss or damage under a title policy occur after issuance of the policy. In the unusual case where the insured becomes aware of the facts giving rise to the claim *before* the policy issues (e.g., because of the insurer's delay in typing or delivering the policy), the earlier date of discovery will *not* start the two-year statute running. At the very least, a policy of title insurance *must have issued* before a claim under the policy can accrue. [*Smeaton v. Fidelity Nat'l Title* (1999) 72 CA4th 1000, 1003-1004, 85 CR2d 591, 593—since CCP § 339(1) "itself requires an obligation evidenced by a title insurance policy, the policy is a prerequisite to an enforcement action"]

(2) [3:362.1] **Actual vs. constructive discovery:** Where accrual of a cause of action is dependent on "discovery," the statute of limitations normally begins to run when a plaintiff learns, o*r should have learned*, the facts essential to the plaintiff's claim (i.e., "constructive discovery"). [See *65 Butterfield v. Chicago Title Ins. Co.* (1999) 70 CA4th 1047, 1053, 83 CR2d 40, 44, fn. 1]

However, CCP § 339(1) has been construed to require *actual* discovery: The two-year statute of limitations commences on the date the insured *actually* discovers the potential loss, *not* "the date when discovery *would have been possible*." [*Contini v. Western Title Ins. Co.* (1974) 40 CA3d 536, 543, 115 CR 257, 261 (emphasis added; internal quotes omitted); *Lee v. Fidelity Nat'l Title Ins. Co.* (2010) 188 CA4th 583, 600, 115 CR3d 748, 761 (same); but see also *65 Butterfield v. Chicago Title Ins. Co.,* supra, 70 CA4th at 1053, 83 CR2d at 44, fn. 1 (declining to resolve whether "actual discovery" rule may have been abrogated by later authority on statutes of limitations generally)]

(3) [3:362.2] **Awareness that facts give rise to covered claim?** Generally, discovery of the *facts*, not their legal significance, starts the clock running. Consequently, a cause of action accrues when the insured discovers the essential *facts*—even if the insured is not then aware those facts give rise to a claim covered by the policy. [*Jolly v. Eli Lilly & Co.* (1988) 44 C3d 1103, 1113, 245 CR 658, 663; *Abari v. State Farm Fire & Cas. Co.* (1988) 205 CA3d 530, 535, 252 CR 565, 567—belated discovery that insured's homeowner's policy might afford coverage "is without import"]

In the context of *title insurance*, however, the insured arguably needs to discover more than the underlying facts. Rather, in order to determine whether the title is "*as represented*," the insured may need to understand the *extent of the policy's coverage*, including its exceptions and exclusions. [*65 Butterfield v. Chicago Title Ins. Co.* (1999) 70 CA4th 1047, 1055, 83 CR2d 40, 45 (noting no known authority holding title insurance claims to this "heightened discovery standard," which requires both discovery of facts and that those facts give rise to policy claim, but declining to resolve question since insured was aware of coverage under policy more than 2 years before tendering its claim); but see *Smeaton v. Fidelity Nat'l Title* (1999) 72 CA4th 1000, 1004, 85 CR2d 591, 593 (*discussed at ¶ 3:362*)—insured's cause of action upon title policy cannot accrue until insured reviews actual policy language to be certain of the viability of its claim]

(4) [3:362.3] **Effect of provision conditioning liability on adverse determination:** A provision in the title policy conditioning the insurer's liability on "a final determination by a court of competent jurisdiction … adverse to the title" does not specify when the insured's cause of action for loss or damage "accrues."

Rather, the provision *assumes* loss has occurred and "merely specifies the point at which the [title insurer] becomes obligated to indemnify." [*65 Butterfield v. Chicago Title Ins. Co.* (1999) 70 CA4th 1047, 1060, 83 CR2d 40, 48]

(a) [3:362.4] **Compare—provision making *coverage dependent on adverse determination:*** The result is different under a policy providing there can be no recoverable loss or damage (i.e., *no coverage*) absent an adverse court determination on the status of the property. In such cases, the insured's cause of action does not accrue, and the limitations period does not commence to run, until such an adverse determination is made. [*65 Butterfield v. Chicago Title Ins. Co.* (1999) 70 CA4th 1047, 1061, 83 CR2d 40, 49; see *Orange County Found. for Preservation of Pub. Property v. Irvine Co.* (1983) 139 CA3d 195, 202, 188 CR 552, 556—policy made coverage dependent on final judgment declaring disputed properties were tidelands belonging to State]

b. [3:363] **Equitable tolling during claim-processing period:** Suit need not necessarily have been commenced within two years of the insured's discovery of the loss. The two-year statute is *equitably tolled* for the entire period the title insurer is processing the insured's claim; i.e., the limitations "clock" stops at the point the insured gives the insured notice of the claim and does not commence to run again until the insurer denies coverage. [*Forman v. Chicago Title Ins. Co.* (1995) 32 CA4th 998, 1001-1006, 38 CR2d 790, 792-795 (relying on *Prudential-LMI Commercial Ins. v. Sup.Ct. (Lundberg)* (1990) 51 C3d 674, 693, 274 CR 387, 399)—2-year statute tolled by 16 months it took insurer to complete its claim evaluation]

(1) [3:363.1] **Rationale:** Having given timely notice of a policy claim, the insured should not be penalized by waiting for the insurance company's investigation to run its course. Moreover, the period during which the insured's right to bring suit is postponed is for the insurer's benefit; and the insurer is not disadvantaged because it will have been on notice and fully investigated the claim before deciding not to honor the claim. [See *Forman v. Chicago Title Ins. Co.* (1995) 32 CA4th 998, 1002-1004, 38 CR2d 790, 793-794]

(2) [3:364] **Compare—failure to give timely notice of claim:** The equitable tolling principle (¶ 3:363 ff.) presupposes the insured gave the insurer *timely notice of its claim* pursuant to the policy provisions (*¶ 3:310 ff.*) *and*, in any event, within two years after discovery of the loss. When there has been no timely-filed policy claim in the first instance, it is *too*

late to toll the running of the statute. [See *Tabachnick v. Ticor Title Ins. Co.* (1994) 24 CA4th 70, 77, 29 CR2d 59, 63—insured did not file claim with insurer until well after 2-year statute had expired; and *65 Butterfield v. Chicago Title Ins. Co.* (1999) 70 CA4th 1047, 1062-1063, 83 CR2d 40, 49-50—"[t]olling can only suspend the running of a statute that still has time to run; it cannot revive a statute which has already run out"]

Thus, the time it takes the insurer to investigate a claim has *no* effect on the statute of limitations where the two-year period *already expired* before the insured tendered its claim. [*65 Butterfield v. Chicago Title Ins. Co.*, supra, 70 CA4th at 1062, 83 CR2d at 49]

(a) [3:364.1] **No "prejudice" limitation:** It is immaterial to the equitable tolling issue whether the insurer can show it was prejudiced by the insured's failure to give timely notice of the claim. Prejudice or lack thereof has *nothing to do with* the *statute of limitations* defense. [*65 Butterfield v. Chicago Title Ins. Co.* (1999) 70 CA4th 1047, 1063, 83 CR2d 40, 50]

Compare: On the other hand, the insurer must show actual prejudice to prevail on a defense based on a policy provision requiring prompt notice of loss; *see* ¶ 3:313 ff.

[3:364.2 - 3:364.4] ***Reserved.***

(3) [3:364.5] **Compare—informal negotiations with adverse claimant:** The insured's engaging in informal negotiations with the adverse claimant will not itself equitably toll the statute. Such informal negotiations do not put the insurer on *notice* of the claim (so as to make it aware of the need to begin investigating the matter). [*65 Butterfield v. Chicago Title Ins. Co.* (1999) 70 CA4th 1047, 1063, 83 CR2d 40, 50]

c. [3:365] **Distinguish—accrual of action based on refusal to defend:** An insured's cause of action based on the insurer's denial of coverage and refusal to defend a third party suit accrues when the insurer *refuses to defend* (not at an earlier point when the insured first learned of the adverse claim). [*Lambert v. Commonwealth Land Title Ins. Co.* (1991) 53 C3d 1072, 1077, 282 CR 445, 447]

(1) [3:366] **Equitable tolling until conclusion of underlying action:** However, although the statutory period commences upon the insurer's refusal to defend, it is *equitably tolled* until the underlying third party action is terminated by final judgment—effectively *extending* the time to commence suit against the insurer until two years after entry of final judgment in the third party action. [*Lambert v. Commonwealth Land Title Ins. Co.* (1991) 53 C3d 1072, 1077, 282 CR 445, 447]

(a) [3:366.1] **Rationale:** The insurer's duty to defend commences upon the insured's tender of the defense and *continues* until the underlying suit is concluded. "Because the underlying litigation may take over two years … [t]he insured must be allowed the option of waiting until the duty to defend has expired before filing suit to vindicate that duty." [*Lambert v. Commonwealth Land Title Ins. Co.* (1991) 53 C3d 1072, 1077, 282 CR 445, 447-448; see also *Oil Base, Inc. v. Continental Cas. Co.* (1969) 271 CA2d 378, 389-390, 76 CR 594, 601-602]

"The protection provided pursuant to a policy of title insurance would ring resoundingly hollow were the holder compelled to simultaneously enforce rights under the policy and defend a costly and potentially devastating claim against the subject property. Thus, we recognize the justice and fairness of equitably tolling the insured's action to establish coverage until resolution of the underlying claim." [*Lambert v. Commonwealth Land Title Ins. Co.*, supra, 53 C3d at 1081, 282 CR at 450]

[3:367 - 3:368] ***Reserved.***

5. Nature and Scope of Insurer's Liability

a. [3:369] **No "abstractor liability" exposure:** As discussed earlier, title companies were at one time subject to liability as "abstractors" … on the theory that title policies and title reports were "abstracts of title"; as abstractors, title companies were thus exposed to both contract *and extracontractual* (tort) damages. [See *White v. Western Title Ins. Co.* (1985) 40 C3d 870, 883-884, 221 CR 509, 515-516; *Soifer v. Chicago Title Co.* (2010) 187 CA4th 365, 371, 114 CR3d 1, 5—prior to enactment of remedial legislation (below), title insurers could be liable in negligence for failing to list all recorded encumbrances in preliminary reports; *¶ 3:212 ff.*]

However, the Insurance Code has since been amended (eff. 1/1/82) to make clear that title policies are not abstracts of title and a title policy, as a contract of indemnity, does not create any of the duties or responsibilities that attach to an abstractor in issuing an abstract of title (see Ins.C. §§ 12340.10 & 12340.11, *discussed at ¶ 3:211 ff.*). Accordingly, with regard to preliminary reports and title policies issued on or after January 1, 1982, unless they contract to provide abstractor services, title insurers are *not* subject to the liability of an abstractor for failure to report matters affecting title to the property. [*Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1190-1193, 54 CR2d 84, 88-90; *Southland Title Corp. v. Sup.Ct. (Nye)* (1991) 231 CA3d 530, 537-538, 282 CR 425, 429-430]

b. [3:370] **Policy liability:** An insured's maximum policy recovery for a covered loss or damage is the amount of insurance (policy limits) specified in the title policy. However, that amount is *exclusive* of defense costs and authorized expenses incurred by the insured (*¶ 3:382*). [See CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2); and ALTA Policies (*Forms 3:C* & *3:D*)]

(1) Measure of policy damages

(a) Insured owners

1) [3:371] **Policy provision:** The CLTA and ALTA policies limit liability to an insured owner on a particular claim to the *lesser* of:

• The amount of insurance specified in the policy; or

• The difference between the fair market value of the property as insured and the fair market value of the property subject to the matter insured against. [See CLTA Standard Coverage Policy (Form 3:B.2); and ALTA Policy (Form 3:D)]

2) [3:372] **Measuring differential value damages:** The difference between the value of the property as insured and the value of the property with the covered defect is measured by either of the following methods:

• The *diminution in value* of the property as of the date of discovery of the defect, lien, encumbrance, etc., based upon the insured's use of the property (*Overholtzer v. Northern Counties Title Ins. Co.* (1953) 116 CA2d 113, 130, 253 P2d 116, 125; see also *Tait v. Commonwealth Land Title Ins. Co.* (2024) 103 CA5th 271, 277, 284-286, 322 CR3d 877, 880, 886-888 (expanding upon *Overholtzer's* method by concluding loss should be based on diminution in property's value according to its *"highest and best use"* as of date defect is discovered); *Nebo, Inc. v. Transamerica Title Ins. Co.* (1971) 21 CA3d 222, 227, 98 CR 237, 240—damages measured by lost rents insured would have been able to collect absent title defect); *or*

• The cost of correcting (removing) the defect, lien or encumbrance (*National Holding Co. v. Title Ins. & Trust Co.* (1941) 45 CA2d 215, 224, 113 P2d 906, 911).

a) [3:372.1] **Policy limits cap:** The appropriate measure in a given case depends on the circumstances surrounding the loss. But, in any event, the *maximum* amount recoverable remains the specified *policy limits* (exclusive of defense costs and other authorized expenses; *¶ 3:370*). [*Overholtzer v. Northern Counties Title Ins. Co.* (1953) 116 CA2d 113, 130, 253 P2d 116, 125]

(b) Insured lenders

1) [3:373] **Policy provision:** By the terms of the CLTA and ALTA policies, liability to insured *lenders* with respect to a particular claim is the *lesser* of:

• The amount of insurance specified in the policy;

• The indebtedness;

• The difference between the fair market value of the insured's interest in the property, as insured, and the fair market value of the insured's interest in the property subject to the matter insured against; *or*

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• If a government mortgage agency or instrumentality is the insured claimant, the amount it paid in acquiring the title or the insured instrument or in satisfaction of its insurance contract or guaranty relating to the title or insured instrument. [See CLTA Standard Coverage Policy (Form 3:B.2); and ALTA Loan Policy (Form 3:C)]

2) [3:374] **Measure of loss:** Title insurance indemnifies a *lender* (as opposed to an owner) only against loss with respect to the *secured debt*. It follows that the mere existence of an insured defect, lien or encumbrance, etc., does not itself give rise to a compensable loss under a lender's policy because the undisclosed (insured) liens might not be valid and enforceable, and the insured might be able to resell the property for a price sufficient to discharge the covered liens plus its loan. [See *Radian Guaranty, Inc. v. Garamendi* (2005) 127 CA4th 1280, 1289, 26 CR3d 464, 470]

In other words, the insurer is liable under a lender's title policy only if and when the insured is unable to obtain repayment of its secured loan because of a senior lien not disclosed in the policy. [*Karl v. Commonwealth Land Title Ins. Co.* (1993) 20 CA4th 972, 983, 24 CR2d 912, 917; *Cale v. Transamerica Title Ins.* (1990) 225 CA3d 422, 427-428, 275 CR 107, 109-110; see also *Hovannisian v. First American Title Ins. Co.* (2017) 14 CA5th 420, 434-435, 221 CR3d 883, 895 (citing *Karl* with approval and noting policy only provided coverage for damage sustained by *insured, not* for damage incurred by third parties)—insurer not liable where plaintiffs purchased property without warranty from insured at foreclosure sale and subsequently discovered preexisting title defect (¶ 3:323.3)]

a) [3:374.1] **Insured lien balance:** The lender's compensable loss normally is measured by "the remaining balance of principal, interest and associated [foreclosure] expenses, or the amount required to remove the prior lien, whichever is less." [*Lawrence v. Chicago Title Ins. Co.* (1987) 192 CA3d 70, 75, 237 CR 264, 267]

In addition, sums spent by the insured to protect its lien prior to foreclosure may be recoverable if the lien so provides (e.g., time and money expended on property repairs and maintenance). [*Karl v. Commonwealth Land Title Ins. Co.* (1993) 20 CA4th 972, 983, 24 CR2d 912, 919, fn. 8]

b) [3:374.2] **Compare—no recovery simply for diminution in value of security:** Title insurance does *not* indemnify lenders against diminution in the size of the "equity cushion" on which they may have been relying. [*Karl v. Commonwealth Land Title Ins. Co.* (1993) 20 CA4th 972, 983, 24 CR2d 912, 919; and see *Karl v. Commonwealth Land Title Ins. Co.* (1997) 60 CA4th 858, 871, 70 CR2d 374, 381-382]

Thus, the insured lender's loss is *not* measured by diminution in value of the secured property as a result of an undisclosed defect; indeed, diminution in value of the security does not necessarily mean the lender has suffered a compensable loss. Again, the actual recoverable loss can never exceed the amount of the unpaid debt. [*Cale v. Transamerica Title Ins.* (1990) 225 CA3d 422, 426, 275 CR 107, 109]

c) [3:374.3] **Example:** Lenders' title policy omitted a $95,000 lien that was senior to their $75,000 trust deed. Lenders paid off the senior lien after foreclosing under their trust deed. Insurer was liable for the amounts spent and costs incurred in paying off the undisclosed senior lien. [*Lawrence v. Chicago Title Ins. Co.* (1987) 192 CA3d 70, 75, 237 CR 264, 267]

On the other hand, the additional profit Lenders would have realized had there been no senior lien was *not* a compensable loss; nor could Lenders recover under the policy for damages allegedly suffered because Insurer's negligence led them to make a loan they otherwise would not have made. [*Lawrence v. Chicago Title Ins. Co.*, supra, 192 CA3d at 74, 237 CR at 266, fn. 3]

3) [3:375] **Date of measure of loss?** Courts are split as to precisely when an insured lender's "loss" from undisclosed liens or encumbrances should be measured:

a) [3:376] **Upon foreclosure of lien:** One line of authority measures the loss on the date the insured completes *foreclosure of its lien* because "only then is there certainty the lender will not be paid in full." [*Karl v. Commonwealth Land Title Ins. Co.* (1993) 20 CA4th 972, 983-984, 24 CR2d 912, 919]

1/ [3:376.1] **Fair market value as of foreclosure date if lender acquires property:** When the insured lender acquires the secured property by credit bid at foreclosure sale, its loss is measured by the property's fair market value as of the date of foreclosure. [*Karl v. Commonwealth Land Title Ins. Co.* (1993) 20 CA4th 972, 985, 24 CR2d 912, 920; see *Karl v. Commonwealth Land Title Ins. Co.* (1997) 60 CA4th 858, 871, 70 CR2d 374, 381-382—"We reaffirm our holding in *Karl I*"]

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The amount *bid* by the lender is *not* controlling: The lender has obtained "payment"—although in property rather than cash—and is charged with what is actually received for its note. [*Karl v. Commonwealth Land Title Ins. Co.*, supra, 20 CA4th at 985, 24 CR2d at 920]

Nor does the fair market value on date of foreclosure take into account the lender's potential costs of subsequent resale. "[F]or purposes of determining whether an acquiring secured lender in possession of the security has sustained a loss under a standard lender's title policy …, the relevant value of the acquired security is the fair market value as of the date of foreclosure, not the fair market value on that date less the reasonable potential cost of selling the security." [*Karl v. Commonwealth Land Title Ins. Co.*, supra, 60 CA4th at 871, 70 CR2d at 381-382]

Further, the compensable loss is not affected by the fact the lender resells the property after foreclosure for a higher or lower price. It would be "unfair" to measure damages after a period of time in which inflation or deflation, or the insured lender's own efforts, may have altered the value of the property. [*Karl v. Commonwealth Land Title Ins. Co.*, supra, 20 CA4th at 986, 24 CR2d at 921]

2/ [3:376.2] **Amount paid if third party acquires property:** On the other hand, if the property is sold at foreclosure to a third party, the amount paid by the third party constitutes a realization of the note which can be used to measure the insured lender's loss. [*Karl v. Commonwealth Land Title Ins. Co.* (1993) 20 CA4th 972, 984, 24 CR2d 912, 919, fn. 11]

b) [3:377] **After foreclosure of lien:** Other authority takes the position that the lender's loss can be measured only *after* foreclosure if the lender were to sell the property on the open market or the undisclosed lienor were to foreclose. [*Cale v. Transamerica Title Ins.* (1990) 225 CA3d 422, 428, 275 CR 107, 110]

Fair market value at the time of foreclosure cannot be the measure of loss because the lender's "insured indebtedness continues to be secured against loss by the terms of the title insurance policy." [*Cale v. Transamerica Title Ins.*, supra, 225 CA3d at 428, 275 CR at 110]

• [3:377.1] **Example:** Insured Lender purchased property securing its loan at a nonjudicial foreclosure sale. Insured was required to purchase the property subject to three undisclosed senior liens and sought recovery under its title insurance policy on account of those liens. But recovery under the policy was denied:

Insurer owed no duty to indemnify Lender until the senior liens *resulted in actual loss or damage* to Lender (e.g., if unable to resell the property at a price sufficient to discharge the three senior liens and its junior lien). A compensable loss under the policy could not be based on the mere diminution in value of Lender's security (¶ *3:374.2*). [*Cale v. Transamerica Title Ins.* (1990) 225 CA3d 422, 427, 275 CR 107, 109]

4) [3:378] **Compare—lender's "loss" without foreclosure:** Under certain circumstances, an insured lender might sustain an indemnifiable loss without foreclosing its lien; for example:

• where an *undisclosed senior lienholder forecloses and wipes out* the insured lender's lien; or

• where the insured lender *sells its lien at a loss* because of the existence of an undisclosed senior lien. [See *Karl v. Commonwealth Land Title Ins. Co.* (1993) 20 CA4th 972, 984, 24 CR2d 912, 919, fn. 11]

(c) [3:379] **Burden of proof:** The *insured*—*not* the insurer—bears the burden of proving the actual amount of the loss or damage for which a policy recovery is sought. [*Hawkins v. Oakland Title Ins. & Guaranty Co.* (1958) 165 CA2d 116, 122, 331 P2d 742, 745—complaint failing to allege compensable loss subject to general demurrer]

(2) [3:380] **Reasonably foreseeable consequential damages:** In addition to recovery for a covered loss or damage (¶ 3:370 ff.), an insured may be entitled to *consequential damages* if *reasonably foreseeable* at the time the contract was entered into and resulting from the insured's *detrimental reliance* upon the policy. [*Overholtzer v. Northern Counties Title Ins. Co.* (1953) 116 CA2d 113, 121, 253 P2d 116, 123] Otherwise, insurers cannot be reached for consequential damages on a policy liability (contract) claim. [See, e.g., *Sullivan v. Transamerica Title Ins. Co.* (1975) 35 Colo.App. 312, 532 P2d 356]

• [3:381] **Comment:** As a practical matter, a title insurer is far more likely to be liable for consequential damages where the insured's claim is based on the insurer's obligations undertaken by agreement separate and distinct from the title policy. [See, e.g., *Red Lobster Inns of America, Inc. v. Lawyers Title Ins. Corp.* (8th Cir. 1981) 656 F2d 381, 384-386 (decided under Ark. law)—insurer liable for insured's lost profits arising from insurer's failure to discover use restriction pursuant to *separate* agreement to examine title and inform insured of use restrictions (lost profits awarded as *tort*

damages based on insurer's misperformance of its agreement which involved foreseeable, reasonable risk of harm to insured's interest)]

(3) [3:382] **Plus insured's defense costs:** A title policy insurer is also liable to its insured for defense costs and other authorized expenses and attorney fees incurred by the insured in prosecuting or defending a claim under the policy. [See CLTA Standard Coverage Policies (Forms 3:B.1 & 3:B.2); and ALTA Policies (*Forms 3:C & 3:D*)]

The insurer's costs liability is rooted in its duty to defend (*¶ 3:320 ff.*); hence, there is no maximum limit on an insured's costs recovery.

(4) [3:383] **Compare—insurer's right to correct or settle:** As earlier discussed, instead of paying policy damages to its insured, the insurer may, where appropriate, elect to correct (remove) the defect, lien or encumbrance or settle with the insured for a lesser amount. Such action terminates the insurer's liability on the claim. *See* ¶ *3:335 ff., 3:340 ff.*

[3:384 - 3:385] ***Reserved.***

c. [3:386] **Damages for wrongful denial of benefits:** Title insurers are subject to the same liability for wrongful withholding of policy benefits as other insurers. Thus, in appropriate cases, a title insurer may be liable for contract and, in some cases, *tort* damages for its wrongful refusal to pay policy benefits.

Cross-refer: A detailed discussion of an insurer's contractual and extracontractual liability arising from the wrongful denial of policy benefits is beyond the scope of this Practice Guide. For a comprehensive treatment of the subject, see Croskey, Heeseman, Ehrlich & Klee, *Cal. Prac. Guide: Insurance Litigation* (TRG), Chs. 11-13.

[3:387 - 3:399] ***Reserved.***

d. [3:400] **"Unfair competition" claim:** The "business of insurance" is expressly made subject to the State Unfair Competition Law (UCL, Bus. & Prof.C. § 17200 et seq.). [See Ins.C. § 1861.03; *State Farm Fire & Cas. Co. v. Sup.Ct. (Allegro)* (1996) 45 CA4th 1093, 1107-1111, 53 CR2d 229, 237-239 (abrogated on other grounds by *Cel-Tech Communications, Inc. v. Los Angeles Cellular Telephone Co.* (1999) 20 C4th 163, 184-185, 83 CR2d 548, 564)]

Thus, "any unlawful, unfair or fraudulent business act or practice [or] unfair, deceptive, untrue or misleading advertising …" by a title insurer may give rise to an unfair competition claim under Bus. & Prof.C. § 17200 et seq. [See Bus. & Prof.C. § 17500 et seq.; *Quelimane Co., Inc. v. Stewart Title Guaranty Co.* (1998) 19 C4th 26, 51, 77 CR2d 709, 723]

(1) [3:401] **Remedy limited to injunctive or restitutive relief:** However, a Bus. & Prof.C. § 17200 claim is *not* remediable by a traditional damages remedy. In a private UCL suit, the insured is limited to *injunctive or restitutive* relief (see Bus. & Prof.C. § 17203). [*State Farm Fire & Cas. Co. v. Sup.Ct. (Allegro)* (1996) 45 CA4th 1093, 1110, 53 CR2d 229, 238-239 (abrogated on other grounds by *Cel-Tech Communications, Inc. v. Los Angeles Cellular Telephone Co.* (1999) 20 C4th 163, 184-185, 83 CR2d 548, 564)—compensatory and punitive damages not recoverable in UCL action]

(2) [3:402] **Misleading or unfair advertisements:** A UCL cause of action can be stated against a title insurer for advertising that is "unfair, deceptive, untrue or misleading" within the meaning of Bus. & Prof.C. § 17200. [*Quelimane Co., Inc. v. Stewart Title Guaranty Co.* (1998) 19 C4th 26, 51-52, 77 CR2d 709, 723-724]

For example:

• [3:403] Title Insurer advertised that title insurance is necessary in land sale transactions and that such insurance would be issued on any property with "good title." Such advertising may be deemed both misleading and false, giving rise to a UCL cause of action, where Title Insurer fails to disclose it will *not* issue title insurance on tax-deeded property. "By representing that title insurance will be issued whenever there is 'good' title … members of the public might reasonably understand such an advertisement to encompass title acquired at a tax sale." [*Quelimane Co., Inc. v. Stewart Title Guaranty Co.* (1998) 19 C4th 26, 52-55, 77 CR2d 709, 726]

Cross-refer: For a comprehensive treatment of the State Unfair Competition Law (Bus. & Prof.C. § 17200 et seq.), see Stern, *Bus. & Prof.C. § 17200 Practice* (TRG).

[3:404 - 3:409] ***Reserved.***

e. [3:410] **Conspiracy in restraint of trade:** Normally, a title insurer can pick and choose the risks it is willing to insure (*see* ¶ *3:70*).

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But where the only title insurers in a particular county (or other market area) agree to refuse all coverage for a particular risk, such refusal may violate the Cartwright Act (Bus. & Prof.C. § 16720), prohibiting "acts by two or more persons… to create … restrictions in trade or commerce." I.e., by agreeing not to insure title to particular property, the insurers together may effectively make the property unmarketable in the area, resulting in a "restraint of trade" in violation of the Act. [*Quelimane Co., Inc. v. Stewart Title Guaranty Co.* (1998) 19 C4th 26, 49, 77 CR2d 709, 722—actionable Cartwright Act violation stated against all title insurers in El Dorado County who allegedly combined to refuse to issue title insurance on tax-defaulted property until purchaser obtained quiet title decree, thereby making such property unmarketable]

f. [3:411] **No general negligence liability arising from matters collateral to policy coverage:** An insured's claim against the insured's title insurer is *under the policy*. Again, insureds have no separate claim against title insurers based on negligence. [See *Stockton Mortg., Inc. v. Tope* (2014) 233 CA4th 437, 455, 183 CR3d 186, 201; *Vournas v. Fidelity Nat'l Title Ins. Co.* (1999) 73 CA4th 668, 675-676, 86 CR2d 490, 495]

• [3:411.1] A title insurer had no inherent tort duty to obtain a full release of a Notice of Abatement Action referenced in a preliminary report but omitted from its policy. [*Stockton Mortg., Inc. v. Tope* (2014) 233 CA4th 437, 455-457, 183 CR3d 186, 201-202]

• [3:411.2] A title insurer had no inherent tort duty to investigate or ascertain a seller's authority to convey property. [*Vournas v. Fidelity Nat'l Title Ins. Co.* (1999) 73 CA4th 668, 676-677, 86 CR2d 490, 496—insurer that issued lender's policy to trustee/seller, insuring priority of purchase money deeds of trust given by buyers, had no duty to trust or trust beneficiaries to investigate trustee's authority to sell without beneficiaries' consent]

(1) [3:412] **No liability based on failure to follow CLTA manual:** A CLTA manual sets forth various procedures and guidelines for title insurers to follow in deciding whether to issue a title policy. This manual is designed solely to guide title company employees on steps to be taken before issuing a policy for the purpose of reducing the risk the insurer will be required to pay a claim on a policy it issues. "[T]he CLTA manual outlines duties intended to affect and benefit [the *title insurer*] rather than third parties"; and thus does not establish a standard of care upon which negligence liability to others may be based. [See *Vournas v. Fidelity Nat'l Title Ins. Co.* (1999) 73 CA4th 668, 676, 86 CR2d 490, 496, fn. 10 (emphasis added)]

(2) [3:413] **Compare—liability as escrow holder:** The rules set forth at ¶ 3:411 ff. limit a title insurer's liability in its capacity as *title insurer*. Title insurers often are also hired as *escrow holders* (¶ *3:28, 3:45, 4:567 ff.*) and, functioning in *that* capacity, title insurers can incur negligence liability independent of any liability resulting from the provisions of the title policy. *See discussion at ¶ 4:644 ff.*

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Chapter 3. Title Insurance

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[Form 3:A] Preliminary Report

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[Form 3:B.1] CLTA Standard Coverage Owner's Policy

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[Form 3:B.2] CLTA Standard Coverage Loan Policy

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[Form 3:C] ALTA Loan Policy

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Chapter 3. Title Insurance

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[Form 3:D] ALTA Owner's Policy

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Chapter 3. Title Insurance

Forms

[Form 3:E] CLTA/ALTA Homeowner's Policy

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Chapter 3. Title Insurance

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[Form 3:F] ALTA Expanded Coverage Residential Loan Policy

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Chapter 3. Title Insurance

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[Form 3:G] Residential Limited Coverage Mortgage Modification Policy

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Chapter 4. Purchase and Sale Agreement

Scope Note

This Chapter focuses on preliminary issues and negotiations leading up to formalization of a purchase and sale agreement, essential terms of the agreement, practical concerns in drafting the agreement, escrows, and closing the transaction.

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Chapter 4. Purchase and Sale Agreement

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1. Preliminary Considerations

a. [4:1] **Significance:** Defining the kinds of property and property rights to be conveyed affects a host of other important issues in a real property purchase and sale transaction—including the form of conveyancing instrument, the method of financing the purchase, title insurance, and tax allocations. All of these issues should be confronted, negotiated and resolved before a purchase agreement is signed.

(1) [4:2] **Conveyancing instruments:** Different conveyancing instruments are used to transfer various kinds of property: i.e., *deeds* to convey *real property* (*¶ 4:37*); *bills of sale* to transfer *personal property* (*¶ 4:38*); and *assignments* to transfer *contract rights* or other *choses in action* (*¶ 4:38*).

(2) [4:3] **Financing documents:** If the sale will be seller-financed in whole or in part, the purchase agreement should identify the encumbered real and personal property, as well as the forms of *security instruments* and methods of perfection to be used. Normally, the loan is secured by a lien in the form of a recorded deed of trust encumbering the real property (*see ¶ 6:336 ff.*). Personal property liens, however, are created by an unrecorded security agreement, and the lien is perfected by filing a Financing Statement with the Secretary of State (*see ¶ 4:36*).

(3) [4:4] **Tax allocations:** Substantial tax benefits can be achieved (or lost) by allocating the purchase price of the various components of the property between real property, personal property, "goodwill" and the like. (*See ¶ 4:305 ff.*)

(4) [4:5] **Apportionment of contract rights and obligations:** If various contracts and contract rights relating to the property sold will be assigned to the buyer, the benefits and burdens of those contracts (including revenues and expenses) may require negotiation and allocation.

For example, it may be relatively easy to prorate a real property tax bill (as where seller agrees to pay its share up to the closing date based on estimated current taxes, *¶ 4:612 ff.*); but it may not be as easy to allocate proceeds (or liability) arising from a lawsuit affecting the property or the owner's interest. (*See ¶ 4:73*.)

b. [4:6] **Drafting tips:** When drafting or reviewing a purchase agreement (and related documents) with a view to the kinds of property to be sold, the following principles should be kept in mind:

(1) [4:7] **Define all items and rights to be transferred:** In a rush to sign a purchase agreement, buyers and sellers may be tempted to defer the preparation of an inventory of all property to be sold. Avoid this temptation, as it is likely to result in a future dispute over precisely what was (and was not) to be conveyed.

With rare exception, all items and rights to be transferred can be identified at the outset and should be *specified in the contract*.

(2) [4:8] **Use *complete and specific descriptions:*** Legal definitions of "real" and "personal" property, "intangible" property, "fixtures" or "trade fixtures," etc. will not necessarily reflect the parties' true intent. Indeed, legal scholars could debate these terms for years. (Many a lawsuit has arisen over such issues as whether specialized power panels, lighting or a "built-in" bookcase are so affixed to the structure as to fall within the legal definition of "real property.")

Avoid future litigation over what property the parties contemplated was to be sold by including *complete and specific descriptions*.

(3) [4:9] **Dispel buyer's assumption that "more is better":** Buyers are often inclined to negotiate "for the maximum." But buyer's counsel should carefully evaluate the *burdens* that accompany the apparent benefits. Certain rights and items of physical property may be *undesirable* because their ownership also carries actual or potential *liability*. (For example,

that rusty trailer, crumbling wall, or stack of empty chemical drums on the property is of no benefit to the buyer and may be a liability trap.)

(4) [4:9.1] **Remember that general rules of contract interpretation apply:** Be as clear and concise as possible. If a dispute as to what was agreed to arises, courts will whenever possible interpret the parties' intentions from the writing itself ("four corners rule," Civ.C. § 1639)—i.e., extrinsic evidence is not admissible unless the contract is reasonably susceptible to different meanings. This is particularly true with respect to documents relating to real estate transactions that, "when recorded, are intended to provide public notice and promote public reliance on their facial meaning." [See *Abers v. Rounsavell* (2010) 189 CA4th 348, 356-357, 116 CR3d 860, 865-866]

c. [4:10] **Sufficiency of real property description in conveyancing instruments:** Deeds and other instruments purporting to convey an interest in real property are void and of no effect *unless* they *sufficiently describe* the property. [*Edwards v. City of Santa Paula* (1956) 138 CA2d 375, 380, 292 P2d 31, 34; *Oatman v. Niemeyer* (1929) 207 C 424, 427, 278 P 1043, 1044]

(1) [4:11] **Property must be identified:** Although a complete legal description may be the most precise, it is not essential. "It is only necessary that the description of premises in a … [conveyancing instrument] be sufficiently definite and certain *to enable the land to be identified*." [*Anderson Cottonwood Irr. Dist. v. Zinzer* (1942) 51 CA2d 587, 590-591, 125 P2d 82, 84 (emphasis added; internal quotes omitted); *King v. Stanley* (1948) 32 C2d 584, 589, 197 P2d 321, 324 (disapproved on other grounds by *Patel v. Liebermensch* (2008) 45 C4th 344, 351, 86 CR3d 366, 371, fn. 4); *see also* ¶ *4:270.7*]

(2) [4:12] **Reformation to correct erroneous descriptions:** A deed that mistakenly omits a sufficient description or contains an erroneous, ambiguous or inconsistent description, may be amenable to *reformation* to reflect the parties' true intent as evidenced by the underlying contract (*see* ¶ *11:410 ff.*). In that event, the deed, as reformed to include a sufficient description, operates as an effective conveyance. [*Oatman v. Niemeyer* (1929) 207 C 424, 427, 278 P 1043, 1044; *Flores v. Flores* (1921) 55 CA 595, 597-599, 204 P 54, 56]

[4:13 - 4:15] ***Reserved.***

d. [4:16] **Merger doctrine:** In virtually every purchase and sale agreement, conveyance of title to the real property is only *one* of the seller's obligations. But, under the *merger doctrine*, seller obligations not specifically mentioned in the deed may be deemed *merged* into the deed and thus *terminated* upon the conveyance (i.e., unless the parties agree to a survival clause, the contractual obligations are "extinguished" by the deed and do not survive the closing). [See *Western Filter Corp. v. Argan, Inc.* (9th Cir. 2008) 540 F3d 947, 952 (applying Calif. law); but see also *Ram's Gate Winery, LLC v. Roche* (2015) 235 CA4th 1071, 1079-1081, 185 CR3d 935, 940-942 (limiting merger doctrine's applicability to cases where contractual terms are *inconsistent* with deed or when parties clearly intend all contractual obligations to be subsumed in recorded deed's recitals)]

Whether a seller's contractual obligations will survive execution and delivery of the deed depends on:

- The parties' *intent* (*Ram's Gate Winery, LLC v. Roche,* supra, 235 CA4th at 1083, 185 CR3d at 944—whether parties intended seller's disclosure warranty to continue after close of escrow could not be decided by summary adjudication; *Szabo v. Sup.Ct. (Hodgkinson)* (1978) 84 CA3d 839, 845, 148 CR 837, 840—whether parties intended deed to supersede zoning covenant in sale agreement could not be decided by summary adjudication); and

- Whether the obligation was "collateral to the deed" and therefore not likely to be referenced in the deed (*Ram's Gate Winery, LLC v. Roche,* supra, 235 CA4th at 1075, 185 CR3d at 938—collateral obligations exception prevented merger doctrine from extinguishing seller's duty to disclose property's active fault trace; *Stiles v. Bodkin* (1941) 43 CA2d 839, 843, 111 P2d 675, 678—merger doctrine inapplicable to obligations "one would not expect to see … in a deed" (here, covenant to construct improvements)).

The "merger" problem typically arises in connection with representations and warranties made by the seller in the purchase agreement. If the seller's breach is not discovered until after closing (recordation of deed), the seller will try to invoke the merger doctrine to avoid liability. *See further discussion at* ¶ *4:434 and 4:454*.

[4:17 - 4:19] ***Reserved.***

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2. [4:20] **General Classifications of Property and Rights—"Real" and "Personal" Property:** The Civil Code generally classifies property as either "real" or "personal": "Property is either: (1) real or immovable; or, (2) personal or movable." [Civ.C. § 657]

In practice, however, a variety of other terms (some archaic, redundant and/or confusing) are used and subsumed within these two basic categories:

a. [4:21] **Real property:** Real property consists of four components: "(1) Land; (2) [t]hat which is affixed to land; (3) [t]hat which is incidental or appurtenant to land; (4) [t]hat which is immovable by law …" [Civ.C. § 658]

(1) [4:22] **Land:** "Land" is the "material of the earth … includ[ing] free or occupied space of an indefinite distance upwards as well as downwards, subject to limitations upon the use of airspace …" [Civ.C. § 659]

(2) [4:23] **Fixtures:** "Fixtures" are a part of the real property (Civ.C. § 658), defined as things "affixed to land," "embedded in it," "permanently resting upon it" or "permanently attached to what is thus permanent." [Civ.C. § 660; see *People v. Acosta* (2014) 226 CA4th 108, 121, 171 CR3d 774, 784—§ 660 defines fixture in terms of its "overarching objective manifestation of the annexing party's intent—namely, 'permanence'"; *Vieira Enterprises, Inc. v. City of East Palo Alto* (2012) 208 CA4th 584, 598, 145 CR3d 722, 730; *Southern Pac. Co. v. Riverside County* (1939) 35 CA2d 380, 386, 95 P2d 688, 692; *and ¶ 4:42 ff.*]

(3) [4:24] **Appurtenances:** "Appurtenances" are also part of real property (Civ.C. § 658), defined as things "deemed to be incidental or appurtenant to land when it is by right used with the land for its benefit …" [Civ.C. § 662; see *State of Calif. v. Sup.Ct. (Underwriters at Lloyd's of London)* (2000) 78 CA4th 1019, 1025, 1027, 93 CR2d 276, 281, 283—riparian water rights, being "appurtenant to" land, are an interest in real property]

(4) [4:25] **Hereditaments and tenements:** "The words 'real property' are coextensive with lands, tenements, and hereditaments." [Civ.C. § 14(b)(2)]

b. [4:26] **Hereditaments, corporeal and incorporeal, chattels, tenements and rents, issues and profits:** These terms are frequently used in transactional documents, with often overlapping definitions:

(1) [4:27] **Hereditaments:** "Hereditaments" are "things capable of being inherited, be it corporeal or incorporeal, real, personal or mixed …" [Black's Law Dictionary]

(2) [4:28] **"Corporeal" or corporeal property:** These terms refer to physical objects—i.e., those possessing a body and which can be distinguished from things that exist only in contemplation. [Black's Law Dictionary]

(3) [4:29] **"Incorporeal" or incorporeal property:** Things that exist only by reason of legal rights, such as a chose in action (i.e., legal claims), are "incorporeal" or incorporeal property. [Black's Law Dictionary]

Thus, a house is corporeal property (¶ 4:28); but the entitlement to rental income from the house is incorporeal property.

(4) [4:30] **Chattels:** "Chattels" are articles of personal property. [Black's Law Dictionary]

(5) [4:31] **Chose in action:** A chose in action is a "personal right not reduced into possession, but recoverable by a suit at law" (i.e., a legal claim). [Black's Law Dictionary]

(6) [4:32] **Rents, issues and profits:** These terms refer collectively to income from land or an estate in land. [Black's Law Dictionary; Ballantine's Law Dictionary]

(7) [4:33] **Tenements:** A "tenement" is best described as incorporeal property (a legal right) that arises out of corporeal property (a tangible piece of property).

[4:34] **Comment:** As evidenced by the definitions at ¶ 4:26 ff., many terms are used to describe what is fundamentally the same thing. Occasionally, circumstances might require the description of a particularly unique right, claim or interest. But it is generally unnecessary (and/or redundant) to use such terms as "rents, issues and profits," "tenements," "hereditaments" and the like in a purchase and sale agreement or deed … because Civ.C. § 658 provides that everything incidental or appurtenant to land is within the definition of "real property" (*¶ 4:21*).

c. [4:35] **Personal property:** "Personal property" is "every kind of property that is not real …" [Civ.C. § 663]

The transfer of various kinds of personal property may or may not be contemplated in a sale of real property. Therefore, it is essential to *enumerate* the specific personal property items to be included in any purchase agreement.

➪ [4:36] ***PRACTICE POINTER—UCC SEARCH*:** It may be advisable to conduct a search of the California Secretary of State's records to determine whether any Uniform Commercial Code (UCC) Financing Statements have been filed against personal property covered by the purchase agreement. The filing of any such Financing Statement creates a *perfected*

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security interest in favor of third party creditors, and any title conveyed to a buyer would be subject to the third party claim. A number of private services will conduct a UCC search for a fairly modest fee.

Of course, the advisability of spending the time and money to conduct such a search will depend on the size and complexity of the transaction. However, it is not unusual for vaults, solar heating devices, security systems, telephone systems, etc. to be subject to a personal property lease or owned by a third party. [See Comm'l C. §§ 9309 & 9501, regarding filing of Financing Statements]

In all events, buyers' counsel should alert their clients to the *possibility* of a third party security interest; and let the *clients* make the final decision whether to incur the costs of a search. (Although generally unnecessary in single family residence transactions, in many other cases it will be well worth the money.)

d. Conveyancing instruments

(1) [4:37] **"Deed" for real property:** The instrument used to convey title to real property is a "deed." A deed is an executed conveyance and operates as a present transfer of the real property. [*Estate of Stephens* (2002) 28 C4th 665, 671-672, 122 CR2d 358, 362; see *Carne v. Worthington* (2016) 246 CA4th 548, 558, 200 CR3d 920, 927, fn. 17—at a minimum, deed must be in writing, signed by grantor or grantor's agent, name grantor and grantee, and be delivered to and accepted by grantee; see also *Lee v. Lee* (2009) 175 CA4th 1553, 1558, 97 CR3d 516, 520—deed signed by grantor and delivered to grantee before being altered by third party constituted fully executed conveyance, enforceable in accordance with its original terms; compare *Lin v. Coronado* (2014) 232 CA4th 696, 703-704, 181 CR3d 674, 679-680—trustee's deed altered by grantee to omit co-grantee following its execution and delivery by trustee deemed fully enforceable according to its *altered* terms (co-grantee's omission immaterial as "a matter of law" because deed's original version showed she had no percentage interest in property)]

(a) [4:37a] **Delivery transfers title:** A deed transfers title when it is legally delivered. [Civ.C. § 1054; see *Luna v. Brownell* (2010) 185 CA4th 668, 673, 110 CR3d 573, 576-577—also noting acceptance by grantee makes delivery effective and deed operative]

The fact that the deed is not recorded is of no consequence to the effective transfer of title. [See *Goodman v. Goodman* (1931) 212 C 730, 733, 300 P 449, 450; *Luna v. Brownell*, supra, 185 CA4th at 674, 110 CR3d at 577 & fn. 8—unrecorded grant deeds physically delivered to and accepted by grantee effectively transferred title]

1) [4:37b] **Grantor's intent controls:** Valid delivery depends on whether the grantor intended the deed to be *presently* operative. Although physical delivery of a deed raises an inference that the grantor intended to immediately transfer title, that inference may be overcome by evidence showing a contrary intent. [See *Luna v. Brownell* (2010) 185 CA4th 668, 673, 110 CR3d 573, 577—in addition to physically delivering deeds to grantee, grantors' lack of confusion and voluntary execution evidenced their intention to immediately transfer title]

2) [4:37c] **Transfer to "anticipated" trust:** A deed drawn and executed in *anticipation* of a trust's creation is not void merely because the entity has yet to exist. Such deeds are valid between the grantor and grantee (the anticipated trust) on the date the entity is formed. [*Luna v. Brownell* (2010) 185 CA4th 668, 673-676, 110 CR3d 573, 576-578—quitclaim deed transferring property from individual to himself as trustee of contemplated trust was valid even though trust did not exist when deed was executed]

3) [4:37d] **Conditional delivery:** A deed cannot be delivered to the grantee under a condition not expressly stated in the deed. Thus, when a grantor executes and delivers a grant deed but imposes an oral condition on the transfer, the condition is disregarded and the grantee receives title free and clear of that condition. [See Civ.C. § 1056; *McMillin v. Eare* (2021) 70 CA5th 893, 914, 285 CR3d 737, 752 (holding, among other things, that § 1056 nullified mother's oral condition requiring son to obtain financing before grant deed was effective)—son received title free and clear notwithstanding mother's failed attempt to place oral condition on transfer]

Comment: Although a grantee receives title free and clear of any oral condition, *McMillin* was quick to point out that a grantor still may have a damages claim against the grantee. [See *McMillin v. Eare*, supra, 70 CA5th at 915, 285 CR3d at 752 (dictum)]

[4:37e - 4:37f] ***Reserved.***

(b) [4:37g] **Types of deeds:** Under current California law, a deed may be either a "grant deed," a "quitclaim deed" or a "tax deed" (see generally, Civ.C. § 1091 et seq.).

1) [4:37.1] **Grant deed:** A grant deed contains the grantor's implied covenant that (i) the grantor has not conveyed the same estate, or any right, title or interest therein, to any person other than the grantee; and (ii) such estate is, at the time of execution of the conveyance, free from encumbrances "done, made, or suffered by the grantor" or any person claiming under the grantor. [Civ.C. § 1113; *see also* ¶ *4:341*]

Nonetheless, the grantee takes title to the property subject to all existing encumbrances (such as a deed of trust) whether or not the deed so provides. [*Nguyen v. Calhoun* (2003) 105 CA4th 428, 438, 129 CR2d 436, 445]

FORM: Sample Grant Deed, *see Form 4:A*.

2) [4:37.2] **Quitclaim deed:** A quitclaim deed transfers or "releases" to the transferee *whatever present right or interest* the grantor has in the described property. Unlike a grant deed, a quitclaim deed carries with it no express or implied covenants. [*City of Manhattan Beach v. Sup.Ct. (Farquhar)* (1996) 13 C4th 232, 239, 52 CR2d 82, 86]

Thus, if the grantor holds *no interest* in the property, a quitclaim deed conveys nothing. [See *Osswald v. Anderson* (1996) 49 CA4th 812, 820, 57 CR2d 23, 27—quitclaim deed from transferors "as trustees" of subject property ineffective to transfer title where transferors did not hold title as trustees at time of attempted conveyance; see also *People v. Denman* (2013) 218 CA4th 800, 809, 159 CR3d 812, 819—recording quitclaim deed transfer with knowledge transferor has *no* title or interest in subject property constitutes felony (Pen.C. § 115)]

FORM: Sample Quitclaim Deed, *see Form 4:B*.

a) [4:37.3] **Operative words:** Use of the words "remise, release, and quitclaim" in a granting clause commonly indicates a quitclaim deed, and generally signifies a relinquishment of all ownership interest then held by the transferor. [*City of Manhattan Beach v. Sup.Ct. (Farquhar)* (1996) 13 C4th 232, 239, 52 CR2d 82, 86-87 & fn. 4]

[4:37.4] *Reserved.*

3) [4:37.5] **Tax deed:** Where property that has defaulted to the state for failure to pay assessed taxes is sold at a "tax sale," the purchaser receives a "tax deed" from the tax collector upon payment of the full purchase price. [See Rev. & Tax.C. § 3708; *Quelimane Co., Inc. v. Stewart Title Guaranty Co.* (1998) 19 C4th 26, 39, 77 CR2d 709, 716]

Tax-defaulted property usually is sold on an "as is" basis; *see* ¶ *4:351.1*.

a) [4:37.6] **Condition of title:** A tax deed conveys title free of all encumbrances existing before the sale *except:*

— special assessment installments due after the sale or which were not included in the amount fixed for presale redemption of the property;

— liens for taxes levied by any agency that has not consented to the sale;

— servitudes (i.e., easements of any kind, including prescriptive), recorded restrictions and water rights for which title is separately held;

— unaccepted, recorded, irrevocable offers of dedication to a public entity;

— recorded options of a taxing agency to purchase;

— federal tax liens; and

— unpaid taxes or assessments under the Improvement Bond Act of 1915 or Mello-Roos Community Facilities Act of 1982. [Rev. & Tax.C. § 3712; *Quelimane Co., Inc. v. Stewart Title Guaranty Co.* (1998) 19 C4th 26, 40, 77 CR2d 709, 716 & fn. 5]

b) [4:37.7] **Presumption that proceedings regularly performed:** Except as against fraud and jurisdictional issues (e.g., the property must have been legally subject to taxation), a tax deed is "conclusive evidence" that all proceedings from the assessment to execution of the deed were regularly performed. [See Rev. & Tax.C. § 3711; *L&B Real Estate v. Housing Auth. of County of Los Angeles* (2007) 149 CA4th 950, 956-957, 57 CR3d 298,

302-303—because public property exempt from taxation, tax deed purporting to convey property originally owned by county housing authority was void]

There is, however, only a *one-year* statute of limitations on a tax sale challenge following the board of supervisor's rejection of a mandatory § 3731 petition for rescission of the tax deed sale. [See Rev. & Tax.C. § 3725 (applicable to sales completed on or after 1/1/12); see also Rev. & Tax.C. § 3726]

Cross-refer: Remedies for defects in tax sale proceedings are strictly statutory; *see discussion at ¶ 11:470.1 ff.*

4) [4:37.8] **Revocable transfer on death deed (revocable TOD deed):** A "revocable transfer on death deed" ("revocable TOD deed") may be used to pass ownership of certain residential real property at death without a probate proceeding, right of survivorship or use of a trust. When properly executed and recorded, the deed automatically transfers such property on the owner's death but does not affect ownership rights during the owner's lifetime. [See Prob.C. § 5600 et seq. (1/1/2032 "sunset" date); see also Prob.C. § 5605 (requiring Cal. Law Rev. Comm'n to study and make recommendations regarding revocable TOD deeds)]

(The revocable TOD deed is discussed in detail in Ross & Cohen, *Cal. Prac. Guide: Probate* (TRG), Ch. 2.)

5) [4:37.9] **Compare—deed of trust:** A deed of trust, though in form a grant, is really only a mortgage with a power of sale and does not convey the fee. Indeed, it carries none of the incidents of ownership other than the right to convey if the debtor defaults on the debtor's obligation. [*Peterson v. Wells Fargo Bank, N.A.* (2015) 236 CA4th 844, 854, 186 CR3d 842, 849]

Cross-refer: Deeds of trust are discussed in detail at *¶ 6:336 ff.*

(2) [4:38] **"Bill of sale" or "assignment" for personal property:** Personal property is typically conveyed by a "bill of sale" or "assignment."

A *bill of sale* is used to convey *tangible* personal property, while an *assignment* is used to convey *intangible* personal property.

FORMS

- Bill of Sale, *see Form 4:C*.

- Assignment of Intangible (and Other) Property, *see Form 4:D*.

3. Intangible Property

a. [4:39] **Definition:** "Intangible property" is that which has no intrinsic or marketable value, but is merely representative evidence of value—e.g., goodwill, rights to use certain tradenames, contracts, stocks and bonds, promissory notes, choses in action, etc.

Intangible property is *personal property*, but constitutes rights not related to physical things. Those rights are tied to relationships between legal persons which the law recognizes as enforceable. [See Black's Law Dictionary; and Ballantine's Law Dictionary]

➪ [4:40] ***PRACTICE POINTER:*** Intangible property that pertains to real property is not necessarily implicitly transferred along with the real property. Thus, as with all personal property, it is essential that intangible property be *carefully enumerated* in both the purchase agreement and the appropriate conveyancing instrument. [See *Heritage Pac. Fin'l, LLC v. Monroy* (2013) 215 CA4th 972, 991-992, 156 CR3d 26, 40-41—following foreclosure on senior trust deed, assignee of debtor's second note acquired assignor's contractual rights, but not its tort claims, because assignment agreement failed to specify any rights other than those "incidental to the contract rights"; compare *SMS Fin'l XXIII, LLC v. Cornerstone Title Co.* (2018) 19 CA5th 1092, 1098-1100, 228 CR3d 562, 566-567 (distinguishing *Heritage Pac. Fin'l*)—by virtue of holding trust deed by assignment, purchaser of secured obligation had its own independent, potential Civ.C. § 2941 damages claim against title company for improperly releasing said secured obligation prior to trust deed's assignment and regardless of any claims assignor "may have been or may still be able to assert"]

b. [4:41] **Conveyancing instrument:** As noted at ¶ 4:38, intangible property is conveyed by an "assignment" (*see Form 4:D*).

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4. [4:42] **Fixtures:** The statutory definition of a "fixture" (Civ.C. § 660, ¶ *4:23*) is not always easy to apply. In practice, courts utilize three fundamental tests (physical annexation, adaptation and intention to annex) in ascertaining whether an item of personal property has become so *affixed* to the land as to become part of the real property (and, hence, a fixture) (*San Diego Trust & Sav. Bank v. San Diego County* (1940) 16 C2d 142, 149, 105 P2d 94, 97; *Vieira Enterprises, Inc. v. City of East Palo Alto* (2012) 208 CA4th 584, 597, 145 CR3d 722, 730-731; *Bell v. Bank of Perris* (1942) 52 CA2d 66, 73, 125 P2d 829, 833):

a. [4:43] **Method of attachment:** If an item is attached to real property in such a manner as to indicate that it is to be *permanently affixed*, it is likely to be considered a part of the real property. An item that can be readily removed may still be a fixture if the clear intention of its purpose is nevertheless to be part of the real property. [*San Diego Trust & Sav. Bank v. San Diego County* (1940) 16 C2d 142, 152, 105 P2d 94, 99—vault doors are fixtures]

b. [4:44] **Adaptability to realty's use and purpose:** An item is a fixture if it is essential to the ordinary and convenient use of the real property to which it is attached. [*M.P. Moller, Inc. v. Wilson* (1936) 8 C2d 31, 38, 63 P2d 818, 821—residential pipe organ (musical instrument) *not* a fixture]

c. [4:45] **Annexing party's intent:** An item of personal property is a fixture if the person attaching it intended it to be so. [*San Diego Trust & Sav. Bank v. San Diego County* (1940) 16 C2d 142, 149, 105 P2d 94, 97-98; see also *People v. Acosta* (2014) 226 CA4th 108, 121, 171 CR3d 774, 784 (defendants convicted under Pen.C. § 502.5 of removing fixtures from foreclosed home)—essential question for jury is whether all evidence of permanence persuades beyond reasonable doubt that attachment was "intended" to be permanent; *Vieira Enterprises, Inc. v. City of East Palo Alto* (2012) 208 CA4th 584, 597, 145 CR3d 722, 731 (finding seller/installer of manufactured homes intended same to be fixtures)—intention most significant of three tests, but manner of annexation and use to which property put relevant in determining intention]

➪ [4:46] ***PRACTICE POINTER:*** Buyers and sellers often justifiably disagree as to whether items such as partitions, specialized lighting systems, electrical power panels, shelving, children's swing sets and even chandeliers are considered part of the real property (and so transferred as part and parcel of the purchased realty). To avoid fixture disputes, carefully analyze what items might be *removed* by the seller without damaging the realty. And, in all events, make sure buyer and seller come to terms on the issue *before* the purchase agreement is executed.

[4:47 - 4:49] ***Reserved.***

5. [4:50] **Subterranean and Air Space Rights:** A fee interest in land includes ownership of the "surface" and "everything permanently situated beneath or above it." [See Civ.C. § 829]

a. Mineral, oil and gas rights

(1) [4:51] **Typically transferred with sale of fee:** Customarily, the buyer is entitled to whatever interest the seller has in subterranean property. Thus, unless previously transferred to a third party or reserved (¶ 4:53.1), mineral, oil and gas rights are typically granted to the buyer; and likewise even if the seller only has a "lessee's" interest (¶ *4:52 ff.*).

(a) [4:51.1] **Dinosaur fossils:** While there is no California decision that directly addresses the issue, the Montana Supreme Court, answering a certified question from the Ninth Circuit, has held that dinosaur fossils are not "minerals" for purpose of a mineral reservation under Montana law. [*Murray v. BEJ Minerals, LLC* (Mont. 2020) 464 P3d 80, 93] Accordingly, under Montana law, dinosaur fossils belong to the owners of the surface estate. [*Murray v. BEJ Minerals, LLC* (9th Cir. 2020) 962 F3d 485, 487]

1) [4:51.2] **Compare—CA statutory designation:** Although the Public Resources Code designates "fossils of all geological ages" as minerals (Pub.Res.C. § 6407), that statute is limited to mineral deposits reserved to the State and "has no bearing whatever on the interpretation of deeds between private parties." [*Bambauer v. Menjoulet* (1963) 214 CA2d 871, 875, 29 CR 874, 877]

(2) [4:52] **Preexisting lease of rights:** It is not uncommon to find an owner's fee interest is subject to a mineral, oil and gas "lease." The "lessor" may be the current owner or a predecessor owner. The amount to be paid may be a fixed periodic sum (typically annual) or a percentage (or royalties) of that which is mined from the property.

(a) [4:53] **Lease creates "profit a prendre" interest:** So-called mineral, oil and gas "leases" are actually "*profits a prendre*" (an interest in the fee owner's real property in the nature of an "incorporeal hereditament")—i.e., a right of entry together with the right to remove certain materials or profits from the land. [See *Dabney-Johnston Oil Corp. v.*

Walden (1935) 4 C2d 637, 649, 52 P2d 237, 243; *Kennecott Corp. v. Union Oil Co. of Calif.* (1987) 196 CA3d 1179, 1186, 242 CR 403, 407; and Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 2A]

Mineral, oil and gas "leases" generally do not transfer any possessory right in favor of the "lessee." However, some oil and gas leases provide the lessee with a right of surface entry (if no such right is granted, the lessee must arrange for lateral subterranean access from an adjoining owner).

(3) [4:53.1] **Reservation of mineral, oil and gas rights:** Sometimes when landowners transfer their ownership interest in land, they reserve an interest in the mineral, oil and gas beneath the land's surface (i.e., the landowners create two separate fee simple estates in the land, each of which has the same status and rank). For example, in the 1950's and 1960's, landowners transferred 19 parcels of land to various individuals by grant deed, but reserved a partial interest in the "oil, gas, and other hydrocarbons and minerals" beneath the surface. Once severed, the surface and mineral estates changed hands over the years. The owners of the surface estate (mining companies) decided to extract sand and gravel through open-pit excavation. The mineral rights holders (descendants of the original grantors) each claimed a one-half interest in the mining proceeds (i.e., the sand and gravel). At issue was whether "minerals" in the original reservations included rights to mine sand and gravel. [*Vulcan Lands, Inc. v. Currie* (2023) 98 CA5th 113, 117, 123, 316 CR3d 494, 497, 502]

In deciding whether the term "minerals" encompassed sand and gravel, the court determined its "overarching goal" was to discern the original parties' mutual intent, first by resorting to the plain language in the grant deeds and by considering extrinsic evidence where the plain language was ambiguous. If evidence of the parties' specific intent did not resolve the issue, then the "general intent" of the reservation would control. Applying all those factors to the record, the court concluded the mineral rights holders had a one-half interest in the mining proceeds because sand and gravel have commercial value, can be mined, and had been mined in the area since the 1920's. [See *Vulcan Lands, Inc. v. Currie*, supra, 98 CA5th at 122-125, 133-134, 316 CR3d at 501-504, 510 & fn. 5 (also concluding reservations in any CA grant are interpreted in favor of the grantor per Civ.C. § 1069)]

b. [4:54] **Air space; unobstructed views:** Despite Civ.C. § 829 (fee owner's interest extends to "everything permanently situated … above" the land), ownership of air space is limited to so much space above the land as one can reasonably and beneficially use and enjoy—a question of fact in each case. [*United States v. Causby* (1946) 328 US 256, 264-265, 66 S.Ct. 1062, 1067-1068]

Moreover, landowners have no right to an unobstructed view over adjoining property. Indeed, "as a general rule, a landowner has no natural right to air, light or an unobstructed view and the law is reluctant to imply such a right." [*Boxer v. City of Beverly Hills* (2016) 246 CA4th 1212, 1219, 201 CR3d 371, 375-376 (noting such rights may be created by Legislature, private parties through easements or CC&Rs and by local governments through adoption of height limits)—residents could not maintain inverse condemnation claim against city for planting redwood trees in park that obstructed residents' views; see also *Eisen v. Tavangarian* (2019) 36 CA5th 626, 638-640, 646-647, 248 CR3d 744, 754-757, 761-762 (citing *Boxer* with approval)—although CC&R provisions that controlled homes' basic size and limited construction of "structures" did not preclude renovations to defendant/neighbor's second story, plaintiff/property owners fully entitled to enforce CC&R provision limiting neighbor's hedge height]

6. [4:55] **Lateral and Subjacent Support:** Real property owners are entitled to the "lateral and subjacent support" which their land receives from adjoining land, subject to the adjoining landowner's right "to make proper and usual excavations on the same for purposes of construction or improvement …" [See Civ.C. § 832; *Sargent v. Jaegeling* (1927) 83 CA 485, 487, 256 P 1116, 1117—owner's "natural" right]

7. [4:56] **Water Rights:** Groundwater in its natural condition is not "owned" by anyone in the sense of a proprietary ownership interest. [*State of Calif. v. Sup.Ct. (Underwriters at Lloyd's of London)* (2000) 78 CA4th 1019, 1031-1032, 93 CR2d 276, 286]

a. [4:56.1] **Landowner's right of reasonable use:** A landowner's right to water or the use or flow of water in or from any natural stream or watercourse is "limited to such water as shall be reasonably required for the beneficial use to be served"; that right "does not … extend to the waste or unreasonable use or unreasonable method of use or unreasonable method of diversion of water." [Water C. §§ 100 & 101; Cal.Const. Art. X, § 2; see also *Montana v. Wyoming* (2011) 563 US 368, 376, 131 S.Ct. 1765, 1772—"beneficial use" concept restricts landowners to amount of water necessary to irrigate land by making reasonable use of water (*discussed further at ¶ 4:110.9a ff.*); *Dow v. Lassen Irrig. Co.* (2022) 79 CA5th 308, 328, 294

CR3d 643, 658—water use must be reasonable in relation to reasonable requirements of all other owners of lands riparian to same water source]

Simply stated, landowners do not own water on or below the surface of the land, but merely have the right to use that water on a reasonable basis. What is a "reasonable" use or method of use is a question of fact to be determined according to the circumstances of each particular case. [See *Light v. State Water Resources Control Bd.* (2014) 226 CA4th 1463, 1479, 173 CR3d 200, 210 (noting courts have never defined what constitutes unreasonable use because reasonableness of particular use depends largely on circumstances); *People ex rel. State Water Resources Control Bd. v. Forni* (1976) 54 CA3d 743, 749-750, 126 CR 851, 854-855; see also *Peabody v. City of Vallejo* (1935) 2 C2d 351, 367, 40 P2d 486, 491; *Tulare Irrig. Dist. v. Lindsay-Strathmore Irrig. Dist.* (1935) 3 C2d 489, 567, 45 P2d 972, 1007]

b. [4:56.2] **Nature of State's "ownership":** Groundwater is the "property of the people of the State" (Water C. § 102), but that does not give the State "ownership" as the term is commonly understood. Despite Civ.C. § 669 (all property has an owner) and Civ.C. § 670 (State is the owner of all property of which there is no other owner), the State's "ownership" of groundwater does not include any power of possession and use to the exclusion of others or any proprietary element. The State's power under the Water Code, as distinct from "ownership," is simply the "power to control and regulate use." [*State of Calif. v. Sup.Ct. (Underwriters at Lloyd's of London)* (2000) 78 CA4th 1019, 1027-1032, 93 CR2d 276, 283-287; see also *State of Mississippi v. Tennessee* (2021) _ US _, _, 142 S.Ct. 31, 40-41—although states have full jurisdiction over waters within their borders, they do not have exclusive ownership/control over *interstate* waters flowing within their boundaries; *Light v. State Water Resources Control Bd.* (2014) 226 CA4th 1463, 1473, 1484-1485, 173 CR3d 200, 205, 215—Board may administer state's water resources by enacting regulations and pursuing judicial and quasi-judicial proceedings]

8. [4:57] **Leases:** Leases are personal property, although they represent "interests" in real property. A "lease" conveys a possessory interest in real property, and a "leasehold" is "an estate in real property." [*Callahan v. Martin* (1935) 3 C2d 110, 118, 43 P2d 788, 792; *Parker v. Sup.Ct. (Dwight)* (1970) 9 CA3d 397, 400, 88 CR 352, 354; see also Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 2A]

a. [4:58] **Leases for term exceeding one year subject to statute of frauds:** An agreement to lease real property for a term exceeding one year must be in writing and signed by the obligated parties. [Civ.C. § 1624(a)(3); see also *Smyth v. Berman* (2019) 31 CA5th 183, 197, 242 CR3d 336, 348 (applying § 1624(a)(3) to right of first refusal to purchase property in lease for term exceeding one year)—right of first refusal expired when leasehold ended; *Bed, Bath & Beyond of La Jolla, Inc. v. La Jolla Village Square Venture Partners* (1997) 52 CA4th 867, 877, 60 CR2d 830, 836—lease for term exceeding one year subject to § 1624(a)(3) notwithstanding provision for cancellation or termination within one year of execution of lease and before commencement of lease term]

Cross-refer: The statute of frauds in connection with the *purchase and sale* of real property is discussed at *¶ 4:263 ff.*

b. [4:59] **Conveyancing instrument:** Leases are transferred by *assignment*. Generally, it is not necessary to record an assignment of the seller lessor's interest in a lease, even if the subject lease is recorded (*but see Ch. 7* regarding ground leases and, in particular, ¶ *7:199 ff., 7:252 ff.*).

• ***FORM:*** (Landlord's) Assignment of Leases, *see Form 4:E*.

9. [4:60] **Property Ownership, Operation and Maintenance Contracts:** Contracts pertaining to the use, ownership and operation of real property to be sold may be significant in number and substance. Such contracts do not necessarily encumber the realty or a new owner's interest (i.e., they are not "covenants running with the land"; *see ¶ 4:63 ff.*); even so, they may be desirable for the buyer to assume.

For example, property management agreements, landscaping contracts, air conditioning service contracts, contracts for laundry facilities, janitorial service contracts, and a host of other service contracts might properly be the subject of the "property" to be transferred.

➪ [4:61] ***PRACTICE POINTER:*** Any such contracts that the buyer wishes to assume should be included on a schedule in the purchase agreement and assigned at the closing. The buyer should also take an assignment from the seller of all *construction warranties* given by third parties to the seller.

a. [4:62] **Conveyancing instrument:** The kinds of contracts noted at ¶ 4:60 are conveyed by an *assignment* (*see Form 4:D*). As with leases (*¶ 4:59*), it ordinarily is not necessary to record the assignment even if the subject contract is of record.

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10. [4:63] **Covenants Running With the Land:** "Certain covenants, contained in grants of … real property, are appurtenant to such estates, and pass with them, so as to bind [subsequent owners] … Such covenants are said to run with the land." [Civ.C. § 1460; see also Civ.C. §§ 1461-1470; *Citizens for Covenant Compliance v. Anderson* (1995) 12 C4th 345, 353, 47 CR2d 898, 903—"covenant is said to run with the land if it binds not only the person who entered into it, but also later owners and assigns who did not personally enter into it"; *Monterey/Santa Cruz County Bldg. & Construction Trades Council v. Cypress Marina Heights LP* (2011) 191 CA4th 1500, 1517-1520, 120 CR3d 830, 843-846—deed covenants requiring payment of prevailing wage to workers on all land development, entered into between city's redevelopment agency and governmental entity created to transition military base to civilian use, ran with land in perpetuity, thereby binding all successor developers]

a. [4:64] **No separate conveyancing instrument required:** In effect, covenants running with the land are part of the bundle of rights (and obligations) included within the real property conveyed. Both the liability for performance of the covenants and the corresponding benefits are transferred by the deed and, therefore, no separate conveyancing instrument is necessary. [Civ.C. § 1460—successor owners bound by covenants running with the land "in the same manner as if they had personally entered into them"; but see also Civ.C. § 1465—"covenant running with the land binds those only who acquire the whole estate of the covenantor in some part of the property"; *Committee to Save Beverly Highlands Homes Ass'n v. Beverly Highlands Homes Ass'n* (2001) 92 CA4th 1247, 1269, 112 CR2d 732, 748—"covenant running with the land is created by language in a deed or other document showing an agreement to do or refrain from doing something with respect to use of the land"]

(1) [4:64.1] **Compare—conveyance required to bring enforceable covenants running with the land into existence:** Of course, no enforceable covenants running with the land spring into existence until an actual conveyance subject to the covenants is made. "The issue of whether [a] covenant runs with the land arises when the covenantor or the covenantee, or both, *convey their estates in the property* and the dispute is between successors of either [of them] or both." [*Del Taco, Inc. v. University Real Estate Partnership V* (2003) 111 CA4th 16, 23, 3 CR3d 311, 316 (quoting from 8 Miller & Starr, California Real Estate (3d ed. 1997) § 24.1) (emphasis added; internal quotes omitted)]

So long as both the benefited and burdened parcels are under *common ownership*, the purported covenants (even if recorded) are not effective and can be modified or rescinded. [*Citizens for Covenant Compliance v. Anderson* (1995) 12 C4th 345, 365, 47 CR2d 898, 911; see also *Monterey/Santa Cruz County Bldg. & Construction Trades Council v. Cypress Marina Heights LP* (2011) 191 CA4th 1500, 1519, 120 CR3d 830, 845—merely recording restrictions does not create mutual servitudes—i.e., they "spring into existence" only upon actual conveyance]

b. [4:65] **Which covenants:** In California, only covenants specified by statute (Civ.C. § 1457 et seq.) run with the land "and those which are incidental thereto." [Civ.C. § 1461; *Citizens for Covenant Compliance v. Anderson* (1995) 12 C4th 345, 353, 47 CR2d 898, 903; see also *Monterey/Santa Cruz County Bldg. & Construction Trades Council v. Cypress Marina Heights LP* (2011) 191 CA4th 1500, 1517, 120 CR3d 830, 843—covenants can run with the land under either Civ.C. § 1462 or Civ.C. § 1468 (see below)]

Covenants *benefiting* a property run with the land if they are "contained in a grant … made for the direct benefit of the property …" [Civ.C. § 1462; *Citizens for Covenant Compliance v. Anderson*, supra, 12 C4th at 353, 47 CR2d at 903; see also *Self v. Sharafi* (2013) 220 CA4th 483, 489-490, 163 CR3d 71, 76-77 (noting § 1462 applies to covenants directly benefitting *conveyed* (*not retained*) property)—building restriction that naturally enhanced value of property *conveyed* 40 years earlier deemed fully enforceable under § 1462 even though it burdened adjoining parcel retained by grantor; *Monterey/Santa Cruz County Bldg. & Construction Trades Council v. Cypress Marina Heights LP*, supra, 191 CA4th at 1517, 120 CR3d at 843—§ 1462 inapplicable to covenants that "burden" property]

Covenants *burdening* a property (i.e., landowner covenantor's *obligations*) run with the land to bind successor owners of the covenantor's property if the requirements specified in Civ.C. § 1468 (¶ 4:66 ff.) are satisfied. [*Citizens for Covenant Compliance v. Anderson*, supra, 12 C4th at 353-354, 47 CR2d at 903-904 & fn. 3 (residential use only deed restriction); *Monterey/Santa Cruz County Bldg. & Construction Trades Council v. Cypress Marina Heights LP,* supra, 191 CA4th at 1518, 120 CR3d at 844 (prevailing wage deed restriction); *Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.* (2009) 171 CA4th 1356, 1376, 124 CR3d 271, 290 (affordable housing deed restriction); *but see ¶ 4:66.5* (special rule for environmental restrictions)]

(1) [4:66] **General requirements (obligations running with the land):** Ordinarily, a covenant "runs with the land" so as to create a right or restriction affecting all current and future owners of the land only if all of the following requirements are

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satisfied (Civ.C. § 1468; *Monterey/Santa Cruz County Bldg. & Construction Trades Council v. Cypress Marina Heights LP* (2011) 191 CA4th 1500, 1517-1518, 120 CR3d 830, 844):

- *Description of benefited and burdened parcels:* The covenantor's land (burdened parcel) and the covenantee's land (benefited parcel) must be "particularly described" in the document containing the covenants (Civ.C. § 1468(a); *see ¶ 4:66.1*);

- *Intent to bind successors:* The document containing the covenants must expressly state the intent to bind successive owners of the burdened land for the benefit of the covenantee's land (Civ.C. § 1468(b));

- *Purpose of covenants:* The covenants must relate to the use, repair, maintenance or improvement of, or payment of taxes and assessments on, the land (Civ.C. § 1468(c));

- *Recordation:* The document containing the covenants must be recorded in the office of the recorder for each county where the property (or any part of it) is located (Civ.C. § 1468(d)).

(a) [4:66.1] **Description of property by reference suffices:** Although Civ.C. § 1468(a) states that the instrument containing the covenants must "particularly describe" both the burdened and benefited land (¶ 4:66), the statute is satisfied by reference to proper legal descriptions in another instrument. [*Kapner v. Meadowlark Ranch Ass'n* (2004) 116 CA4th 1182, 1187, 11 CR3d 138, 143—amended covenant document's reference to prior recorded covenant document containing proper legal description satisfied § 1468(a)]

Likewise, § 1468(a) is satisfied where an instrument containing covenants includes a proper legal description for an *entire* property (e.g., ranch, subdivision, etc.). [See *Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.* (2009) 171 CA4th 1356, 1372-1374, 124 CR3d 271, 287-289—recorded affordable housing deed restriction that particularly described entire subdivision applied with equal force to individual lots]

(b) [4:66.2] **Recordation of planned community CC&Rs with subdivision map suffices:** Covenants, conditions and restrictions (CC&Rs) in a planned community subdivision need not necessarily be recited or referenced in a deed or other document each time an individual parcel in the subdivision is sold. The CC&Rs bind all future owners in the subdivision so long as they are recorded with the subdivision map before any parcel in the subdivision is originally sold, and the recorded document describes the property to be governed by the CC&Rs and states it is to bind all purchasers and their successors. [*Citizens for Covenant Compliance v. Anderson* (1995) 12 C4th 345, 349, 47 CR2d 898, 901; see *Committee to Save Beverly Highlands Homes Ass'n v. Beverly Highlands Homes Ass'n* (2001) 92 CA4th 1247, 1270, 112 CR2d 732, 748]

Such recordation gives all subsequent purchasers in the subdivision *constructive notice* of the CC&Rs (Civ.C. § 1215). Consequently, all subsequent purchasers are deemed to acquire their parcels with knowledge that the parcels are subject to the recorded covenants and restrictions; they thereby impliedly intend and agree to accept the burdens and benefits even if there is no additional documentation referring to the CC&Rs at the time of the conveyance. [*Citizens for Covenant Compliance v. Anderson* (1995) 12 C4th 345, 365-366, 47 CR2d 898, 911; see also *Colyear v. Rolling Hills Community Ass'n of Rancho Palos Verdes* (2024) 100 CA5th 110, 125-127, 318 CR3d 805, 817-818 (certified for partial publication)—tree-cutting covenant contained in original recorded declaration that established subdivision's general plan did not bind purchaser of property not described therein (also concluding purchaser did not impliedly agree to be bound by original declaration's tree-cutting covenant because subsequently recorded declaration that governed his property did not contain said covenant and neither his deeds nor title reports referenced original declaration); *Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.* (2009) 171 CA4th 1356, 1372-1374, 124 CR3d 271, 287-289—recording affordable housing deed restriction "well before" original sale of subdivision's parcels gave constructive notice of its contents notwithstanding absence of any reference to restriction in subsequent grant deeds]

1) [4:66.2a] **Arbitration provisions contained in CC&Rs:** A homeowners association is bound by arbitration provisions contained in CC&Rs that are executed and recorded prior to the time the association comes into existence. This is so even though the arbitration provisions were never contractually agreed to by the association: "[I]t is settled under the statutory and decisional law pertaining to common interest developments that the covenants and

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terms in the recorded declaration reflect written promises and agreements that are subject to enforcement against the association … Even when strict privity of contract is lacking, the Davis-Stirling Act ensures that the covenants, conditions, and restrictions of a recorded declaration—which manifest the intent and expectations of the developer and those who take title to property in a community interest development—will be honored and enforced unless proven unreasonable.” [See *Pinnacle Museum Tower Ass'n v. Pinnacle Market Develop. (US), LLC* (2012) 55 C4th 223, 232, 247-252, 145 CR3d 514, 519, 533-535 (also finding subject arbitration provisions neither procedurally nor substantively unconscionable)]

2) [4:66.2b] **Compare—unrecorded guidelines, etc.:** Various *unrecorded* guidelines, regulations and rules adopted by the homeowners association also may bind future owners in a planned community (*¶ 4:67.7 ff.*).

(c) [4:66.3] **Compare—notice of noncompliance with CC&Rs not recordable:** A notice of noncompliance with CC&Rs (indicating a homeowner's violation of recorded restrictions on the homeowner's property) is *not a legally recordable instrument* because it does not affect the title to or possession of real property (see Gov.C. §§ 27279(a), 27280(a)). Therefore, its recordation cannot encumber title and is subject to expungement. [*Ward v. Sup.Ct. (Beverlywood Homes Ass'n)* (1997) 55 CA4th 60, 65-67, 63 CR2d 731, 733-734]

[4:66.4] ***Reserved.***

(2) [4:66.5] **Special rule for environmental restrictions:** *Environmental restrictions* are enforceable covenants running with the land that bind all successive owners of the restricted parcel *even though there is no identified benefited parcel* (as ordinarily required pursuant to Civ.C. § 1468(a), ¶ 4:66), provided all of the following requirements are satisfied (Civ.C. § 1471):

- *Description of covenantor's land (burdened parcel):* The document containing the covenants must “particularly describe” the land of the covenantor that is affected (burdened) by the covenants (Civ.C. § 1471(a));

- *Intent to bind successors:* The document containing the covenants must expressly state the intent to bind successive owners of the burdened land for the benefit of the covenantee (Civ.C. § 1471(b));

- *Purpose of covenants:* The covenants must relate to the use of the burdened land and the restrictions imposed by the covenants must be reasonably necessary to protect present or future human health or safety or the environment as a result of the presence on the land of hazardous materials (as defined in Health & Saf.C. § 25260) (Civ.C. § 1471(c));

- *Recordation and “environmental restriction” title:* The document containing the covenants must be recorded in the office of the recorder for each county where the land (or any part of it) is located, and the recorded document must include in its title the words “Environmental Restriction” (Civ.C. § 1471(d)).

(a) [4:66.6] **Purpose:** By eliminating the Civ.C. § 1468(a) requirement that there be an identified *benefited parcel*, Civ.C. § 1471 facilitates the use and implementation of “risk assessment/management plans” for contaminated properties as an effective alternative to full-blown, potentially “cost prohibitive” remediation.

For example, appropriate governmental agencies (California Department of Toxic Substances, etc.) might agree not to require complete remediation of a contaminated industrial property so long as the owner agrees to an environmental restriction that the property not be developed or operated for residential or other incompatible purposes (such as a school, park, hospital, day care facility, etc.). Under federal and state “Superfund” laws, the owner runs the risk of clean-up liability for a release of hazardous materials on the property caused by its buyer or future successors (*see* ¶ *5:60 ff., 5:205 ff.*); but by recording the environmental restriction as a covenant running with the land when it sells the property, the owner/seller can maintain control over the property to restrict the actions of future owners or operators and thus minimize its exposure to future potential clean-up liability.

Were it not for Civ.C. § 1471, such an environmental restriction would not be effective to bind the buyer (covenantor) and its successors unless the seller (covenantee) owned adjacent land that benefited by the restriction (Civ.C. § 1468(a), ¶ *4:66*). Of course, this is not the case where the seller is transferring all of its interest in the contaminated property and owns no other property nearby.

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Cross-refer: The use of environmental restrictions in a purchase and sale transaction is treated further in *Ch. 5* in connection with environmental hazards liability.

(3) [4:67] **Distinguish—"personal" covenants:** Unless all of the Civ.C. § 1468 or Civ.C. § 1471 conditions are satisfied, a recorded covenant is "personal" and does not "run with the land"—i.e., buyers and all successive owners are bound only if they *expressly assume* the obligations (otherwise, the seller remains bound even after the conveyance). [See *Glenbrook Homeowners Ass'n v. Tahoe Regional Planning Agency* (9th Cir. 2005) 425 F3d 611, 619—right to use community pier reserved in deed conveying parcel was "purely contractual" personal covenant that did not run with land]

In contrast, covenants running with the land *attach to ownership* of the property and are not, by their definition, "personal" in nature. Thus, once the estate and property are transferred, the seller is no longer personally obligated. [See Civ.C. § 1466—landowners not liable for breach of covenant running with the land after they have "parted with" the land; see also *Del Taco, Inc. v. University Real Estate Partnership V* (2003) 111 CA4th 16, 23, 3 CR3d 311, 316—"While a personal covenant only obligates the original parties, a covenant that runs with the land is binding on successive owners"]

[4:67.1 - 4:67.4] ***Reserved.***

c. [4:67.5] **Enforcement of recorded covenants:** Homeowners may enforce a recorded covenant running with the land by either seeking an *injunction* to prevent further violations of the restriction or suing for *damages*. [See *Cutujian v. Benedict Hills Estates Ass'n* (1996) 41 CA4th 1379, 1385, 49 CR2d 166, 171 (money damages); *Ezer v. Fuchsloch* (1979) 99 CA3d 849, 853-854, 160 CR 486, 487 (injunctive relief)]

A recorded covenant generally will be enforced unless it:

— violates public policy;

— bears no rational relationship to the protection, preservation, operation or purpose of the affected land; or

— imposes a disproportionate burden on the affected land that greatly outweighs any beneficial effects. [*Nahrstedt v. Lakeside Village Condominium Ass'n* (1994) 8 C4th 361, 386, 33 CR2d 63, 78; *Harvey v. Landing Homeowners Ass'n* (2008) 162 CA4th 809, 819, 76 CR3d 41, 49; see *Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.* (2009) 171 CA4th 1356, 1373-1374, 124 CR3d 271, 288-289 (rejecting argument that affordable housing deed restriction depressed market values and thus violated public policy)]

(1) [4:67.6] **Compare—enforcement as equitable servitude:** Restrictions on the use of property that do not meet the requirements of covenants running with the land may be enforceable as *equitable servitudes* provided the person to be bound *had notice* of their existence at the time of purchase. [*Nahrstedt v. Lakeside Village Condominium Ass'n* (1994) 8 C4th 361, 375, 33 CR2d 63, 71; see *Southern Calif. School of Theology v. Claremont Graduate Univ.* (2021) 60 CA5th 1, 4-5, 8, 274 CR3d 180, 183, 185-186—grant deed conditions limiting property's use to education and giving grantor "first offer" rights are enforceable as equitable servitudes (*see discussion at* ¶ 8:209.2); *Cebular v. Cooper Arms Homeowners Ass'n* (2006) 142 CA4th 106, 122, 47 CR3d 666, 677—idea underlying equitable servitude is that landowner's promise to refrain from particular conduct pertaining to land creates equitable interest in land in favor of beneficiary of promise; *Committee to Save Beverly Highlands Homes Ass'n v. Beverly Highlands Homes Ass'n* (2001) 92 CA4th 1247, 1269, 112 CR2d 732, 748—equitable servitude may be created when covenant does not run with land but equity requires it to be enforced]

(2) [4:67.7] **Compare—enforcement of unrecorded guidelines, regulations and rules:** A planned community's homeowners association may adopt *reasonable* guidelines, regulations and/or rules for land use and property improvement projects (e.g., site and design standards, aesthetic criteria, etc.). However, unlike recorded covenants running with the land (¶ *4:67.5*), and equitable servitudes for which the person to be bound also had notice (¶ *4:67.6*), *no presumption of reasonableness* attaches to these *unrecorded* restrictions. Rather, they are viewed under a "straight reasonableness test," which may affect their enforceability. [See *Dolan-King v. Rancho Santa Fe Ass'n* (2000) 81 CA4th 965, 975-978, 97 CR2d 280, 287-289 (discussing recorded and unrecorded restrictions in planned residential development); *Pacific Hills Homeowners Ass'n v. Prun* (2008) 160 CA4th 1557, 1563-1564, 73 CR3d 653, 657-658 (noting statutory definition of restriction encompasses unrecorded guidelines, rules and regulations)]

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A restriction's "reasonableness" is evaluated by its effect on the common interest development as a whole—not from an individual homeowner's perspective. [*Pacific Hills Homeowners Ass'n v. Prun*, supra, 160 CA4th at 1566-1567, 73 CR3d at 660; *Dolan-King v. Rancho Santa Fe Ass'n*, supra, 81 CA4th at 975, 97 CR2d at 287]

[4:67.8 - 4:67.14] ***Reserved.***

(3) [4:67.15] **Five-year statute of limitations; recorded and unrecorded restrictions:** An action for violation of a covenant or other restriction on the use of real property (see Civ.C. § 784, defining "restriction" to include covenants, conditions, equitable servitudes and any other form of restriction) must be brought within *five years* of actual or constructive discovery of the violation. [CCP § 336(b); *Pacific Hills Homeowners Ass'n v. Prun* (2008) 160 CA4th 1557, 1563, 73 CR3d 653, 658—limitations period applies to both recorded and unrecorded restrictions]

(a) [4:67.16] **Covenant not abrogated by failure to commence timely suit:** Failure to commence an action for violation of a restrictive covenant within the five-year period (*¶ 4:67.15*) does not waive the right to sue for any other violation. Nor does a failure to enforce a violation within the statutory period itself imply a waiver or abandonment of the covenant. [CCP § 336(b)]

However, failure to commence timely suit as to one violation may, when *combined with other circumstances*, be grounds for waiver or estoppel, or *evidence* of abandonment or obsolescence of the covenant. [See CCP § 336, Law Rev. Comm'n Comment]

(4) [4:67.17] **Laches defense:** Even a timely-filed action for violation of a covenant or other restriction (*¶ 4:67.15*) may be barred under the doctrine of laches. This is so if plaintiff has unreasonably delayed enforcement and either (a) acquiesced in the act complained about, or (b) caused prejudice to the defendant as a result of the delay. [*Johnson v. City of Loma Linda* (2000) 24 C4th 61, 68, 99 CR2d 316, 321; see *Pacific Hills Homeowners Ass'n v. Prun* (2008) 160 CA4th 1557, 1564-1565, 73 CR3d 653, 658-659 (criticizing plaintiff's 4-year delay in filing suit, but declining to find laches in absence of prejudice to defendants)]

(5) [4:67.18] **Waiver defense:** So too, a common interest development may waive its right to enforce a covenant or other restriction by not applying it fairly, reasonably or uniformly. "When a homeowners' association seeks to enforce the provisions of its CCRs to compel an act by one of its member owners, it is incumbent upon it to show that it has followed its own standards and procedures prior to pursuing such a remedy, that those procedures were fair and reasonable and that its substantive decision was made in good faith, and is reasonable, not arbitrary or capricious …" [*Pacific Hills Homeowners Ass'n v. Prun* (2008) 160 CA4th 1557, 1565-1566, 73 CR3d 653, 659 (internal quotes omitted)]

Likewise, the right to enforce a restrictive covenant in a planned development generally may be deemed waived when "substantially all of the landowners have acquiesced in a violation so as to indicate an abandonment." [*Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.* (2009) 171 CA4th 1356, 1380, 124 CR3d 271, 293 (internal quotes omitted) (waiver rejected under the facts)]

11. [4:68] **Permits, Approvals and Applications:** At the time of execution of a purchase agreement or at the closing, the seller may own (or have previously submitted various applications for) land use, building or development permits. The buyer may want to acquire those rights, permits or applications by assignment.

a. [4:69] **Public permits:** Public permits are issued by governmental or quasi-governmental entities—e.g., subdivision tract maps (tentative or final), permits issued by public architectural review boards, California Coastal Commission permits (Pub.Res.C. § 30000 et seq.), zoning variances, demolition permits, condominium conversion permits, building permits, etc.

(1) [4:69.1] **Vacation home rentals:** Cities can regulate short-term, vacation home rentals. For example, one city's ordinance allows *residents* to rent out their homes in the city's residential zones for periods of less than 30 days provided the owners and managers of the properties obtain permits that expire after one year. These permits are subject to renewal on an annual basis so long as the city's director makes required findings. Any vested rights the owners and managers may have, however, are limited by the permits' terms and conditions. Indeed, the rights that may "vest" through reliance on a government permit are "no greater than those specifically granted by the permit itself." [*South Lake Tahoe Property Owners Group v. South Lake Tahoe* (2023) 92 CA5th 735, 742-743, 748, 310 CR3d 9, 17, 21—ministerial nature of association's one-year rental permits did not entitle it to renew or grant it vested renewal rights; see also *Hobbs v. City of Pacific Grove*

(2022) 85 CA5th 311, 325, 301 CR3d 274, 285 (concluding plaintiffs did not have vested right to renewal given limitations on number of licenses city could issue)]

Comment: The ordinance at issue in *South Lake Tahoe* (above) prohibited short-term or vacation rental housing *except* for rentals of *permanent residents'* dwellings. A "permanent resident" is defined as a person who lives in their home for the majority of the year and claims a homeowner's property tax exemption. The lower court's judgment in *South Lake Tahoe* was reversed to the extent it found this exception did not violate the dormant Commerce Clause. [See *South Lake Tahoe Property Owners Group v. South Lake Tahoe,* supra, 92 CA5th at 770-771, 764, 310 CR3d at 34, 39 (concluding ordinance prohibits out-of-state owners from doing what it authorizes residents to do, i.e., rent out their homes in City's residential zones for periods of less than 30 days)]

(a) [4:69.2] **Short-term rentals (STRs) in coastal zone:** A substantial number of STRs are properties within California's coastal zone. Any person wishing to undertake a development in the coastal zone generally must obtain a coastal development permit in addition to any other permit required by law (Pub.Res.C. § 30600(a)). STRs, however, are not "per se" developments subject to the Coastal Act's permit requirements. Indeed, "[w]hether using a residence as an STR is a change in the density or intensity of the use of land and thus a development under the Coastal Act depends on the permissible scope of the residence's *existing* use." [See *Coastal Protection Alliance, Inc. v. AIRBNB, INC.* (2023) 95 CA5th 207, 212, 215-219, 313 CR3d 262, 265, 267-271 (internal quotes omitted) (emphasis added)—online marketplace that connected residential STR owners with renters was neither directly nor vicariously liable for allowing STR owners to list and rent unpermitted STRs on its website (acknowledging different analysis "might apply" if city's zoning does not allow STRs or distinguishes STRs from other residential uses)]

b. [4:70] **Private permits:** These are issued by private associations, such as private homeowners associations (e.g., approval of proposed improvements by a homeowner association's architectural review board; or a homeowner's agreement with a neighbor concerning a common wall or some other common boundary issue).

c. [4:70.1] **Scope of permit:** The holder of a specific use permit for real property is *not* the "owner" of that property where the fee title owner retains power to control the permittee's use. Instead, the permittee holds only a possessory interest in the land, comparable to the interest of a licensee (*¶ 4:103*) or easement holder (*¶ 4:102 ff.*). [See *City of Los Angeles v. San Pedro Boat Works* (9th Cir. 2011) 635 F3d 440, 449—holder of revocable permits to operate harbor berth not "owner" for purposes of imposing CERCLA liability (*discussed further at ¶ 5:62*)]

➪ [4:71] ***PRACTICE POINTER—UNDESIRABLE PERMITS AND APPLICATIONS*:** The buyer may not wish to acquire certain kinds of permits and applications—typically, those which commit the owner to a definitive obligation (that would pass to the buyer) … such as obligations to make certain improvements, dedicate land to a public or quasi-public entity, or pay certain fees.

Since unrecorded agreements (including applications to governmental entities) generally do not constitute "covenants running with the land" which bind the property and successor owners (*¶ 4:66*), buyers seldom become bound to a seller's permit application simply by transfer of the deed. Review of a current title report usually will apprise counsel of all land use agreements and restrictions that will affect the buyer upon closing (*see Ch. 3*).

Nevertheless, if the seller is in the process of developing the property, it is prudent to investigate the status of any permit application.

d. [4:72] **Conveyancing instrument:** Permits and applications for permits are transferred by *assignment* (*see* Form 4:D). Recordation of the assignment is usually unnecessary.

e. [4:72.1] **Preexisting unpermitted structures; effect on subsequent purchasers:** A subsequent purchaser is subject to the same permit requirements as the prior property owner. [*Ojavan Investors, Inc. v. Calif. Coastal Comm'n* (1994) 26 CA4th 516, 526, 32 CR2d 103, 109—"It is well settled that the burdens of permits run with the land once the benefits have been accepted"; see also *City of Berkeley v. 1080 Del., LLC* (2015) 234 CA4th 1144, 1151, 184 CR3d 177, 182—permit conditions "remain enforceable against a subsequent owner of the property"; *Serra Canyon Co. v. Calif. Coastal Comm'n* (2004) 120 CA4th 663, 668, 16 CR3d 110, 113—although subsequent property owner "was not a party to the original permits, it was bound by the inaction of its predecessor in interest"]

Accordingly, if a subsequent purchaser acquires property with preexisting unpermitted structures, the subsequent purchaser can be held responsible for the permit violation. [See *Lent v. Calif. Coastal Comm'n* (2021) 62 CA5th 812, 824-825, 831-834, 860, 277 CR3d 106, 116-117, 122-124, 147 (denying petition to set aside cease and desist order imposing

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$4,185,000 penalty against property owners who acquired property with preexisting unpermitted deck, staircase and gate that blocked public beach access easement and who refused to remove said barriers)]

12. [4:73] **Claims and Causes of Action:** The seller may have a legal claim, or may have commenced litigation, arising from ownership of the property—e.g., an unlawful detainer or damages action against a tenant. Typically, those legal rights should be assigned to the buyer.

It may also be desirable (or essential) for the buyer to acquire a host of other potential claims against third parties for damage to the property or nuisance. This is true whether the claim is the subject of a lawsuit, arbitration or administrative or other proceeding.

a. [4:74] **Conveyancing instrument:** The sale of real property does not automatically transfer related causes of action or divest the seller of legal claims pertaining to the property. [See, e.g., *Vaughn v. Dame Const. Co.* (1990) 223 CA3d 144, 148-149, 272 CR 261, 263-264—closing did not divest seller of standing to sue third party for construction defects] Rather, the seller's legal rights pass to the buyer only if *expressly* conveyed; the conveyancing instrument is an *assignment* (*see Form 4:D*).

b. [4:74.1] **Other procedural steps:** If the conveyance transfers the seller's rights in *pending* litigation, other specific procedures and documentation will be required to perfect the buyer's standing—including, a *substitution* of the buyer as plaintiff in the action. (See generally, Weil & Brown et al., *Cal. Prac. Guide: Civ. Pro. Before Trial* (TRG), Ch. 2.)

13. [4:75] **Common Interest Developments:** "Common interest developments" may be either residential or commercial and industrial in nature. The Davis-Stirling Common Interest Development Act (Civ.C. § 4000 et seq.) defines and governs residential common interest developments, even if they were created before the Act's 1986 effective Date. [*Bear Creek Master Ass'n v. Edwards* (2005) 130 CA4th 1470, 1480-1481, 31 CR3d 337, 346; *see also* ¶ *4:76.4*]

The Commercial and Industrial Common Interest Development Act (Civ.C. § 6500 et seq.) defines and governs commercial and industrial common interest developments. While quite similar to the David-Stirling Act, the Commercial and Industrial Act differs in some respects.

The discussion that follows focuses broadly on *residential* common interest developments. Significant variances with commercial and industrial common interest developments are noted.

a. [4:76] **Characteristics:** There are a variety of forms of "common interest developments" (condominium project, planned development, stock cooperative and, in the case of residential developments, also the community apartment project; see Civ.C. §§ 4100, 6534 (commercial/industrial)). All, however, share two common characteristics:

- Individual ownership of separate lots, parcels, areas or spaces; and

- Mutual, common or reciprocal interests in or restrictions upon all of such separately-owned lots, parcels, areas or spaces.

A common interest development is created whenever a *separate interest coupled with an interest in the common area or membership in the association* is, or has been, conveyed, provided a declaration, condominium plan (if any) and final map or parcel map (if required pursuant to Gov.C. § 66410 et seq.) are recorded. [Civ.C. §§ 4200, 6580 (commercial/industrial); *Villa De Las Palmas Homeowners Ass'n v. Terifaj* (2004) 33 C4th 73, 81, 14 CR3d 67, 70; see also 85 Ops.Cal.Atty.Gen. 162]

(1) [4:76.1] **"Common area":** The "common area" is "the entire common interest development except the separate interests therein." The estate in the common area may be a fee simple, life estate, estate for years, or any combination thereof. [Civ.C. §§ 4095, 6532 (commercial/industrial); *Committee to Save Beverly Highlands Homes Ass'n v. Beverly Highlands Homes Ass'n* (2001) 92 CA4th 1247, 1268-1269, 112 CR2d 732, 747; 85 Ops.Cal.Atty.Gen. 162]

The common area estate is typically owned as tenants in common, in equal shares, one for each unit or lot in the development. However, the development's recorded declaration (¶ *4:76.3*) may provide for unequal ownership among the tenants in common. [*Cebular v. Cooper Arms Homeowners Ass'n* (2006) 142 CA4th 106, 120, 47 CR3d 666, 675]

(2) [4:76.2] **"Association":** The "association" is a nonprofit corporation or unincorporated association created for the purpose of managing the common interest development. [Civ.C. §§ 4080, 6528 (commercial/industrial); *Villa De Las Palmas Homeowners Ass'n v. Terifaj* (2004) 33 C4th 73, 81, 14 CR3d 67, 70-71; 85 Ops.Cal.Atty.Gen. 162; see also

Berryman v. Merit Property Mgmt., Inc. (2007) 152 CA4th 1544, 1550, 62 CR3d 177, 183—homeowners generally must join association]

(a) [4:76.2a] **Managing agents (residential developments):** Associations may hire managing agents to conduct day-to-day operations (see generally, Civ.C. §§ 4158 & 5375 et seq.). For example, managing agents may facilitate ownership transfers on behalf of the association when residences in the development are sold by providing sellers with the extensive documentation the sellers are required to give prospective buyers (¶ *4:79*) and causing title records to be transferred. [*Berryman v. Merit Property Mgmt., Inc.* (2007) 152 CA4th 1544, 1550-1551, 62 CR3d 177, 183]

Prior to processing a written request for this documentation, the association's managing agent also may furnish the seller's authorized recipient with a copy of a statutorily-required written or electronic estimate of the fees to be assessed against the seller for providing the documentation, prepared on the form described in Civ.C. § 4528. [See Civ.C. § 4530(a)(1), (b)(2), (4)—cost of providing such documentation must be separately stated and billed from other charges relating to transfer or sales transaction]

The association itself is statutorily prohibited from charging the seller a fee greater than the association's actual costs to transfer title records, may only charge a "reasonable fee" based on its actual cost of procuring, preparing, reproducing and delivering the requested documents, and may not charge additional fees for electronic delivery of those documents in lieu of hard copy delivery (Civ.C. §§ 4530(b)(1) & 4575). Managing agents, on the other hand, are not so constrained. [See *Berryman v. Merit Property Mgmt., Inc.,* supra, 152 CA4th at 1551-1552, 62 CR3d at 183-184 (decided under former law)—association "costs" include *fees and profit* managing agent charges for its services]

(3) [4:76.3] **CC&Rs in recorded declaration enforceable as equitable servitudes:** Covenants and restrictions in a common interest development's recorded declaration are enforceable as equitable servitudes unless "unreasonable," and they inure to the benefit of and bind all of the development's separate interest owners. [Civ.C. §§ 5975, 6856 (commercial/industrial); see *Villa De Las Palmas Homeowners Ass'n v. Terifaj* (2004) 33 C4th 73, 86, 14 CR3d 67, 75; *Almanor Lakeside Villas Owners Ass'n v. Carson* (2016) 246 CA4th 761, 773, 201 CR3d 268, 277; and *Pinnacle Museum Tower Ass'n v. Pinnacle Market Develop. (US), LLC* (2012) 55 C4th 223, 231, 237, 145 CR3d 514, 519, 524—once first buyer manifests acceptance of CC&Rs by purchasing unit, common interest development is created and all reasonable recorded terms become enforceable servitudes that bind all separate interest owners]

The recorded covenants and restrictions are *presumptively reasonable* unless found to be arbitrary or in violation of a fundamental public policy. [See *Villa De Las Palmas Homeowners Ass'n v. Terifaj*, supra, 33 C4th at 88, 14 CR3d at 76; *Pinnacle Museum Tower Ass'n v. Pinnacle Market Develop. (US), LLC* (2012) 55 C4th 223, 239, 145 CR3d 514, 525—reasonableness presumption requires recorded CC&Rs be enforced unless wholly arbitrary or violative of public policy, or they impose burden on land that far outweighs any benefit; *Aldea Dos Vientos v. CalAtlantic Group, Inc.* (2020) 44 CA5th 1073, 1077-1079, 258 CR3d 285, 288-289—CC&R provision giving developer veto power over association's claims despite members' vote to proceed with arbitration violated public policy]

(a) [4:76.4] **Including restrictions added by postpurchase amended declaration:** Under traditional property law, deed restrictions must be agreed to at the time of purchase or be properly recorded prepurchase so that the buyer minimally can be charged with constructive notice (¶ *4:66.2*, *4:67.6*). But the statutes governing both residential and commercial/industrial common interest developments (Civ.C. §§ 4000 et seq. & 6500 et seq.) *contain no such limitation* (Civ.C. §§ 5975(a) & 6856(a) do not distinguish between preexisting declarations and *subsequently amended* ones) and in fact contain several provisions *authorizing amended declarations*. As such, pursuant to §§ 5975(a) & 6856(a), restrictions in duly adopted *amended* declarations are enforceable against the development's *existing* unit owners—i.e., even though not recorded at the time those units were purchased. [*Villa De Las Palmas Homeowners Ass'n v. Terifaj* (2004) 33 C4th 73, 87, 14 CR3d 67, 75]

(b) [4:76.5] **Arbitration provisions contained in CC&Rs:** *See ¶ 4:66.2a.*

b. [4:77] **Condominiums:** The condominium is perhaps the most recognizable "common interest development." A condominium "consists of an undivided interest in common in a portion of real property coupled with a separate interest in space called a unit, the boundaries of which are described on a recorded final map, parcel map, or condominium plan in sufficient detail to locate all boundaries thereof." [Civ.C. §§ 4125(b), 6542(b) (commercial/industrial); *Bear Creek Master Ass'n v. Edwards* (2005) 130 CA4th 1470, 1479, 31 CR3d 337, 345; 85 Ops.Cal.Atty.Gen. 162; see also Civ.C. § 783 (describing duration of condominium estate)]

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Thus, condominium owners own the *air space* of their respective units (the existence of a structure or building is *not* required; *Bear Creek Master Ass'n v. Edwards,* supra, 130 CA4th at 1479-1480, 31 CR3d at 345-346), and often have exclusive use of a designated balcony, patio, storage area and parking space. Swimming pool grounds, recreation halls and other common areas of the project are typically owned by the various condominium owners as tenants in common (see Civ.C. §§ 4500, 6650 (commercial/industrial); *Abers v. Rounsavell* (2010) 189 CA4th 348, 360, 116 CR3d 860, 868); and the sale of an owner's unit also transfers the owner's undivided interest in the common areas (Civ.C. §§ 4630, 6662 (commercial/industrial)). [See 85 Ops.Cal.Atty.Gen. 162] (Occasionally, the developer may retain ownership of the common areas and lease it to the owners or homeowners association.)

Some unique considerations apply in the purchase or sale of a condominium:

(1) [4:78] **CC&Rs:** Condominium owners are usually bound by various covenants, conditions and restrictions (CC&Rs) contained in the homeowners association bylaws, articles of incorporation, rules and regulations, and/or agreements. Prospective buyers should be careful to review the CC&Rs for such important points as restrictions on leasing, pet policies and owner rights to make improvements to their individual units. Likewise, the bylaws should be reviewed to determine how the governing board is elected.

(2) [4:79] **Documents to be provided prospective buyer (residential developments):** As soon as practicable before the transfer of title, a condominium (or other common interest development) seller must deliver to the prospective buyer the following documents (Civ.C. § 4525(a)):

• A copy of the “governing documents” (bylaws, association's operating rules, and articles of incorporation, or if the association is not incorporated, a written statement from an authorized association representative so stating; see Civ.C. § 4150; see also Gov.C. § 12956.1—before providing copy of governing documents to others, homeowners association must affix prescribed statement regarding any discriminatory restrictive covenants);

• A copy of the most recent financial documents distributed by the homeowners association to its members pursuant to Civ.C. §§ 5300-5320 (annual pro forma budget, notice of anticipated special assessment levies, statement of procedures used to establish and calculate reserves, etc.; see Civ.C. §§ 5300-5320);

• A “true statement” in writing obtained from an authorized representative of the homeowners association regarding the amount of the current regular and special assessments and fees, as well as any unpaid assessments levied upon the seller's interest in the development (including information on monetary fines and penalties, late charges, interest, and costs of collection that, as of the date of the statement, are or may be made a lien on the seller's interest pursuant to Civ.C. §§ 5650-5740);

• A copy or summary of any notice of a meeting of the board of directors previously sent to the seller pursuant to Civ.C. § 5855 (concerning the possible imposition of discipline against the seller), setting forth any alleged violation of the governing documents that remains unresolved (such notice does not waive the association's right to enforce the governing documents against the seller or prospective buyer with respect to any violation);

• A copy of the initial list of design/construction defects provided to each member of the association pursuant to Civ.C. § 6000 (*unless* the association and builder subsequently enter into a settlement agreement or otherwise resolve the matter and the association complies with Civ.C. § 6100 regarding disclosure to association members of the resolution of the defect claim against the builder); the initial list of defects must include a statement that a final determination concerning accuracy and completeness of the list has not been made;

• A copy of the latest information provided for in Civ.C. § 6100 (concerning disclosure to association members of any settlement agreement or other resolution of the defect claim against the builder);

• Any change in the association's current regular and special assessments and fees approved by the board of directors but that have not become due and payable as of the date the Civ.C. § 4525 disclosure is made to the prospective buyer;

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- If there is a provision in the governing documents that prohibits renting or leasing any of the separate interests, a statement describing the prohibition and its applicability (separate interests acquired prior to the governing documents' effective date(s) are exempt from this prohibition; Civ.C. § 4740(a); see also *Brown v. Montage at Mission Hills, Inc.* (2021) 68 CA5th 124, 127, 283 CR3d 215, 217—Civ.C. § 4740(a) exempted condominium owner from restriction prohibiting short-term rentals not in place when owner purchased unit);

Compare: Notwithstanding Civ.C. § 4740 (above), an owner of a separate interest is not subject to a governing document provision (or amendment thereto) that prohibits the renting or leasing of a *portion* of the owner-occupied separate interest for *more than 30 days*. This is so regardless of whether the restriction existed at the time the homeowner acquired title to their interest. However, the owner (or a resident renting or leasing a portion of the owner-occupied separate interest) is not permitted to violate any provision in the governing documents that regulates conduct in the separate interest or common areas, or that governs membership rights or privileges, including parking restrictions and guest access to common facilities. [Civ.C. § 4739]

- If requested, a copy of the approved minutes of the board of directors' meetings (excluding executive session meetings) conducted over the previous 12 months; and

- If there is an age-based restriction in the governing documents limiting occupancy, residency or use, a statement that the restriction is only enforceable to the extent permitted by Civ.C. § 51.3, and a statement specifying the applicable provisions of § 51.3. [Civ.C. § 4525(a)(2); see also Bus. & Prof.C. §§ 11004.5, 11018.1 & 11018.6]

Cross-refer: Civ.C. § 51.3 defines the boundaries of permissible "age-based" discrimination in the sale and rental of housing under the Unruh Act ("senior citizen housing") and is explained in detail in Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 2C.

c. [4:80] **Stock cooperatives:** Stock cooperatives, although extremely rare in California, are broadly similar to condominiums. The distinguishing feature is that the owners hold an interest in a corporation rather than in the fee; the corporation owns the fee interest in the property. Each owner/shareholder has the exclusive right to use a particular unit (typically evidenced by a lease, often denominated as a "proprietary lease") and ancillary rights to the use and benefit of common areas. [Civ.C. §§ 4190, 6566 (commercial/industrial); see also Civ.C. § 783.1—interest in stock cooperative generally considered real property; Civ.C. §§ 4640 & 6666—sale transfers owner's interest in corporation and membership interest in association]

The principal and *very significant difficulty* with stock cooperatives is that many California lenders are reluctant to finance them … typically, because:

- Lenders lack the experience, documentation or infrastructure to make such loans; and

- Lenders encounter unique foreclosure difficulties, since foreclosure is upon both the stock and the proprietary lease (not upon a fee interest).

d. [4:81] **Other forms of common interest developments:** "Planned developments" and "community apartment projects" are other forms of common interest developments. [Civ.C. § 4100] A "time share" also is considered a form of common interest ownership.

(1) [4:82] **Community apartment project (residential developments):** A "community apartment project" is a common interest development in which each owner owns an undivided interest in land together with a right of exclusive occupancy of a particular unit. [Civ.C. § 4105] The undivided interest in land cannot be transferred separately from the interest in the right to exclusive occupancy. [Civ.C. § 4625]

(2) [4:83] **Planned development:** A "planned development" is a development (other than a community apartment project, condominium project or stock cooperative) that has either or both of the following features (Civ.C. §§ 4175 & 6562 (commercial/industrial)):

- A common area owned by either an association or in common by the owners of the separate interests who possess appurtenant rights to the beneficial use and enjoyment of the common areas (Civ.C. §§ 4175(a), 6562(a));

• A common area and an association that maintains the common area with the power to levy assessments that may become a lien upon separate interests pursuant to Civ.C. §§ 5650 & 6808 et seq. (Civ.C. §§ 4175(b), 6562(b)); see also Civ.C. §§ 4095(b) & 6532(b)—"common area" (¶ *4:76.1*) specified in §§ 4175(b) & 6562(b) may consist of mutual reciprocal easement rights appurtenant to separate interests. [See 85 Ops.Cal.Atty.Gen. 162 (decided under predecessor statutes)]

(a) [4:83.1] **CC&Rs:** Like condominium projects, planned developments generally are governed by CC&Rs, enforceable as covenants running with the land or equitable servitudes. [*Committee to Save Beverly Highlands Homes Ass'n v. Beverly Highlands Homes Ass'n* (2001) 92 CA4th 1247, 1270, 112 CR2d 732, 748; *see* ¶ *4:67.5 ff.*]

(b) [4:83.2] **Interests transferred by conveyance:** The conveyance of an owner's separate interest in a planned development also transfers the owner's undivided interest (if any) in the common areas and the owner's membership interest in the association. [Civ.C. §§ 4635 & 6664 (commercial/industrial)]

(c) [4:83.3] **Condominium project compared:** A planned development may resemble a condominium project, but there are technical legal distinctions: In a planned development, the separate interest owner owns a lot and the structural improvements situated on that lot. In contrast, the condominium owner receives title primarily to a "cube of airspace" without receiving undivided ownership of any underlying land or structural improvements; the land and structures are "common area" (¶ *4:76.1*). [See 85 Ops.Cal.Atty.Gen. 162—development recorded under map of "condominium project" and granted special use permit for "Planned Residential Development that is condominium" was in fact planned development]

Also, a planned development's common area is often owned by the development's community association, although it may be held in undivided interests; but in a condominium project, at least some portion of the common area must be owned in undivided interests (¶ *4:77*). [See 85 Ops.Cal.Atty.Gen. 162]

(3) [4:84] **Time shares:** Time shares are governed by the Vacation Ownership and Time-Share Act (Bus. & Prof.C. § 11210 et seq.).

(a) [4:84.1] **Time-share plan:** A "time-share plan" is an arrangement (other than an "exchange program," see Bus. & Prof.C. §§ 11212(*l*), 11216) under which a purchaser receives ownership rights in, or the right to use, an "accommodation" (apartment, condominium, cooperative unit, cabin, lodge, hotel or motel room, commercial passenger ship berth, etc.; see Bus & Prof.C. § 11212(a)) for a period of less than a full year during any given year, on a recurring basis for more than one year but not necessarily for consecutive years. [Bus. & Prof.C. § 11212(z)]

A time-share plan may be a "single site" plan or a "multisite" plan. [See Bus. & Prof.C. § 11212(z)(1) & (2)]

(b) [4:84.2] **Time-share property:** A "time-share property" is one or more accommodations subject to the same "time-share instrument" creating or governing the operation of a time-share plan. [Bus. & Prof.C. § 11212(w), (aa)]

(c) [4:84.3] **Time-share interest:** A "time-share interest" can be either a "time-share estate" or "time-share use." [Bus. & Prof.C. § 11212(x)]

A "time-share estate" is a right of occupancy in a time-share property that is coupled with a freehold estate or estate for years with a future interest in the property. For title purposes, each time-share estate constitutes a separate estate or interest in real property, including ownership in real property for tax purposes. [Bus. & Prof.C. §§ 11212(x)(1), 11213] If the right of occupancy is not coupled with an estate in the property, it is a "time-share use." [Bus. & Prof.C. § 11212(x)]

14. [4:85] **Mobilehome Parks:** The rental and occupancy of space in a mobilehome park is governed by the Mobilehome Residency Law (Civ.C. § 798 et seq.). A "mobilehome park" is an area of land where two or more mobilehome sites are rented, or held out for rent, to accommodate mobilehomes used for human habitation. [Civ.C. § 798.4]

a. [4:86] **Sale of mobilehome park—notice of intent to sell required:** When selling or listing for sale a mobilehome park, subject to certain conditions and exceptions, the seller must give the resident homeowners association prior notice of intent to sell. [Civ.C. § 798.80]

b. [4:87] **Transfer or sale of *individual home in mobilehome park subject to disclosure requirements:*** The transfer or sale of a manufactured home or mobilehome in a mobilehome park is subject to the Civ.C. § 1102 et seq. transfer disclosure requirements (¶ *2:185.1*). [Civ.C. § 798.74.4—transfer disclosure requirements include use of Civ.C. § 1102.6d Manufactured Home and Mobilehome Transfer Disclosure Statement]

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Cross-refer: Other provisions of the Mobilehome Residency Law regulating ownership and operation of mobilehome parks and residencies therein also should be reviewed. For a comprehensive treatment of the subject, see Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 11.

15. [4:87.1] **Laws Facilitating Higher Density Housing:** Given the gravity and persistence of California's affordable housing crisis, legislation supporting alternatives to the traditional housing supply has been and continues to be enacted. While a full treatment of all current housing laws is beyond the scope of this Practice Guide, some examples follow (¶ 4:88 ff.).

a. [4:88] **Accessory dwelling units:** An "accessory dwelling unit" (ADU) is an attached or detached residential dwelling unit that provides *complete* independent living facilities for one or more persons and is located on a lot with a proposed or existing primary residence. [Gov.C. § 66313(a) (added Stats. 2023, Ch.7; eff. 3/25/24)]

An ADU must include permanent provisions for living, sleeping, eating, cooking, and sanitation on the same parcel as the single-family or multifamily dwelling is or will be situated. [Gov.C. § 66313(a)]

(1) [4:88.1] **Junior ADUs:** A "junior accessory dwelling unit" (JADU) is a unit contained entirely within a single-family residence and is no more than 500 square feet. It may include separate sanitation facilities or share sanitation facilities with the existing structure. [Gov.C. § 66313(d) (added Stats. 2023, Ch. 7; eff. 3/25/24)]

(2) [4:88.2] **Limited local government regulation:** The California Legislature has declared ADUs to be "an essential component" of California's housing supply, especially in view of the state's "severe housing crisis." [Gov.C. § 66310(e) & (h) (added Stats. 2024, Ch. 7; eff. 3/25/24)]

Thus, the Government Code limits a local government's authority to impose or enforce certain building restrictions on ADUs, including minimum lot size requirements and minimum and maximum square footage requirements. [See Gov.C. §§ 66314(b)(1), 66321 (added Stats. 2024, Ch.7; eff. 3/25/24); *Riddick v. City of Malibu* (2024) 99 CA5th 956, 969-970, 317 CR3d 895, 904-905—no error in directing City to process proposed ADU as exempt from coastal development permit (CDP) requirements (concluding ADUs subject to city ordinance were in class of improvements to existing single-family residences exempt from CDP requirements)]

The Government Code also restricts local agencies' authority to deny building permits for ADUs and JADUs. [See, e.g., Gov.C. §§ 66316, 66317 & 66323 (added Stats. 2024, Ch. 7; eff. 3/25/24)]

(3) [4:88.3] **ADUs constructed *before 1/1/2018:*** Local agencies may *not* deny permits for unpermitted ADUs that were constructed *before* January 1, 2018, if the ADUs (i) are in violation of Health & Saf.C. § 17960 et seq. building standards, (ii) do not comply with Gov.C. § 66314 et seq. (¶ 4:88.2), or (iii) do not comply with any local ordinance that regulates ADUs. This is so unless the local agencies find that correcting the violations is necessary to protect the health and safety of the public or a structure's occupants. [Gov.C. § 66332 (added Stats. 2024, Ch. 7; eff. 3/25/24)]

(4) [4:88.4] **ADUs may be sold separately in limited circumstances:** Local agencies must allow ADUs to be sold or conveyed separately from the primary residence to qualified buyers provided the ADU or primary dwelling was built or developed by a qualified nonprofit corporation and other requirements are met. [See Gov.C. § 66341 (added Stats. 2024, Ch. 7; eff. 3/25/24)]

(5) [4:88.5] **Common interest developments cannot prohibit ADUs or JADUs:** Any provision in an instrument affecting the sale or transfer of property in a planned development that effectively prohibits or unreasonably restricts the construction or use of statutorily compliant ADUs or JADUs on a lot within a single-family residential zone is void and unenforceable. [Civ.C. § 4751(a)]

b. [4:89] **Urban residential zoning and development:** The California Housing Opportunity and More Efficiency (HOME) Act (Gov.C. §§ 65852.21, 66411.7 & 66452.6) requires local agencies to ministerially approve, under certain conditions, the splitting of residential lots and construction of multiple housing units on each lot. The Act is in response to statewide concerns about access to affordable housing and applies to all cities, including charter cities. [See Stats. 2021, Ch. 162, § 4]

Covered projects are exempt from review under the California Environmental Quality Act (CEQA) (Pub.Res.C. § 21000 et seq.). Although they remain subject to the California Coastal Act (Pub.Res.C. § 30000 et seq.), a local agency is not required to hold public hearings for applicable coastal development permit applications. [Gov.C. §§ 65852.21, 66411.7(n), (o)]

(1) [4:89.1] **Two dwelling units on single parcel:** A local jurisdiction must *ministerially approve* (without discretionary review or hearings) a proposed housing development containing no more than two residential units on a single parcel, if

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located in an "urbanized area" or "urban cluster" (as defined). This is so provided certain statutory requirements are met. [See Gov.C. § 65852.21(a)]

(2) [4:89.2] **Urban lot splits:** A local jurisdiction must *ministerially approve* a parcel map to split a lot in an "urbanized area" or "urban cluster" (as defined), provided statutory requirements are met. Among other things, each new parcel may not be smaller than 40 percent of the original parcel size, and each parcel must be at least 1,200 square feet (unless a smaller size is permitted by local ordinance). A local agency is not required to permit more than two units on each resulting parcel. The applicant must submit an affidavit of intent to occupy one of the units for at least three years, and neither unit may be used for short-term rentals. Additionally, only one lot split is permitted. [See Gov.C. § 66411.7(a)(1)-(2), (g), (h), (j)]

(3) [4:89.3] **Exceptions:** There are multiple exceptions to the ministerial approval requirements. For example, they do not apply to areas that are prime farmland or farmland of statewide importance, wetlands, very high fire hazard severity zones, hazardous waste sites, delineated earthquake fault zones, special flood hazard areas or regulatory floodways, certain conservation areas, areas designated as habitats for protected species, historic districts, proposed developments that would require the demolition of certain types of affordable housing, rent-controlled housing, or properties that have been tenant-occupied for the past three years. [See Gov.C. §§ 65852.21(a)(2)-(6), 66411.7(a)(3)(C)-(E)]

c. [4:89.4] **"Up-zoning" residential property:** Prior to 1/1/29, a local government may voluntarily pass an ordinance to "up-zone" any parcel for up to 10 residential units per parcel, if the parcel is located in a "transit-rich area" or "urban infill site," as defined. Adoption of such an ordinance is exempt from review under the California Environmental Quality Act (CEQA) (Pub.Res.C. § 21000 et seq.). [Gov.C. § 65913.5(a), (e)]

d. Residential development in commercial zones

(1) [4:89.5] **Affordable Housing and High Road Jobs Act of 2022 (1/1/2033 "sunset" date):** The Affordable Housing and High Road Jobs Act of 2022 (Gov.C. § 65912.100 et seq.) makes available a "streamlined, ministerial review process" for residential development projects in areas where office, retail or parking are the "principally permitted use." This is so provided the projects meet specified objective development standards, affordability criteria, site criteria, and wage and labor requirements. The Act also exempts qualified multi-family housing development projects from review under the California Environmental Quality Act (CEQA). [Gov.C. §§ 65912.111-65212.114, 65912.121-65912.123, 65912.124(h), 65912.130]

With respect to labor, housing project contracts that have been approved must indicate certain wage and labor standards will be met, and that all construction workers will be paid at least the general prevailing rate of wages. Moreover, a project's proponent must certify that those standards will be met in project construction, and that a government approved development of 50 or more housing units will, among other things, either require construction contractors to participate in apprenticeship programs or request the dispatch of apprentices from state-approved apprenticeship programs. [See Gov.C. §§ 65912.130, 65912.131(b)]

(2) [4:89.6] **Middle Class Housing Act of 2022 (1/1/2033 "sunset" date):** The Middle Class Housing Act of 2022 (Gov.C. § 65852.24) also promotes residential development projects in zones where office, retail or parking are a "principally permitted use" (Gov.C. § 65852.24(b)). The Act responds to the "continued need for housing development at all income levels, including missing middle class housing that will provide a variety of housing options and configurations to allow every Californian to live near where they work." [See Gov.C. § 65852.24(a)(2)(C), (*l*) (declaring Act applicable to "all cities, including charter cities")]

"Middle class" housing projects may be all residential or mixed use. If both, at least 50% of the square footage must be for residential use. And none of the square footage may be designated for hotels, motels, bed and breakfast inns, or other transient lodgings (except for residential hotels). [See Gov.C. § 65852.24(k)]

Unlike the Affordable Housing and High Road Jobs Act of 2022 (¶ 4:89.5), the Middle Class Housing Act of 2022 permits multifamily projects in commercial zones without requiring a zone change. This is so provided specific conditions are met (e.g. conditions related to density, public notice, site location, size, etc.). However, compliance with all housing, environmental, and labor laws applicable to housing developments authorized by the Act is mandatory (e.g., the California Coastal Act of 1976 (Pub.Res.C. § 30000 et seq.), California Environmental Quality Act (CEQA) (Pub.Res.C. § 21000, et seq.), Housing Accountability Act (Gov.C. § 65589.5), and Density Bonus Law (Gov.C. § 65915), etc.). [Gov.C. § 65852.24(b), (f)]

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e. [4:89.7] **Residential development on land owned by higher education or religious institutions:** The Affordable Housing on Faith and Higher Education Lands Act of 2023 provides a streamlined, ministerial process for approving housing development projects that meet specified criteria with respect to land owned on or before January 1, 2024 by independent higher education or religious institutions. For example, projects that qualify may not be adjoined to any site where more than 1/3 of the square footage on the site is dedicated to "light industrial use." And at least 75% of the units, exclusive of manager units, must be offered to "lower income households" at "affordable housing cost" or "affordable rent." Housing development projects that meet all the Act's specific criteria are deemed a "use by right" on the land. [See Gov.C. § 65913.16 (added Stats. 2023, Ch. 771; eff. 1/1/24) (1/1/2036 "sunset" date)]

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Cal. Prac. Guide Real Prop. Trans. Ch. 4-B

California Practice Guide: Real Property Transactions | September 2024 Update
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Chapter 4. Purchase and Sale Agreement

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[4:90] Real property interests come in a variety of forms; several do not fit within the traditional common law definition of "interests in real property" but are nevertheless the subject of modern real property transactions.

It is important for counsel representing parties to a real property sale to initially identify not only the particular real and personal property (tangible and intangible) that is to be transferred, but also the form or type of interest to be conveyed.

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The interest to be conveyed will determine such issues as contract documentation, conveyancing instruments, title insurance, taxation and financing.

1. [4:91] **Traditional Estates:** An "estate" is the degree of ownership and possessory right that a person has in real property. The four traditional categories of estates—fee, life estate, estate for years, and estate at will—differ principally by reason of their duration (see Civ.C. § 761). Typically, buyers and sellers are dealing with the sale of either a fee interest, a vendee's interest in a land sale contract or an interest in a long-term ground lease.

a. [4:92] **Fee simple:** A "fee simple" (or a "fee" or "estate in fee") is the highest and broadest form of ownership; it is the "fullest and most absolute estate in lands known to the law." [*Callahan v. Martin* (1935) 3 C2d 110, 120, 43 P2d 788, 793; *Apartment Ass'n of Los Angeles County, Inc. v. City of Los Angeles* (2001) 24 C4th 830, 840, 102 CR2d 719, 726, fn. 3—"ownership of real property in fee simple absolute is the greatest possible estate"; and see Civ.C. § 761(1)—"perpetual estate"]

Fee simple title generally is *presumed* to pass by the grant of real property unless it appears from the grant that a lesser estate was intended. [Civ.C. § 1105; *City of Manhattan Beach v. Sup.Ct. (Farquhar)* (1996) 13 C4th 232, 242, 52 CR2d 82, 89; see also Civ.C. § 1072—"words of inheritance or succession" not required to transfer fee; *Severns v. Union Pac. R.R. Co.* (2002) 101 CA4th 1209, 1212, 125 CR2d 100, 102—"To convey a fee, all that is required is the word 'grant'"]

However, the general presumption of fee title conveyance is subject to more *specific* statutory presumptions applicable to certain types of real property acquisitions. [See 88 Ops.Cal.Atty.Gen. 136—under Civ.C. §§ 831, 1112, easement (rather than fee title) presumed to pass by grant of property to government for use as public highway]

(1) [4:92.1] **Fee simple "subject to" conditions:** Fee simples are not necessarily "absolute"; they may be *subject to* a condition subsequent with a power of termination (i.e., an executory interest ordinarily reserved by the grantor) (Civ.C. §§ 762, 885.010 et seq.). [*City of Palm Springs v. Living Desert Reserve* (1999) 70 CA4th 613, 621, 82 CR2d 859, 866, fn. 4; see *Severns v. Union Pac. R.R. Co.* (2002) 101 CA4th 1209, 1216, 125 CR2d 100, 105-106]

(a) [4:92.2] **Effect of conveyance:** When property is conveyed subject to a condition subsequent, the transferee receives both legal and equitable title. Unless and until the condition is breached, the transferee is in the same position as an owner in fee simple absolute. [*City of Palm Springs v. Living Desert Reserve* (1999) 70 CA4th 613, 621, 82 CR2d 859, 866]

But if the transferee (or a successor in interest) breaches the condition, the transferor (or other third party contingent transferee) may exercise its power of termination, causing a forfeiture of the transferee's interest. [*City of Palm Springs v. Living Desert Reserve*, supra, 70 CA4th at 622, 82 CR2d at 867; see *Severns v. Union Pac. R.R. Co.* (2002) 101 CA4th 1209, 1216, 125 CR2d 100, 105]

Cross-refer: A power of termination may *expire*, however, with the passage of time or because it has become obsolete; *see discussion at¶ 3:300.5 ff.*

(b) [4:92.3] **Determining type of interest conveyed:** The fact the deed uses the word "condition" or "subject to" does not necessarily indicate a conveyance of fee simple title subject to a condition subsequent. The deed may have conveyed fee simple title with a reservation of rights in the grantor (e.g., an easement or other right not amounting to a power of termination) or, perhaps, a charitable trust (*¶ 4:92.10*).

1) [4:92.4] **Forfeiture intent must be clear; admissibility of extrinsic evidence:** Because the law disfavors forfeitures, a conveyance will *not* be construed as fee simple subject to condition subsequent unless the transferor *clearly manifested an intention* to create such an interest. [See Civ.C. § 1442—condition involving forfeiture strictly interpreted against party for whose benefit it is created; *City of Palm Springs v. Living Desert Reserve* (1999) 70 CA4th 613, 622, 82 CR2d 859, 867]

By the same token, when a deed *unambiguously* manifests the grantor's intention to create a fee simple subject to condition subsequent, extrinsic evidence is not admissible to determine that some other type of interest was conveyed. [*Severns v. Union Pac. R.R. Co.* (2002) 101 CA4th 1209, 1216, 125 CR2d 100, 105-106—trial court improperly considered extrinsic evidence to decide deed unambiguously granting fee subject to condition subsequent instead conveyed only an easement]

• [4:92.5] Deed granting City 30 acres of land on condition it be used solely and perpetually as a desert wildlife preserve and equestrian center conveyed a fee simple subject to condition subsequent where it expressly stated Grantor's intent that Grantee shall forfeit its interest in favor of Third Party in event of a breach of the condition.

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[*City of Palm Springs v. Living Desert Reserve* (1999) 70 CA4th 613, 621-622, 82 CR2d 859, 866-867—city breached condition and forfeited fee simple interest when it built a golf course on property]

• [4:92.6] Deed granting a 60-foot strip of land to be used as a right of way for an electric railroad, but that also provided the property would revert to Grantor if Grantee failed to use it as a railroad, unambiguously conveyed a fee simple subject to a condition subsequent. [*Concord & Bay Point Land Co. v. City of Concord* (1991) 229 CA3d 289, 294-295, 280 CR 623, 625-626; see also *Severns v. Union Pac. R.R. Co.* (2002) 101 CA4th 1209, 1214, 125 CR2d 100, 104 (same)]

• [4:92.7] *Compare:* A probate order granting a widow the right to live in property rent free "for her lifetime," with the property passing to her stepsons upon her death, also permitted the widow to sell the property during her life (and required her to sell it upon remarriage) with the proceeds to be divided equally between the widow and her stepsons. This option (or requirement) to sell the property, however, did *not* convert the widow's life estate into a fee interest subject to conditions subsequent. Rather, the order established in the widow a life estate interest and in her stepsons a fee interest as remaindermen. [See *Peterson v. Wells Fargo Bank, N.A.* (2015) 236 CA4th 844, 853, 186 CR3d 842, 848-849 (rejecting contrary argument raised by lender attempting to foreclose on trust deed wrongfully executed by widow to secure loan)]

[4:92.8 - 4:92.9] ***Reserved.***

(c) Other interests compared

1) [4:92.10] **Charitable trust:** A conveyance of property in trust for a charitable purpose may resemble a conveyance subject to condition subsequent. But the two are distinct in legal effect:

A charitable trust is created where property is transferred to a trustee who has an *enforceable obligation* to use the property for charitable purposes (by contrast, the transferee of a fee subject to condition subsequent does not have enforceable duties but, as stated, risks forfeiture). Where a charitable trust is created, the trustee holds legal title, but the trust beneficiaries hold an equitable estate (whereas a fee simple transferee holds both legal and equitable title). [*City of Palm Springs v. Living Desert Reserve* (1999) 70 CA4th 613, 621, 82 CR2d 859, 866]

Whether a trust or condition subsequent is created depends upon the transferor's manifested intent (*¶ 4:92.4*). For this purpose, courts look to the manner in which the conveyancing instrument treats a breach:

• If the conveyance is expressly made subject to *forfeiture* upon a breach of the condition, the transferor intended to create a *condition subsequent;*

• However, if the transferor simply intended to impose an enforceable obligation on a trustee (i.e., subjecting the trustee to a damages action or suit to enforce the condition), the transfer created a charitable trust. [See *City of Palm Springs v. Living Desert Reserve*, supra, 70 CA4th at 621, 82 CR2d at 866—property transferred "upon condition" that it be applied to specified charitable purposes "is especially likely to be construed as having been given in a charitable trust"]

2) [4:92.11] **Easement:** Language in a deed stating it is "subject to" specified covenants commonly connotes a reservation of rights in the grantor (e.g., an easement) rather than a limitation on the estate conveyed. [See *City & County of San Francisco v. Union Pac. R.R. Co.* (1996) 50 CA4th 987, 995-997, 58 CR2d 1, 6-7—grant of 80-foot-wide strip of land to City, reserving specified rights to grantor railroad to use surface property, conveyed fee simple title]

3) [4:92.12] **Unconditional grant for specified use:** Where land is granted for a *specified use*, an otherwise *unconditional* grant will likely be construed to convey a fee simple interest; the language defining the use is merely descriptive—i.e., a declaration of purpose, not a limitation of the grant. [*Machado v. Southern Pac. Transp. Co.* (1991) 233 CA3d 347, 358-359, 284 CR 560, 567—grant of land "for right of way for a standard gauge railroad" conveyed a fee, not an easement]

4) [4:92.13] **Property acquired by public entity through private dedication:** A "private dedication" is the transfer of an interest in real property to a public entity for the public's use. There are two types of private dedication: those made in compliance with statute and those made under controlling principles of common law. Nonetheless, the two

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do not always operate independently of each other (*¶ 4:92.14*). [*Biagini v. Beckham* (2008) 163 CA4th 1000, 1009, 1014, 78 CR3d 171, 178, 182]

a) [4:92.14] **Statutory dedications:** A "statutory dedication" is effected when, in compliance with the Subdivision Map Act then in force, an offer to transfer a real property interest is *formally accepted* by the appropriate public agency. [See *Biagini v. Beckham* (2008) 163 CA4th 1000, 1009, 1014, 78 CR3d 171, 178; *McKinney v. Ruderman* (1962) 203 CA2d 109, 115-116, 21 CR 263, 266—filing of subdivision map delineating street thereon was offer to dedicate for street purposes land identified by such delineation]

A statutory offer of dedication that has not been formally accepted, however, does not rule out the possibility of a common law dedication, which may arise when the offer is *impliedly accepted* from the *public's use* of the subject property over a reasonable period of time (*¶ 4:92.15*). [*Biagini v. Beckham*, supra, 163 CA4th at 1009, 1014, 78 CR3d at 178, 182; see also *Prout v. Department of Transportation* (2018) 31 CA5th 200, 212, 242 CR3d 483, 493 (citing *Biagini* with approval)—incomplete statutory dedications operate as common law dedications when accepted by public]

b) [4:92.15] **Common law dedications:** Under the common law, a dedication may be made either expressly or by implication. Whether express or implied, however, a common law dedication requires both an offer of dedication and an acceptance of that offer by the public (*¶ 4:92.51a*). [*Scher v. Burke* (2017) 3 C5th 136, 141, 218 CR3d 643, 647; see also *Ruiz v. County of San Diego* (2020) 47 CA5th 504, 515, 260 CR3d 740, 748—"Until an offer of dedication has been accepted, there is no public property interest"; *Friends of the Hastain Trail v. Coldwater Development LLC* (2016) 1 CA5th 1013, 1027, 205 CR3d 270, 282—express dedication arises when owner's intent manifests through overt acts (e.g., execution of a deed), and implied dedication arises when evidence supports intent to dedicate without overt acts (e.g., adverse public use that exceeds prescription period)]

1/ [4:92.15a] **Offer and acceptance:** A property owner may manifest their intent to dedicate an interest in land to the public through words or conduct, and the public may accept the "offer" to dedicate in various ways. No writing or statutory formality is required. "All that is necessary is sufficient evidence that the property owner either expressly or impliedly manifested an unequivocal intention to offer the property for a public purpose, and that there was an acceptance of the offer by the public." [*Cherokee Valley Farms, Inc. v. Summerville Elementary School Dist.* (1973) 30 CA3d 579, 584-585, 106 CR 467, 470; see also *Prout v. Department of Transportation* (2018) 31 CA5th 200, 214-215, 242 CR3d 483, 495 (finding 20-year delay in completing dedication "reasonable" where, among other things, property owner never attempted to revoke offer until after its acceptance)—public agency (Caltrans) impliedly accepted property owner's offer to dedicate strip of land for highway improvement purposes by physically occupying property for 20 years, at which time road improvements were made that completed said dedication]

Moreover, a "common law dedication" is based on public convenience and rests largely on grounds of estoppel: "[W]here the public at large relies on an offer to dedicate land to public use to such an extent that it would be unfair under principles of estoppel to deny the public continued use of the land for that purpose, implied acceptance of the offer of dedication will be found." [*Biagini v. Beckham* (2008) 163 CA4th 1000, 1012, 78 CR3d 171, 180-181—no implied acceptance of offer of dedication by public use where actual use was consistent with private easement]

Public use of property alone, however, is insufficient to constitute implied acceptance of a dedication. [*Ruiz v. County of San Diego* (2020) 47 CA5th 504, 515-518, 260 CR3d 740, 749-751—absent evidence of its "control" or "maintenance," county did not impliedly accept dedication of privately owned storm drain pipe under homeowners' property by using pipe as part of public drainage system and, therefore, was not liable to homeowners for inverse condemnation after pipe failed]

(Legislation was adopted in 1972 limiting the doctrine of implied dedication; *see ¶ 4:92.16 ff.*)

c) [4:92.16] **Post-3/3/72 public use of private property:** Civil Code § 1009 limits the doctrine of implied dedication for public use of private property. The statute, however, operates prospectively only and does not affect a public use that ripened into an offer of dedication prior to March 4, 1972. [*Friends of the Trails v. Blasius* (2000) 78 CA4th 810, 823, 93 CR2d 193, 201; see also *Friends of the Hastain Trail v. Coldwater Development LLC* (2016) 1 CA5th 1013, 1029-1030, 205 CR3d 270, 284—hikers' public use of wilderness fire road between 1967 and 1972 insufficient to

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put property owners' predecessors on actual or constructive notice their property was in danger of public dedication (fire road was conditional, temporary public easement located on predecessors' property that could not be materially changed without notice, making it impossible to anticipate road's use might result in permanent hiking trail)]

1/ [4:92.17] **Public use of private *noncoastal property:*** Strong public policy favors public use of noncoastal private property for both recreational *and* nonrecreational purposes. To encourage property owners to make their property available for such use without risking loss of ownership rights, the Legislature determined that the public's mere use of such property *effective 3/4/72* does *not* establish an implied dedication of the property (except for coastal property; ¶ 4:92.18). [Civ.C. § 1009(a), (b); *Scher v. Burke* (2017) 3 C5th 136, 139, 145-150, 218 CR3d 643, 646, 650-654 & fn. 5 (disapproving prior authority holding public's *nonrecreational* use of private *noncoastal* property may give rise to implied offer of dedication)—statutory rule against implied dedication applied to roadways; see also *Mikkelsen v. Hansen* (2019) 31 CA5th 170, 175-178, 181, 242 CR3d 304, 307-310, 312—§ 1009(b) not only *prohibits* post-3/3/72 *implied-in-law* dedications (i.e., where public use is adverse and exceeds 5-year prescription period), but also post-3/3/72 *implied in-fact* dedications (i.e., where public use is less than 5-year prescription period and owner's acts/omissions imply actual consent or acquiescence to dedication); compare *Ditzian v. Unger* (2019) 31 CA5th 738, 743-746, 243 CR3d 322, 326-328 (finding property owners and their guests had interest in path over neighbor's land that was distinguishable from general public's interest)—Civ.C. § 1009 did *not* preclude property owners from establishing *private prescriptive easement* over neighbor's property to gain access to public recreational area (prescriptive easements are discussed in detail at ¶ 4:102.10 ff.)]

2/ [4:92.18] **Public use of private *coastal property:*** There also is a strong public policy to preserve and provide public access to beaches and other property adjacent to navigable waters. Thus, *effective 3/4/72*, owners of private coastal property, as defined, must post signs, publish notices or enter into agreements for public use with public agencies in order to prevent private coastal property from ripening into a dedication based on public use. [Civ.C. § 1009(e), (f); see also *Scher v. Burke* (2017) 3 C5th 136, 148, 218 CR3d 643, 653—by enacting Civ.C. § 1009, Legislature made it easier to find implied dedication in coastal region than elsewhere in California]

d) [4:92.19] **"Public trust" doctrine:** Land may be donated to a public entity through a grant deed containing specific restrictions (e.g., property donated solely for a county fair ground, public park or other recreational area). Under these circumstances, the public entity *cannot* legally divert the property's use to purposes inconsistent with the grant deed's terms. [*Spinks v. City of Los Angeles* (1934) 220 C 366, 368, 31 P2d 193, 194; see also *County of Solano v. Handlery* (2007) 155 CA4th 566, 575, 66 CR3d 201, 207-208—properties donated for public use held upon "public trust"; *Big Sur Properties v. Mott* (1976) 62 CA3d 99, 103-104, 132 CR 835, 838—grant deeds dedicating properties for public use are "strictly construed"]

It is immaterial that the interest conveyed amounts to a fee simple absolute (*¶ 4:92*). "The [public entity] has neither the right nor the power to apply any such property to other than public uses and those included within the objects of the grant … Whatever estate or interest it holds … is in trust for the public use." [*County of Solano v. Handlery*, supra, 155 CA4th at 580, 66 CR3d at 212 (brackets in original; internal quotes and citations omitted)]

(2) [4:92.20] **Compare—modification of grant in fee:** An interest conveyed by grant deed can be modified by a separate agreement. Thus, by separate contract and with full knowledge of its rights, a party granted fee title can *waive* its fee interest in favor of a lesser estate. [See *City & County of San Francisco v. Union Pac. R.R. Co.* (1996) 50 CA4th 987, 998-999, 58 CR2d 1, 8—although deed indicated City would acquire fee simple interest, City was "forever estopped" to claim fee interest by its contractual waiver of ownership rights]

b. [4:93] **Life estate:** A "life estate" (Civ.C. § 761(2)) is an interest in real property measured by the life of a person or persons. The measuring life may be the person owning the life estate or someone else. Life estates are followed by some form of future interest after the life of the measuring person. [See *Zanelli v. McGrath* (2008) 166 CA4th 615, 631, 82 CR3d 835, 848—life estate terminates upon holder's death by operation of law; see also *Peterson v. Wells Fargo Bank, N.A.* (2015) 236 CA4th 844, 853, 186 CR3d 842, 849 (affirming stepsons' fee interest as remaindermen following widow's life estate); *discussed further at¶ 4:92.7*]

Although recognized by statute (Civ.C. §§ 761, 765 & 766), life estates are seldom used. They were traditionally created as an estate planning tool so that, after the estate holder's death, the surviving spouse and/or children would have the use

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and benefit of real property. However, trusts and other more sophisticated estate planning devices have supplanted their use; and thus, arms'-length purchase transactions in California rarely, if ever, involve a life estate.

c. [4:94] **Estate for years:** An "estate for years" (Civ.C. § 761(3)) is limited in time, having a specific definitive term—i.e., a *leasehold*. (See generally, Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 2A.) It is regarded as "inferior to an estate for life or an inheritance." [*Apartment Ass'n of Los Angeles County, Inc. v. City of Los Angeles* (2001) 24 C4th 830, 840-841, 102 CR2d 719, 725-726 & fn. 3; see also *Auerbach v. Assessment Appeals Bd. No. 1 for County of Los Angeles* (2006) 39 C4th 153, 162-163, 45 CR3d 774, 780—estate for years not real property but a form of personalty, even though substance of estate is real property]

(The term "leasehold" rather than "estate for years" is most commonly used in modern real property transactions.)

d. [4:95] **Estate at will:** An "estate at will" (Civ.C. § 761(4)) is also a *leasehold*, but without any definitive fixed term. Theoretically, it may be terminated at the lessor's or lessee's election; but the lessor's "at will" termination must be preceded by minimum 30 days' written notice (Civ.C. § 789). (See generally, Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Chs. 2A & 7.)

e. [4:96] **Future interests:** Issues pertaining to future interests (both vested and contingent), reversions and remainders (see Civ.C. §§ 767-780) are primarily relevant in the estate planning context; they rarely (if ever) arise in connection with real property purchase agreements (and thus are not separately discussed in this text).

2. [4:97] **Ground Leaseholds:** Once improvements have been constructed, a so-called "ground leasehold" is simply a euphemism for a long-term lease. At the commencement of most ground leases, vacant land is rented and the lessee (or sometimes the lessor) builds the improvements. Although there is no fixed or minimum term for a ground leasehold, a surprising number of residential and commercial improvements have been developed on ground leases.

It is critical that counsel for both buyer and seller determine at the inception of negotiations whether the transaction is to be a sale of a fee interest or the transfer of a lessee's ground leasehold interest. While the lessee's interest in a ground leasehold may, as a practical matter, carry with it all of the benefits and burdens of a fee interest, substantial issues are presented when it is the subject of a purchase and sale transaction.

a. [4:97.1] **Defining "leased land":** In determining what constitutes "leased land" for purposes of assessing the ground lessee's rental/financial obligations, general rules of contract interpretation apply. Thus, whenever possible, the parties' mutual intent *as expressed in the agreement alone* controls (Civ.C. § 1636). [See *Abers v. Rounsavell* (2010) 189 CA4th 348, 356, 116 CR3d 860, 865]

b. [4:98] **Financing:** Lender requirements for financing the purchase of a ground leasehold differ from those applicable to the purchase of a fee interest.

c. [4:99] **Valuation:** A leasehold (unlike a fee) has a definitive term and the value of the estate diminishes over time.

d. [4:100] **Development and use:** Certain kinds of improvements should not be made on leased land.

Cross-refer: Ground leases are discussed in detail in *Ch. 7*.

3. [4:101] **Long-Term Easements and Licenses:** A fee interest, easement, license and lease each have distinct legal characteristics. However, easements, long-term leases and licenses are sometimes drafted so that their subject, scope and duration are so extensive as to transfer the equivalent of a fee simple estate. Indeed, although the conveyancing instrument makes reference to an "easement," "right of way" or similar lesser interest, other language in the instrument may indicate the parties actually intended to transfer a fee simple estate. [See *City of Manhattan Beach v. Sup.Ct. (Farquhar)* (1996) 13 C4th 232, 246-250, 52 CR2d 82, 91-94; see also *Hirschfield v. Schwartz* (2001) 91 CA4th 749, 768, 110 CR2d 861, 874; 88 Ops.Cal.Atty.Gen. 136; *and*¶ *4:102.1b*]

a. [4:102] **Easement:** An "easement" is the right to *use* the land of another owner (or the right to prevent other property owners from using their land) for a special purpose. It is *not* an ownership interest in land but, rather, a nonpossessory interest in the *land of another*. [*Kazi v. State Farm Fire & Cas. Co.* (2001) 24 C4th 871, 880-881, 103 CR2d 1, 7; see also *Zissler v. Saville* (2018) 29 CA5th 630, 638, 240 CR3d 590, 597—easement is restricted right to "specific, limited, definable use or activity upon another's property" that is less than right of ownership (internal quotes omitted); *Main Street Plaza v. Cartwright & Main, LLC* (2011) 194 CA4th 1044, 1053, 124 CR3d 170, 177—easement creates nonpossessory right to enter and use land in another's possession and obligates the one in possession of the land not to interfere with uses authorized by easement]

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Easements are created by (1) express grant; (2) express reservation; (3) implied grant; (4) implied reservation; (5) necessity; (6) prescription; (7) a recorded covenant; (8) dedication; (9) condemnation; (10) estoppel; or (11) a court decision. [*Main Street Plaza v. Cartwright & Main, LLC,* supra, 194 CA4th at 1053-1054, 124 CR3d at 178; see also *Thorstrom v. Thorstrom* (2011) 196 CA4th 1406, 1415, 127 CR3d 526, 533—an easement, however created, fundamentally conveys rights in or over another's land]

An easement owner has no right to use the land beyond the limited use granted by the easement. [See *Cody F. v. Falletti* (2001) 92 CA4th 1232, 1242-1243, 112 CR2d 593, 601; *Blackmore v. Powell* (2007) 150 CA4th 1593, 1598, 59 CR3d 527, 531—easement represents limited privilege to use another's property]

(1) [4:102a] **Compare—easements on own land:** Generally, an easement cannot be held by one who owns the underlying land (the "servient tenement") because all the uses of an easement are already included in the owner's fee simple ownership. [See Civ.C. § 805; *Beyer v. Tahoe Sands Resort* (2005) 129 CA4th 1458, 1473, 29 CR3d 561, 571-572; *Zanelli v. McGrath* (2008) 166 CA4th 615, 623, 82 CR3d 835, 841—rationale underlying Civ.C. § 805 is to avoid nonsensical easements (i.e., those that are unnecessary because owner owns estate); *see also*¶ *4:102.30 ff.* (termination of easement under merger doctrine)]

The above principle presupposes, however, that the landowner has *full fee title*—both legal and equitable. Property owners who own *less* than full title may create easements in their favor on the land. [*Beyer v. Tahoe Sands Resort*, supra, 129 CA4th at 1473, 29 CR3d at 572]

(2) [4:102b] **"Appurtenant" vs. "in gross":** Easements may be "appurtenant" to the land (¶ 4:102c ff.) or "in gross" (¶ 4:102g ff.). [Civ.C. §§ 801, 802]

Where the instrument creating the easement is ambiguous and the grantor's intent is unclear, the law favors interpreting the easement as appurtenant. [*Elliott v. McCombs* (1941) 17 C2d 23, 29, 109 P2d 329, 333; *City of Anaheim v. Metropolitan Water Dist. of Southern Calif.* (1978) 82 CA3d 763, 768, 147 CR 336, 339—where easement grant ambiguous and grantor's intent unascertainable, appurtenant easement presumed]

(a) [4:102c] **Easement appurtenant:** An easement "appurtenant" is attached to and runs with (passes with) the easement holder's land. The land to which it is attached is the "dominant tenement" (estate) and the land burdened by the easement is the "servient tenement" (estate). [See Civ.C. §§ 801, 803; *Thorstrom v. Thorstrom* (2011) 196 CA4th 1406, 1415, 127 CR3d 526, 533]

Generally, an easement appurtenant may be used *only* for the benefit of the dominant tenement specified in the grant of the easement *except* to the extent its terms provide otherwise. [*Wright v. Best* (1942) 19 C2d 368, 384, 121 P2d 702, 711; *see further discussion at*¶ *4:102.1 ff.*]

1) [4:102d] **Effect on servient owner's fee interest:** The burden imposed on the servient tenement likewise is determined by the terms of the deed. "Where the easement is founded upon a grant … only those interests expressed in the grant and those necessarily incident thereto pass from the owner of the fee." The servient owner retains every incident of ownership *not inconsistent with the easement* and its enjoyment. [*Blackmore v. Powell* (2007) 150 CA4th 1593, 1599, 59 CR3d 527, 531 (internal quotes omitted); see also *Thorstrom v. Thorstrom* (2011) 196 CA4th 1406, 1421, 127 CR3d 526, 538—"well established is the rule that the extent of a servitude is determined by the terms of the grant" (internal quotes omitted); *Main Street Plaza v. Cartwright & Main, LLC* (2011) 194 CA4th 1044, 1053-1054, 124 CR3d 170, 178—general rule is that servient owner may make any use of land that does not interfere unreasonably with easement]

Servient owners, therefore, may not use their land in a way that unreasonably interferes with the easement rights of the dominant owner. [*Blackmore v. Powell*, supra, 150 CA4th at 1599, 59 CR3d at 531—servient owner could not prevent dominant owner from building parking garage, for its exclusive use, on 11% of easement granted for "parking and garage purposes" (nonexclusive use would interfere unreasonably with dominant owner's easement rights)]

2) [4:102e] **Statutory categories not exclusive:**Civ.C. § 801 enumerates 18 categories of appurtenant easements (right of way, rights of pasture, fishing, party wall, burial, etc.). However, the statutory list is not exhaustive. [*Laux v. Freed* (1960) 53 C2d 512, 521, 2 CR 265, 269; see *Blackmore v. Powell* (2007) 150 CA4th 1593, 1602, 59 CR3d 527, 534 (collecting cases)—although not listed in § 801, private easement may encompass right to maintain or use a permanent structure on servient tenement]

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3) [4:102f] **Valuation:** Appurtenant easements have no value or use apart from serving the dominant tenement for which they were created. Thus, there generally is no market for these easements because they may not be severed and transferred separately from the dominant estate. They may, however, be released to the servient estate's owner (e.g., as a bargaining chip in exchange for something of particular value to the dominant estate's owner), at which point the easement is extinguished. [See *SCI Calif. Funeral Services, Inc. v. Five Bridges Found.* (2012) 203 CA4th 549, 567-568, 137 CR3d 693, 709 (finding appurtenant easement had value based on its ability to be sold or traded to servient estate's owner in exchange for water rights, acreage, etc.)]

(b) [4:102g] **Easement in gross:** An easement "in gross" is not attached to any particular land. It is a *personal right* to use the land of another and thus does not pass with the easement holder's land but can be conveyed independent of the land. [See Civ.C. § 802; *Moylan v. Dykes* (1986) 181 CA3d 561, 568, 226 CR 673, 676]

1) [4:102h] **Statutory categories:** As it does with appurtenant easements (¶ 4:102c ff.), the Civil Code lists certain categories of easements in gross (Civ.C. § 802—right of way, rights of pasture, fishing, burial, etc.). Presumably, the § 802 list (like the Civ.C. § 801 list) is not exclusive (*see*¶ *4:102e*).

(3) [4:102.1] **Scope of easement:** The scope of an express easement is determined by the language of the instrument conveying it. [See *Rye v. Tahoe Truckee Sierra Disposal Co., Inc.* (2013) 222 CA4th 84, 92, 170 CR3d 275, 281—where easement is founded upon a grant, only those interests expressed in grant and those necessarily incident thereto pass from fee owner; *Van Klompenburg v. Berghold* (2005) 126 CA4th 345, 349-350, 23 CR3d 799, 801-802—language in conveyancing instrument stating private roadway easement was to be "kept open" and "wholly unobstructed" precluded servient tenement owners from maintaining gates across easement, regardless of whether gates unreasonably interfered with easement owner's use; compare *Zissler v. Saville* (2018) 29 CA5th 630, 634, 641-643, 240 CR3d 590, 594, 599-601 (distinguishing *Rye* and finding bona fide purchaser for value without notice entitled to rely on easement's language rather than be bound by purported "historic use" limitation re easement's scope)—express easement constituted "broad grant of right-of-way" limited only by requirement that it be "reasonably necessary" to provide vehicles/pedestrians with access, ingress and egress]

On the other hand, an easement also must be interpreted according to statutory and decisional law in effect at the time it was established. [*Anderson v. Time Warner Telecom of Calif., Inc.* (2005) 129 CA4th 411, 418-419, 28 CR3d 289, 294-295—public highway "right of way" easements incorporated telephone corporation's statutory right to use highway to install telephone lines, including fiber optic cables; *see also*¶ *4:104 ff.*]

(a) Ambiguous grant of easement

1) [4:102.1a] **Grant by private party—mutual intent controls:** General rules of contract interpretation normally apply to resolve any ambiguity in the grant of an express easement (see Civ.C. § 1066): Ordinarily, the grant is interpreted to give effect to the mutual intent of the parties (Civ.C. § 1636). In this regard, courts look to the surrounding circumstances and relationship of the parties and properties involved. [See *Christian v. Flora* (2008) 164 CA4th 539, 550, 78 CR3d 892, 899—plaintiffs prevailed in action to quiet title to easements incorrectly referenced in their grant deeds (ambiguity in deeds arose from fact subdivider mistakenly granted easements it had no right to convey, and subdivision map referenced in deeds no longer reflected reality of subdivision's amended map) (*discussed further at* ¶ *4:102.4a ff.*)]

2) [4:102.1b] **Government grants and reservations in grants are construed in grantor's favor:** Normal rules favoring the grantee in the interpretation of grants do not apply when (i) the grant is made by a public entity or officer to a private party, or (ii) the grant contains a reservation. In those situations, when there is an ambiguity in the scope of the grant, the rules of interpretation favor the *grantor*. [Civ.C. § 1069; see *Pear v. City & County of San Francisco* (2021) 67 CA5th 61, 72-73, 281 CR3d 841, 850-851—easement reservations in deeds from private grantor to public entity grantee interpreted in private grantor's favor; *Red Mountain, LLC v. Fallbrook Pub. Util. Dist.* (2006) 143 CA4th 333, 344-347, 48 CR3d 875, 885-887 (ambiguity in scope of grant of access easement)]

(b) [4:102.1c] **"Exclusive" easements; fee ownership distinguished:** An "exclusive easement" in effect amounts almost to the conveyance of a fee and, for that reason, will not be imputed to the owner of the servient tenement absent a clear indication in the grant of that intention. [*City of Pasadena v. California-Michigan Land & Water Co.* (1941) 17 C2d 576, 578-579, 110 P2d 983, 984-985 (dictum); see also *Romero v. Shih* (2024) 15 C5th 680, 687, 694-695, 701-704,

317 CR3d 478, 481, 487-488, 493-495—*implied* exclusive easements that preclude servient owners from making most practical use of easements' surface areas deemed permissible, *discussed further at* ¶ 4:102.2, 4:102.4j; *Alaska Railroad Corporation v. Flying Crown Subdivision Addition No. 1 & Addition No. 2 Property Owners Ass'n* (9th Cir. 2023) 82 F4th 762, 766, 772-773 (concluding federal government reserved "no less" than exclusive-use easement in its right-of-way over homeowner association's property and subsequently transferred said interest to state of Alaska); *Rye v. Tahoe Truckee Sierra Disposal Co., Inc.* (2013) 222 CA4th 84, 93, 170 CR3d 275, 282 (noting exclusive easement cannot be inferred from general language)—where grant contained no clear indication of intention to extend parking and storage area to all of easement, garbage disposal business could not establish exclusive easement and therefore was limited to its historic use of easement's paved area; *Gray v. McCormick* (2008) 167 CA4th 1019, 1025-1026, 84 CR3d 777, 782—express provision in subdivision CC&Rs granting dominant tenement owner exclusive easement precluded servient tenement owner from making *any* use of easement area surface]

Whether the grant of an easement incorporating a right of exclusive use actually conveys ownership in fee, rather than an easement, depends upon the circumstances of the case—and, most particularly, whether the terms of the grant are restricted in scope. [See *Blackmore v. Powell* (2007) 150 CA4th 1593, 1600, 59 CR3d 527, 532—deed conveying "easement for parking and garage purposes," construed to give right of exclusive use, did not rise to fee ownership because it also circumscribed dominant tenement owner's rights and award of exclusive control over garage to be built (which would occupy only 11% of easement) was intended only to protect those restricted rights]

[4:102.1d - 4:102.1g] ***Reserved.***

(c) [4:102.1h] **Future uses:** An easement owner may not materially increase the burden of the easement on the servient estate or impose a new burden beyond that identified in the conveyancing instrument. "Normal future uses" of the easement are within the parties' reasonable contemplation and therefore permissible, while "uncontemplated abnormal uses," which greatly increase the burden, are not. [*Red Mountain, LLC v. Fallbrook Pub. Util. Dist.* (2006) 143 CA4th 333, 350, 48 CR3d 875, 889]

(d) [4:102.1i] **Changing location:** The location of an easement may be changed with the parties' consent, which may be *implied* from "use and acquiescence" (*see also* ¶ *4:102.2*). The parties' rights in the relocated easement are not affected but simply "attach" to the new location. [*Red Mountain, LLC v. Fallbrook Pub. Util. Dist.* (2006) 143 CA4th 333, 352, 48 CR3d 875, 891]

1) [4:102.1j] **"Floating easements":** An easement's location may or may not be delineated in the instrument creating the easement. Express easements that lack a specifically defined location are known as "floating easements" and are fully valid and enforceable. The floating easement's location becomes "fixed" based on the holder's use of the property and conduct. [*Southern Calif. Edison Co. v. Severns* (2019) 39 CA5th 815, 823-826, 252 CR3d 667, 673-675—utility had floating easement along dirt roads across defendant's property based on instruments granting utility "free access" to electrical facilities and "uncontested history" of utility using roads]

(e) [4:102.1k] **Subject to conflicting laws and ordinances:** Even when the scope of an easement is unambiguously expressed in the grant, its use is subject to applicable law. The grant of an easement cannot circumvent zoning ordinances and other applicable law, and to the extent that it does, the easement is unenforceable. [See *Baccouche v. Blankenship* (2007) 154 CA4th 1551, 1557-1559, 65 CR3d 659, 664-665—valid equine use easement over vacant servient tenement unenforceable where zoning ordinance prohibited keeping horses on undeveloped lots]

➪ [4:102.1*l*] ***PRACTICE POINTER:*** When faced with a local ordinance limiting the use of an otherwise valid easement, the holder may seek a zoning variance to allow the proscribed use. [*Baccouche v. Blankenship* (2007) 154 CA4th 1551, 1557, 65 CR3d 659, 664]

(4) [4:102.2] **Implied easements:** Even without a writing, state law recognizes the grant or reservation of an easement by *implication* in appropriate cases. Indeed, "[t]he doctrine of implied easements is applied by courts to carry into effect the intention of the parties as manifested by the facts and circumstances of the transaction." [*Romero v. Shih* (2024) 15 C5th 680, 692-693, 317 CR3d 478, 485 (internal quotes omitted)]

An easement will be implied if the following conditions exist at the time of the conveyance:

• the property owner conveys a portion of the property to another;

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• the owner's prior existing use was of such a nature that the parties must have intended or believed the use would continue (i.e., the existing use was either known to the grantor and grantee or "so obviously and apparently permanent that the parties should have known of the use"); and

• the easement is reasonably necessary to the use and benefit of the quasi-dominant tenement. [Civ.C. § 1104; *Thorstrom v. Thorstrom* (2011) 196 CA4th 1406, 1419-1420, 127 CR3d 526, 536-537—purpose of implied easement doctrine is to give effect to actual intent of parties as shown by all facts and circumstances; see also *Larsson v. Grabach* (2004) 121 CA4th 1147, 1151-1152, 18 CR3d 136, 139-140—implied easements are not based on grantor's actual subjective intent, but on parties' presumed objective intent as determined from circumstances that existed at time of conveyance; *Tusher v. Gabrielsen* (1998) 68 CA4th 131, 141, 144-145, 80 CR2d 126, 131, 133—preponderance of evidence standard applies]

(a) [4:102.3] **Not violative of statute of frauds:** An implied easement arises from the grant of an estate in land. Since the grant of the associated estate must be in writing (CCP § 1971; Civ.C. § 1091; *see*¶ *4:263*), implying the easement does not violate the statute of frauds. "If, in order to be valid and enforceable, an easement had to be in writing, there would be no such thing as an easement … by implication." [*Dubin v. Robert Newhall Chesebrough Trust* (2002) 96 CA4th 465, 475, 116 CR2d 872, 879—plaintiff stated valid claim to appurtenant easement arising by implication from lease]

(b) [4:102.4] **May arise when property transferred by court decree:** The doctrine of implied easements is not limited to cases of direct conveyance by deed from the common owner; if all the elements are present (¶ *4:102.2*), an implied easement may arise when an interest in property is transferred by court decree, as in partition proceedings, or even when property is divided and distributed by testate or intestate succession after the common owner's death. [*Larsson v. Grabach* (2004) 121 CA4th 1147, 1149-1150, 18 CR3d 136, 138, 141-142]

(c) [4:102.4a] **May arise by estoppel:** An implied easement may arise by estoppel where the owner of the dominant parcel relies on the conduct or representations of the servient owner such that equity establishes an easement in order to prevent an injustice. [*Christian v. Flora* (2008) 164 CA4th 539, 549, 78 CR3d 892, 899]

• [4:102.4b] Plaintiff-owners of three parcels in a subdivision brought an action to quiet title in an easement across the defendants' parcels based on the incorporation in plaintiffs' deeds by the subdivider (defendants' predecessor in interest) of a recorded 1977 parcel map. The 1977 map was amended in 1979 to resubdivide the defendants' parcels and to create a new road easement that connected to the original easement granted plaintiffs by the incorporation in their deeds of the 1977 map. However, at the same time the 1979 map was recorded, quitclaim deeds mistakenly recorded by the subdivider extinguished the portion of the easement shown on the 1977 map. In short, the subdivider lacked all authority to deed an easement over defendants' parcels by the time plaintiffs' parcels were acquired.

Nonetheless, because the owners of the three parcels were misled into believing they had an easement across defendants' parcels, the defendants were estopped from claiming the 1979 parcel map did not constitute an amendment of the 1977 parcel map. [*Christian v. Flora* (2008) 164 CA4th 539, 542, 78 CR3d 892, 894]

[4:102.4c - 4:102.4g] ***Reserved.***

(d) [4:102.4h] **Scope of implied easement:** The scope of an implied easement is measured by the extent to which the property was obviously and permanently used at the time the transfer was completed. [Civ.C. § 1104; see also *Thorstrom v. Thorstrom* (2011) 196 CA4th 1406, 1422, 127 CR3d 526, 539—intent is fundamental criterion for determining degree to which implied easement may impose burden on servient tenement]

1) [4:102.4i] **May not impose unreasonable/unintended burden on servient tenement; "normal" future uses permitted:** Use of an implied easement may *not* be altered to impose an unreasonable or unintended burden on the servient tenement. Nonetheless, the easement's scope is not fixed and determined strictly by its original manner of use. So-called "normal" future uses are considered within the reasonable contemplation of the parties and therefore permissible. [See *Thorstrom v. Thorstrom* (2011) 196 CA4th 1406, 1424-1425, 127 CR3d 526, 540-541—dominant tenement owner's addition of storage tank with automatic refill feature that functioned to deprive servient tenement owner of beneficial use and enjoyment of well water was not within parties' reasonable contemplation when implied easement was created (both parties were entitled to reasonable use consistent with volume of water available)]

2) [4:102.4j] **Exclusive implied easement:** Although not favored, an exclusive implied easement that precludes a servient owner from making the most practical use of an easement's surface area is permissible. In a case of "first impression," a trial court found the parties to a 1986 division and sale of two adjacent residential properties intended to create an implied easement over an eight-foot-wide strip of land that belonged to one parcel, but that had been used as the driveway to the home on the neighboring parcel. The appellate court reversed the trial court's ruling, finding the implied easement *excluded* a subsequent servient owner from any practical use of the disputed area and therefore was impermissible. The California Supreme Court, however, determined if there is "clear evidence" that the parties to the 1986 sale intended for the neighboring parcel's preexisting use of the area to continue after the title's separation, the "law obligates courts to give effect to that intent." [See *Romero v. Shih* (2024) 15 C5th 680, 687-688, 317 CR3d 478, 481 (reversed and remanded for appellate court to consider whether substantial evidence supported trial court's finding that exclusive implied easement existed)]

(5) [4:102.5] **"Easements by necessity":** An "easement by necessity" (essentially a species of implied easement, ¶ 4:102.2 ff.) is created when (a) there is a *strict necessity* for the "right of way" provided by the easement—i.e., the dominant tenement is completely landlocked; and (b) the dominant and servient tenements were under the same ownership at the time of the conveyance giving rise to the necessity. [*Murphy v. Burch* (2009) 46 C4th 157, 162-163, 92 CR3d 381, 386—easement arises from implied grant or implied reservation when property owner conveys one of two or more adjoining parcels; *Daywalt v. Walker* (1963) 217 CA2d 669, 672, 31 CR 899, 901—easement by necessity is supported by sound public policy that land not be rendered unfit for occupancy or successful cultivation]

Thus, when there is no express provision for access and the parcel conveyed is entirely landlocked, the grantee may claim an implied *grant* of a right-of-way by necessity over the land *retained* by the grantor. Conversely, when the grantor conveys adjoining property without an express agreement for access to a retained parcel left landlocked, the grantor may seek an implied *reservation* of a right-of-way of necessity over the *conveyed* property for the retained parcel's benefit. [*Murphy v. Burch*, supra—party who conveys property presumably also grants whatever is necessary for its beneficial use and retains whatever is necessary for beneficial use of land still in party's possession]

[4:102.5a - 4:102.5b] ***Reserved.***

(a) Application

• [4:102.5c] An easement by necessity was created when the common owner of two contiguous parcels sold one under the mistaken belief a reserved easement in the deed provided him with a right of access over a historic trail. In fact, he had no such right and his parcel was landlocked (¶ 4:102.20b). [*Hinrichs v. Melton* (2017) 11 CA5th 516, 529, 218 CR3d 13, 23]

• [4:102.5d] *Compare:* But no actionable claim for easement by necessity was stated where a commercial tenant sued his landlord for installing crash posts on a road located on an adjoining property owned by the landlord that obstructed the tenant's use of the road as a driveway. Reason: The tenant failed to allege a lack of any other means of access. [*Dubin v. Robert Newhall Chesebrough Trust* (2002) 96 CA4th 465, 477, 116 CR2d 872, 881-882]

(b) [4:102.6] **Easement passes with each transfer:** Being appurtenant to the dominant estate (the landlocked parcel), an easement by necessity passes with each transfer of title to that property, and may be exercised at any time by the then-holder of the title for so long as the necessity exists and regardless of whether it was exercised by prior grantees in the chain of title. [*Murphy v. Burch* (2009) 46 C4th 157, 163, 92 CR3d 381, 386; *Lichty v. Sickels* (1983) 149 CA3d 696, 700-704, 197 CR 137, 140-142—5-year statute of limitations for real property actions inapplicable to suit for easement by necessity]

(c) [4:102.7] **Easement does not survive into perpetuity:** On the other hand, an easement by necessity, once created, does not survive into perpetuity. It ceases to exist when its *necessity no longer exists*—i.e., when the dominant estate is no longer landlocked because the owner has acquired a new means of access to the property. [*Lichty v. Sickels* (1983) 149 CA3d 696, 699, 197 CR 137, 139; *Daywalt v. Walker* (1963) 217 CA2d 669, 676-677, 31 CR 899, 903-904; see also *Murphy v. Burch* (2009) 46 C4th 157, 164, 92 CR3d 381, 387—easement terminates once alternative access becomes available because easement no longer serves to promote underlying public policy considerations]

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(d) [4:102.8] **Limitation where government entity is common grantor:** It is possible for an easement by necessity to be created where the common owner of the conveyed parcels is a governmental entity … at least insofar as the access right involved is over the *retained* parcel(s). [*Murphy v. Burch* (2009) 46 C4th 157, 165, 92 CR3d 381, 388, fn. 2; see also *Kellogg v. Garcia* (2002) 102 CA4th 796, 799, 125 CR2d 817, 820—federal government impliedly granted access right over land it *retained* when it conveyed completely landlocked parcel to private party]

However, conveyances involving a common owner governmental entity typically do *not* give rise to implied easement reservations in the *conveyed* land. This is because exercise of the government's *power of eminent domain* removes the strict necessity required for the creation of these easements—i.e., the "sovereign can exercise the power of eminent domain to obtain any and all reasonable rights-of-way" should it so choose. Thus, "extreme caution" is exercised in determining whether the circumstances surrounding a government land grant are sufficient to overcome the inference prompted by the omission of an express reference to a reserved right of access. [See *Murphy v. Burch*, supra, 46 C4th at 165-167, 92 CR3d at 388-390 (declining to impose "categorical bar" to easement-by-necessity claims tracing common ownership to federal government, while imposing burden of proof on easement claimant re government's intent to reserve and its lack of power to condemn)]

• [4:102.8a] Over the course of some 50 years, the federal government deeded two parcels of property, by patent, to various private parties without expressly reserving an easement for the benefit of the adjacent four landlocked parcels it retained. Thereafter, the government conveyed the remaining four landlocked parcels, by patent, to Plaintiff's predecessors in interest. Because the government still owned the four landlocked parcels when it conveyed the first two parcels, it had the power at that time to condemn an easement over the two parcels to provide access to the four retained parcels. However, the government chose otherwise. Under the circumstances, Plaintiff could not overcome the inference prompted by the government's omission of an expressly reserved right of access and her claim for an easement by necessity failed. [*Murphy v. Burch* (2009) 46 C4th 157, 167-168, 92 CR3d 381, 389-391]

[4:102.9] ***Reserved.***

(6) [4:102.10] **Prescriptive easements:** A "prescriptive easement" arises in much the same way that one may acquire title to real property by adverse possession: A party claiming a "prescriptive easement" must prove use of the land of another, which use has been (a) "open and notorious," (b) "hostile to the true owner," (c) under claim of right, and (d) continuous and uninterrupted for five years. [*Harrison v. Welch* (2004) 116 CA4th 1084, 1090, 11 CR3d 92, 97; see *Windsor Pac. LLC v. Samwood Co., Inc.* (2013) 213 CA4th 263, 270-271, 152 CR3d 518, 525 (disapproved on other grounds by *Mountain Air Enterprises, LLC v. Sundowner Towers, LLC* (2017) 3 C5th 744, 756, 220 CR3d 650, 660, fn. 3) (noting "hostile" and "under claim of right" are terms essentially synonymous with "adverse")—claimant's use is "adverse" if wrongful, in defiance of owner's property rights and supportive of action by owner against claimant; *Nielsen v. Gibson* (2009) 178 CA4th 318, 326, 100 CR3d 335, 341—"open and notorious" element, combined with others, ensures owner of encroached property has notice of adverse use (actual or constructive) and sufficient time to prevent that use from ripening into prescriptive easement; see also *Grant v. Ratliff* (2008) 164 CA4th 1304, 1308-1310, 79 CR3d 902, 904-906—son's use of road to and from former family home *not* adverse, but rather "a matter of family accommodation"]

However, unlike adverse possession, the successful claimant of a prescriptive easement "gains not title, but the right to make a specific use of someone else's property …" [*Blackmore v. Powell* (2007) 150 CA4th 1593, 1601, 59 CR3d 527, 533 (internal quotes and citations omitted)]

And, unlike adverse possession (see CCP § 325), a prescriptive easement does *not* require the payment of property taxes. Again, this is because a prescriptive easement is not an ownership right. In fact, someone claiming a prescriptive easement must show payment of taxes *only* "in the rare instance the easement has been separately assessed." [*Main Street Plaza v. Cartwright & Main, LLC* (2011) 194 CA4th 1044, 1054, 124 CR3d 170, 178—retail center claiming prescriptive easement for access to and parking in alleyway did not have to show it paid taxes assessed separately against adjacent railway easement (payment of said taxes was not an element of center's prescriptive claim because the easements were not "coextensive in use"); see also *McLear-Gary v. Scott* (2018) 25 CA5th 145, 152-153, 235 CR3d 443, 449-450 (¶ 4:102.33); *Kapner v. Meadowlark Ranch Ass'n* (2004) 116 CA4th 1182, 1186, 11 CR3d 138, 142 (noting courts have uniformly rejected prescriptive easement claims by those who exercise possessory rights over parts of adjoining parcels to escape the adverse possession tax requirement)]

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(a) [4:102.11] **"Claim of right":** Use of the property under a "claim of right" does not require a belief that the use is legally justified. It simply means that the claimant's use for the requisite period occurred *without the landowner's permission.* [*Felgenhauer v. Soni* (2004) 121 CA4th 445, 447-450, 17 CR3d 135, 136-138; *Aaron v. Dunham* (2006) 137 CA4th 1244, 1252, 41 CR3d 32, 38; see also *Windsor Pac. LLC v. Samwood Co., Inc.* (2013) 213 CA4th 263, 270, 152 CR3d 518, 525 (disapproved on other grounds by *Mountain Air Enterprises, LLC v. Sundowner Towers, LLC* (2017) 3 C5th 744, 756, 220 CR3d 650, 660, fn. 3)—"claim of right" is adverse when use of property is made without any express or implied recognition of owner's property rights; compare *Ranch at the Falls LLC v. O'Neal* (2019) 38 CA5th 155, 181-182, 250 CR3d 585, 604-605—no prescriptive easement where plaintiff allowed to use private streets as property owner and resident of gated community]

The "claim of right" need *not* be expressly communicated to the property owner; the requisite continuous use of the property over a long period of time itself constitutes communication of the claim of right. [*Aaron v. Dunham*, supra, 137 CA4th at 1253, 41 CR3d at 38-39]

(b) [4:102.11a] **Owner need not be in continuous possession:** California law does not require that the actual owners of adversely used land be in continuous possession for five years. Indeed, "[i]f at any point during the adverse use an owner or landlord has been in possession, including constructively at the expiration of a renewable lease, he or she could and should have taken action to interrupt such use." [*King v. Wu* (2013) 218 CA4th 1211, 1214, 160 CR3d 819, 821-822—prescriptive easement not defeated by actual owner's lack of continuous possession where property was rented to series of tenants, owners were in actual possession during some brief vacancies and they had constructive possession at end of each lease]

(c) [4:102.11b] **Continuing use after common ownership ends:** In some cases, the underlying use of the servient estate began while the dominant and servient estates were under common ownership. The use of the servient estate during this time does not count toward the requisite five-year prescriptive period because a person cannot have an easement over their own property. [See *Husain v. Calif. Pac. Bank* (2021) 61 CA5th 717, 728-729, 276 CR3d 34, 43; *and* ¶ 4:102a]

If common ownership of the dominant and servient estates ends, the dominant estate owner may acquire a prescriptive easement to continue the preexisting use. The dominant owner must use the servient estate without the servient owner's permission and the use must be open, notorious, continuous, and hostile for more than the five-year prescriptive period. [*Husain v. Calif. Pac. Bank*, supra, 61 CA5th at 720, 728-733, 276 CR3d at 36, 42-46—property owner had prescriptive easement to use adjacent property for access, parking, garbage removal and recreational purposes where such uses began during common ownership and continued for 5 years after properties sold to separate parties]

[4:102.11c] ***Reserved.***

(d) [4:102.11d] **Presumption that open, notorious and continuous use is adverse?** Two California Supreme Court decisions have given mixed indications whether the open, notorious and continuous use of land of another gives rise to a presumption that such use is adverse. [See *O'Banion v. Borba* (1948) 32 C2d 145, 149-150—no such presumption arises; compare *Warsaw v. Chicago Metallic Ceilings, Inc.* (1984) 35 C3d 564, 570—presumption arises where continuous use of easement occurs over long period of time without landowner's interference, shifting burden to servient owner to establish use was permissive]

1) [4:102.11e] **Comment:** Although *Warsaw* was decided after *O'Banion,* it most likely did *not* overrule *O'Banion.* In fact, *Warsaw* has been criticized for entirely ignoring *O'Banion's* substantial discussion of the presumption and reason for rejecting it. [See *Grant v. Ratliff* (2008) 164 CA4th 1304, 1309, 79 CR3d 902, 905; compare *Ditzian v. Unger* (2019) 31 CA5th 738, 743, 748, 243 CR3d 322, 326, 330 & fn. 9 (acknowledging pre-*Warsaw* split of authority but citing *Warsaw* with approval)]

"*Warsaw's* analysis was based on substantial evidence, not a presumption. *Warsaw* stands for nothing more than that the open, notorious and continuous use of another's land is sufficient evidence to support a finding that the use was adverse. Not to be presumptive, we think the discussion of presumption was at best dictum." [*Grant v. Ratliff,* supra]

(e) [4:102.12] **Postcreation use with landowner's permission irrelevant:** Once a prescriptive easement is created, the claimant's use "continues as a matter of legal right" and it is irrelevant whether the owner of the servient estate purports

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to grant permission. [*Felgenhauer v. Soni* (2004) 121 CA4th 445, 450-451, 17 CR3d 135, 138-139—once easement created, claimant need not "keep the flag of hostility flying"]

(f) [4:102.13] **Exclusive prescriptive easements:** Prescriptive easements may be exclusive or nonexclusive. An *exclusive* prescriptive easement completely prohibits the owner of the burdened parcel from using it. [See *Harrison v. Welch* (2004) 116 CA4th 1084, 1092, 11 CR3d 92, 99—no exclusive prescriptive easement for claimant's use of adjacent property to maintain woodshed and landscaping scheme (including trees, planter boxes, and irrigation system), which essentially "co-opted" area for claimant's exclusive use]

1) [4:102.14] **Compare—equitable encroachment rights:** An exclusive prescriptive easement will not be found in a case involving a "garden-variety" residential boundary encroachment, such as when a structure and/or landscaping merely *encroaches* on adjacent property. Instead, an "*equitable encroachment right*" may be fashioned to create an interest in the owner's property that will protect the encroacher's use of the property. [*Harrison v. Welch* (2004) 116 CA4th 1084, 1093, 11 CR3d 92, 99 & fn. 5 (emphasis added; internal quotes omitted)]

(g) [4:102.15] **Posting signs to prevent prescriptive easement:** A landowner can protect against the acquisition of a prescriptive easement by posting signs at each entrance to the property, or at maximum 200 foot intervals along the boundary, stating substantially "Right to pass by permission, and subject to control, of owner: Section 1008, Civil Code" (Civ.C. § 1008). In effect, the signs give notice to the world that it has permission to pass upon the land, thus defeating any hostile use under claim of right. [*Aaron v. Dunham* (2006) 137 CA4th 1244, 1250, 41 CR3d 32, 36; *Grant v. Ratliff* (2008) 164 CA4th 1304, 1307, 79 CR3d 902, 904]

But pursuant to § 1008, the signs must be posted by the property *owner*, or at least by someone acting at the owner's direction. [*Aaron v. Dunham*, supra, 137 CA4th at 1251, 41 CR3d at 37-38—signs posted by property *lessee* did not prevent ripening of prescriptive easement]

(h) [4:102.16] **No "potential" prescriptive rights; judicial determination required:** A prescriptive easement cannot arise unless the land belonging to another is *actually used* in the prescribed manner for at least five years (¶ *4:102.10*). Speculation as to the *potential* existence of such an easement is insufficient to establish prescriptive rights … even when the "speculator" is a governmental agency (e.g., the California Coastal Commission). Indeed, governmental entities are not vested with authority to declare the existence of prescriptive easements—a judicial determination is required. [See *LT-WR, LLC v. California Coastal Comm'n* (2007) 152 CA4th 770, 805, 60 CR3d 417, 443]

• [4:102.17] In the absence of a judicial determination that prescriptive rights existed for public use of privately owned property, the California Coastal Commission erred in denying an application to erect gates and no trespass signs on the property:

"Inherent in one's ownership of real property is the right to exclude uninvited visitors … The Commission's decision would deny [plaintiff] that right … [T]he Commission is not vested with authority to adjudicate the existence of prescriptive rights for public use of privately owned property … [and its] denial of a permit for the gates and signs, premised on the existence of 'potential' prescriptive rights, was speculative …" [*LT-WR, LLC v. California Coastal Comm'n* (2007) 152 CA4th 770, 806, 60 CR3d 417, 444; compare *Cave Landing, LLC v. California Coastal Comm'n* (2023) 94 CA5th 654, 656-657, 659, 312 CR3d 447, 448, 450 (noting Commission's staff report determined public "very likely" acquired prescriptive right to use existing trail)—Commission did not err in denying permit granted by local county agency that would have allowed property owners to move easement for public hiking trail from owners' parcel to contiguous parcel]

(i) [4:102.18] **Action to determine prescriptive easement's existence; laches inapplicable:** Once the conditions for establishing a prescriptive easement are met (¶ *4:102.10*), the easement holder is *not* required to take any further steps to perfect the easement holder's interest. Should a dispute concerning the easement's existence arise at any time subsequent thereto, and the easement holder is required to file an action to confirm the easement holder's interest (i.e., action to quiet title or for declaratory relief), the doctrine of laches may not be raised as an equitable defense: "[I]t is well-established, both in California and generally, that laches applies to equitable actions, not actions at law … And it is also clear that an action to determine the existence of an easement by prescription, whether via a claim for quiet title or a request for declaratory relief, is an action at law and not equity." [*Connolly v. Trabue* (2012) 204 CA4th 1154, 1164, 139 CR3d 537, 545]

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[4:102.19] ***Reserved.***

(7) [4:102.20] **Equitable easements:** Through the doctrine of "balancing conveniences" or "relative hardship," courts may create *equitable easements* by refusing to enjoin what otherwise would be deemed an encroachment or nuisance. [*Linthicum v. Butterfield* (2009) 175 CA4th 259, 265, 95 CR3d 538, 544; see also *Christensen v. Tucker* (1952) 114 CA2d 554, 562-563, 250 P2d 660, 665—doubtful cases should be decided in favor of granting injunction]

Factors trial courts should consider in exercising their discretion not to enjoin the encroachment, thereby granting an equitable easement, include whether (a) the "encroacher" is innocent of willful and possibly negligent conduct; (b) the party seeking the injunction will suffer irreparable injury by the encroachment; and (c) the hardship created by enjoining the encroachment is greatly disproportionate to the hardship caused by its continuance. [See *Tashakori v. Lakis* (2011) 196 CA4th 1003, 1009, 126 CR3d 838, 842-843—factors apply to both physical encroachments and disputed rights of access over neighbors' properties (equitable easement proper where land accessible only through neighbor's driveway)]

• [4:102.20a] An equitable easement was found where the roadway over plaintiff's parcel provided the only means of access to defendant's property. [*Linthicum v. Butterfield* (2009) 175 CA4th 259, 266-267, 95 CR3d 538, 544-546]

• [4:102.20b] After "balancing the hardships" and finding plaintiff would suffer "irreparable harm" if he was denied access to his landlocked property, an equitable easement was found over a neighbor's parcel. This was so even though there had been no preexisting use of the area by plaintiff and he had previously sold a parcel to another neighbor that left his property landlocked. Plaintiff's decision to sell the parcel was considered "innocent" of willful or negligent conduct because he mistakenly believed long after the sale that he had a right of way over a historical trail (¶ 4:102.5c). [See *Hinrichs v. Melton* (2017) 11 CA5th 516, 523-524, 218 CR3d 13, 18-19]

• [4:102.20c] *Compare:* It was error to impose an equitable easement where the hardship to a neighbor in having to spend $300 to remove patio furniture from the landowner's property was not "greatly disproportionate" to the hardship on the landowner in losing the use of the property. [*Shoen v. Zacarias* (2015) 237 CA4th 16, 21, 187 CR3d 560, 564-565 (finding deprivation of substantial benefit falls short of imposing substantial hardship)]

• [4:102.20d] It was error to impose an equitable easement "as a matter of law" where landowners *negligently* encroached on their neighbor's property by planting pistachio trees and installing an irrigation system. Even though there was evidence the encroachment was not intentional, the landowners were "negligent" because they knew of an unspecified "lot line issue" with their neighbor at the time they planted the trees and installed the irrigation system. [*Hansen v. Sandridge Partners, L.P.* (2018) 22 CA5th 1020, 1028-1029, 232 CR3d 247, 252-253 (noting landowner's encroachment failed to satisfy first and *most important element* of equitable easement)]

(a) [4:102.21] **Scope of easement; damages:** The scope of an equitable easement should *not* be greater than is reasonably necessary to protect the interests of the purported dominant owner. [*Christensen v. Tucker* (1952) 114 CA2d 554, 563, 250 P2d 660, 665; *Linthicum v. Butterfield* (2009) 175 CA4th 259, 267-269, 95 CR3d 538, 546—abundance of caution is warranted when imposing easement on unwilling landowner]

Moreover, when an equitable easement is created by the denial of an injunction, the burdened landowner ordinarily is entitled to damages upon proof. [*Linthicum v. Butterfield*, supra, 175 CA4th at 267-269, 95 CR3d at 546; see also *Tashakori v. Lakis* (2011) 196 CA4th 1003, 1014, 126 CR3d 838, 847—no error in declining to award damages where burdened landowners failed to demonstrate their property would suffer diminished value or that they were damaged in any other way by grant of equitable easement]

(b) [4:102.22] **Procedural posture:** In most cases where an equitable easement is sought, the requested relief is raised by an encroacher as a *defense* to the plaintiff's claim seeking removal of the encroachment. However, a plaintiff's equitable easement claim is not defective simply because it does not rest on any alleged wrongdoing by the plaintiff. Properly construed, an affirmative claim for an equitable easement is one for *declaratory relief*, even if not literally designated as such. In short, the encroacher seeks a judicial determination that the encroacher is equitably entitled to continue accessing the property notwithstanding the burdened landowner's property rights. [See *Tashakori v. Lakis* (2011) 196 CA4th 1003, 1010-1013, 126 CR3d 838, 844-846—complaint seeking equitable easement adequately raised justiciable issue]

[4:102.23 - 4:102.24] ***Reserved.***

(8) [4:102.25] **Conservation easements:** Finding that "the preservation of land in its natural, scenic, agricultural, historical, forested, or open-space condition is among the most important environmental assets of California," the Legislature enacted Civ.C. § 815 et seq. for the purpose of encouraging the "voluntary conveyance of conservation easements to qualified nonprofit organizations." [Civ.C. § 815; *Canyon Vineyard Estates I, LLC v. DeJoria* (2022) 78 CA5th 995, 1004, 294 CR3d 198, 207; *Building Industry Ass'n of Central Calif. v. County of Stanislaus* (2010) 190 CA4th 582, 593-594, 118 CR3d 467, 477; see also *Wooster v. Department of Fish & Game* (2012) 211 CA4th 1020, 1026, 151 CR3d 340, 345—state agency may acquire voluntarily conveyed conservation easement if otherwise authorized to acquire and hold title to real property]

(a) [4:102.25a] **Defined:** The term "conservation easement" means any written limitation in the form of an easement, restriction, covenant or condition, executed by or on behalf of a landowner, that is binding on successive owners. It is a voluntarily created interest in real property that is freely transferable in whole or in part and perpetual in duration. [Civ.C. §§ 815.1 & 815.2(a), (b); see also *Canyon Vineyard Estates I, LLC v. DeJoria* (2022) 78 CA5th 995, 1004, 294 CR3d 198, 207; *Wooster v. Department of Fish & Game* (2012) 211 CA4th 1020, 1026, 151 CR3d 340, 345—conservation easements are "negative" easements that impose specific restrictions on property's use]

Conservation easements are not personal in nature. Rather, they constitute interests in real property, the particular characteristics of which are those granted or specified in the instrument creating or transferring the easement. [Civ.C. § 815.2(c), (d); *Wooster v. Department of Fish & Game*, supra, 211 CA4th at 1026, 151 CR3d at 345]

(b) [4:102.25b] **Involuntary conveyances prohibited:** While it is California's public policy to encourage creation of conservation easements (¶ *4:102.25*), no local governmental entity may condition land use approval on the granting of a conservation easement. [See Civ.C. § 815.3(b); compare *Building Industry Ass'n of Central Calif. v. County of Stanislaus* (2010) 190 CA4th 582, 599-601, 118 CR3d 467, 481-483—county's policy of conditioning land use approval on developer *arranging for third party* to "voluntarily" dedicate permanent easements did not run afoul of Civ.C. § 815.3's involuntary conveyance prohibition (statute specifically limits conservation easement prohibition to "applicant"—i.e., the developer)]

(c) [4:102.25c] **Statutory relief for violations:** If a person violates a conservation easement, a court may award injunctive relief and monetary damages, including restoration costs and compensation for the loss of scenic, aesthetic and environmental value. [Civ.C. § 815.7(b), (c); *Sonoma Land Trust v. Thompson* (2021) 63 CA5th 978, 982, 278 CR3d 324, 327]

In an action to enforce a conservation easement, the prevailing party is entitled to the costs of litigation, including reasonable attorney fees. [Civ.C. § 815.7(d); *Sonoma Land Trust v. Thompson*, supra, 63 CA5th at 982-983, 989, 278 CR3d at 327-328, 332 (affirming $2,961,264.29 attorney fees and costs award against property owners who intentionally violated conservation easement)]

(9) [4:102.26] **Secondary easements:** Every easement includes "secondary easements," i.e., the right to do such things as are necessary for the full enjoyment of the easement itself. A secondary easement can be the right to make repairs, renewals and replacements on the servient property and to do such things as are necessary to the exercise of that right. The dominant and servient owners' rights and duties are correlative in this regard. Indeed, each owner is required to respect the rights of the other, and neither party may conduct activities or place obstructions on the property that unreasonably interfere (¶ 4:102.27) with the other party's use. [See *Dolnikov v. Ekizian* (2013) 222 CA4th 419, 428-429, 165 CR3d 658, 665 (noting secondary easements are limited by "rule of reason"); *Inzana v. Turlock Irrigation Dist. Bd. of Directors* (2019) 35 CA5th 429, 450, 247 CR3d 427, 447, fn. 15]

(a) [4:102.27] **Interference with easement:** Interference with an easement is actionable when the grantor "unreasonably impedes" the grantee's rights through *"[a]ctions that make it more difficult to use an easement, that interfere with the ability to maintain and repair improvements built for its enjoyment, or that increase the risks attendant on exercise of rights created by the easement are prohibited ... unless justified by needs of the servient estate*." [*Dolnikov v. Ekizian* (2013) 222 CA4th 419, 429-430, 165 CR3d 658, 666 (emphasis in original; internal quotes omitted)—servient tenement owners' refusal to sign two documents required by city before it would issue dominant tenement owner permits necessary to make easement roadway useable for its intended purpose constituted unreasonable interference with dominant tenement owner's use and enjoyment of easement; see also *Inzana v. Turlock Irrigation Dist. Bd. of Directors* (2019) 35 CA5th 429, 433, 447, 451-452, 247 CR3d 427, 433, 444, 447-449—pistachio trees planted by servient tenement owner within irrigation district's pipeline easement "unreasonably interfered" with district's easement

rights, justifying district's tree removal order and subsequent cessation of water deliveries (a remedy provided for under district's irrigation rules)]

(b) [4:102.28] **Subsequent agreements:** Grantees do not automatically lose their easement rights by entering into agreements that allow grantors to improve or otherwise alter the encumbered property. A subsequent agreement's effect on existing easement rights depends on the contractual language, and courts will attempt to harmonize the contracts "'so as to give effect to every part.'" [*3500 Sepulveda, LLC v. Macy's West Stores, Inc.* (9th Cir. 2020) 980 F3d 1317, 1323-1324 (quoting Civ.C. § 1641)—owners of commercial property within shopping center did not give up express easement rights over common areas, including parking areas, driveways and sidewalks, by (i) agreeing to allow another property owner to expand retail space and construct new parking structures and (ii) giving that owner "discretion" to revise site plans]

[4:102.29] ***Reserved.***

(10) Extinguishment of easement

(a) [4:102.30] **By merger of estates:** An easement is extinguished under the *doctrine of merger* when the right to the easement and right to the servient tenement vest in the same person (or group of persons). In other words, when the burdens and benefits are united through common ownership in a single person (or group of persons), the servitude ceases to have any function and therefore terminates. [See Civ.C. § 811; Rest.3d Property Servitudes, § 7.5, comm. a; and *Zanelli v. McGrath* (2008) 166 CA4th 615, 625-630, 82 CR3d 835, 842-847—view easement extinguished by merger when cotenants acquired *all* interests *equally* in dominant and servient tenements; compare *Hamilton Court, LLC v. East Olympic, L.P.* (2013) 215 CA4th 501, 505-506, 154 CR3d 924, 927-928 (finding merger doctrine applicable only when it prevents injustice and serves interests of person holding two estates)—error to apply merger doctrine and extinguish commercial property easement where interested parties stipulated easement constituted "first priority security interest" and any transfer of related property would not affect that priority; *Tariwala v. Mack* (2022) 84 CA5th 807, 809-811, 300 CR3d 51, 52-53—merger doctrine did not automatically apply to driveway easement even though servient tenement owner obtained sole title to both servient and dominant tenements prior to foreclosure sale of dominant tenement]

Comment: In *Tariwala* (above), the servient owner never actually held both properties in "unity of title," as required under the merger doctrine. Instead, he encumbered the dominant tenement immediately after acquiring sole ownership, did not dispute the dominant tenement was legally and physically landlocked, and presented no evidence the lender would have funded his loan absent the easement in the pledged trust deed. Moreover, the dominant tenants would have suffered "profound prejudice" if the merger doctrine had been applied and they were left with no means to lawfully access their house. [*Tariwala v. Mack,* supra, 84 CA5th at 811-812, 300 CR3d at 54-55 (citing *Hamilton Court* with approval)]

1) [4:102.31] **Revival of extinguished easement:** An easement once extinguished by merger of estates does not spring back into existence merely by severance of the united estates. "It must … be newly created by an express stipulation in the conveyance by which the severance is made or from the implication of the circumstances of the severance." [*Zanelli v. McGrath* (2008) 166 CA4th 615, 634, 82 CR3d 835, 851 (internal quotes omitted)—view easement previously extinguished by merger was not revived when common owners of dominant and servient tenements sold dominant tenement to third party]

(b) [4:102.32] **By prescription:** An easement may be extinguished by the user of the servient tenement in a manner adverse to the exercise of the easement, for the period of time required to give title to land by adverse possession. Thus, "the nonpermissive erection and maintenance for the statutory period of time of permanent structures, such as buildings, which obstruct and prevent the use of the easement will operate to extinguish the easement." [*Glatts v. Henson* (1948) 31 C2d 368, 371, 188 P2d 745, 746-747—owner of fee interest in property on which easement was located constructed buildings on easement without easement claimants' consent and maintained same for more than five years; *Main Street Plaza v. Cartwright & Main, LLC* (2011) 194 CA4th 1044, 1054, 124 CR3d 170, 178 (citing *Glatts* with approval); see also *Cottonwood Duplexes, LLC v. Barlow* (2012) 210 CA4th 1501, 1509, 149 CR3d 235, 241—"three elements, nonuser, intention to abandon, and damage to the owner of the servient estate, must concur in order to extinguish the easement" (internal quotes omitted)]

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1) [4:102.33] **"Timely" payment of property taxes:** Provided the easement is not separately assessed (¶ 4:102.10), the servient estate owner also must "timely" pay all state, county or municipal taxes levied and assessed on the servient tenement to extinguish the easement by adverse possession. [See CCP § 325(b); *McLear-Gary v. Scott* (2018) 25 CA5th 145, 156, 235 CR3d 443, 453—servient estate owner's lump sum payment of several years' worth of delinquent property taxes did not qualify as "timely" payment for purposes of extinguishing dominant estate owner's prescriptive easement]

(c) [4:102.34] **By abandonment:** Abandoning an easement created by grant requires proof of (i) cessation of use by the dominant tenement owner and (ii) unequivocal and decisive acts on the dominant tenant's part that clearly show an intention to abandon. [See *Visitacion Investment, LLC v. 424 Jessie Historic Properties, LLC* (2023) 92 CA5th 1081, 1089, 310 CR3d 263, 270 (summary judgment reversed due to disputed issues of fact re easement's alleged abandonment); *Concord & Bay Point Land Co. v. City of Concord* (1991) 229 CA3d 289, 295, 280 CR 623, 626—easements found to be abandoned do *not* "revert" to grantor; they are "simply extinguished," *discussed further* in conjunction with rights of way at ¶ 4:92.6]

(d) [4:102.35] **Compare—no extinguishment against owner's will:** Neither public policy nor any rule of law authorizes the extinguishment of a granted easement, in whole or in part, against the will of the easement owner. It makes no difference if the easement's owner does not reasonably need the entirety of the easement. [See *Cottonwood Duplexes, LLC v. Barlow* (2012) 210 CA4th 1501, 1509-1510, 149 CR3d 235, 241-242—error to shorten and narrow road/utility easement simply because court believed owner did not appear to need it "either now or in the future"]

b. [4:103] **License:** A "license" is the grant of permission to come upon the land of another to perform an act or series of acts. A license is a personal right; the license holder does not possess any estate or interest in the property to which the license is subject. [*Gamerberg v. 3000 E. 11th St., LLC* (2020) 44 CA5th 424, 429, 257 CR3d 652, 657; *San Jose Parking, Inc. v. Sup.Ct. (City of San Jose Redevelop. Agency)* (2003) 110 CA4th 1321, 1329, 2 CR3d 505, 511; see also Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 2A]

(1) [4:103.1] **Irrevocable license:** Although licenses generally may be revoked at any time, courts can declare them "irrevocable" if the licensee has expended money or labor while reasonably relying on the license's existence. This is so, however, *only* where the expenditures are "substantial," "considerable" or "great." [See *Shoen v. Zacarias* (2019) 33 CA5th 1112, 1119-1121, 245 CR3d 683, 687-690—neighbor's expenditure evidence ($15,000 to $25,000 estimate based on "handful of receipts" for improving/maintaining flat area, a portion of which belonged to licensor) did not constitute "substantial evidence" of "substantial expenditures" and therefore did not support irrevocable license finding]

For all practical purposes, an *irrevocable license* is essentially an easement (*see*¶ *4:102 ff.*). [*Shoen v. Zacarias,* supra, 33 CA5th at 1120, 245 CR3d at 689; *Barnes v. Hussa* (2006) 136 CA4th 1358, 1370, 39 CR3d 659, 667]

(2) [4:103.2] **Assignability of license by licensee; transfer of property benefitting from license:** Any attempt by a licensee to assign a routine license "ordinarily destroys and terminates it." [*Gamerberg v. 3000 E. 11th St., LLC* (2020) 44 CA5th 424, 429, 257 CR3d 652, 657 (internal quotes omitted)]

As the equivalent of an easement, however, an *irrevocable* license may continue after the property benefitting from the license is transferred. This is so provided the requisite intent is established and notice of the license is given. Otherwise, the license is lost. [See *Gamerberg v. 3000 E. 11th St., LLC*, supra, 44 CA5th at 434-436, 257 CR3d at 661-662—purchaser of lot "A" lost alleged "irrevocable license" to use neighbor's lot "B" for parking purposes because affidavit memorializing said usage, entered into by properties' prior owners, was not recorded and lot "A's" purchaser lacked actual notice]

(3) [4:103.3] **Assignability of license by licensor; transfer of property encumbered by license:** In general, a license does not run with the land to bind subsequent purchasers and a transfer of property encumbered by a license will revoke the license. [*Riverside County Transp. Comm'n v. Southern Calif. Gas Co.* (2020) 54 CA5th 823, 841, 268 CR3d 196, 210 (collecting authorities)]

However, a license can be made assignable by contract. If it is, a transfer of property encumbered by the license may be sufficient to convey the license to the subsequent purchaser, even if the license was not separately or expressly assigned. Under Civ.C. § 1084, a license will be conveyed along with the property it encumbers if the license is (i) assignable and (ii) reasonably essential to the beneficial use and enjoyment of the property. [*Riverside County Transp. Comm'n v. Southern Calif. Gas Co.*, supra, 54 CA5th at 841-842, 268 CR3d at 210-211—transportation commission's property

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acquisition included licenses requiring gas company to remove pipelines; see also Civ.C. § 1084—"[t]he transfer of a thing transfers also all its incidents, unless expressly excepted"]

c. [4:104] **Rights of way:** A "right of way" consists of a right of passage over and upon a piece or parcel of land. Generally, it may constitute either an easement or a license (¶ 4:103). [See Civ.C. §§ 801(4) (easement appurtenant), 802(5) (easement "in gross"); *Vieira Enterprises, Inc. v. McCoy* (2017) 8 CA5th 1057, 1075, 214 CR3d 193, 206—right of way is among easements that may be created by grant; compare *City of Manhattan Beach v. Sup.Ct. (Farquhar)* (1996) 13 C4th 232, 238-248, 52 CR2d 82, 86-93—despite its multiple references to "right of way," deed that "release[d], remise[d], and quit-claim[ed]" property to railroad construed to convey fee simple title; *Severns v. Union Pac. R.R. Co.* (2002) 101 CA4th 1209, 1215-1216, 125 CR2d 100, 105-106—deed using "right of way" to describe purpose to which land was to be put construed to convey fee simple subject to condition subsequent; and see *Barahona v. Union Pac. R.R. Co.* (9th Cir. 2018) 881 F3d 1122, 1131-1135 (finding pre-1871 Congressional Acts conveyed fee simple defeasible interest to railroad companies via rights of way through public lands while 1875 Act conveyed only an easement in the right-of-way, albeit a broad easement, "for railroad purposes")]

(1) [4:104a] **Grants across federal lands:** A federal agency may grant rights of way across federal lands. In determining which agency has the requisite authority, however, the key issue is whether the agency granting the right of way has "jurisdiction to exercise the incidents of ownership." [*United States Forest Service v. Cowpasture River Preservation Ass'n* (2020) _ US _, _, 140 S.Ct. 1837, 1845-1850—Forest Service, not National Park Service, had authority to grant right of way for pipeline under Appalachian Trail because Forest Service had jurisdiction over land itself, while National Park Service "administers the *Trail* as an easement—an easement that is separate from the underlying land"]

(2) [4:104.1] **Public rights of way:** Unlike a private easement, the right to use a public "right of way" is "vested equally in each and every member of the public." [*Bello v. ABA Energy Corp.* (2004) 121 CA4th 301, 308, 16 CR3d 818, 823; see also *Schmidt v. Bank of America, N.A.* (2014) 223 CA4th 1489, 1501, 1502, 168 CR3d 240, 251-252 (noting mere inclusion of phrase "for public road purposes" does not transform otherwise private easement into public right of way)—public rights of way usually are termed "highways" or "public roads"]

"Specific language has never been required in California to establish the scope of a public right-of-way." The public may obtain a right of way through a private landowner's affirmative grant (a "dedication") or through "persistent public use of private land, whether or not permissive." [*Bello v. ABA Energy Corp.*, supra, 121 CA4th at 317, 16 CR3d at 831] When private property abuts an "established" public street, a "right of way" is *presumed*. [*Bello v. ABA Energy Corp.*, supra, 121 CA4th at 317, 16 CR3d at 831]

(3) [4:104.2] **Extinguishment by adverse possession:** While a right of way (or easement) created by grant cannot be lost by mere nonuse, it may be extinguished if the use by the servient tenement (property burdened by the right of way) amounts to adverse possession. [See *Vieira Enterprises, Inc. v. McCoy* (2017) 8 CA5th 1057, 1075-1082, 214 CR3d 193, 206-212 (summarizing law governing rights of way and easements)—use of neighbor's recorded right of way in private road by, among other things, planting palm trees and maintaining waste bins deemed insufficiently hostile to establish adverse possession]

d. [4:105] **Using leases, easements or licenses to avoid subdivision restrictions:** The division of real property into legal lots is governed by the Subdivision Map Act (Gov.C. § 66410 et seq.), the Subdivided Lands Act (Bus. & Prof.C. § 11000 et seq.) and regulations promulgated by the California Department of Real Estate. These statutes and regulations make it *unlawful* to sell a piece of property consisting of less than a legal lot.

Lawyers sometimes attempt to avoid the "legal lot" impediment by creating long-term ground leases, long-term easements or long-term licenses to effectuate the transfer of what would otherwise be a fee interest in a lot. It is difficult to precisely determine when the length or scope of an easement, license or lease has become so extensive as to constitute an unlawful subdivision. Nevertheless, counsel should take care not to run afoul of the statutory schemes by trying to effectuate through a lease, license or easement what the seller and buyer cannot lawfully accomplish by means of a grant deed.

(1) [4:106] **Example:** This problem frequently arises when an owner of a legal lot wants to acquire a portion of an adjoining owner's land to use, e.g., as a parking area. The two adjoining owners might then enter into a perpetual easement, license or lease, giving one the exclusive right to use a portion of the adjoining owner's lot. This could violate the California Subdivision Map Act, as well as other statutes. [But see *Blackmore v. Powell* (2007) 150 CA4th 1593, 1602-1605, 59 CR3d 527, 534-537—private exclusive use easement appurtenant for parking and garage purposes deemed too restrictive in scope to contravene Map Act (*discussed further at*¶ *4:102d, 4:102.1c*)]

➪ [4:107] ***PRACTICE POINTER:*** Counsel representing buyers who propose to purchase the seller's long-term lease, easement or license in such cases should make certain that the arrangement has not violated subdivision laws.

(2) [4:108] **Financing issues:** Leases can be financed (*see¶ 7:390 ff.* regarding ground leases). However, most institutional lenders are unwilling to provide financing if their security will consist merely (or substantially) of an easement or license.

➪ [4:109] ***PRACTICE POINTER:*** Even though the arrangement passes muster under the subdivision laws, buyer's counsel should ascertain in advance whether the client's *lender* will accept the arrangement.

(3) [4:110] **Other legal requirements:** Aside from concerns with the subdivision laws, a long-term (or "perpetual") easement, license or right of way must also satisfy certain other legal requirements.

For example, certain usages of property are not legally permissible (and building permits will not be issued) unless ingress, egress and parking requirements are met. Thus, a local governmental entity might not issue a building permit or allow a particular usage of property if the ingress, egress and/or parking areas are not supported by an underlying fee interest.

And, of course, any long-term easement, license or right of way also must comply with municipal zoning restrictions; *see¶ 4:102.1j*.

[4:110.1 - 4:110.4] ***Reserved.***

4. [4:110.5] **Riparian, Littoral and Appropriative Water Rights:** Under California law, landowners may have "riparian," "littoral" or "appropriative" rights to *use* the watercourse abutting their properties. These so-called "usufructuary" water rights, however, do *not* confer a *right of private ownership* in the abutting watercourse itself. [*People v. Shirokow* (1980) 26 C3d 301, 307, 162 CR 30, 34; *People v. Murrison* (2002) 101 CA4th 349, 358, 124 CR2d 68, 74; see also *State of Calif. v. Sup.Ct. (Underwriters at Lloyd's of London)* (2000) 78 CA4th 1019, 1031-1032, 93 CR2d 276, 286—groundwater not "owned" by anyone; *and¶ 4:56 ff.*]

a. [4:110.6] **Riparian and littoral rights:** The "riparian" doctrine confers upon a landowner the right to the *reasonable and beneficial use* of the water. Riparian water rights are *not* unlimited—riparian usage must be curtailed during water shortage periods. [*People v. Shirokow* (1980) 26 C3d 301, 307, 162 CR 30, 34; *People v. Murrison* (2002) 101 CA4th 349, 358-359, 124 CR2d 68, 74-75; see also *Light v. State Water Resources Control Bd.* (2014) 226 CA4th 1463, 1489, 173 CR3d 200, 218 (upholding State Board's power to prevent unreasonable water use by riparians in order to protect wildlife habitat)—riparian users must curtail their beneficial use proportionately when water supplies run sufficiently short]

A similar "littoral right" attaches to land abutting a natural lake or pond. However, such rights generally do *not* attach to land abutting an *artificial* lake or pond. [*Tusher v. Gabrielsen* (1998) 68 CA4th 131, 146-147, 80 CR2d 126, 134-135—no littoral rights attached to land abutting pond serviced by drain pipe]

(For a discussion of the method for determining littoral boundaries between adjoining owners of land bordering on tide waters, see *Kendall v. Walker* (2009) 181 CA4th 584, 593-595, 104 CR3d 262, 268-271.)

(1) [4:110.6a] **Transfer of rights:** Riparian rights vest in land that is contiguous to a watercourse ("riparian land") and continue after the land is transferred, even if the instrument that transfers the riparian land is silent about riparian rights. [*Modesto Irrigation Dist. v. Tanaka* (2020) 48 CA5th 898, 900, 262 CR3d 408, 410; *Murphy Slough Ass'n v. Avila* (1972) 27 CA3d 649, 655-656, 104 CR 136, 142]

If riparian land is subdivided, resulting in parcels that no longer are contiguous to a watercourse, riparian rights may continue to attach to the noncontiguous parcel if the grantor and grantee so intended. While a deed expressly conveying riparian rights to a noncontiguous parcel is the "clearest expression of intent," extrinsic evidence is admissible to demonstrate intent where the deed is ambiguous, including the time and place of sale, and the respective interests of the grantor and grantee. [*Modesto Irrigation Dist. v. Tanaka*, supra, 48 CA5th at 900-901, 910, 913, 262 CR3d at 410, 417-420—broad language in grant deed demonstrated intent to convey riparian rights to defendant's great-grandfather, a farmer who purchased noncontiguous parcel of reclaimed land from mortgage holders]

b. [4:110.7] **Appropriative rights:** At common law, rights to appropriate water were acquired by its actual diversion and use. In fact, the "appropriation doctrine" contemplates the diversion of water and applies to "any taking of water for other than riparian or overlying uses." [*People v. Shirokow* (1980) 26 C3d 301, 307, 162 CR 30, 34 (internal quotes omitted); *People v. Murrison* (2002) 101 CA4th 349, 358, 124 CR2d 68, 74]

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In 1913, the Water Commission Act superseded common law and by amendment became the exclusive means of acquiring appropriative rights against the State of California (¶ *4:110.8*). [*People v. Shirokow*, supra, 26 C3d at 308, 162 CR at 35 & fn. 15; see also *Dow v. Lassen Irrig. Co.* (2022) 79 CA5th 308, 327-328, 294 CR3d 643, 657-658—post-1914 appropriators may possess water rights only through state permit/license, while pre-1914 appropriative rights are not subject to state's statutory scheme; *Millview County Water Dist. v. State Water Resources Control Bd.* (2014) 229 CA4th 879, 889, 177 CR3d 735, 743—pre-1914 appropriators' water rights are determined by historical use]

(1) [4:110.8] **Against the State:** Appropriative rights against the State of California are acquired exclusively through a statutory procedure administered by the State Water Resources Control Board. [See Water C. § 1200 et seq.; *Millview County Water Dist. v. State Water Resources Control Bd.* (2014) 229 CA4th 879, 889, 177 CR3d 735, 743—post-1914 appropriators possess water rights only through Board-issued permits or licenses; *People v. Shirokow* (1980) 26 C3d 301, 308-312, 162 CR 30, 35-38 & fn. 15—nonriparian user's prescriptive rights claim cannot lie against the State]

(a) [4:110.9] **Compare—prescriptive surplus water rights as between private parties:** At least one case has concluded California law recognizes the perfection of *prescriptive* surplus water rights as between *private parties*—i.e., the Water Code is *not* the exclusive means of obtaining such rights. [See *Brewer v. Murphy* (2008) 161 CA4th 928, 936-937, 74 CR3d 436, 442-443 (declining to extend *Shirokow* to private party prescriptive rights); see also *Saxon v. DuBois* (1962) 209 CA2d 713, 719, 26 CR 196, 200-201—prescriptive water right established when use exceeds 5 years and is open, notorious, continuous, peaceable and uninterrupted under claim of right]

(2) [4:110.9a] **Scope of appropriative rights:** The scope of appropriative rights is limited by the concept of "beneficial use"—i.e., "a farmer is restricted to the amount of water that is necessary to irrigate his land by making a reasonable use of the water." [*Montana v. Wyoming* (2011) 563 US 368, 376, 131 S.Ct. 1765, 1772; see also *United States v. United States Bd. of Water Commrs.* (9th Cir. 2018) 893 F3d 578, 598—appropriative rights are untethered from land ownership, acquired and maintained by active, beneficial water diversion, provide for fixed water flow and are tiered as senior and junior rights based on chronological claim priority (¶ 4:110.10 ff.)]

(3) [4:110.10] **Priority-in-time rules:** Appropriative rights are subject to priority-in-time rules—i.e., they are subordinate to the rights of preexisting holders (riparians and senior appropriators). [*Montana v. Wyoming* (2011) 563 US 368, 375-376, 131 S.Ct. 1765, 1772—irrigation water rights are perfected and enforced in order of seniority, starting with first person to divert water from natural stream and apply it to beneficial use; see also *Light v. State Water Resources Control Bd.* (2014) 226 CA4th 1463, 1478, 173 CR3d 200, 210—although riparian users must curtail their use proportionately among themselves in times of shortage (¶ *4:110.6*), they are entitled to satisfy their reasonable needs before appropriators can even begin to divert water]

(a) [4:110.10a] **Junior appropriators:** Notwithstanding the foregoing, junior appropriators are not completely without rights. As they come online, all appropriators acquire rights to the stream basically as it exists when they find it. Thus, "subject to the fulfillment of all senior users' existing rights, under the no-injury rule junior users can prevent senior users from enlarging their rights to the junior users' detriment." [*Montana v. Wyoming* (2011) 563 US 368, 376-377, 131 S.Ct. 1765, 1772; *see*¶ *4:110.11*]

(4) [4:110.11] **Changing purpose/place of use; transference, forfeiture and abandonment:** The owner of an appropriative right may change the purpose and place of use of the water so long as the change does not injure others with rights in the watercourse ("no-injury rule"). [*Montana v. Wyoming* (2011) 563 US 368, 378, 131 S.Ct. 1765, 1773; *North Kern Water Storage Dist. v. Kern Delta Water Dist.* (2007) 147 CA4th 555, 559, 54 CR3d 578, 581; see also *Orange Cove Irrigation Dist. v. Los Molinos Mutual Water Co.* (2018) 30 CA5th 1, 21-23, 241 CR3d 283, 299-300—pre-1914 appropriative water rights owner entitled to change water's use, location or diversion point until said change enjoined upon showing of injury; *United States v. United States Bd. of Water Commrs.* (9th Cir. 2018) 893 F3d 578, 600—when rights holders change purpose and place of water right use they must consider how change will affect fellow appropriators; *Nicoll v. Rudnick* (2008) 160 CA4th 550, 560, 72 CR3d 879, 887—appropriation, use and nonuse test owner's rights, *not* place or character of use]

The right is transferable, subject to the "no-injury rule" and the "reasonable and beneficial use" requirement applicable to all water rights (¶ *4:56.1*). [*North Kern Water Storage Dist. v. Kern Delta Water Dist.,* supra]

Appropriative rights also may be abandoned or forfeited through nonuse. [*North Kern Water Storage Dist. v. Kern Delta Water Dist.*, supra, 147 CA4th at 559-560, 54 CR3d at 581; see *Millview County Water Dist. v. State Water Resources*

Control Bd. (2014) 229 CA4th 879, 889, 177 CR3d 735, 743—appropriators who fail to "beneficially" use all or portion of their water for five years risk forfeiting unused amount, in which case maximum amount available to them is reduced by volume found to be forfeited]

(5) [4:110.11a] **Improving irrigation systems:** Senior water users may improve their irrigation systems without violating the "no-injury rule" (¶ *4:110.11*), provided there is no change in the amount of water diverted and the conserved water is used on the same acreage for the same agricultural purpose. [*Montana v. Wyoming* (2011) 563 US 368, 376-379, 131 S.Ct. 1765, 1773-1774—improvements to irrigation systems "seem to be" the sort of changes that fall outside "no-injury rule"; see also *United States v. United States Bd. of Water Commrs.* (9th Cir. 2018) 893 F3d 578, 603-604 (distinguishing between river's natural flow which counted towards appropriators' current river water allocation and water stored by irrigation districts in reservoirs to which appropriators had no right)—farmers failed to demonstrate they had any right to stored water that would be injured by irrigation district's proposed change regarding water's release]

(a) [4:110.11b] **Effect of recapture doctrine:** The doctrine of recapture also supports treating improvements in irrigation efficiency as within the original appropriative right. Under this doctrine, appropriators who have diverted water for irrigation purposes have the right to recapture and reuse their own runoff and seepage water before it escapes their control or property. Indeed, "if the senior appropriator, through scientific and technical advances, can utilize his water so that none is wasted, no other appropriator can complain." [See *Montana v. Wyoming* (2011) 563 US 368, 379-385, 131 S.Ct. 1765, 1774-1777—at least in Montana and Wyoming, doctrines of appropriation and recapture, along with apparent scope of "no-injury rule," allow appropriators to improve their irrigation systems "even to the detriment of downstream appropriators"]

(6) [4:110.12] **Appropriative rights included in foreclosure sales:** Appropriative water rights are included in foreclosure sales under the general rule that rights and appurtenances that ordinarily pass with a land conveyance, pass to a purchaser on foreclosure. Moreover, water rights are considered appurtenant to land and therefore presumed transferred with land absent an express reservation. [See *Nicoll v. Rudnick* (2008) 160 CA4th 550, 559-560, 72 CR3d 879, 886; *Stanislaus Water Co. v. Bachman* (1908) 152 C 716, 724, 93 P 858, 862—water right becomes easement appurtenant upon foreclosure sale in same manner as any other appurtenance passes with title and possession of land]

5. [4:111] **Options and Rights of First Refusal:** An "option" or "right of first refusal" contemplates an eventual purchase and sale; it does not create in the option holder an estate in the property that is the subject of the option. [*San Jose Parking, Inc. v. Sup.Ct. (City of San Jose Redevelop. Agency)* (2003) 110 CA4th 1321, 1326-1327, 2 CR3d 505, 509; see also *Cyr v. McGovran* (2012) 206 CA4th 645, 650-651, 142 CR3d 34, 38—option constitutes mere offer to sell and does not give option holder *any* "interest" in subject property]

Nonetheless, because it contemplates an eventual purchase and sale, an option or right of first refusal should be negotiated and documented to include all terms and conditions of the ultimate transaction, and these should be included in the purchase and sale agreement.

Cross-refer: Options and rights of first refusal are discussed in detail in *Ch. 8*.

6. [4:112] **Land Sale Contracts:** The term "land sale contract" is used interchangeably with such terms as "real property sales contract" (Civ.C. § 2985 et seq.), "installment land contract" and "land contract secured by deed of trust." It is statutorily defined as "an agreement in which one party agrees to convey title to real property to another party upon the satisfaction of specified conditions set forth in the contract and that does not require conveyance of title within one year from the date of formation of the contract." [Civ.C. § 2985(a); but see also Civ.C. § 2985(b) (excluding contract for purchase of attached residential condo unit entered into pursuant to conditional public report issued by DRE under Bus. & Prof.C. § 11018.12)]

Essentially, under a land sale contract, the seller retains fee title until the buyer pays the balance of the purchase price. Pending full payment, the buyer simply holds a "vendee's interest," in the nature of an equitable interest. The seller holds the "vendor's interest" in the land sale contract (i.e., seller retains fee interest during the term of the land sale contract).

a. [4:113] **Statutes:** The principal features of a land sale contract are overviewed at ¶ 4:114 ff. Applicable statutory rules are set forth in Civ.C. §§ 2985-2985.6 and should be consulted when using this form of purchase and sale agreement.

b. [4:114] **Financing element:** The entire purchase price is neither paid when the contract is executed nor at the closing (although a portion—the downpayment—is usually paid at closing). Thus, land sale contracts have a seller-financing element.

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At one time, the financing mechanism, as well as the vendor's foreclosure remedies, were contained within the "four corners" of the land sale contract. However, that mechanism created complexities and consequential enforcement difficulties since judges and lawyers often had little experience with this form of instrument.

Presently, the typical land sale contract takes the form of a "Land Contract Secured by Deed of Trust." This document essentially consists of two instruments, each separately executed, but comprising one document. By this method, the vendor uses a separate deed of trust to foreclose on the vendee's interest in the event of the vendee's breach. (After foreclosure against the vendee's interest, the vendor's interest in the land contract automatically merges with the vendor's fee interest, thereby eliminating the entire land contract.)

Conceptually, a land sale contract may thus be viewed as a seller-financed conveyance whereby the seller takes back a deed of trust from the buyer encumbering the property sold. Sellers under a land sale contract are essentially treated the same as a purchase money seller/lender under a conventional sale. [See CCP § 580b; and *Petersen v. Hartell* (1985) 40 C3d 102, 106, 219 CR 170, 172 (defaulting vendee's right of redemption)] However, the seller may elect either judicial or nonjudicial foreclosure (*see*¶ *6:512 ff.* on foreclosures generally).

c. [4:115] **Conventional purchase agreements compared:** Land sale contracts differ fundamentally from conventional purchase agreements in that they do not convey fee title to the buyer at the closing (whereas the typical purchase and sale agreement culminates with the conveyance of fee title at closing).

d. Purpose and advantage of land sale contracts

(1) [4:116] **Alternative financing:** Historically, residential developers used land sale contracts as a method for financing the sale of their projects to buyers who could only afford a minimum downpayment. While institutional lenders required a substantial downpayment, a developer/seller would be willing to accept a smaller sum up front.

Where the developer/seller had existing financing encumbering the property, it would continue to make payments on the senior existing lien from payments due under the land sale contract. When the seller's equity in the property was paid off, a deed would be recorded and the vendee (who then became the owner) would make payments directly to the senior lienholder.

(2) [4:117] **Attempted avoidance of due-on-sale clause:** Some believe that use of a land sale contract will avoid triggering a due-on-sale clause in an existing deed of trust encumbering the property. This was at one time true (see *Tucker v. Lassen Sav. & Loan Ass'n* (1974) 12 C3d 629, 638-639, 116 CR 633, 639); however, the Garn-St. Germain Depository Institutions Act of 1983 (12 USC § 1701j-3) has preempted this issue and all such due-on-sale clauses are now valid irrespective of state law.

Even so, some may prefer a land sale contract under the notion that a lienholder will never learn about the transfer since the loan payments will continue to be made by the seller. But this thinking is *wrong*. Institutional lenders do not notice or care whose name is on the installment payment check (the check is usually cashed without investigation or notation as to the account from which it is drawn). Indeed, institutional lenders typically discover a change in ownership by the change in owner's name *reflected on the insurance certificate* (a copy of which is typically provided to the lender). Thus, a land sale contract will *not* camouflage a sale.

Cross-refer: Due-on-sale clauses are discussed in detail at *¶ 6:388 ff.*

e. [4:118] **Disadvantages of land sale contract:** There are certain disadvantages to a land sale contract which should be considered at the outset:

(1) [4:119] **Unnecessarily complex:** The principal disadvantage is that it is complicated and unnecessary. Since a land sale contract is fundamentally no more than a financing device, the better practice is to structure the transaction in a form consistent with its practical effect: i.e., the seller should simply take back a deed of trust to secure payment of the unpaid portion of the purchase price. This is less complicated, consistent with what the parties desire, and simplifies the seller's enforcement rights.

(2) [4:120] **Potential delay in passing clear title:** After the closing, the seller's obligation to *deliver the deed* still remains outstanding. Thus, after making all payments, the buyer still needs to obtain clear title. The seller may then be deceased, unavailable or unwilling to issue the deed. Delays can therefore result.

(3) [4:121] **Difficulties in financing buyer's equity:** As time goes by, the vendee builds up equity in the property. However, financing that equity may be difficult, if not impossible, because lenders are uncomfortable with financing a contract right

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that is not a fee (but only an “equitable interest” in a fee). Simply stated, lenders are unfamiliar with financing a vendee's interest in a land sale contract.

f. [4:122] **Execution, recordation and description of property:** Like any other conveyance of an interest in real property, a land sale contract must be in writing and recorded. The property must also be described as in any deed (*see¶ 4:10*).

g. [4:123] **Mechanics and closing:** Because it potentially, and ultimately, transfers a fee interest, an agreement for transfer by way of a land sale contract should cover the same issues as the transfer of a fee interest. Accordingly, the sections in this Chapter explaining terms, mechanics and closing apply equally to land sale contracts and conventional fee transfers.

However, since the conveyancing instrument is a land sale contract and not a deed, the form of the contract should be agreed to and attached to the purchase and sale agreement. (Title insurance companies and the California Association of Realtors (*¶ 4:278*) publish standard forms of land sale contracts.)

h. [4:124] **Title insurance:** Title insurance on a land sale contract is similar to that on a fee interest. The principal difference is that the interest insured is that of a vendee's interest in a land sale contract.

Cross-refer: For a comprehensive discussion of title insurance, *see Ch. 3*.

[4:125 - 4:129] ***Reserved.***

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Chapter 4. Purchase and Sale Agreement

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1. Preliminary Considerations

a. [4:130] **Identifying "necessary" parties:** All parties necessary to consummate the transfer of all property to be sold should execute both the purchase agreement and the appropriate conveyancing instrument (deed, assignment, etc.).

The question of who should be parties to the purchase agreement is of mutual importance to buyers and sellers. Buyers have the obvious interest in making certain they are dealing with those parties who have the lawful right to convey the property. (Buyers cannot prevail in a specific performance action against anyone who is not contractually bound.) So too, to ensure a binding deal, those signing for the sellers must have the *authority* to sign and/or all co-owners (or other necessary parties) must execute the purchase contract.

Ideally, to the extent practicable, all necessary parties to the transaction should be identified *before* the purchase agreement is signed. [See generally, Civ.C. § 1558—"It is essential to the validity of a contract, not only that the parties should exist, but that it should be possible to identify them"]

➪ [4:130.1] ***PRACTICE POINTER:*** When dealing with individuals, counsel should determine whether the seller is married, or has co-owners or partners. Secondarily (as discussed in greater detail at *¶ 4:185 ff.*), if the seller is a partnership, corporation, trust or some other entity, both buyer and seller should determine at the outset whether those signing the contract have the *authority* to bind the selling entity.

b. [4:131] **Party capacity and other essential contract elements:** As a contract, purchase and sale agreements must satisfy four general statutory prerequisites: (1) the parties must be *capable of contracting;* (2) the parties must *consent;* (3) the contract must have a "lawful object"; and (4) the contract must be supported by "sufficient cause or consideration." [Civ.C. § 1550]

Any person has "capacity" to enter into a contract … *except* "minors, persons of unsound mind, and persons deprived of civil rights." [Civ.C. §§ 1556, 1557; but see also Fam.C. § 7050(e)(2) & (3)—"emancipated" minors have capacity to enter into binding contracts and to buy, sell, lease, encumber, exchange or transfer interest in property]

2. [4:132] **Forms of Ownership:** Property may be held by one person or two or more persons. Co-owner *sellers* must each join in the instrument of transfer. And, when more than one *buyer* is involved, the parties must address the secondary issue of the appropriate *form of title*.

a. [4:133] **Sole ownership:** When property is owned solely by *one* person, that person may alone enjoy the benefits and be responsible for the burdens of the property. Also, the sole owner may dispose of the property as they desire; and only that person's signature is required to effect a valid transfer. [See generally, Civ.C. § 679 ("absolute" ownership)]

(Ownership by a single person is referred to as "sole" or "several" ownership. See Civ.C. § 681.)

(1) [4:134] **Community property concerns:** However, certain complexities may arise where a person holding sole record title is *married* or a member of a *registered domestic partnership*. Here, community property law may require *both* spouses'/domestic partners' signatures. *See ¶ 4:166 ff.*

b. [4:135] **Co-ownership (two or more owners):** Ownership shared between one or more persons is a form of "qualified" ownership (commonly referred to as "co-ownership," "cotenancy" or "concurrent ownership"). [Civ.C. § 680(2); see *State of Calif. v. Sup.Ct. (Underwriters at Lloyd's of London)* (2000) 78 CA4th 1019, 1027-1028, 93 CR2d 276, 283]

Cross-refer: Agreements between co-owners of residential property are separately discussed in *Ch. 12*.

(1) [4:136] **General rules:** As discussed in detail at ¶ 4:140 ff., there are four types of co-ownership: (a) tenancy in common; (b) joint tenancy; (c) partnership; and (d) community property. [Civ.C. § 682]

(a) [4:137] **Equal possessory interests:** Regardless of the type of co-ownership, unless the coowners have agreed to the contrary, each has an "equal" right to the possession, use and benefit of the entire property. [See *Zaslow v. Kroenert* (1946) 29 C2d 541, 548, 176 P2d 1, 5; *Dabney v. Dabney* (2002) 104 CA4th 379, 382, 127 CR2d 917, 918]

(b) [4:137.1] **Power to unilaterally encumber undivided interest:** Joint tenants and tenants in common may encumber their separate undivided interests without the consent, and without affecting the interests, of the other cotenants. [*Dieden v. Schmidt* (2002) 104 CA4th 645, 650-651, 128 CR2d 365, 369]

(c) [4:138] **Presumptive tenancy in common:** A conveyance of co-ownership interests creates a tenancy in common among the co-owners *unless* the conveyancing instrument specifies that the property is acquired in joint tenancy, in partnership, or as community property. [Civ.C. § 686; *In re Horn's Estate* (1951) 102 CA2d 635, 640, 228 P2d 99, 102; but see Fam.C. § 760 (*¶ 4:168*)—presumptive community property if acquired during marriage (or registered domestic partnership; see Fam.C. § 297.5)]

Thus, e.g., a tenancy in common is deemed created when the instrument refers only to owners as "co-owners," regardless of whether the drafter may have intended to create a joint tenancy.

➪ [4:139] ***PRACTICE POINTER:*** The lesson is obvious: To avoid the creation of tenancy in common interests, it is important to designate in the conveyancing instrument the *exact form* of co-ownership desired. Indeed, even if the intent is to create a tenancy in common, it is advisable to explicitly so state in the conveyancing instrument, thereby eliminating potential ambiguities.

(d) [4:139.1] **Termination of relationship; sale of property:** Unless co-owners previously agreed upon an "exit strategy" should divergent opinions about selling the property arise and/or their relationship not work out, a partition suit (i.e., a court-ordered sale of the property per CCP § 872.010 et seq.) may be inevitable. [See *Summers v. Sup.Ct. (Tan)* (2018) 24 CA5th 138, 144, 234 CR3d 63, 67 (finding court must resolve each party's respective interest in property before ordering its sale); ¶ 12:37 ff.]

(2) [4:140] **Tenancy in common:** A tenancy in common is created whenever an instrument conveying property to two or more persons specifies that the owners are "tenants in common" *or*, as stated at ¶ 4:138, whenever the conveyancing instrument *fails* to specify another form of co-ownership. [Civ.C. § 686; see also Civ.C. § 685—interest in common is one owned by several persons, not in joint ownership or partnership]

(a) [4:141] **Nature of undivided interests:** Any number of persons may own property as tenants in common; and their interests may be equal or unequal.

The tenants in common may hold separate legal titles to their undivided interests. Unlike joint tenants (*¶ 4:147*), they may therefore acquire their interests at different times and from different sources, and may sell or mortgage their undivided interests as they please. [*Meyer v. Sup.Ct.* (1927) 200 C 776, 792, 254 P 1108, 1114]

1) [4:142] **No right of survivorship:** The principal distinguishing feature from a joint tenancy (*¶ 4:151*) is that tenancy in common ownership carries *no* right of survivorship. Thus, the interest of a deceased tenant in common passes by testate or intestate succession to the decedent's devisees or heirs rather than by operation of law to the surviving cotenants. [*Dieden v. Schmidt* (2002) 104 CA4th 645, 650, 128 CR2d 365, 369]

(b) [4:143] **Equal possessory rights:** Unless they have agreed otherwise, all tenants in common have equal rights to possession of the property. [*Meyer v. Sup.Ct.* (1927) 200 C 776, 792, 254 P 1108, 1114; *Kapner v. Meadowlark Ranch Ass'n* (2004) 116 CA4th 1182, 1189, 11 CR3d 138, 144; see also *Hacienda Ranch Homes, Inc. v. Sup.Ct. (Elissagaray)* (2011) 198 CA4th 1122, 1128, 131 CR3d 498, 503—each tenant in common may assume another in exclusive possession is possessing for all and not adversely to others (*discussed further at ¶ 4:143.5*)]

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1) [4:143.1] **No right to exclude cotenant:** Because they have equal possessory rights, no single tenant in common has the right to exclude the others from any part of the property. [*Zaslow v. Kroenert* (1946) 29 C2d 541, 548, 176 P2d 1, 5; *Preciado v. Wilde* (2006) 139 CA4th 321, 325, 42 CR3d 792, 795; see *Kapner v. Meadowlark Ranch Ass'n* (2004) 116 CA4th 1182, 1189, 11 CR3d 138, 144—cotenant's cause of action for wrongful ouster "is properly characterized as an action for possession"]

2) [4:143.2] **No right to recover rental value from cotenant:** Nor, absent "ouster" or wrongful dispossession, may one tenant in common recover the rental value of the property from a cotenant in possession. [*Estate of Hughes* (1992) 5 CA4th 1607, 1611-1612, 7 CR2d 742, 745]

3) [4:143.3] **No trespass claims among cotenants:** Because no single tenant in common has the exclusive right of possession, a tenant in common cannot "trespass" on the commonly-owned property. [*Kapner v. Meadowlark Ranch Ass'n* (2004) 116 CA4th 1182, 1189, 11 CR3d 138, 144]

4) [4:143.4] **No right to force cotenant to change boundaries:** And, because they share an equal right to possession of the whole property, one tenant in common has no right to force another cotenant to change the boundaries of the possessory interest other than through an action for partition. [*Dabney v. Dabney* (2002) 104 CA4th 379, 382-383, 127 CR2d 917, 918-919—probate court erred in ordering one tenant in common to execute documents for lot line adjustment between tenants in common where no partition action]

5) [4:143.5] **Sole ownership title not acquired by mere exclusive possession:** A tenant in common cannot by mere exclusive possession of the property acquire the title of their "out-of-possession" cotenants. The occupant cotenant in such circumstances can prevail as against the ownership rights of the other co-tenants only by establishing the normal elements of *adverse possession* (including providing notice to the other cotenants, by "open, notorious and unequivocal" acts of ownership, that the occupant cotenant intends to oust the others of their interest in the property). [*Preciado v. Wilde* (2006) 139 CA4th 321, 325, 42 CR3d 792, 795]

In fact, "[b]efore title may be acquired by adverse possession as between cotenants, the occupying tenant must bring home or impart notice to the tenant out of possession, by acts of ownership of the *most* open, notorious and unequivocal character, that he intends to oust the latter of his interest in the common property. Such evidence must be *stronger* than that which would be required to establish a title by adverse possession in a stranger … In short, one tenant in common cannot by *mere* exclusive possession acquire the title of his cotenant." [*Hacienda Ranch Homes, Inc. v. Sup.Ct. (Elissagaray)* (2011) 198 CA4th 1122, 1128, 131 CR3d 498, 503 (emphasis added)]

(c) [4:144] **Pro rata sharing of rents and expenses:** Rent received from a third party for use of the property belongs to all the cotenants in common in accordance with their proportionate undivided interests. [*Dabney-Johnston Oil Corp. v. Walden* (1935) 4 C2d 637, 655, 52 P2d 237, 246]

Conversely, the cotenants share responsibility for *expenses* on the property in accordance with their proportionate undivided interests (a tenant in common who pays more than their share of expenses can recover a pro rata share from the other tenant(s) in common). [*Willmon v. Koyer* (1914) 168 C 369, 374, 143 P 694, 696]

1) [4:145] **Compare—losses and improvements:** However, a tenant in common is not obligated to protect against the loss of another tenant in common's interest in the property. [*Russell v. Williams* (1962) 58 C2d 487, 491, 24 CR 859, 862 (same rule applies to other types of cotenancy)—one cotenant cannot recover proceeds of fire insurance policy issued to another cotenant]

And a tenant in common cannot require reimbursement from the others for *improvements* (as opposed to expenses) to the property, unless consented to by the others. [*Higgins v. Eva* (1928) 204 C 231, 237-238, 267 P 1081, 1083-1084]

(3) [4:146] **Joint tenancy:** Broadly, a joint tenancy is co-ownership title among two or more persons created by a *single* transfer that *expressly declares* the form of co-ownership to be a joint tenancy.

More specifically, a joint tenancy is statutorily defined as:

> "[O]ne owned by two or more persons in equal shares, by a title created by a single will or transfer, when expressly declared in the will or transfer to be a joint tenancy, or by transfer from a sole owner to himself or herself and others, or from tenants in common or joint tenants to themselves or some of them, or to themselves or any of them and others, or from spouses, when holding title as community property or otherwise to themselves or to themselves and others or to one of them and to another or others, when

expressly declared in the transfer to be a joint tenancy, or when granted or devised to executors or trustees as joint tenants." [Civ.C. § 683]

(a) [4:146.1] **Subject to statute of frauds:** The creation of a joint tenancy is subject to the statute of frauds and, therefore, generally must be evidenced by a *writing* expressly declaring the joint tenancy. [Civ.C. § 683; see *Estate of MacDonald* (1990) 51 C3d 262, 271-272, 272 CR 153, 159-160; *and ¶ 4:263*]

1) [4:146.2] **Equitable estoppel defense:** However, an oral joint tenancy may be enforceable under an applicable defense to the statute of frauds—including *equitable estoppel* to assert the statute (generally, where one party has detrimentally changed their position in reliance on the other party's representations that the agreement would be reduced to a writing or that the contract would be performed, *¶ 4:272.2*). [See *Byrne v. Laura* (1997) 52 CA4th 1054, 1069-1070, 60 CR2d 908, 918 (disagreeing with contrary conclusion in *Estate of Seibert* (1990) 226 CA3d 338, 342-343, 276 CR 508, 511); *see also ¶ 4:271* re "part performance" defense to statute of frauds]

(b) [4:147] **Four unities of interest:** To create a joint tenancy, a conveyance must transfer "to two or more persons at the *same time* the *same title* to the *same interest* with the *same right of possession*." In other words, the creation of a joint tenancy requires the *four unities* of *time, title, possession* and *interest*. [*Estate of Propst* (1990) 50 C3d 448, 455, 268 CR 114, 117 (emphasis added); see *Re v. Re* (1995) 39 CA4th 91, 95-96, 46 CR2d 62, 64-65]

Similarly, a joint tenancy lasts only so long as the four essential unities continue to exist: i.e., as at common law, destruction of one of the unities (e.g., by a cotenant's unilateral conveyance of the cotenant's undivided shares) severs the joint tenancy. [*Estate of Propst*, supra; *Tenhet v. Boswell* (1976) 18 C3d 150, 155-156, 133 CR 10, 14; *Re v. Re*, supra, 39 CA4th at 96, 46 CR2d at 65; see also *Estate of Blair* (1988) 199 CA3d 161, 169, 244 CR 627, 631—agreement between joint tenants that is inconsistent with one or more of essential unities (e.g., agreement to eliminate right of survivorship) severs joint tenancy; *Walters v. Boosinger* (2016) 2 CA5th 421, 438, 205 CR3d 895, 908, fn. 20 (declining to decide whether party's judicial admission that real property is not held in joint tenancy constitutes *agreement* that property is not held in joint tenancy)]

1) [4:148] **Exception to "unity of title" requirement:** Were the "unity of title" requirement strictly applied, no sole owner of property could directly create a joint tenancy among themselves and another (since the sole owner already owned the property, the joint tenants' ownership would not result from the *same* conveyance). This was in fact the rule at common law (to accomplish the same result, the sole owner had to convey the property to a third person, who would then reconvey back to the sole owner and another as joint tenants).

Civ.C. § 683 resolves this dilemma by expressly creating an exception to the "unity of title" requirement: As noted at ¶ 4:146, a joint tenancy may be created by a "transfer from a sole owner to himself or herself and others …" [See Civ.C. § 683]

(c) [4:149] **Equal undivided interests and rights of possession:** Because of the four unities of interest, each joint tenant "simultaneously possesses" an equal undivided interest in the property and (absent agreement to the contrary) equal rights of possession to the whole. [*Estate of Propst* (1990) 50 C3d 448, 455, 268 CR 114, 117; *Tenhet v. Boswell* (1976) 18 C3d 150, 155, 133 CR 10, 14; see *Swartzbaugh v. Sampson* (1936) 11 CA2d 451, 454, 54 P2d 73, 75—"Possession by one is possession by all"]

Likewise, one joint tenant cannot eject a cotenant in possession; and a joint tenant out of possession cannot recover exclusive possession of the property from a cotenant. Further, absent "ouster," one joint tenant cannot recover rent from a cotenant for the latter's occupancy. [*Swartzbaugh v. Sampson*, supra, 11 CA2d at 454-455, 54 P2d at 75]

(d) [4:150] **Right of conveyance; severance:** An "indisputable right" of each joint tenant is the power to convey their interest in the property with or without the knowledge and consent of the cotenants. [*Estate of Propst* (1990) 50 C3d 448, 455-456, 268 CR 114, 117-118; *Zanelli v. McGrath* (2008) 166 CA4th 615, 631, 82 CR3d 835, 848; see also Civ.C. § 683.2 (severance of real property joint tenancy without cotenants' "joinder or consent" by conveyance to third person, etc.)]

However, because such a conveyance is inconsistent with continuance of the essential unities, it *severs* the joint tenancy with respect to the conveying joint tenant's interest (thereafter, the remaining joint tenants retain their fractional shares as tenants in common with the transferee). [*Estate of Propst*, supra; *Zanelli v. McGrath,* supra—survivorship right is "mere expectancy," arising only upon success of "ultimate gamble—survival"; and see *Re v. Re*

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(1995) 39 CA4th 91, 96-99, 46 CR2d 62, 65-67—posthumously-recorded deed between 2 of 3 joint tenants severs joint tenancy among the 3 joint tenants]

1) [4:150a] **Statutory limitations on severance by unilateral conveyance:** A joint tenant's conveyance to a third person, without the cotenants' joinder or consent, is effective to terminate the cotenants' right of survivorship as to the severing joint tenant's interest only if (Civ.C. § 683.2(c)):

- Before the severing joint tenant's death, the deed (or other conveyancing instrument) is recorded in the county where the property is located; *or*

- The deed (or other instrument of conveyance) is executed and acknowledged before a notary public by the severing joint tenant no earlier than three days before the severing joint tenant's death and recorded in the county where the property is located no later than seven days after the severing joint tenant's death. [Civ.C. § 683.2(c); see *Dorn v. Solomon* (1997) 57 CA4th 650, 653, 67 CR2d 311, 313—attempted severance of joint tenancy interest in family home by quitclaim to irrevocable trust ineffective because deed not recorded until one month after severing joint tenant's death]

a) [4:150b] **Domestic relations proceedings:** In dissolution, legal separation and nullity actions, the parties are subject to four automatic temporary restraining orders that, among other things, generally prohibit each party from transferring real property or creating/modifying nonprobate property transfers without the other party's written consent or a court order (Fam.C. § 2040(a)(2)(A), (4)). The restraining orders do not, however, restrain either party from eliminating a right of survivorship to property provided "notice of the change is filed and served on the other party before the change takes effect." [Fam.C. § 2040(b)(3)]

In addition to § 2043(b)(3)'s notice requirement (above), case law holds a party must satisfy Civ.C. § 683.2(c)'s recordation requirement *before* severance of a joint tenancy effectively eliminates the survivorship right. The notice and recordation requirements, however, may be satisfied in any order. [*Raney v. Cerkueira* (2019) 36 CA5th 311, 316-317, 330, 248 CR3d 426, 428-429, 440 (¶ *12:5.2a*)]

Cross-refer: For a comprehensive treatment of Fam.C. § 2040 automatic temporary restraining orders, see Hogoboom & King, *Cal. Prac. Guide: Family Law* (TRG), Ch. 5.

[4:150.1] ***Reserved.***

2) [4:150.2] **Compare—severance with concurrence of all joint tenants:** A joint tenancy may also be severed of course by the *concurrence* of all joint tenants. Where all joint tenants join in executing a written instrument of severance, it is effective to terminate the survivorship feature whether or not recorded. [Civ.C. § 683.2(d); *Estate of Powell* (2000) 83 CA4th 1434, 1442-1443, 100 CR2d 501, 506—joint tenancy character of family residence terminated when spouses included it in trust executed by both of them]

3) [4:150.3] **Compare—severance of joint tenancies between spouses/registered domestic partners by judgment of dissolution:** A judgment of dissolution or nullity *automatically severs* (by operation of law) a joint tenancy between spouses or registered domestic partners (whether the joint tenancy was created before or during the parties' marriage or domestic partnership) upon a spouse's/domestic partner's death. [Prob.C. § 5042(a), (d) (same re property held as community property with right of survivorship); see also Fam.C. §§ 297.5, 299(d)—registered domestic partners and former registered domestic partners have almost all rights, benefits and obligations of spouses and former spouses under Calif. law]

Exceptions: The automatic severance rule (above) does not apply where (i) the joint tenancy is *not subject to severance* at the time of decedent's death (as where the judgment of dissolution orders that the joint tenancy be maintained), *or* (ii) there is "clear and convincing evidence" the decedent *intended to preserve* the joint tenancy in favor of the former spouse/partner. [Prob.C. § 5042(b)]

(e) [4:151] **Right of survivorship:** The principal distinguishing characteristic of a joint tenancy is the *right of survivorship*. This means that upon the death of a joint tenant, title to the deceased's undivided interest vests in the surviving joint tenant(s) *by operation of law*—the interest passes to the surviving cotenants *automatically*, without the necessity of a probate or any other proceeding. (However, title companies will require a copy of the death certificate

and/or recordation of an appropriate instrument confirming the joint tenant's death.) [*Swan v. Walden* (1909) 156 C 195, 196, 103 P 931, 932; *Dieden v. Schmidt* (2002) 104 CA4th 645, 650, 128 CR2d 365, 368-369; *Walters v. Boosinger* (2016) 2 CA5th 421, 434, 205 CR3d 895, 905—joint tenancy is estate designed to allow two or more persons who jointly own property to avoid probate upon death of one joint tenant; and see detailed discussion in Ross & Cohen, *Cal. Prac. Guide: Probate* (TRG), Ch. 2]

The right of survivorship in joint tenancy property continues to exist only for so long as the four essential unities continue. *A fortiori*, a joint tenant's conveyance of their undivided interest extinguishes the right of survivorship as to that interest (but subject to the limitations of Civ.C. § 683.2; *see ¶ 4:150a*). [*Estate of Propst* (1990) 50 C3d 448, 455, 268 CR 114, 117; *Tenhet v. Boswell* (1976) 18 C3d 150, 155-156, 133 CR 10, 14]

(f) Pros and cons

1) [4:152] **Advantages of joint tenancy:** For property owners concerned about disposition at death, the right of survivorship generally is viewed as representing the greatest advantage of joint tenancy title over tenancies in common: As stated, a deceased joint tenant's interest vests immediately in the surviving joint tenant(s) without legal action. In addition, the surviving joint tenant(s) take title to the deceased's interest free and clear of all involuntary liens and claims against the deceased joint tenant. [*Clark v. Carter* (1968) 265 CA2d 291, 294, 70 CR 923, 926 (superseded by statute on other grounds as stated in *Estate of Mitchell* (1999) 76 CA4th 1378, 1390, 91 CR 192, 200)]

Cross-refer: Spouses and registered domestic partners, however, can realize the same “survivorship” benefit by taking title as “community property with right of survivorship”; *see ¶ 4:177*.

2) [4:153] **Disadvantages of joint tenancy:** Offsetting the right of survivorship are these points to consider:

a) [4:154] **Interest not subject to testamentary disposition:** Though a joint tenant's interest may be the subject of a *lifetime conveyance* (*¶ 4:150*), it *cannot* be bequeathed by will (the right of survivorship prevails … unless, of course, the decedent is the last remaining joint tenant). [*Santoro v. Carbone* (1972) 22 CA3d 721, 729, 99 CR 488, 493 (disapproved on other grounds by *Tenzer v. Superscope, Inc.* (1985) 39 C3d 18, 30, 216 CR 130, 137); see also *Estate of Blair* (1988) 199 CA3d 161, 166, 244 CR 627, 630 (distinguishing community property)]

b) [4:155] **Severable:** No matter how desirable the survivorship feature, it is simply “an *expectancy* that is not irrevocably fixed upon the creation of the [joint tenancy] estate.” [*Tenhet v. Boswell* (1976) 18 C3d 150, 155-156, 133 CR 10, 14 (emphasis added); see *Re v. Re* (1995) 39 CA4th 91, 96, 46 CR2d 62, 65]

Again, subject to certain statutory conditions (see Civ.C. § 683.2, *¶ 4:150a*), joint tenancies may easily be severed by the conveyance of one joint tenant's interest (thus extinguishing the right of survivorship), whether the transfer is voluntary or involuntary (e.g., execution). [*Estate of Propst* (1990) 50 C3d 448, 455-456, 268 CR 114, 117-118; *see also ¶ 4:150 ff.*]

(g) [4:156] **Combined joint tenancy and tenancy in common relationships:** Two or more individuals may hold a *tenancy in common* interest among themselves as *joint tenants*—i.e., there may be a joint tenancy of undivided interests in an overall tenancy in common. Here, a deceased joint tenant's share passes by right of survivorship to the remaining joint tenant(s); but the death does not impact the overall tenancy in common relationship. [See *Re v. Re* (1995) 39 CA4th 91, 98-99, 46 CR2d 62, 67—deeds between 2 of 3 joint tenants granting each other joint tenancy as to their 2/3 interest severed overall joint tenancy to create tenancy in common with third former joint tenant]

[4:157 - 4:159] ***Reserved.***

(4) Partnerships

(a) [4:160] **Nature of “partnership”:** A “partnership interest” is “one owned by several persons, in partnership, for partnership purposes.” [Civ.C. § 684]

A “partnership” is “an association of two or more persons to carry on as coowners a business for profit … and includes … a registered limited liability partnership …” [Corps.C. § 16101(a)(9) (1/1/26 “sunset” date); see Corps.C. § 16951 et seq. re registration of limited liability partnerships; see also *Enea v. Sup.Ct. (3-D)* (2005) 132 CA4th 1559, 1564, 34 CR3d 513, 516 (defining characteristic of partnership is combination of two or more persons to jointly conduct business)]

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But coownership of property (as joint tenants, tenants in common or any form of part ownership) does not itself establish a partnership, whether or not the coowners share profits realized from use of the property. [See Corps.C. § 16202(c)(1)]

(b) [4:161] **Property ownership:** A partnership is an entity distinct from its individual partners. [Corps.C. § 16201] Real property acquired by the partnership is property of the partnership and not of the partners individually; and, therefore, may only be conveyed in the partnership name. [Corps.C. §§ 16203, 16302]

1) [4:161.1] **Acquisition:** Property is partnership property if acquired in the name of *either* (i) the partnership or (ii) one or more partners with an indication in the instrument of transfer of the person's capacity as a partner or of the existence of a partnership but without an indication of the name of the partnership. [Corps.C. § 16204(a)]

Property is acquired in the partnership name by transfer to *either* (i) the partnership in its name or (ii) one or more partners in their capacity as partners if the name of the partnership is indicated in the instrument of transfer. [Corps.C. § 16204(b)]

2) [4:161.2] **Presumptions:** Property is presumed to be *partnership* property if purchased with partnership assets, even if not acquired in the partnership name or the name of one or more partners with an indication in the instrument of transfer of the person's capacity as partner or of the existence of the partnership. [Corps.C. § 16204(c)]

Conversely, even if used for partnership purposes, property is presumed to be a partner's *separate property* if acquired in the partner's name without an indication in the instrument of transfer of the person's capacity as a partner or of the existence of a partnership and without use of partnership assets. [Corps.C. § 16204(d)]

(c) [4:162] **Partners' interest in partnership property:** Individual partners are not "coowners" of partnership property and have no interest in partnership property that can be transferred (whether voluntarily or involuntarily). The only interest transferrable by a partner is their share of partnership profits and losses and the right to receive distributions (a personal property interest). [See Corps.C. §§ 16501, 16502]

Partners may use or possess partnership property only on behalf of the partnership. [Corps.C. § 16401(g)]

[4:163 - 4:165] ***Reserved.***

(5) [4:166] **Community property:** Community property is all property, no matter where situated, acquired by a married person or registered domestic partner during the marriage/domestic partnership while domiciled in California, unless otherwise provided by statute. [Fam.C. § 760; see also Fam.C. § 297.5(a), (b), (c) (registered domestic partners have rights and obligations of spouses under Calif. law)] However, the parties may hold property as joint tenants or tenants in common instead of community property. [Fam.C. § 750]

(By contrast, a spouse's or registered domestic partner's separate property consists generally of premarital/prepartnership acquisitions; acquisitions during the marriage/domestic partnership by gift, devise or descent; the rents, issues and profits on all of such property; and the spouse's/domestic partner's postseparation earnings and accumulations not traceable to a community property interest. See Fam.C. §§ 770, 771(a), 772.)

Cross-refer: The sections at ¶ 4:167 ff. overview the pertinent provisions of California community property law. For a detailed discussion of the subject, see Hogoboom & King, *Cal. Prac. Guide: Family Law* (TRG), Ch. 8.

(a) [4:167] **Presumptive community property:** The Fam.C. § 760 definition of community property is effectively applied as a general *presumption* that all marital/domestic partnership acquisitions are community property. [Fam.C. § 760; but see also Fam.C. § 802—general community property presumption inapplicable to property held at death if marriage/domestic partnership dissolved more than 4 years before death]

1) [4:168] **Special community property presumption for purposes of dissolution or legal separation:** Another community property presumption attaches to property acquired by spouses or registered domestic partners during the marriage/domestic partnership in "joint form" (including joint tenancy and tenancy in common property). However, unlike the general Fam.C. § 760 presumption (¶ 4:167), this presumption applies *only* for purposes of a property division upon marriage/domestic partnership dissolution or legal separation. [Fam.C. § 2581; see also Fam.C. § 299(d) (upon dissolution/legal separation, registered domestic partners have rights of spouses under Calif. law); *Dorn v. Solomon* (1997) 57 CA4th 650, 652, 67 CR2d 311, 312—joint tenancy between spouses presumptively passes by right of survivorship upon joint tenant spouse's death, *not* as CP pursuant to § 2581 presumption]

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(b) [4:169] **Nature of community property interests:** During a marriage or registered domestic partnership, each spouse/domestic partner has "present, existing and equal" interests in the parties' community property. [Fam.C. § 751; see *State Board of Equalization v. Woo* (2000) 82 CA4th 481, 483, 98 CR2d 206, 208]

The parties' "equal" interests are 50-50 interests in the *whole* of the community property—*not* "exclusive" interests in only half of the community property. [*In re McIntyre* (9th Cir. 2000) 222 F3d 655, 658 (applying Calif. law)]

(c) [4:170] **Equal rights of management and control:** Spouses and registered domestic partners share equal rights of management and control in community real and personal property (except that a spouse/domestic partner managing or operating a community personal property business has "primary" management and control of the business). [Fam.C. §§ 1100, 1102]

1) [4:171] **Subject to fiduciary obligations:** In the management and control of their community estate, spouses/ registered domestic partners stand in a *fiduciary relationship* and owe each other a duty of the "highest good faith and fair dealing." [See Fam.C. §§ 721(b), 1100(e)]

[4:172 - 4:175] ***Reserved.***

(d) [4:176] **Devolution of interests upon spouse's/domestic partner's death:** Upon the death of a spouse or registered domestic partner, one-half of the community property passes to the surviving spouse/domestic partner and the other half to decedent's devisees (or, if none, to the surviving spouse/domestic partner). [Prob.C. §§ 37(b), 100, 6401; Fam.C. § 297.5(c)]

Assuming there are devisees, the surviving spouse/domestic partner thereafter holds title to the property as tenant in common with the devisees; if no devisees, the property passes to the surviving spouse/domestic partner as their sole and separate property. [Prob.C. §§ 37(b), 6401(a); Fam.C. § 297.5(c)] (See also Ross & Cohen, *Cal. Prac. Guide: Probate* (TRG), Ch. 4.)

1) [4:176.1] **Compare—community property with right of survivorship:** The result is otherwise if the property is held as "community property with right of survivorship"; *see ¶ 4:177 ff.*

(6) [4:177] **Community property with right of survivorship:** Spouses and registered domestic partners also can hold title as "community property with right of survivorship." [Civ.C. § 682.1; Fam.C. §§ 297.5(a), 750]

This is a "hybrid" form of community property that shares the *survivorship* feature of joint tenancy property: i.e., upon the first spouse's/domestic partner's death, property so held passes to the survivor as if it were joint tenancy property —i.e., by right of survivorship without probate administration. In all other respects, however, the property is treated as community property. [Civ.C. § 682.1(a)(1)]

(a) [4:177.1] **How created:** The right of survivorship in community property must *expressly* be designated on the transfer instrument or title document; and both parties must affirmatively indicate, by their signatures or initials on the face of that instrument or document, their intention to take title as community property with right of survivorship. [Civ.C. § 682.1(a)(1); see also Comm. Report for 1999 AB No. 2913, 1999–00 Reg. Sess.]

(b) [4:177.2] **Severance of survivorship feature:** As with joint tenancy property (¶ *4:155*), the survivorship feature in community property with right of survivorship is only an expectancy. Before either party's death, the right of survivorship may be terminated in the *same manner* that a joint tenancy may be severed (*see ¶ 4:150 ff.*). [Civ.C. § 682.1(a)(1)]

[4:178 - 4:179] ***Reserved.***

c. [4:180] **Co-ownership agreements:** Even though coowners generally share identical rights and obligations (¶ *4:135 ff.*), they may *agree* to allocate the benefits and burdens of the property, along with its use and possession, among themselves.

➪ [4:181] ***PRACTICE POINTER:*** Joint buyers (other than spouses or registered domestic partners) should never rely exclusively on the legal definitions of tenancy in common, joint tenancy, partnership and community property to completely define their co-ownership rights and obligations. Outside the marriage/domestic partnership context, a co-ownership agreement is always prudent; it should cover such important issues as how and when the property is to be used, operated, maintained and financially supported; and how and when it will be sold.

While it may not be practical to go to the effort and expense of preparing a co-ownership agreement before the purchase contract is signed, some form of co-ownership agreement should be executed prior to the closing (many clients are reluctant to pay for the cost of such an agreement until they are certain the transaction will close).

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Cross-refer: Residential co-ownership agreements are discussed separately in *Ch. 12*. (For a sample co-ownership agreement, *see Form 12:A*.)

d. [4:182] **Common interest developments:** The relationship among various condominium owners in a condominium project or shareholders in a stock cooperative is, as to the common areas, a tenancy in common. No specific language need be used in the purchase agreement or conveyancing instrument to describe that relationship.

[4:183 - 4:184] ***Reserved.***

3. [4:185] **Status of Seller (Who Must Execute Conveyance):** To ensure that there will be an enforceable contract, the named seller must have the *lawful right* to convey title. Thus, issues pertaining to the *status* of the seller should be of equal concern to both parties.

a. [4:186] **Verifying vesting of title:** The initial concern is with verifying the manner in which the seller holds legal title to the property (occasionally, this may reveal that the purported seller is not the lawful title holder of record).

There are several approaches to ascertaining how title is vested:

(1) [4:187] **Telephone title insurance company:** Counsel may request a "vesting" by telephoning the customer service department of any reputable title insurance company. As a free courtesy to lawyers, title insurance companies typically will provide telephonic same-day confirmation of vesting. They will then send counsel a copy of the last recorded deed for the property, either at no cost or for a nominal charge.

➪ [4:188] ***PRACTICE POINTER:*** This approach offers a time and cost-savings advantage. However, the oral report and follow-up deed are *not always reliable;* and the information provided creates *no liability* for the title company.

(2) [4:189] **Order preliminary report:** Although a preliminary report (or "preliminary title report") is more expensive than simply telephoning a title company, it is more reliable. This is because vesting is carefully prepared in writing by a title officer and a description of the state of title is provided. In any event, since a preliminary report will have to be ordered at some point in the transaction, it makes sense to obtain it early to verify the vesting of title.

Cross-refer: Preliminary title reports are discussed in detail in *Ch. 3* in connection with title insurance.

(3) [4:190] **Examine title insurance policy:** Check the seller's existing title insurance policy.

➪ [4:191] ***PRACTICE POINTER:*** Don't rely entirely on the title insurance policy. The seller may have transferred the property, or a portion thereof, after the policy was issued.

[4:192 - 4:200] ***Reserved.***

b. [4:201] **Community property title:** Although they have "equal" rights of management and control over community property (¶ *4:170*), *both* spouses/domestic partners "are required to" join (either personally or through a duly authorized agent) in executing an instrument transferring community real property (or an interest therein) by lease for more than one year, sale, conveyance or encumbrance. Thus, both spouses/domestic partners must execute an agreement for the sale and purchase of community real property. [Fam.C. § 1102(a); see also Fam.C. § 1100—both parties' written consent required for gift of community personal property or sale, conveyance or encumbrance of community personal property used as family dwelling, furnishings and clothing]

(1) [4:201.1] **Transaction voidable by nonconsenting spouse/domestic partner:** A conveyance (or encumbrance) of community property in violation of Fam.C. § 1102 (i.e., lacking both parties' consent) is subject to *avoidance* (affirmative set-aside or defense) by the nonconsenting spouse/domestic partner as follows (*Droeger v. Friedman, Sloan & Ross* (1991) 54 C3d 26, 36-39, 283 CR 584, 590-592):

(a) [4:201.2] **100% avoidance during marriage/domestic partnership:** For so long as the community remains in existence (i.e., during the parties' marriage/domestic partnership and prior to the transferor's death), the nonconsenting spouse/domestic partner is entitled to invalidate the transaction *in its entirety*. [*Droeger v. Friedman, Sloan & Ross* (1991) 54 C3d 26, 46-47, 283 CR 584, 597; see *Andrade Develop. Co. v. Martin* (1982) 138 CA3d 330, 334, 187 CR 863, 866—complete defense to transferee's suit for damages or specific performance]

(b) [4:201.3] **50% avoidance after dissolution or transferor's death:** On the other hand, after the community has been dissolved by judgment of dissolution or the transferor spouse's/domestic partner's death, the unilateral property disposition is voidable only as to the nonconsenting party's 50% community property interest. [*Droeger v. Friedman,*

Sloan & Ross (1991) 54 C3d 26, 33-34, 283 CR 584, 587-589; see *Trimble v. Trimble* (1933) 219 C 340, 345-347, 26 P2d 477, 480]

Thus, if the unauthorized transfer or encumbrance involved *only* the transferor spouse's/domestic partner's community interest, the nonconsenting party has *no set-aside* (or other) *remedy* after the marriage/domestic partnership has been terminated. [See *Hyatt v. Mabie* (1994) 24 CA4th 541, 546, 29 CR2d 447, 450]

➪ [4:201.4] ***PRACTICE POINTER FOR BUYERS:*** Buyers purchasing property from a married person or registered domestic partner should determine as soon as possible the state of record title to verify whether it is held as community property or, instead, as the prospective seller's sole and separate property. Moreover, never assume the property is truly "separate property" even if the deed by which the seller took title states the property is separately owned: A title insurance company will typically require a quitclaim deed (or other form of written, recorded relinquishment of any interest from the other party) before it will insure title.

If community property title is verified, the buyer should decline to go forward with the deal unless and until both spouses/domestic partners state in writing their willingness to join in the transfer.

➪ [4:201.5] ***PRACTICE POINTER FOR SELLERS:*** Since one spouse/domestic partner desiring to sell community property has nothing to gain by signing without the other, it would probably be prudent simply to forego execution of the purchase agreement unless and until both spouses/domestic partners are willing to sign.

At a minimum, if the other spouse/domestic partner is not available to sign, it behooves sellers to specifically provide in the purchase agreement that the signing party's obligations are subject to and contingent upon the nonsigning spouse's/domestic partner's written consent to the transaction, and that the nonsigning party may give or withhold such consent in their sole and absolute discretion.

c. [4:202] **Joint tenancy or tenancy in common title:** If the property is held in joint tenancy or tenancy in common (¶ *4:140 ff., 4:146 ff.*), *all* co-owners should sign the purchase agreement and conveyancing instrument. This is so even if the co-owners have a separate co-ownership agreement permitting fewer than all of them to execute contracts or conveyances. Title insurance companies will nonetheless usually require a deed from all co-owners. (The only exception is when the co-ownership agreement is recorded and essentially contains a power of attorney from one co-owner to another; *see ¶ 4:225 ff.*)

d. Partnerships and joint ventures

(1) [4:203] **General partnerships:** Partnership property held in the partnership name may be transferred by any single partner executing the instrument of transfer in the partnership name. [Corps.C. § 16302(a)(1)]

Partnership property held in the name of one or more partners with an indication in the instrument transferring the property to them of their capacity as partners or of the existence of the partnership, but without an indication of the partnership name, may be transferred by an instrument executed by the persons in whose name the property is held. [Corps.C. § 16302(a)(2)]

Partnership property held in the name of one or more partners *without* an indication in the instrument transferring the property to them of their capacity as partners or of the existence of the partnership, may be transferred by an instrument executed by the person in whose name the property is held. [Corps.C. § 16302(a)(3)]

(a) [4:203.1] **Agency limitation:** Agency principles apply. Thus, the partnership generally is not bound by a partner's attempted conveyance of partnership property *outside the ordinary course of partnership business* unless the other partners expressly authorized the conveyance. [See Corps.C. §§ 16301, 16302(b) & (c) (partnership's right to recover unauthorized conveyance)]

1) [4:203.2] **BFP exception:** However, a conveyance that would not normally bind the partnership (because outside the normal course of partnership business or because made by a partner otherwise lacking authority) may be effective as to a *bona fide purchaser for value*. [Corps.C. § 16302(b)]

(b) [4:204] **Impact of statement of partnership/partnership authority:** To determine who is required to sign on behalf of a general partnership, counsel should review the entity's recorded "statement of partnership authority" (Corps.C. § 16303). Any bona fide purchaser for value has the absolute right to rely on the information set forth in the statement (i.e., the statement establishes a conclusive presumption of authority). [See Corps.C. § 16303]

A grant of authority to transfer partnership real property contained in a certified copy of a statement of partnership authority filed with the Secretary of State and recorded in the recorder's office for the county where the property

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is located is *conclusive* in favor of a person who gives value without knowledge to the contrary … *except* to the extent a certified copy of the filed and recorded statement limits that authority (see Corps.C. § 16302(a)—making partners' authority to transfer partnership property subject to statement of partnership authority under Corps.C. §§ 16303, 16105, 16303(a)(2)). [Corps.C. § 16303(d)(2) & (e)]

However, the conclusive presumption of authority that derives from a recorded statement of partnership authority operates only *in favor of* bona fide purchasers for value; it does not operate *against* BFPs. [*Federal Dep. Ins. Corp. v. Sup.Ct. (BMB Properties)* (1997) 54 CA4th 337, 346-350, 62 CR2d 713, 718-720 (decided under former UPA)—statutory conclusive presumption not applied against lender that accepted deed of trust encumbering property signed by two partners, who had withdrawn from partnership as reflected in amended recorded partnership statement, and was considered BFP]

1) [4:204.1] **Contents:** A statement of partnership authority must be executed by at least two partners. [Corps.C. § 16105(c)]

The statement must set forth the partnership name; the street address of the entity's principal office and of one principal office in California (if any); the names and mailing addresses of all partners (or of an agent appointed and maintained by the partnership for the purpose of keeping a list of all partners' names and mailing addresses and making it available to any person on request for good cause shown); and the names of the partners authorized to execute an instrument transferring partnership real property. It may also specify the authority, or limitations on authority, of some or all of the partners to enter into other transactions on behalf of the partnership “and any other matter.” [Corps.C § 16303(a)]

➪ [4:205] ***PRACTICE POINTERS:*** When representing a buyer that is a newly-formed (or to-be-formed) general partnership, joint venture or limited partnership, any title insurance company from whom your client may seek to obtain title insurance will *require* that a statement of partnership (*¶ 4:204 ff.*) or certificate of limited partnership (*¶ 4:209 ff.*) (as applicable) be filed and recorded. *See ¶ 4:242 ff.*

If no statement of partnership authority has been recorded, review the partnership agreement. It is also prudent to require a representation and warranty from the party signing on behalf of the selling partnership as to the signatory's authority to bind the partnership (*see ¶ 4:436*).

Cross-refer: For a comprehensive treatment of partnership (general partnerships, limited partnerships and limited liability partnerships), see Soza & Jann, *Cal. Prac. Guide: Pass-Through Entities* (TRG).

(2) [4:206] **Joint ventures:** The Corporations Code does not clearly define a “joint venture” or provide for a joint venture to hold title to real property; thus, it may be advisable to denominate the entity as a general partnership (*¶ 4:205*).

However, title insurance companies regularly insure title in the name of a joint venture; and case law holds that “the law of partnership” applies to joint ventures. [*Weiner v. Fleischman* (1991) 54 C3d 476, 482, 286 CR 40, 43; *Orlopp v. Willardson Co.* (1965) 232 CA2d 750, 754, 43 CR 125, 128]

➪ [4:207] ***PRACTICE POINTER:*** As when partnership property is purchased (*¶ 4:205*), any title insurance company from whom the purchaser of joint venture property attempts to obtain title insurance will require some verification from the joint venturers regarding who has authority to sign for the entity. It is also good practice for the buyer to obtain a warranty from the signing party as to the signing party's authority to bind each of the joint venturers (*¶ 4:436*).

(3) [4:208] **Limited partnerships:** A limited partnership is comprised of at least one general partner and one or more limited partners. The general partners manage the partnership and are personally liable for its debts. On the other hand, limited partners, although they contribute capital to the entity, do not run the partnership business and do not have any personal liability for its obligations (other than their capital contributions). Thus, like shareholders of a corporation, limited partners have limited liability. [Corps.C. §§ 15901.02(q), 15903.03(a), 15903.05(a), 15904.02(a) & 15904.04(a); *Evans v. Galardi* (1976) 16 C3d 300, 305, 128 CR 25, 29]

Since they run the business and are personally liable for partnership debts, the *general partners*, or any one or more of them with authority to bind the entity, should sign the purchase agreement and conveyancing instrument. [See Corps.C. §§ 15904.02(a) & 15904.06(a)—as agents of limited partnership, general partners have authority to bind partnership in matters concerning partnership business] Limited partners, on the other hand, are not required to sign (nor should they sign) the purchase and sale documents.

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(a) [4:209] **Impact of certificate of limited partnership:** The counterpart to a statement of partnership/statement of partnership authority (¶ *4:204 ff.*) for a limited partnership is a "certificate of limited partnership" (or so-called "LP-1"). To form a limited partnership, a certificate of limited partnership must be *filed* with the California Secretary of State. [Corps.C. § 15902.01(a), (b), (c)]

A title insurance company will require the filing and recordation of a certificate of limited partnership before it will issue title insurance based on the partnership's execution of a deed, deed of trust or any other instrument that conveys an interest in real property.

1) [4:209.1] **Contents:** The certificate must contain the name of the limited partnership; the street address of the partnership's principal office; the names and addresses of the general partners; the name and street address of the agent for service of process; the mailing address of the limited partnership if different from the partnership's principal office, and "[a]ny other matters" the person filing the certificate determines to include, provided those matters do not "vary or otherwise affect" in an inconsistent manner Civ.C. § 15901.10(b)'s specified provisions (e.g., vary the limited partnership's power to sue, be sued and defend in its own name, vary the law applicable to limited partnerships, etc.). [See Corps.C. § 15902.01(a), (b)]

2) [4:209.2] **Conclusive presumption from recordation:** A certified copy of the certificate may be recorded in the office of the county recorder of any county in California (recordation is not essential to formation of the limited partnership but will be required by title insurance companies, ¶ *4:209*). [Corps.C. § 15902.01(e)]

The recording creates a conclusive presumption in favor of bona fide purchasers or encumbrancers for value of partnership real property located in the county where the certificate was recorded, that the persons named as general partners therein constitute all of the general partners. [Corps.C. § 15902.01(e)]

➪ [4:210] ***PRACTICE POINTER:*** Even if all of the general partners executing the purchase agreement constitute all of the general partners identified in the certificate of limited partnership, it may be advisable to review the limited partnership agreement to ensure that authority to sell the property is vested in the general partners without prior approval by the limited partners.

Alternatively (or perhaps, in addition), the purchase agreement should provide a warranty of authority by the general partner(s) executing the agreement. (*See* ¶ *4:436*.)

Cross-refer: For a comprehensive treatment of partnership (general partnerships, limited partnerships and limited liability partnerships), see Soza & Jann, *Cal. Prac. Guide: Pass-Through Entities* (TRG).

e. Corporations

(1) Authority to convey

(a) [4:211] **Agency authority generally:** Any corporate contract or conveyance binds the corporation if made in the name of the corporation and either authorized (or ratified) by the board of directors or within the signing officer's actual or apparent scope of authority (or agency power). [Corps.C. § 208(b)]

(b) [4:211.1] **Signatures barring defense of lack of authority:** Absent the other party's (buyer's) actual knowledge that a signing officer lacked authority, the corporation is *bound by*, and cannot assert lack of authority to avoid liability under, a contract or conveyance signed by (i) the board chairman, president or any vice president, *and* (ii) the secretary, any assistant secretary, chief financial officer or assistant treasurer. [Corps.C. § 313]

1) [4:211.2] **Purpose and effect:** If its requirements are met, Corps.C. § 313 precludes invalidation of a corporate instrument on the basis of lack of authority *despite* evidence the signing officers had no authority to execute the instrument on the corporation's behalf. The statute thus operates as a *conclusive presumption of authority;* it effectively creates a "safe harbor," the purpose of which is to afford third parties protection from subsequent efforts by the corporation to disavow its agents' authority in order to avoid its contractual obligations. [*Snukal v. Flightways Mfg., Inc.* (2000) 23 C4th 754, 782-784, 98 CR2d 1, 24-26]

a) [4:211.3] **Compare—other bases for disaffirmance:** Corps.C. § 313 conclusively presumes only the signing officers' authority to bind the corporation to the contract. The corporation is *not* thereby prevented from challenging the validity of the agreement on a theory *other than* lack of authority—such as fraud, mistake or failure of consideration. [*Snukal v. Flightways Mfg., Inc.* (2000) 23 C4th 754, 783, 98 CR2d 1, 25, fn. 10]

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2) [4:211.4] **"Two-hat" officers—discrete signatures not required:** The statute does not require that the signing officers be separate individuals or that they specify the office or offices they hold. Thus, although Corps.C. § 313 applies only where officers in each of the two designated categories (¶ *4:211.1*) execute the instrument, the statute is satisfied when *one individual* who in fact *holds offices in each of the two* described categories signs … even if both corporate offices are not recorded on the face of the instrument. [*Snukal v. Flightways Mfg., Inc.* (2000) 23 C4th 754, 785-787, 98 CR2d 1, 27-28 (corporate president who signed lease on corporation's behalf was also its secretary and chief financial officer)]

3) [4:211.5] **Compare—enforceability of contract where § 313 criteria not met:** Corps.C. § 313 provides only *one* basis for validating the authority of corporate signatories; it is not the exclusive means of establishing whether a corporate signatory binds the corporation. Thus, even when lacking the signature(s) of the specified categories of officers, a corporate contract may be validated under traditional common law theories by proving the actual, apparent or ostensible authority of the signatory. [*Snukal v. Flightways Mfg., Inc.* (2000) 23 C4th 754, 783-784, 98 CR2d 1, 25-26]

4) [4:211.6] **Basis for notice of ultra vires act:** Third parties may be imputed with notice that a conveyance is not authorized if the recorded conveyance instrument does not comply with Corps.C. § 313. [See *In re AME Zion Western Episcopal Dist.* (BC ED CA 2021) 629 BR 69, 80—recorded deed signed by only 1 corporate officer "imputes notice to the [lenders] that the transfer may not have been authorized"]

(2) [4:212] **Corporate resolution advisable:** Despite the Corps. Code provisions (¶ 4:211.1 ff.), it behooves buyers to insist upon a corporate resolution by the seller's board of directors authorizing the sale. This will ensure that the officers' action in signing the purchase agreement is pursuant to *specific* corporate authority. Also, some title insurance companies require such a corporate resolution (although there is not uniform consistency on this point within the industry).

(3) [4:212.1] **Enforceability of preincorporation contracts:** Preincorporation contracts made for the benefit of a corporation to be formed are fully enforceable by the corporation after it is organized and has adopted or ratified the contracts. [*El Rio Oils v. Pacific Coast Asphalt Co.* (1949) 95 CA2d 186, 192-193, 213 P2d 1, 5—preincorporation contract for sale of oil to asphalt corporation fully enforceable once asphalt corporation came into existence and ratified same; see also *02 Develop. LLC v. 607 South Park, LLC* (2008) 159 CA4th 609, 612, 71 CR3d 608, 610 (enforceability of preorganization assignments of real estate purchase agreements; *see* ¶ *4:214.5*)]

Cross-refer: For a comprehensive treatment of the law governing corporations, see Friedman, Soza & Jann, *Cal. Prac. Guide: Corporations* (TRG).

f. [4:213] **Unincorporated associations:** An "unincorporated association" is "an unincorporated group of two or more persons joined by mutual consent for a common lawful purpose, whether organized for profit or not." Joint tenancy (¶ *4:146 ff.*), tenancy in common (¶ *4:140 ff.*), community property (¶ *4:166 ff.*), or other form of property ownership does not itself establish an unincorporated association "even if coowners share ownership of the property for a common purpose." Likewise, an unincorporated association is not established simply by a marriage or creation of a registered domestic partnership. [Corps.C. § 18035]

(1) [4:213.1] **Authority to convey:** An unincorporated association may acquire, hold, manage, encumber or transfer real property. [Corps.C. § 18105] A conveyance of real property by an unincorporated association must be executed by its "president and secretary or other comparable officers," or by a person specifically designated by the association's duly-adopted resolution, "or by a committee or other body or person authorized to act" by the association's governing principles. [Corps.C. § 18115]

(2) [4:213.2] **Statement of authority; BFP rights:** An unincorporated association may record a verified and acknowledged "statement of authority" in any county in which it owns or has an interest in real property, setting forth the name of the association, the names and titles or capacity of its officers and other persons authorized on its behalf to transfer, acquire or encumber real property. Any bona fide purchaser, transferor or encumbrancer for value of the association's real property located in the county where the statement of authority has been recorded has the benefit of a *conclusive presumption* that a person designated in the statement is authorized to transfer, acquire or encumber the property. [Corps.C. § 18120(a), (c)]

(3) [4:213.3] **Recordation to evidence surviving entity's property ownership after association's merger:** An unincorporated association may merge into a domestic or foreign corporation, general or limited partnership, or limited liability company, so long as each constituent entity is duly authorized to effect the merger. [Corps.C. § 18360]

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If the surviving entity succeeds to ownership of California real property as a result of the merger, its record ownership may be evidenced by recording in the county where the property is located a copy of the merger agreement duly signed by the appropriate officers of the constituent entities. [Corps.C. § 18390]

g. Limited liability companies (LLCs)

(1) [4:214] **Nature of LLC—in general:** California law recognizes a hybrid form of business entity known as a "limited liability company" (LLC, Corps.C. § 17701.01 et seq.). If structured properly, LLCs combine a corporation's limited liability protection with the pass-through taxation of partnerships, but without the restrictions imposed on limited partners and Subchapter S corporations. Thus, owners of an LLC interest ("members"), like shareholders of a corporation, generally are not personally liable for the entity's debts (Corps.C. § 17703.04(a)(2)); and an LLC's income or loss, like that of a partnership, is passed through to its members (see IRC §§ 701, 702(a)).

An LLC may have one or more members (who can be almost any person or form of legal entity). [Corps.C. § 17702.01(a)] It springs into existence upon filing of executed articles of organization with the Secretary of State (see Corps.C. §§ 17702.01, 17704.07); either before or after filing the articles, the members also must enter into an "operating agreement" (which need not be a formal written document). [See Corps.C. §§ 17701.02(s), 17701.10, 17701.11(c)]

Cross-refer: For a comprehensive treatment of LLCs, see Soza & Jann, *Cal. Prac. Guide: Pass-Through Entities* (TRG).

(2) [4:214.1] **Authority to convey:** Management of an LLC's business is vested in *all* LLC members *unless* the articles of organization and the operating agreement provide otherwise. [Corps.C. § 17704.07 et seq.]

(a) [4:214.2] **No centralized management ("member-managed"):** Where the articles and operating agreement do *not* provide for managers, LLC members' management and control rights are more akin to those of the general partners of a general partnership than to limited partners or corporate shareholders. Each member is deemed an *agent* of the LLC in dealings with third persons and can bind the LLC in the same way a general partner can bind a partnership. [Corps.C. § 17703.01(a)]

(b) [4:214.3] **Centralized management ("manager-managed"):** If the articles of organization provide that the entity's business and affairs are to be managed by or under the authority of one or more designated managers ("centralized management"), only the designated managers (who need not necessarily be LLC members) can bind the LLC. [See Corps.C. § 17704.07(a)(1), (c)(1), (6)]

➪ [4:214.4] ***PRACTICE POINTER:*** The principles set forth at ¶ 4:214.1 ff. make clear the prudence of verifying *who* among LLC owners and/or managers has the authority to bind the LLC before executing a contract to purchase real property owned by an LLC. Buyer's counsel should review the LLC's articles of organization to determine whether the entity has provided for centralized management (and, if so, to identify the authorized managers) … in which event, an LLC member will *not* have authority to bind the entity to the purchase agreement strictly in their capacity as member.

Similarly, even if the articles do not provide for centralized management, prudent buyers will verify that the member purporting to act on the entity's behalf in executing a purchase and sale agreement is *in fact* an LLC member in good standing.

(3) [4:214.5] **Enforceability of preorganization agreements:** An LLC may enforce any preorganization contract made on its behalf (e.g., preorganization assignment of real estate purchase agreement) once the LLC formally "comes into existence" and either adopts or ratifies the contract. It is immaterial whether the LLC existed at the time the assignment was executed. [See *02 Develop. LLC v. 607 South Park, LLC* (2008) 159 CA4th 609, 612, 71 CR3d 608, 610]

h. [4:215] **Minors:** Minors (any person under age 18, Fam.C. § 6500) may acquire title to property. [*In re Scott K.* (1979) 24 C3d 395, 405, 155 CR 671, 676-677] However, unless emancipated (e.g., person has entered into valid marriage/domestic partnership or is on active military service; see Fam.C. § 7002), minors may transfer or encumber real property, or make a contract to do so, only if the conveyancing instrument is executed by a duly appointed guardian. [Fam.C. § 6701; Prob.C. § 1500 et seq.] Any real property contract or deed executed solely by an unemancipated minor is *void* from its inception. [*Hakes Inv. Co. v. Lyons* (1913) 166 C 557, 561, 137 P 911, 913; *Sparks v. Sparks* (1950) 101 CA2d 129, 136, 225 P2d 238, 243]

i. [4:216] **Trust:** A trust is not itself a legal entity (unlike a corporation). Legal title to property owned by a trust is held by the trustee; thus, the trustee should execute both the sale contract and instrument of conveyance. [*Stoltenberg v. Newman* (2009) 179 CA4th 287, 293, 101 CR3d 606, 611; see also *Portico Mgmt. Group, LLC v. Harrison* (2011) 202 CA4th 464, 473, 136

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CR3d 151, 157—trust is simply collection of assets and liabilities to which trustee holds legal title; *Presta v. Tepper* (2009) 179 CA4th 909, 914, 102 CR3d 12, 16—ordinary express trusts are not entities separate from their trustees]

(1) [4:216.1] **Capacity in which contract signed:** So long as the trustee has the power to convey property owned by the trust, a sale contract, as well as a deed, is enforceable against the trust even if executed by the trustee in the trustee's individual, rather than representative, capacity. [*Galdjie v. Darwish* (2003) 113 CA4th 1331, 1347-1350, 7 CR3d 178, 190-193—individual signatures of revocable inter vivos trusts' sole trustees and beneficiaries sufficient to convey title; see also *Carne v. Worthington* (2016) 246 CA4th 548, 551, 200 CR3d 920, 922—because decedent as sole trustee of 1985 revocable inter vivos trust had power during his lifetime to convey title to real property held therein, his signature as grantor on 2009 irrevocable inter vivos trust deemed sufficient to convey title to property from 1985 trust to 2009 trust (¶ *4:2172*); *Zanelli v. McGrath* (2008) 166 CA4th 615, 632-634, 82 CR3d 835, 849-850 & fn. 13—settlor and trustee being one and the same, trustee had "equivalent of full ownership" for purposes of transferring title to property held in revocable inter vivos trust; compare *Portico Mgmt. Group, LLC v. Harrison* (2011) 202 CA4th 464, 477, 136 CR3d 151, 160 (distinguishing *Galdjie*)—arbitration judgment erroneously awarded against *irrevocable trust for benefit of trustees' children* in action against trustees for breach of real property sales contract deemed unenforceable]

➪ [4:216.2] ***PRACTICE POINTER:*** When selling trust property, prudence suggests that trustees always specify in the contract (and the deed) that they are signing in their representative capacity on behalf of the trust. [See Prob.C. §§ 18000, 18004]

(2) [4:216.3] **Authority to convey:** To ensure they will have recourse against the trust estate, prospective buyers should examine the trust instrument or a certification of trust (Prob.C. § 18100.5) for verification of the *trustee's authority* to sell; and should also insist on a warranty of authority in the purchase and sale agreement (¶ *4:436*). [See generally, Prob.C. §§ 16200, 16226; *Church v. Church* (1940) 40 CA2d 696, 700, 105 P2d 640, 642—unless forbidden by trust terms, trustee has power to sell trust property as necessary or appropriate for trust purposes; see also Prob.C. §§ 18105-18108 (concerning right to record, and legal effect of recording, affidavit of change of trustee when title to interest in real property is affected by change of trustee)]

Further, if there are multiple trustees, prospective buyers should examine the trust instrument or a certification of trust (Prob.C. § 18100.5) to verify whether all are required to sign in order to properly exercise the power to sell.

(3) [4:217] **Validity of trust—statute of frauds:** Those proposing to purchase real property from a trust also must ensure they are dealing with a trust that was *validly created*. Significantly, a trust "in relation to real property" is subject to a *statute of frauds:* i.e., such a trust is valid *only if evidenced by* (a) a written instrument signed by the trustee or the trustee's duly authorized agent; (b) a written instrument conveying the trust property signed by the settlor or the settlor's duly authorized agent; *or* (c) "operation of law." [Prob.C. § 15206; *Carne v. Worthington* (2016) 246 CA4th 548, 559, 200 CR3d 920, 928, fn. 19]

• [4:217.1] A written declaration of trust by the owner of real property, naming themself as trustee, satisfied the statute of frauds and thus was sufficient to create a trust in real property without the owner having to prepare a separate deed. [*Estate of Heggstad* (1993) 16 CA4th 943, 950, 20 CR2d 433, 436]

• [4:217.2] The statute of frauds also was satisfied absent a separate deed where a settlor, by signing his irrevocable inter vivos trust, conveyed title to specified real property that was held in his earlier revocable inter vivos trust of which he was the sole trustee (¶ *4:216.1*). [*Carne v. Worthington* (2016) 246 CA4th 548, 559, 564, 200 CR3d 920, 928, 932-933, fn. 20]

• [4:217.3] The statute of frauds was satisfied where a settlor stated in their trust instrument that they were conveying *all their real property wherever situated* to themself as trustee, making it possible to determine with certainty which real property was part of the trust's assets by reference to publicly available records. [*Ukkestad v. RBS Asset Finance, Inc.* (2015) 235 CA4th 156, 163-164, 185 CR3d 145, 150-151]

• [4:217.4] A constructive trust imposed as an equitable remedy against a fiduciary who wrongfully acquires real property arises by "operation of law" and thus is not barred by the statute of frauds. [*Mazzera v. Wolf* (1947) 30 C2d 531, 535, 183 P2d 649, 651]

• [4:217.5] *Compare:* The statute of frauds was *not* satisfied where a trust instrument purported to identify the trustors' real property by referring to an attached schedule A. No schedule was attached and the trust instrument itself was devoid of any real property description. Thus, unlike *Ukkestad* (¶ *4:217.3*), there was no writing identifying the trustors' real

property that could be made more certain by extrinsic evidence. [See *Osswald v. Anderson* (1996) 49 CA4th 812, 818, 57 CR2d 23, 26 & fn. 1]

(4) [4:218] **BFP rights:** A person acting in good faith and for value, and without actual knowledge that the trustee is exceeding or improperly exercising their powers (i.e., a BFP), may assume without inquiry that the trustee is acting within the proper exercise of the trustee's powers; and such person is "fully protected" in dealings with the trustee as if the trustee has and is properly exercising the power the trustee purports to exercise. [Prob.C. § 18100]

[4:219] *Reserved.*

j. [4:220] **Conservators:** A conservator may be appointed by the court (voluntarily or involuntarily) for any adult or married minor (or minor whose marriage has been dissolved) who is unable to manage their affairs. [Prob.C. § 1800 et seq.] (A *guardian*, rather than a conservator, may be appointed for a minor who has not been married; Prob.C. § 1500 et seq.)

(1) [4:221] **Contractual capacity:** If the seller is under a conservatorship, and absent court order to the contrary, only the *conservator* (not the conservatee) may convey or encumber title. [Prob.C. § 1872; Civ.C. § 40; see also *O'Brien v. Dudenhoeffer* (1993) 16 CA4th 327, 330-332, 19 CR2d 826, 827-829—same rule applicable where transferor under temporary conservatorship]

Before issuing a title insurance policy, a title insurance company will require a certified copy of the court order appointing the conservator.

(2) [4:222] **BFP rights:** Notwithstanding the general principle set forth at ¶ 4:221, a sale or encumbrance by the *conservatee* in favor of a person acting in good faith and for value, and without knowledge of establishment of the conservatorship (i.e., a BFP), is valid … *unless*, before consummation of the transaction, a notice of establishment of the conservatorship was *recorded* in the county where the real property is located. [Prob.C. § 1875]

(The purpose of § 1875 is to protect innocent third parties who have no notice of the conservatorship and conservatee's resulting incapacity. See Prob.C. § 1875, Law Revision Comm'n Comment.)

(a) [4:223] **Compare—lack of capacity regardless of conservatorship:** However, Prob.C. § 1875 does *not* operate to validate transactions entered into by a conservatee if the conservatee would lack legal capacity absent the establishment of a conservatorship (i.e., under Civ.C. § 38—person "entirely without understanding" has no contractual capacity). Nor does § 1875 prevent *rescission* of a conservatee's transaction under Civ.C. § 39 (see Civ.C. § 39(a)—conveyance or contract by person "of unsound mind" made before their incapacity has been judicially determined). [See Prob.C. § 1875, Law Revision Comm'n Comment]

k. [4:224] **Equity participation lenders:** Lenders who participate in the owner's equity in the property often have the right to approve or disapprove any proposed sale. It is therefore essential that the seller obtain the equity participation lender's written approval before signing a purchase and sale agreement; or, alternatively, the equity participation lender's approval can be a seller's contingency (*see ¶ 4:394*).

Cross-refer: For further discussion of equity participation loans, *see ¶ 6:60 ff.*

l. [4:225] **Powers of attorney:** Purchase agreements and conveyancing instruments may be executed by a person with a valid power of attorney acting on behalf of the owner.

(1) [4:226] **Definitions:** A "power of attorney" is a written instrument giving authority to a person (the "attorney-in-fact") to perform certain acts for the person executing the power (the "principal"). [See Prob.C. §§ 4014, 4022, 4026; *Rosenberg v. C.W. Clarke Co.* (1962) 200 CA2d 178, 186, 19 CR 191, 197]

An attorney-in-fact is an *agent* for the person empowering the attorney-in-fact to act; therefore, powers of attorney are governed generally by agency law (Civ.C. § 2295 et seq.) except to the extent a more specific rule applies under the Power of Attorney Law (Prob.C. § 4000 et seq.). [Prob.C. § 4051]

(2) [4:226.1] **Must be in writing:** Since an agreement for the sale of real property must be in writing (*see ¶ 4:263 ff.* re statute of frauds), so too must a power of attorney authorizing a third person to make such a contract. [Civ.C. §§ 1624(a)(3), 2309; see also Prob.C. §§ 4121 & 4122 re execution formalities under Power of Attorney Law]

The same rule applies to the conveyancing instrument (the deed): Being an executed contract, a deed is subject to the rules applicable to contracts. Therefore, an agent's authority to execute a deed on behalf of the principal must be conferred in writing. [Civ.C. § 1091; *Estate of Stephens* (2002) 28 C4th 665, 672, 122 CR2d 358, 362—conveyance by agent not authorized when no written authority to execute deed as principal's agent]

(3) [4:227] **Interpretation:** Powers of attorney are strictly interpreted according to the language creating the power. [*Rosenberg v. C.W. Clarke Co.* (1962) 200 CA2d 178, 186, 19 CR 191, 197; see Civ.C. § 2321]

An agent's conveyance beyond the scope of the power conferred is void. [See *Estate of Stephens* (2002) 28 C4th 665, 672, 122 CR2d 358, 362-363—power of attorney authorizing agent to "sell, convey, and transfer" real property for principal's benefit did *not* authorize conveyance as gift or without substantial consideration (thus, agent's conveyance of property to herself as gift void)]

(a) [4:227.1] **"Necessary" incidental powers implied:** On the other hand, notwithstanding the rule of strict construction, an attorney-in-fact is deemed empowered to do all acts necessary and proper within the scope of authority expressly granted. [See Prob.C. §§ 4261, 4262, 4450; Civ.C. § 2319; *County of Los Angeles v. Stuyvesant Ins. Co.* (1964) 227 CA2d 428, 431, 38 CR 713, 715]

(4) [4:228] **"General" and "limited" powers:** Powers of attorney can be "general" or "limited" (or "special"). A general power authorizes the attorney-in-fact to transact *all* kinds of business for the principal. [Prob.C. § 4261; see also Prob.C. § 4401 (statutory form power of attorney); *Moore v. Gould* (1907) 151 C 723, 727-728, 91 P 616, 618] A limited (or special) power *restricts* the attorney-in-fact's authority to those acts *specified* in the power of attorney (plus incidental acts necessary to carry out the expressly-granted authority). [Prob.C. § 4262; see also Prob.C. § 4450 (construction of powers granted in statutory form power of attorney)]

If the power of attorney contains language that both limits the acts of the attorney-in-fact and suggests that a general power of attorney exists, the attorney-in-fact will be limited by the *particular terms and designations*. [*Washburn v. Alden* (1855) 5 C 463, 464; see also Civ.C. § 2321]

(5) [4:229] **Types of powers of attorney:** Powers of attorney, whether general or limited, may be executed in a variety of fashions—e.g., durable powers, springing powers, joint powers, and powers coupled with an interest.

(a) [4:230] **Durable power:** A durable power of attorney is created pursuant to Prob.C. § 4124. Its distinguishing characteristic from nondurable powers is that it may be exercised notwithstanding the principal's subsequent incapacity; or may be designated to take effect only upon the principal's subsequent incapacity. [See Prob.C. §§ 4018, 4124, 4155]

Upon the principal's incapacity, the attorney-in-fact is accountable to any court-appointed conservator or other fiduciary for the principal; and the power may be revoked by the principal's conservator upon court order. [See Prob.C. § 4206]

(A special form of durable power, separately regulated by Prob.C. § 4600 et seq. (the Health Care Decisions Law), empowers an attorney-in-fact to make health care decisions for the principal upon the principal's incapacity. See discussion in Ross & Cohen, *Cal. Prac. Guide: Probate* (TRG), Ch. 1.)

1) [4:230.1] **Mandatory warning statements in preprinted form:** A preprinted form durable power of attorney, promulgated for use by persons who do not have the advice of legal counsel, *must* contain two statutorily-prescribed warning statements: one to the person executing the document, and another to the person accepting the appointment as attorney-in-fact. [See Prob.C. § 4128(a); and detailed discussion in Ross & Cohen, *Cal. Prac. Guide: Probate* (TRG), Ch. 1]

(b) [4:231] **Springing power:** A springing power of attorney takes effect only at a specified future time or on the occurrence of a specified event or contingency; it may be a durable or nondurable power. [Prob.C. § 4030]

In a springing power of attorney, the principal may designate one or more persons who have the authority to conclusively determine, by written declaration under penalty of perjury, that the specified event or contingency has occurred … at which point, the power of attorney becomes effective. [See Prob.C. § 4129]

(c) [4:232] **Joint power:** A joint power of attorney confers authority on the attorney-in-fact to act with respect to two or more principals' joint and separate property. [*Cousino v. Western Shore Lumber Co.* (1918) 179 C 1, 4-5, 175 P 406, 407]

1) [4:232.1] **Compare—multiple powers:** A principal may designate multiple attorneys-in-fact in more than one power of attorney, in which case their authority is generally exercisable only by their unanimous action. [Prob.C. § 4202]

If the powers of attorney grant inconsistent authority to more than one attorney-in-fact, the authority granted last in time controls to the extent of the inconsistency. [See Prob.C. § 4130]

(d) [4:233] **Power coupled with interest:** A power of attorney is "coupled with an interest" if the attorney-in-fact acquires an interest in the subject of the power of attorney. [*Jay v. Dollarhide* (1970) 3 CA3d 1001, 1023, 84 CR 538,

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551-552 (disapproved on other grounds by *Morris v. Thogmartin* (1973) 29 CA3d 922, 930, 105 CR 919, 924 which, in turn, was disapproved on other grounds by *McAdams v. McElroy* (1976) 62 CA3d 985, 994, 133 CR 637, 643); see also *Bonfigli v. Strachan* (2011) 192 CA4th 1302, 1309, 122 CR3d 447, 452-453—power and interest are united in same person for purpose of protecting their interest in agency's subject and its value]

The Power of Attorney Law (Prob.C. § 4000 et seq.) does not apply to a power of attorney to the extent it is coupled with an interest. [Prob.C. § 4050(b)(1); see also *Bonfigli v. Strachan*, supra, 192 CA4th at 1309, 122 CR3d at 453—"this kind of power of attorney is not an 'agency' as that term is commonly understood," i.e., holder is not subject to creator's control and does not owe creator fiduciary duties]

1) [4:233.1] **Prerequisites:** For an agency or power to be "coupled with an interest," it must (i) be held for the benefit of the agent, not the principal; (ii) be created to secure the performance of a duty to the agent or to protect a title in the agent; and (iii) be created at the same time that the duty or title is created. [*Becket v. Welton Becket & Associates* (1974) 39 CA3d 815, 820, 114 CR 531, 533]

2) [4:233.2] **Not revocable:** A power of attorney usually is revocable at any time by the principal because it is created for the benefit of the principal (Prob.C. § 4150 et seq.). However, when the agency is for the benefit of the *agent*, it is not freely revocable by the principal. [*Becket v. Welton Becket & Associates* (1974) 39 CA3d 815, 820, 114 CR 531, 533]

Indeed, "[g]iven the unusual nature of a power coupled with an interest—in that it is not a true agency because the power is not controlled by the principal nor is it required to be exercised in the interest of the principal—the power is not merely revocable upon extinction of the interest but *is itself extinguished at the time the interest in the subject matter terminates*." [See *Bonfigli v. Strachan* (2011) 192 CA4th 1302, 1311-1313, 122 CR3d 447, 454-456 (emphasis added)—developer's power over two land parcels was extinguished after developer assigned (terminated) its underlying interest in option to purchase]

(6) [4:234] **Statutory form power of attorney:** California has adopted the Uniform Statutory Form Power of Attorney Act (Prob.C. § 4400 et seq.), under which a durable power of attorney (or a nondurable power if so indicated by the principal) may be created using a standard statutory form (Prob.C. § 4401).

The standard statutory form gives the principal the option of granting a broad range of powers (see Prob.C. §§ 4401, 4450 et seq.) or any one or more of them as specifically designated, including the power to engage in "real property transactions." However, the form does not include all powers available under the Probate Code, any of which may be added by specifically listing it under the form's special instructions section.

➪ [4:234.1] ***PRACTICE POINTER:*** For those unsophisticated in business dealings, using the statutory form power can be risky. The particular powers listed on the form are described by general label only and thus can be misleading. Indeed, unless modified by the principal, a statutory form power of attorney grants the attorney-in-fact expansive authority with regard to each of the listed subjects. For instance, the power to engage in "real property transactions" includes far more than authority to sell, lease or encumber (see Prob.C. §§ 4450, 4451).

(7) [4:235] **Recordation:** There is no general legal requirement that a power of attorney be recorded (but see Civ.C. § 2933—power of attorney to execute mortgage or deed of trust must be recorded). Nonetheless, if the seller's attorney-in-fact will be signing the deed (or other conveyancing instrument to be recorded), the title insurance company will require that the power of attorney be *of record* (recorded in the county where the property is located). (Likewise, no revocation of a recorded power of attorney is effective unless the revocation is itself recorded. Civ.C. § 1216.)

On the other hand, title insurance companies are not concerned about an attorney-in-fact's authority to execute the *purchase agreement*. Thus, the power of attorney need not be recorded if used only for the purpose of authorizing the attorney-in-fact to sign the real property purchase contract (or any other document that will *not* be recorded).

(8) [4:236] **Revocation of power of attorney:** A power of attorney may be revoked by the principal (even if it states it is irrevocable), unless it is coupled with an interest (*¶ 4:233.2*). [See Prob.C. §§ 4151, 4153]

Also, unless it is coupled with an interest or a durable power (*¶ 4:230*), a power of attorney is revoked by operation of law upon the death or incapacity of the principal or attorney-in-fact. [See Prob.C. §§ 4152(a)(7) & (9), 4155; *Jay v. Dollarhide* (1970) 3 CA3d 1001, 1023, 84 CR 538, 552 (disapproved on other grounds by *Morris v. Thogmartin* (1973) 29 CA3d 922, 930, 105 CR 919, 924 which, in turn, was disapproved on other grounds by *McAdams v. McElroy* (1976) 62 CA3d 985, 994, 133 CR 637, 643); see also Civ.C. § 1216—revocation of recorded power of attorney must be recorded]

(a) [4:236.1] **Limitation as to "innocent" third persons/attorney-in-fact:** However, a revocation is not effective as against a third person who, without actual knowledge of the revocation, enters into a transaction with the attorney-in-fact. And, as to acts undertaken in good faith reliance thereon, the attorney-in-fact's affidavit stating that, at the time of exercise of the power, the attorney-in-fact did not have actual knowledge of a revocation of the power, is *conclusive proof* of nonrevocation of the power at that time. [See Prob.C. §§ 4151(b), 4152(b), 4153(b), 4304, 4305]

(9) [4:237] **Practical considerations in drafting powers of attorney:** When a power of attorney is used in a real property sale transaction, it must satisfy the other party *and* the escrow holder, title insurance company and sometimes a lender. Thus, the power should clearly specify the entire scope of the attorney-in-fact's authority—including the authority (as applicable) to execute the purchase agreement, escrow instructions (and any amendments thereto), the conveyancing instrument, and all other documents essential to close the deal, as well as the power to take all other actions which may be necessary or beneficial to consummate the transactions contemplated by the contract.

FORM: Power of Attorney (Limited) for Real Property Purchase and Sale Transaction, *see Form 4:F*.

Cross-refer: For a detailed treatment of the use of powers of attorney in general, see Ross & Cohen, *Cal. Prac. Guide: Probate* (TRG), Ch. 1.

[4:238 - 4:239] ***Reserved.***

4. [4:240] **Status of Buyer (How Buyer Takes Title):** Much of the discussion concerning the status of sellers (¶ 4:185 ff.), applies as well to the status of buyers. However, certain considerations are uniquely relevant to buyers:

a. [4:241] **Tenancies in common and other co-ownership arrangements:** Buyers taking title as co-owners should have an agreement in place prior to, or effective upon, closing of the sale, as to their ownership rights and obligations.

Cross-refer: Co-ownership agreements are discussed in detail in *Ch. 12*.

b. Partnerships and joint ventures

(1) [4:242] **Need for partnership agreement, statement of partnership or certification:** Some (but not all) title insurance companies refuse to issue a title insurance policy to partnership buyers until furnished with a copy of an executed partnership agreement (whether a general or limited partnership). And all title companies require the filing and recordation of a statement of partnership authority (in the case of a general partnership, *¶ 4:204 ff.*) or a certificate of limited partnership (in the case of a limited partnership, *¶ 4:209 ff.*) before issuing title insurance to a partnership buyer.

➪ [4:243] ***PRACTICE POINTER:*** Even in those rare instances where title insurance is not being obtained (*see Ch. 3*), a partnership buyer should record its statement of partnership authority or certificate of limited partnership (as the case may be) *before* recordation of the conveyancing instrument. This will put the partnership's existence in the chain of title.

(2) [4:244] **Impact on closing:** As a practical matter, it is imprudent for a partnership buyer to close without an executed partnership agreement. Even so, the closing usually can still occur (and title insurance issued) even if the buyer's partnership agreement is not yet finalized and executed, so long as the appropriate statement of partnership authority or certificate of limited partnership exists. But the converse is not true: Notwithstanding a comprehensive partnership agreement, no title insurance company will issue a policy without a recorded statement of partnership authority or certificate of limited partnership.

c. [4:245] **Corporations:** Title insurance companies rarely require a corporate buyer's corporate resolutions. But the seller may want to see such resolutions (or, alternatively, may insist on the signing officer's warranty of authority) to circumvent a later claim that the purchase agreement is "ultra vires" (transaction prohibited by articles of incorporation).

➪ [4:245.1] ***PRACTICE POINTER:*** In practical effect, the "ultra vires" doctrine should be no obstacle to the validity of the transaction (see Corps.C. § 208(b), *¶ 4:211*). Indeed, a seller's concern about the authority of individuals executing the purchase agreement on behalf of a corporate buyer can be minimized by adhering to the Corps.C. § 313 "safe harbor" (which will bar the corporation from claiming lack of authority; *see ¶ 4:211.1 ff.*). The seller should, however, verify that those who sign the agreement are in fact duly-appointed officers of the corporation.

d. [4:246] **Unincorporated associations:** The acquisition of an interest in real property by an unincorporated association (*¶ 4:213*) must be executed by its "president and secretary or other comparable officers," or by a person specifically designated

by the association's duly-adopted resolution, "or by a committee or other body or person authorized to act" by the association's governing principles. [Corps.C. § 18115; *see also* ¶ *4:213.2* re recorded "statement of authority"]

e. [4:247] **Trusts:** Trustees buying real property on behalf of a trust must record a Memorandum of Trust before a title company will issue its policy of insurance. (*See* ¶ *4:216*.)

f. [4:248] **Entities not yet formed:** Occasionally, buyers intend to form an entity to take title to the property; such buyers should execute the purchase agreement in their individual names and provide for a right of assignment.

➪ [4:249] ***PRACTICE POINTER:*** Do *not* execute any contract in the name of an entity *not yet in existence*.

Doing so may leave the contract vulnerable to avoidance by the seller for lack of contractual capacity (Civ.C. § 1550(1)); and the signing entity will have no standing to enforce the contract because it has not come into existence. (*Compare* ¶ *4:37c* re validity of *deed* transferring property to yet-to-be-formed trust.)

(Of course, this is more of a problem for corporations, limited partnerships and limited liability companies, which require certain statutory prerequisites to formation. It is generally no impediment for general partnerships, which may exist pursuant to an oral or informal written agreement. Even so, it is not wise for any contemplated entity, not yet formed, to enter into business transactions without a clear understanding among the principals regarding their rights and obligations.)

g. [4:250] **Spouses and registered domestic partners—community property vs. joint tenancy vs. other co-ownership forms:** Spouses and registered domestic partners often want advice regarding whether they should take title to the property as community property; there is no simple answer. (That the parties will be buying the property with community funds does not necessarily mean they must take title as community property. They can agree to another form of ownership, and may effectively "transmute" the community property character to either party's separate property; see Fam.C. §§ 850-853, and detailed discussion in Hogoboom & King, *Cal. Prac. Guide: Family Law* (TRG), Ch. 8.)

Typically, the decision is made from an estate planning perspective: i.e., whether the parties want a right of survivorship (joint tenancy title, ¶ *4:146 ff.*, or community property with right of survivorship, ¶ *4:177 ff.*) so as to avoid a formal probate of the property upon the first spouse's/domestic partner's death. Accordingly, the buyer's estate plans should be discussed before the closing.

Also the form of title decision should reflect consideration of consequential *tax ramifications*. On this point, remember that if the buyer wants to transfer title *after* the closing (to conform with the buyer's estate plan), the transfer may constitute a "change in ownership" triggering property tax reassessment and/or an additional documentary transfer tax (Rev. & Tax.C. § 11911). [See Rev. & Tax.C. § 61; *and* ¶ *13:65 ff.*]

[4:251 - 4:254] ***Reserved.***

5. Other Parties to the Purchase Agreement

a. [4:255] **Real estate brokers:** Third persons (anyone other than buyer and seller) are *rarely* made parties to the purchase agreement. Those few third party situations typically involve the seller's and/or buyer's real estate broker (either as a party to the contract or as a third party beneficiary).

(Compare: More often, third parties acquire rights under the agreement by way of an *assignment*. But they are not "parties" to the contract when it is executed.)

➪ [4:256] ***PRACTICE POINTER:*** Usually, the broker's only interest in being a party to the purchase agreement is to ensure the payment of commissions. But this invariably complicates the transaction and/or can lead to liability (e.g., a broker who is a party to the contract might thereby have a contractual right to sue the buyer and/or seller for commissions; *see* ¶ *4:578*). Indeed, the broker's right to commissions can be easily protected *without* making the broker a party to the purchase contract:

• Ordinarily, the seller is already bound to pay a broker's commission by reason of a listing agreement (*Ch. 2*). A second contract for payment of the commission would only be superfluous.

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- If an escrow is used, the seller can instruct the escrow holder to pay the broker's commission out of the seller's proceeds (*see ¶ 4:578 ff.*). In this manner, the broker has the specific right to receive proceeds from the sale even though not a party to the underlying purchase agreement.

  Cross-refer: Real estate brokers and listing agreements are discussed in detail in *Ch. 2*.

b. [4:257] **Other third persons:** Occasionally, it may be beneficial to have third parties who hold some interest of record execute the purchase contract or some other instrument to evidence their agreement to relinquish their interest at the closing. For example, if a party is the holder of an option to purchase, a right of first refusal to purchase, or some other preemptive purchase right of record but which has expired (or will be relinquished at or before the closing), it is advisable to have the party "sign off" at the inception of the transaction.

c. [4:257a] **Third party beneficiaries:** *See ¶ 4:525*.

[4:258 - 4:259] ***Reserved.***

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Cal. Prac. Guide Real Prop. Trans. Ch. 4-D

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 4. Purchase and Sale Agreement

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1. [4:260] **General Concerns:** Except to the extent the agreement must be in writing (¶ *4:263 ff.*) and subject to statutes governing certain types of purchase and sale agreements (e.g., home equity sales contracts, ¶ *4:279.5*), no particular form of real property purchase agreement is required by law. In practice, the form and structure of the contract (both as to substance and timing) are dictated by the parties' goals.

a. [4:261] **Competing concerns:** The chief difficulty typically encountered by counsel is balancing two basic competing interests: the parties' (and their brokers') desire, on the one hand, to commit to the transaction legally and emotionally by "signing a deal," against counsel's desire, on the other hand, to ensure that any document evidencing the transaction is lucid, complete and legally enforceable. While the parties are usually intensely motivated to have "something" in writing, counsel are more concerned about the *legal* issues; significantly:

• Whether the writing satisfies the statute of frauds (¶ *4:263 ff.*);

• Whether the writing creates a binding, enforceable agreement (or whether it is intended to be nonbinding, ¶ *4:275 ff.*);

• Whether the contract includes the mechanics for closing the transaction (typically, creation of an escrow, ¶ *4:560 ff.*);

• Whether various statutory requirements relating to such matters as liquidated damages (¶ *4:310 ff.*) and disclosure statements (¶ *4:354 ff.*) have been satisfied.

b. [4:262] **Threshold issue:** Regardless of the label given the document, there are only two legally recognized kinds of written agreements pertaining to the sale of real property: (1) a binding, complete, enforceable agreement; or (2) a nonbinding memorandum for purposes of further negotiations and/or documentation. Thus, the initial critical issue is whether the parties want a preliminary memorandum of understanding for purposes of further discussion (i.e., a preliminary agreement leading up to the negotiation and memorialization of a more complete document) or whether they want to proceed directly from oral discussions to a binding and complete written agreement.

2. [4:263] **Statute of Frauds:** A binding, enforceable agreement for the sale of real property must be stated *in a signed writing* sufficient to satisfy the *statute of frauds* (Civ.C. §§ 1624(a)(3), 1698(c), 1091; CCP § 1971):

> **Civ.C. § 1624(a):** "The following contracts are invalid, unless they, or some note or memorandum thereof, are *in writing* and *subscribed by the party to be charged* or by the party's agent: …
>
> "(3) An agreement for the leasing for a longer period than one year, or *for the sale of real property*, or of an interest therein; such an agreement, if made by an agent of the party sought to be charged, is invalid, unless the *authority of the agent is in writing*, subscribed by the party sought to be charged." [Civ.C. § 1624(a)(3) (emphasis added)]
>
> **Civ.C. § 1698(c):** "… The statute of frauds (Section 1624) is required to be satisfied if the contract *as modified* is within its provisions." [Civ.C. § 1698(c) (emphasis added); and see *Secrest v. Security Nat'l Mortg. Loan Trust 2002-2* (2008) 167 CA4th 544, 553, 84 CR3d 275, 282—agreement to modify contract that is subject to statute of frauds also is subject to statute of frauds]
>
> **Civ.C. § 1091:** "An estate in real property, other than an estate at will or for a term not exceeding one year, can be transferred *only* by operation of law, or by an *instrument in writing, subscribed by the party disposing of the same*, or by his *agent* thereunto *authorized by writing*." [Civ.C. § 1091 (emphasis added); see also CCP § 1971, containing similar language]

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The primary purpose of the statute of frauds is to "require reliable *evidence* of the existence and terms of the contract and to prevent enforcement through fraud or perjury of contracts never in fact made." [*Sterling v. Taylor* (2007) 40 C4th 757, 766, 55 CR3d 116, 123 (emphasis added); *Lee v. Lee* (2009) 175 CA4th 1553, 1556, 97 CR3d 516, 519]

Cross-refer: The statute of frauds also applies to options to purchase (Civ.C. § 1624(a)(3), ¶ *8:75 ff.*); to the purchaser's assumption of an indebtedness secured by mortgage or deed of trust on the purchased property (Civ.C. § 1624(a)(6), ¶ *6:323*); and to real estate broker commission agreements (Civ.C. § 1624(a)(4), ¶ *2:281 ff.*).

a. [4:263.1] **Any agreement for sale or interest in real property:** The statute of frauds (Civ.C. § 1624(a)(3), ¶ *4:263*) applies to *any agreement* for the sale of real property or an interest in real property, including agreements to modify such contracts. [See *Reeder v. Specialized Loan Servicing LLC* (2020) 52 CA5th 795, 801-802, 266 CR3d 578, 583-584—alleged oral agreement subject to statute of frauds even if it preceded loan and trust deed because it changed and eliminated written agreement's terms; *Smyth v. Berman* (2019) 31 CA5th 183, 197, 242 CR3d 336, 348—statute of frauds applicable to commercial tenant's alleged agreed-upon right of first refusal to purchase leased building (¶ 4:272.6); *Rossberg v. Bank of America, N.A.* (2013) 219 CA4th 1481, 1503, 162 CR3d 525, 543—statute of frauds applicable to loan modification agreements]

(1) [4:263.1a] **Sale between partners/joint venturers included:** There is a line of authority recognizing that oral agreements among *partners or joint venturers* relating to real property are not within the statute of frauds. However, most of these cases involve agreements that only tangentially affect an interest in or disposition of real property (e.g., agreement to share profits from a real estate transaction). The statute of frauds is *fully applicable* to an agreement by one partner or joint venturer to transfer an interest in real property to another member of the partnership or joint venture. [See *Kaljian v. Menezes* (1995) 36 CA4th 573, 583-586, 42 CR2d 510, 516-518, and cases cited therein]

(2) [4:263.2] **Limited exception—sale of real property negotiated at judicially-supervised settlement conference:** An oral settlement for the sale of real property, if agreed to by the parties "before the court" (i.e., at a *judicially-supervised* proceeding), is enforceable pursuant to CCP § 664.6 notwithstanding that it was never reduced to a signed writing. In effect, the court's participation in and supervision of the settlement process serves the same function as the statute of frauds in preventing fraud and perjury. [*Kohn v. Jaymar-Ruby, Inc.* (1994) 23 CA4th 1530, 1534-1535, 28 CR2d 780, 782-783 (involving Civ.C. § 1624(a)(1) statute of frauds re agreements not capable of performance within one year)—"statute of frauds was never intended to bar enforcement of judicially supervised settlements"; see also *BTHHM Berkeley, LLC v. Johnston* (2024) 100 CA5th 1220, 1222, 1225-1226, 319 CR3d 852, 853, 855-856 (certified for partial publication)—settlement term sheet entered into between commercial landlord and cannabis dispensary tenant following mediation deemed fully enforceable under CCP § 664.6 while unauthorized prejudgment interest award that differed "materially" from parties' agreement was reversed (concluding § 664.6 authorizes entering judgments that reflect parties' settlement agreement terms—i.e., "nothing more and nothing less")]

b. [4:264] **Compare—formation of contract:** Compliance with the statute of frauds should not be confused with basic contract law concerning offer, acceptance and formation of a contract. Thus, although there may be a written document that ostensibly satisfies the execution requirement of the statute of frauds (¶ *4:266*), there must still be an offer to sell on specified terms and an "absolute" acceptance—i.e., an essential "meeting of the minds." [*Ajax Holding Co. v. Heinsbergen* (1944) 64 CA2d 665, 669-670, 149 P2d 189, 192—buyer's written escrow instructions, modified by sellers before signing, did not form binding purchase contract because buyer never accepted sellers' modifications]

(1) [4:264.1] **Unqualified acceptance required:** An acceptance forms a binding contract only if it is *absolute* and *unqualified*. The offeror's proposed terms must be met "exactly, precisely and unequivocally." [Civ.C. § 1585; *Marcus & Millichap Real Estate Invest. Brokerage Co. v. Hock Invest. Co.* (1998) 68 CA4th 83, 89, 80 CR2d 147, 150; *Roth v. Malson* (1998) 67 CA4th 552, 557, 79 CR2d 226, 229]

(2) [4:264.2] **Qualified acceptance as counteroffer:** A qualified acceptance that fails to give assent to an essential term of the offer, or a purported acceptance on new or different terms, is simply a *counteroffer*. And an acceptance with material changes effectively *rejects* the original offer; the original offer can no longer be accepted to form a contract unless and until renewed by the offeror. [*Niles v. Hancock* (1903) 140 C 157, 161, 73 P 840, 841-842; see *Panagotacos v. Bank of America*

(1998) 60 CA4th 851, 855-856, 70 CR2d 595, 597—buyers' purported acceptance never gave rise to binding purchase agreement because it proposed payment occur elsewhere than specified by offeror (an essential condition of the offer)]

(3) [4:264.3] **Mistakenly-labeled counteroffers:** The parties' *objective intent* as evidenced by the words of the instrument controls its interpretation and, indeed, whether it amounts to a binding contract. [*Harris v. Rudin, Richman & Appel* (1999) 74 CA4th 299, 307, 87 CR2d 822, 828]

Thus, a purported acceptance on terms written in the section of a form contract labeled “counteroffer” or “changes/ amendments” most likely will be treated as a counteroffer—even if the proposed terms in substance match the original offer. Since the parties' *objective* manifestation of intent controls the interpretation, courts generally are reluctant to compare and contrast terms to determine whether there is a material variance when a response to an offer is *facially* presented as a counteroffer. [*Roth v. Malson* (1998) 67 CA4th 552, 559, 79 CR2d 226, 230—no binding contract arose when buyer's purported acceptance of seller's counteroffer was put in section of form contract labeled “counter to counteroffer” and buyer also wrote purchase terms in section labeled “changes/amendments” (immaterial that buyer's terms did not vary from terms of seller's counteroffer); see also *Krasley v. Sup.Ct. (Brennan)* (1980) 101 CA3d 425, 430, 161 CR 629, 632]

➪ [4:264.4] ***PRACTICE POINTER:*** It is not unusual for several counteroffers to pass between the parties. Be sure that an intended acceptance at any stage of this exchange is clearly labeled as such, and that it does not introduce additional terms; this is especially important when the “counteroffers” are presented on *preprinted form contracts* (as demonstrated in the *Roth* case, *¶ 4:264.3*).

When a contract eventually is formed following an exchange of multiple counteroffers, prudence suggests that both parties execute a single document incorporating all of the agreed-upon terms.

(4) [4:264.5] **Effect of reserving essential term for *future agreement:*** Generally, where an essential element of a contract is reserved for the parties' *future* agreement, no legal obligation arises until the future agreement is made. Whether a term is “essential” depends on its relative importance to the parties and whether its absence would make enforcing the remainder of the agreement unfair to either party. [*Copeland v. Baskin Robbins U.S.A.* (2002) 96 CA4th 1251, 1256, 117 CR2d 875, 879 & fn. 3; see *Bustamante v. Intuit, Inc.* (2006) 141 CA4th 199, 213, 45 CR3d 692, 703—because essential terms only sketched out, with final form to be agreed upon in future and subject to third-party approval, parties had at best “agreement to agree”; *and ¶ 4:270 ff.*]

➪ [4:264.5a] ***PRACTICE POINTER:*** It is *never* advisable to include terms in an agreement that are neither specific nor understandable. For example, avoid language that requires the parties to “*act in good faith*” or that suggests a term is *subject to future agreement of the parties.*

(5) [4:264.6] **Effect of no signature:** When it is clear from a provision in a proposed written contract and any other relevant evidence that the parties contemplated that acceptance of the proposed contract's terms would be signified by signing the contract, no binding contract comes into existence until it is signed. [*Basura v. U.S. Home Corp.* (2002) 98 CA4th 1205, 1215, 120 CR2d 328, 335]

(Of course, even if legally formed without signatures, a contract may nonetheless be unenforceable because the *statute of frauds* signature requirement operates independently of formation issues; *see ¶ 4:266 ff.*)

Cross-refer: Contract formation is discussed further in *Ch. 11* in connection with remedies; *see ¶ 11:20 ff.*

c. [4:265] **Writing requirement:** The statute of frauds simply requires that *evidence* of the contract be in writing. The writing need not be in a single document; it may be pieced together from various writings or documents and no particular formality is required. [*Brewer v. Horst-Lachmund Co.* (1900) 127 C 643, 646, 60 P 418, 419; see *Goodman v. Community Sav. & Loan Ass'n* (1966) 246 CA2d 13, 22, 54 CR 456, 462; *Alameda Belt Line v. City of Alameda* (2003) 113 CA4th 15, 21, 5 CR3d 879, 883—municipal *ordinance* may be deemed sufficient written evidence of purchase agreement where one party to agreement is a municipality; compare *Smyth v. Berman* (2019) 31 CA5th 183, 197, 242 CR3d 336, 348 (finding landlord's “equivocal and non-confirmatory” email responses did not evidence contract or set forth “essential contract terms with reasonable certainty”) —email exchange between commercial tenant's attorney and landlord referencing tenant's alleged right of first refusal to purchase leased property did not satisfy statute of frauds; *see also ¶ 4:268*]

Compare: The writing requirement serves only to prevent the contract from being unenforceable under the statute of frauds; it does not necessarily establish the contract terms (*see ¶ 4:270 ff.*). [*Sterling v. Taylor* (2007) 40 C4th 757, 766, 55 CR3d 116, 123]

(1) [4:265.1] **Electronic messages:** Electronic messages of an "ephemeral" nature that are not designed to be retained or to create a permanent record (e.g., text messages and instant message format communications) are insufficient to constitute a contract to convey real property *unless* confirmed in writing as statutorily described. [See Civ.C. § 1624(d)]

d. [4:266] **"Subscribed by the party to be charged":** The statute of frauds is satisfied so long as the "*party to be charged*" (i.e., the person charged with performance of the obligation) signs the writing—all parties to the contract are not technically required to sign. [Civ.C. § 1624(a)(3) (emphasis added); *Harper v. Goldschmidt* (1909) 156 C 245, 248, 104 P 451, 452-453—"party to be charged" does not mean buyer or seller, but person charged in court with performance of the obligation; see also *Ulloa v. McMillin Real Estate & Mortg., Inc.* (2007) 149 CA4th 333, 338-339, 57 CR3d 1, 4-5—"party to be charged" is defendant in action brought to enforce contract; *Secrest v. Security Nat'l Mortg. Loan Trust 2002-2* (2008) 167 CA4th 544, 552, 84 CR3d 275, 281-282 (same)]

➪ [4:266.1] ***PRACTICE POINTER:*** Frequently, the drafting party will send an *unexecuted* copy of the purchase agreement to the other party, requesting that it be signed and returned. A statute of frauds problem arises when the other party executes and returns the contract, but the drafting party then refuses to sign it. Absent an equitable estoppel defense (¶ *4:272.2*) or sufficient "part performance" (¶ *4:271*) to satisfy the statute of frauds, the contract is *unenforceable* against an ostensibly obligated party who failed to sign. [See *Bed, Bath & Beyond of La Jolla, Inc. v. La Jolla Village Square Venture Partners* (1997) 52 CA4th 867, 877, 60 CR2d 830, 836 (involving comparable lease situation)—alleged lease agreement executed by lessee but not lessor unenforceable against lessor]

(1) [4:267] **Manner of execution:** No particular manner of execution is required; parties need not sign their full names, nor need the signature be handwritten (e.g., signature may be typed, lithographed, rubber-stamped or printed). It is sufficient that the "party to be charged" *intended* there to be an execution, regardless of the form or location of the signature. [See *Marks v. Walter G. McCarty Corp.* (1949) 33 C2d 814, 820, 205 P2d 1025, 1028; *Rader Co. v. Stone* (1986) 178 CA3d 10, 23, 223 CR 806, 812; *J.B.B. Investment Partners, Ltd. v. Fair* (2014) 232 CA4th 974, 992, 182 CR3d 154, 168 (citing *Marks* with approval)—printed name relied upon as signature does not satisfy statute of frauds absent proof it was placed on document or adopted by party to be charged (¶ *4:267.1*)]

(a) [4:267.1] **Electronic signatures:** A record, signature or contract may not be denied legal effect or enforceability solely because it is in electronic form or an electronic record was used in its formation. [Civ.C. § 1633.7(a), (b); see also 15 USC § 7001 et seq. ("Electronic Signatures in Global & National Commerce Act")—applicable to interstate or foreign transactions; compare *J.B.B. Investment Partners, Ltd. v. Fair* (2014) 232 CA4th 974, 986-989, 182 CR3d 154, 163-165, 167-168 (noting electronic signature must, among other things, be adopted by person with intent to sign electronic record)—defendant's printed name at end of email responding to proposed settlement terms did not evidence his intent to execute settlement agreement by electronic means, nor did it constitute a signature under contract law]

(2) [4:268] **Piecemeal writings:** Where the "writing" for statute of frauds purposes is made up of several documents, it suffices that *one* of them is signed by the "party to be charged" … so long as, under the circumstances, the writings indicate that they relate to the same transaction. [See Rest.2d Contracts § 132—sufficient memorandum to satisfy statute of frauds; and, e.g., *Karl v. JeBien* (1965) 231 CA2d 769, 772, 42 CR 461, 462]

(3) Execution by agent

(a) [4:269] **"Equal dignities" rule:** An *agent* may sign in the place of the "party sought to be charged." But in that event, the statute of frauds is satisfied only if the *agent's authority* is evidenced by a *writing* signed by the principal ("equal dignities rule"). [Civ.C. §§ 1624(a)(3), 2309; *Ulloa v. McMillin Real Estate & Mortg., Inc.* (2007) 149 CA4th 333, 339, 57 CR3d 1, 5; see *Estate of Stephens* (2002) 28 C4th 665, 672, 122 CR2d 358, 362—where agent did not have written authority to execute deed as principal's agent, conveyance *not* authorized under § 2309]

1) [4:269.1] **Applicable to ratification of agent's invalid act:** The principal's ratification may validate an agent's unauthorized act. But the "equal dignities" rule also applies to a ratification: A principal's ratification of an agent's act "can be made only in the manner that would have been necessary to confer an original authority for the act ratified." [Civ.C. § 2310]

Thus, just as an agent's authority to execute a deed (or purchase/sale agreement) must be in writing, so too must a principal's ratification of an invalid execution by the agent. [*Estate of Stephens* (2002) 28 C4th 665, 673, 122

CR2d 358, 363—principal's oral ratification of agent's execution of deed ineffective; *Behniwal v. Mix* (2005) 133 CA4th 1027, 1039, 35 CR3d 320, 329]

Documents of "high levels of specificity, such as escrow instructions, have been held to easily ratify an agent's acts in entering into a deal." [*Behniwal v. Mix*, supra, 133 CA4th at 1039, 35 CR3d at 329; compare *Tribeca Cos., LLC v. First American Title Ins. Co.* (2015) 239 CA4th 1088, 1113, 192 CR3d 354, 374-375—investment firm had no authority to act as joint venture's agent in executing escrow instructions absent written authorization]

a) [4:269.2] **Ratification need not restate terms of underlying contract:** A principal's written ratification of an agent's invalid execution of an agreement need not itself set forth the terms of the agreement. This is because the terms have been identified already, and the only outstanding issue is whether the principal's acceptance of them can be ascertained from the ratification document. [*Behniwal v. Mix* (2005) 133 CA4th 1027, 1040, 35 CR3d 320, 329-330]

Thus, e.g., the principal's signature on disclosure documents executed in connection with a real property purchase and sale transaction (e.g., a natural hazard disclosure statement, or a notice of the availability of a statewide database showing the proximity of registered sex offenders; *see generally*, *¶ 4:354 ff.*) effectively ratifies the underlying purchase and sale agreement and, consequently, the transaction. [*Behniwal v. Mix*, supra, 133 CA4th at 1040-1042, 35 CR3d at 329-331]

[4:269.3 - 4:269.4] ***Reserved.***

(b) [4:269.5] **Compare—agent signing in "ministerial" capacity ("amanuensis rule"):** The agent's authority need not be in writing if the agent was *not* given authority to *enter into a contract*, but rather acted as an "amanuensis" by merely *signing the principal's name* in a *"ministerial" or "clerical" capacity* at the principal's request. [*Ellis v. Mihelis* (1963) 60 C2d 206, 214, 32 CR 415, 419; *Estate of Stephens* (2002) 28 C4th 665, 674, 122 CR2d 358, 364—"the amanuensis rule has successfully been invoked as an exception to [CC] section 2309"; see also *Kadota Fig Ass'n of Producers v. Case-Swayne Co.* (1946) 73 CA2d 815, 821, 167 P2d 523, 526—"an oral request to perform the mere mechanical act of signing another person's name to an instrument is valid and binding even though the instrument is required to be in writing"]

1) [4:269.6] **Agent's signature in principal's presence *not required:*** Application of the "amanuensis rule" is *not* restricted to situations where an agent signs a contract in the principal's immediate presence. The rule may also apply when an agent, acting with only "mechanical and no discretionary authority," signs the principal's name *outside* the principal's presence. The dispositive issue is whether the agent's signing was a "mechanical act." [*Estate of Stephens* (2002) 28 C4th 665, 676, 122 CR2d 358, 365—"we again reject the formalistic notion that an amanuensis must sign the document in the presence of the principal"]

2) [4:269.7] **"Interested amanuensis" limitation:** When the amanuensis will directly benefit from the transfer of title effected by the deed they executed for the principal in a ministerial capacity, "the validity of the transfer must be examined under a *heightened level* of judicial scrutiny" to eliminate concerns of fraud, duress or undue influence. [*Estate of Stephens* (2002) 28 C4th 665, 677, 122 CR2d 358, 366 (emphasis added)]

"Because unscrupulous parties could attempt to use the amanuensis rule to sidestep the protections provided by [the equal dignities rule, etc.], … the signing of a grantor's name by an *interested amanuensis* is *presumed invalid*." In such cases, the interested amanuensis bears the burden of showing "his or her signing of the grantor's name was a ministerial act in that the grantor intended to sign the document using the instrumentality of the amanuensis." [*Estate of Stephens*, supra, 28 C4th at 677-678, 122 CR2d at 367 (emphasis added)—overwhelming evidence showed that daughter who signed father's name to deed transferring property to her and father as joint tenants, albeit not in his immediate presence, acted as mere amanuensis, thereby validating father's oral instruction to daughter to sign his name to deed]

[4:269.8 - 4:269.9] ***Reserved.***

(c) [4:269.10] **Identification of undisclosed principal:** *See discussion at ¶ 4:270.5*.

e. [4:270] **Essential terms:** Although not expressly specified in the California statute of frauds (*¶ 4:263*), it is well-established that the writing is enforceable under the statute of frauds (and general contract law, *¶ 4:264.5*) only if it sets forth all the

essential terms of the contract with "reasonable certainty." [*Sterling v. Taylor* (2007) 40 C4th 757, 766, 55 CR3d 116, 123; see also *Smyth v. Berman* (2019) 31 CA5th 183, 197, 242 CR3d 336, 348 (¶ 4:265); *Marriage of Benson* (2005) 36 C4th 1096, 1108, 32 CR3d 471, 479—since statute of frauds primarily serves to prove contract exists (*¶ 4:263*), writing need only mention certain "essential" or "meaningful" terms]

This principle is also codified in Civ.C. § 3390, which bars a *specific performance* remedy unless the terms of the agreement are sufficiently clear. [See Civ.C. § 3390(e)—agreement cannot be specifically enforced if its terms "are not sufficiently certain to make the precise act which is to be done clearly ascertainable"; *and further discussion at ¶ 11:227 ff.*]

(1) [4:270.1] **Restatement requirements:** Under the Restatement of Contracts, a writing is enforceable only if it "reasonably" identifies the contract's subject matter, indicates that a contract has been made between the parties or offered by the signer to the other party, *and* states "with reasonable certainty the essential terms of the unperformed promises in the contract." [Rest.2d Contracts § 131]

(2) [4:270.2] **Identifying essential terms:** The "essential" terms of an agreement depends on its context and the subsequent conduct of the parties. [*Sterling v. Taylor* (2007) 40 C4th 757, 766, 55 CR3d 116, 123]

At a minimum, however, as applied to purchase and sale agreements, the writing must identify the *buyer*, the *seller*, the *price*, and the *property*. [*Sterling v. Taylor*, supra, 40 C4th at 772, 55 CR3d at 128]

(a) [4:270.3] **Time and manner of payment not "essential":** The traditional formulation of "essential terms" also included the time and manner of payment—i.e., a time for performance of the contract. However, because real property purchase and sale contracts are enforceable although lacking specification of a time for performance, the time and manner of payment are not truly "essential terms" for purposes of compliance with the statute of frauds. [*Sterling v. Taylor* (2007) 40 C4th 757, 772, 55 CR3d 116, 128, fn. 14; *see also ¶ 4:282.1*, *11:56 ff.*]

Indeed, real property purchase and sale contracts do not have to be drawn with "technical exactness" to be binding. "It is settled that if a contract for the sale of real property specifies no time of payment, a reasonable time is allowed. The manner of payment is also a term that may be supplied by implication." [*Patel v. Liebermensch* (2008) 45 C4th 344, 346, 86 CR3d 366, 367 & fn. 2—manner and time of payment may be determined by reference to "custom and reason" when contract is silent]

(b) [4:270.4] **Use of parol evidence, generally:** When a writing includes the essential terms of the agreement but the *meaning* of the terms is *unclear or ambiguous*, it nonetheless satisfies the statute of frauds if parol evidence clarifies the terms with reasonable certainty, *and* the evidence "as a whole" demonstrates that the parties intended to be bound by the agreement. [*Sterling v. Taylor* (2007) 40 C4th 757, 771, 55 CR3d 116, 127; see *Tiffany Builders, LLC v. Delrahim* (2023) 97 CA5th 536, 545-546, 315 CR3d 582, 588-589—hand-written deal to purchase multiple gas stations deemed sufficiently definite for judicial enforcement even though it failed, among other things, to indicate whether transaction included only parties or also their business entities (concluding record showed both parties were sole owners of their respective companies), *discussed further at* ¶ 4:270.6 & 4:270.7; compare *Hot Rods, LLC v. Northrop Grumman Systems Corp.* (2015) 242 CA4th 1166, 1175-1177, 196 CR3d 53, 59-61—integration clause stating "no extrinsic evidence whatsoever may be introduced" to interpret contract fully enforceable as express indication of "sophisticated" parties' intent to bypass general rule; *see also ¶ 4:270.6* (parol evidence to clarify purchase price) *& ¶ 4:270.7* (parol evidence to clarify property description)]

However, parol evidence may *not* be used to *contradict* the terms of the writing. [*Sterling v. Taylor*, supra, 40 C4th at 771, 55 CR3d at 127; see also *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Ass'n* (2013) 55 C4th 1169, 1174, 151 CR3d 93, 96—rule's purpose is to ensure parties' final understanding, deliberately expressed in writing, is not subject to change; *Abers v. Rounsavell* (2010) 189 CA4th 348, 356, 116 CR3d 860, 865—written agreements whose language appears clear in the context of the parties' dispute are not open to claims of "latent" ambiguity]

Cross-refer: For a comprehensive treatment of the parol evidence rule, see Wegner, Fairbank, Wegner, Wegner & Chernow, *Cal. Prac. Guide: Civil Trials & Evidence* (TRG), Ch. 8E.

(c) [4:270.5] **Contracts signed by agent—identity of undisclosed principal:** When an agent executes the contract on behalf of the "party to be charged" (*¶ 4:269 ff.*), the principal need not necessarily be disclosed in the written agreement. The contract is enforceable against the undisclosed principal, and parol evidence is admissible to identify the principal. [*Sterling v. Taylor* (2007) 40 C4th 757, 773, 55 CR3d 116, 128; *Curran v. Holland* (1903) 141 C 437, 439-440, 75 P

46, 47—extrinsic evidence admissible to identify principal because it does not contradict writing, but merely explains transaction]

(d) [4:270.6] **Purchase price:** Parol evidence is also admissible to clarify an ambiguous purchase price in a real property purchase agreement. So long as the price may be *objectively* determined from the written agreement (e.g., derived from a negotiated formula), a contract in which the price is not expressed may nonetheless satisfy the statute of frauds. [See *Sterling v. Taylor* (2007) 40 C4th 757, 773-776, 55 CR3d 116, 129-130—where agreement described price by "approximate" multiplier of "gross income" and mistakenly omitted zero, plaintiffs' extrinsic evidence of price term insufficient to show with "reasonable certainty" (¶ *4:270.4*) that parties understood and agreed to term; compare *Tiffany Builders, LLC v. Delrahim* (2023) 97 CA5th 536, 545-547, 315 CR3d 582, 588-590—hand-written deal to purchase multiple gas stations deemed sufficiently definite for judicial enforcement even though it used "X" to denote price-related term (finding plaintiff's declaration explained "X" was just a placeholder and deal provided formula for ultimately ascertaining "X"s presently unknown value), *discussed further at* ¶ 4:270.4 & 4:270.7; *Carver v. Teitsworth* (1991) 1 CA4th 845, 852-853, 2 CR2d 446, 450—buyer's written statement that he would pay $1,000 more than any other bid for property sufficiently certain to satisfy statute of frauds]

(e) [4:270.7] **Sufficiency of property description:** A liberal rule of construction is applied to the sufficiency of the property description in a purchase and sale contract. Generally, less certainty is required in a contract to convey than in a deed (¶ *4:10*). [*Wright v. L.W. Wilson Co., Inc.* (1931) 212 C 569, 572, 299 P 521, 523; see *Alameda Belt Line v. City of Alameda* (2003) 113 CA4th 15, 21, 5 CR3d 879, 883—"courts have been most liberal in construing executory contracts for the sale of real estate" (internal brackets and quotes omitted)]

Parol evidence "may be consulted" to identify property described in imprecise terms, even though a more complete description is preferable. [*Sterling v. Taylor* (2007) 40 C4th 757, 773, 55 CR3d 116, 129; see *Tiffany Builders, LLC v. Delrahim* (2023) 97 CA5th 536, 545, 315 CR3d 582, 588-589—hand-written deal to purchase multiple gas stations deemed sufficiently definite for judicial enforcement even though it failed to identify stations' locations (finding record showed locations were known to or easily discoverable by parties), *discussed further at* ¶ 4:270.4 & 4:270.6; *Wright v. L.W. Wilson Co., Inc.*, supra, 212 C at 574, 299 P at 523—contract deemed to adequately describe property if it refers to something as certain or provides means of ascertaining and identifying subject property; *Beverage v. Canton Placer Mining Co.* (1955) 43 C2d 769, 774, 278 P2d 694, 698—"description fulfills the test of reasonable certainty (¶ *4:270.4*) if it *furnishes the 'means or key'* by which the description may be made certain and identified with its location on the ground" (emphasis added); *Quan Shew Yung v. Woods* (1963) 218 CA2d 506, 510, 32 CR 453, 455—technical legal description not required where property location well known to parties]

On the other hand, the writing does *not* satisfy the statute of frauds if the property can be identified *only* by reference to parol evidence. [*Gordon v. Perkins* (1930) 108 CA 336, 339, 291 P 644, 645; see also *Alameda Belt Line v. City of Alameda* (2003) 113 CA4th 15, 21, 5 CR3d 879, 883—parol evidence not admissible to supply description that parties *entirely omitted* from writing]

1) [4:270.8] **Evidence coming into existence after contract's execution:** So long as the written agreement provides the "means or key" by which parol evidence may be used to identify the property, the evidence is admissible for that purpose even though it did not come into existence until *after* the agreement was executed. [See *Alameda Belt Line v. City of Alameda* (2003) 113 CA4th 15, 21, 5 CR3d 879, 883—annual reports filed with city after agreement executed could be considered to identify subject property (*discussed further at* ¶ *8:79*); *Hansen Pac. Corp. v. Buck Mountain Logging Co.* (1961) 191 CA2d 826, 832-833, 13 CR 82, 86—admittedly vague property description sufficient to satisfy statute of frauds when coupled with evidence of title reports given to buyer after execution of contract]

[4:270.9 - 4:270.24] ***Reserved.***

(3) [4:270.25] **Reformation to cure mistake or fraud:** If, because of fraud or mistake, the written contract "does not truly express the written intent of the parties," it may be reformed (revised) on one party's application … so long as this can be done without prejudice to rights acquired by third party BFPs. [See Civ.C. § 3399; *Demetris v. Demetris* (1954) 125 CA2d 440, 443, 270 P2d 891, 893; *Nunes v. De Faria* (1951) 107 CA2d 794, 797, 238 P2d 106, 108]

Cross-refer: The reformation remedy is discussed in detail at ¶ *11:410 ff.*

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f. [4:271] **Part performance exception to statute of frauds:** One party's "partial" (or full) performance of, and resulting detrimental change of position in reliance on, an oral real property sale contract takes the contract *out* of the statute of frauds. (The theory is that such performance would not have been undertaken absent a binding contract and hence is sufficient to evidence the contract.) [See CCP § 1972(a); *Marriage of Benson* (2005) 36 C4th 1096, 1108-1109, 32 CR3d 471, 480; *Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.* (2009) 171 CA4th 1356, 1396, 124 CR3d 271, 306; *Secrest v. Security Nat'l Mortg. Loan Trust 2002-2* (2008) 167 CA4th 544, 555, 84 CR3d 275, 283]

(1) [4:271.1] **Payment of money not enough:** But the "part performance" must consist of acts that "unequivocally refer" to the contract or "clearly relate to" its terms (acts that would not have been performed *but for the contract*). [See generally, *Marriage of Benson* (2005) 36 C4th 1096, 1109, 32 CR3d 471, 480 (internal quotes omitted); and, e.g., *Calanchini v. Branstetter* (1890) 84 C 249, 252, 24 P 149, 150—buyer's taking possession is sufficient part performance because, but for the contract, buyer might be treated as trespasser; *Peixouto v. Peixouto* (1919) 40 CA 782, 789, 181 P 830, 834—buyer's constructing improvements is sufficient part performance]

The mere *payment of money* (purchase price), without more, is *not* sufficient "part performance" … because the money might have been paid anyway. [*Davis v. Judson* (1910) 159 C 121, 131, 113 P 147, 152; *Harrison v. Warner* (1993) 12 CA4th 415, 422, 15 CR2d 632, 636-637; see also *Smyth v. Berman* (2019) 31 CA5th 183, 198-199, 242 CR3d 336, 349 (finding time and money spent by commercial tenant "working up" offer to purchase leased building (as well as making said offer) did not constitute sufficient "part performance" to take alleged oral agreement with landlord out of statute of frauds, *discussed further at* ¶ 4:272.6); *Secrest v. Security Nat'l Mortg. Loan Trust 2002-2* (2008) 167 CA4th 544, 555, 84 CR3d 275, 283—downpayment on unsigned forbearance agreement modifying note and deed of trust not sufficient part performance to bar lender from asserting statute of frauds in borrower's action to enjoin foreclosure]

[4:271.2 - 4:271.4] ***Reserved.***

g. [4:271.5] **Effect of contract provision requiring approval of separate agreement subject to statute of frauds:** A real estate purchase contract may contain a provision requiring the parties to approve the terms of, or execute, a separate agreement that itself is subject to the statute of frauds. Regardless of whether the separate agreement has been reduced to a writing that satisfies the statute of frauds, the purchase contract is enforceable so long as *it* satisfies the statute of frauds. [*Gaggero v. Yura* (2003) 108 CA4th 884, 894-895, 134 CR2d 313, 321-322—although CC&Rs are subject to statute of frauds, purchase contract requiring parties to agree to CC&Rs as condition to close of escrow was enforceable despite no writing memorializing agreement re CC&Rs]

h. [4:272] **Consequences of noncompliance—contract voidable (not void):** An oral agreement within the statute of frauds is *not* "void"; rather, it is simply *voidable* at the election of a party. [*O'Brien v. O'Brien* (1925) 187 C 577, 586, 241 P 861, 864; *Goldstein v. McNeil* (1954) 122 CA2d 608, 611, 265 P2d 113, 115]

(1) [4:272.1] **Subject to waiver:** Thus, noncompliance with the statute of frauds is a *defense* to an action to enforce the contract and, as such, is *waived* if not timely raised in litigation. [*Coleman v. Satterfield* (1950) 100 CA2d 81, 83, 223 P2d 61, 63; *Turell v. Anderson* (1936) 16 CA2d 445, 449, 60 P2d 906, 908]

(2) [4:272.2] **Estoppel exception:** Even though it is timely raised as an affirmative defense, a party may be *estopped* to assert the statute of frauds where "*unconscionable injury* would result from denying enforcement of the oral contract after one party has been induced by the other *seriously* to change his position in reliance on the contract or where there would be *unjust enrichment* …" [*Isaac v. A & B Loan Co., Inc.* (1988) 201 CA3d 307, 313, 247 CR 104, 108 (emphasis added); see also *Byrne v. Laura* (1997) 52 CA4th 1054, 1069-1070, 60 CR2d 908, 918—oral joint tenancy enforceable on basis of estoppel]

• [4:272.3] For example, a lender was equitably estopped from asserting the statute of frauds defense where the borrower complied fully with a HAMP loan modification agreement and the Trial Period Plan. [*Chavez v. Indymac Mortg. Services* (2013) 219 CA4th 1052, 1061, 162 CR3d 382, 388; *see further discussion at ¶ 6:511.26*]

• [4:272.4] *Compare:* A lender's alleged oral statement that no foreclosure sale was scheduled because the borrowers were "under active review for a modification" was unenforceable absent the lender's signed writing. Among other things, the oral statement was not a promise that the lender would refrain from completing a trustee's sale in the future. Moreover, evidence showed the borrowers did not have enough money to reinstate the loan even if they had known of the sale date.

[*Granadino v. Wells Fargo Bank, N.A.* (2015) 236 CA4th 411, 416-419, 186 CR3d 408, 413-415 (also noting borrowers failed to establish damages since they had no equity in property)]

• [4:272.5] Similarly, a lender's refusal to honor an alleged oral promise to postpone a foreclosure sale did not result in an unconscionable injury sufficient to avoid application of the statute of frauds. Indeed, the sale was conducted only 10 days earlier than promised and evidence showed the borrowers' statutory right to cure would have expired before they planned to contact the lender to request another postponement. [*Jones v. Wachovia Bank* (2014) 230 CA4th 935, 944, 949, 179 CR3d 21, 28, 32]

• [4:272.6] A landlord was *not* estopped from asserting the statute of frauds defense to her commercial tenant's claim that an alleged oral agreement between the parties granted the tenant a right of first refusal to purchase the leased premises. This was so despite the tenant's contention that he (i) "seriously changed [his] position" by expending time and money working up an offer (and making an offer) to buy the property, and (ii) relied on the alleged agreement by paying rent, making physical changes to the property and purchasing another property located next door. In so holding, the court first confirmed that time and money spent working up an offer (as well as making the offer) do not count because "the payment of money is not sufficient part performance to take an oral agreement out of the statute of frauds." Moreover, the court found the tenant's payment of rent, physical changes to the property and purchase of the property next door "all happened *before* the [landlord's alleged oral agreement] and thus could not have been made" in reliance thereon. [*Smyth v. Berman* (2019) 31 CA5th 183, 198-199, 242 CR3d 336, 349 (emphasis in original)]

[4:273 - 4:274] ***Reserved.***

3. [4:275] **Letters of Intent, Memoranda and Other "Informal" Instruments:** A "letter of intent" is often used in real estate transactions but the term has no inherent legal significance. In practice, "letter of intent" generally refers to a writing documenting the parties' preliminary understanding of desire to enter into a future contract. The purpose is not to bind the parties to their ultimate contractual obligations but simply to provide the framework (the basic "deal points") from which they will negotiate toward a binding contract; or to provide a guideline to assist the attorneys in preparing a binding agreement. [See *Rennick v. O.P.T.I.O.N. Care, Inc.* (9th Cir. 1996) 77 F3d 309, 315]

Nonetheless, letters of intent, memoranda and other "informal" writings are sometimes intended by the parties to be binding and enforceable and are used instead of comprehensive purchase and sale agreements or escrow instructions.

• ***FORM:*** (Nonbinding) Letter of Intent, *see Form 4:G*.

a. Pros and cons

(1) [4:275.1] **Framework for drafting; "tying up" property:** If properly prepared, letters of intent and memoranda can serve the useful purposes of (a) focusing the parties on the material terms; (b) psychologically committing the parties to the transaction; and (c) providing a working outline from which a complete and binding contract can be prepared. In essence, these types of informal preliminary documents serve as the backdrop against which the parties may later determine whether they have reached an agreement on the major "deal points" (price, contingencies, closing date, etc.).

Occasionally, letters of intent are also used to preclude the seller from negotiating with other potential buyers during a specified period of time (*¶ 4:276*).

(2) [4:275.1a] **Unintended enforceable obligations:** The major disadvantage, however, is that unless carefully drafted, such instruments may create binding, enforceable obligations or (at the very least) result in litigation over the issue (*see ¶ 4:275.2 ff.*).

b. [4:275.2] **Binding vs. nonbinding; parties' intent determines enforceability:** Under general principles of contract law, the interpretation of a letter of intent, memoranda or similar instrument—i.e., whether it is intended to be a binding, enforceable agreement—is governed by the parties' *objective* intent as evidenced, first and foremost, by the *words used*. [See *Beck v. American Health Group Int'l, Inc.* (1989) 211 CA3d 1555, 1562, 260 CR 237, 241 (overruled by statute on other grounds as stated in *Epic Medical Mgmt., LLC v. Paquette* (2015) 244 CA4th 504, 516, 198 CR3d 28, 38); *see also ¶ 4:264.3*]

➪ [4:275.2a] ***PRACTICE POINTER:*** Don't be misled by the *title* of the document. Many so-called "letters of intent" read just like a contract, contain all the material terms and, indeed, often state they are intended to be "binding and enforceable."

(1) [4:275.2b] **Binding agreements:** Where a writing shows no more than an intent to further reduce it to a more formal one, "the failure to follow it with a more formal writing does not negate the existence of the prior contract." [*Harris v. Rudin, Richman & Appel* (1999) 74 CA4th 299, 307, 87 CR2d 822, 828 (internal quotes omitted); see also *Rennick v. O.P.T.I.O.N. Care, Inc.* (9th Cir. 1996) 77 F3d 309, 316—"Where a letter says that it is subject to the terms of a contemplated mutual agreement to be written and signed in the future, but other evidence indicates that the parties decided to be bound by the terms of the letter, the letter may amount to a contract"; *City of Santa Cruz v. MacGregor* (1960) 178 CA2d 45, 52, 2 CR 727, 731—parties' conduct may convert letter of intent into binding agreement]

(a) [4:275.2c] **May include preliminary *oral agreement:*** Consistent with the principles set forth at ¶ *4:275.2 ff.*, when parties orally agree upon all material terms and conditions to a proposed written contract with the mutual intent that the oral agreement should thereupon become binding, the absence of a signed written agreement does not alter the binding validity of the oral agreement. [*Khajavi v. Feather River Anesthesia Med. Group* (2000) 84 CA4th 32, 61, 100 CR2d 627, 648]

1) [4:275.2d] **Statute of frauds defense:** Of course, notwithstanding the parties' intent that a binding contract become operative with their oral agreement, an oral agreement within the *statute of frauds* (including a real property purchase and sale agreement, ¶ *4:263 ff.*) is voidable at the option of the party against whom enforcement is sought (¶ *4:272 ff.*).

(2) [4:275.3] **Nonbinding agreements:** On the other hand, where an informal writing shows it is not intended to be binding *until a formal written contract is executed*, there is no contract. [*Harris v. Rudin, Richman & Appel* (1999) 74 CA4th 299, 307, 87 CR2d 822, 828; *Rennick v. O.P.T.I.O.N. Care, Inc.* (9th Cir. 1996) 77 F3d 309, 316—no binding contract arose from letter of intent indicating parties did not intend to be bound unless and until subsequent agreement was made and approved by respective boards of directors]

The same principle applies where it is clear from the evidence that the parties reaching an *oral* agreement intended it to become operative only when reduced to a signed writing; no binding contract comes into existence until the parties sign the writing. [*Khajavi v. Feather River Anesthesia Med. Group* (2000) 84 CA4th 32, 61-62, 100 CR2d 627, 648]

➪ [4:275.4] ***PRACTICE POINTERS:*** Avoid litigation over these issues. It is critical that any letter of intent, memorandum or other preliminary writing *clearly state* whether it is *intended* to be a binding, enforceable agreement.

If *not* intended to be binding, the parties should use words to the effect that the document is solely for purposes of discussion, to provide an initial framework from which they might negotiate a final agreement, that no binding obligations are created thereby and that no party has an obligation to negotiate further.

On the other hand, if the parties intend the document to be a binding agreement, it should both (a) clearly so specify, and (b) contain all of the material and nonmaterial terms. In other words, the document should be a *complete* agreement that satisfies the statute of frauds.

Moreover, because the parties' conduct may be evidence of their intent regarding the effect of preliminary writings, counsel should advise their clients to conduct themselves accordingly.

c. [4:275.5] **Impact of covenant of good faith and fair dealing:** If a "letter of intent" is construed to be a binding contract, like all contracts it will be deemed to include an *implied covenant of good faith and fair dealing* that cannot be disclaimed. [*Seaman's Direct Buying Service, Inc. v. Standard Oil Co. of Calif.* (1984) 36 C3d 752, 768, 206 CR 354, 362 (overruled on other grounds by *Freeman & Mills, Inc. v. Belcher Oil Co.* (1995) 11 C4th 85, 88, 44 CR2d 420, 421; and disapproved on other grounds by *Della Penna v. Toyota Motor Sales, U.S.A., Inc.* (1995) 11 C4th 376, 393, 45 CR2d 436, 447, fn. 5); *Bleecher v. Conte* (1981) 29 C3d 345, 350, 213 CR 852, 854; *Riess v. Murchison* (9th Cir. 1974) 503 F2d 999, 1012]

(Conversely, if there is no contract between the parties, there can be no implied covenant of good faith and fair dealing between them. See *Guz v. Bechtel Nat'l, Inc.* (2000) 24 C4th 317, 349, 100 CR2d 352, 375—implied covenant cannot be "endowed with existence independent of its contractual underpinnings"; *Rennick v. O.P.T.I.O.N. Care, Inc.* (9th Cir. 1996) 77 F3d 309, 317; *and* ¶ *4:275.7*.)

(1) [4:275.6] **Application—in general:** The covenant of good faith and fair dealing requires, among other things, that neither party do anything that will deprive the other party of the benefit of their bargain. [*Guz v. Bechtel Nat'l, Inc.* (2000) 24 C4th 317, 349, 100 CR2d 352, 375; and see *Steiner v. Thexton* (2010) 48 C4th 411, 419, 106 CR3d 252, 259—all contracts impose duty of good faith and fair dealing, especially when one party is invested with discretionary power affecting another's rights]

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Thus, e.g., even though the parties may have contemplated the satisfaction of a condition before the contract becomes effective, the covenant of good faith and fair dealing may require that they take such action as is necessary to satisfy the condition. [*Moreland Develop. Co. v. Gladstone Holmes, Inc.* (1982) 135 CA3d 973, 977-978, 186 CR 6, 8-9—provision stating contract subject to approval by board of directors interpreted as requiring agreement to be submitted to board and that board consider agreement "in good faith"]

(2) [4:275.7] **Limitation—generally no *precontractual* implied covenant to *negotiate in good faith:*** The covenant of good faith and fair dealing arises out of an express contract and is implied only to *supplement express* contractual terms. The covenant cannot be stretched to impose terms and conditions or create obligations *not contemplated by the parties' contract.* [*Guz v. Bechtel Nat'l, Inc.* (2000) 24 C4th 317, 349, 100 CR2d 352, 375; see also *Steiner v. Thexton* (2010) 48 C4th 411, 419, 106 CR3d 252, 259—implied covenant may not trump agreement's express language; *Barroso v. Ocwen Loan Servicing, LLC* (2012) 208 CA4th 1001, 1015, 146 CR3d 90, 101—implied covenant rests upon existence of some specific contractual obligation; *Ninety Nine Investments, Ltd. v. Overseas Courier Service (Singapore) Private, Ltd.* (2003) 113 CA4th 1118, 1131-1132, 6 CR3d 891, 901—implied covenant cannot prohibit party from doing what is expressly permitted by agreement]

Thus, the fact parties have commenced negotiations in *anticipation of executing* (*or amending*) *a contract* does *not* itself impose any duty on either to negotiate the contract (or modification) in good faith; i.e., in such a scenario, there is no implied obligation not to be "unreasonable" in the contract negotiations or not to break off negotiations (for any reason or no reason at all). [See *Racine & Laramie, Ltd., Inc. v. California Dept. of Parks & Recreation* (1992) 11 CA4th 1026, 1034, 14 CR2d 335, 340; *Copeland v. Baskin Robbins U.S.A.* (2002) 96 CA4th 1251, 1260, 117 CR2d 875, 883]

(a) [4:275.8] **Compare—independent contract to negotiate:** Occasionally, however, parties to a contemplated transaction form a separate *contract* to negotiate. Such a contract does not obligate the parties to reach an ultimate agreement; but it obligates them to bargain in good faith. If, despite their good faith efforts, they fail to reach an ultimate agreement on the terms in issue, the contract to negotiate is deemed performed. "Failure to agree is not, itself, a breach of the contract to negotiate. A party will be liable only if a failure to reach ultimate agreement resulted from a breach of that party's obligation to negotiate or to negotiate in good faith." [*Copeland v. Baskin Robbins U.S.A.* (2002) 96 CA4th 1251, 1257, 117 CR2d 875, 880-881 (distinguishing binding contract to negotiate from unenforceable "agreement to agree")]

(b) [4:275.9] **Compare—independent duty imposed during negotiating process:** Even in the absence of a separate contract to negotiate, once negotiations commence, circumstances may occur that impose a duty of continued bargaining in good faith. [*Racine & Laramie, Ltd., Inc. v. California Dept. of Parks & Recreation* (1992) 11 CA4th 1026, 1034-1035, 14 CR2d 335, 340-341]

For example, during the course of negotiations, one party might "so mislead" the other by promises or representations, upon which the latter detrimentally relies, as to trigger a promissory estoppel. But absent such special circumstances, "there is no obligation in California to bargain for a new or amended contract in good faith." [*Racine & Laramie, Ltd., Inc. v. California Dept. of Parks & Recreation*, supra, 11 CA4th at 1035, 14 CR2d at 341]

d. [4:276] **Exclusive negotiation agreements:** Preliminary agreements, in the form of a "letter of intent" or other informal writing, are sometimes used by prospective buyers who want a seller to commit to negotiate solely with them for a certain period of time. This gives the buyer peace of mind that the seller will not be marketing the property for a higher price or better terms while extensive contract negotiations continue.

At least one case expressly recognizes that a contract to negotiate can be formed and breached like any other contract. [*Copeland v. Baskin Robbins U.S.A.* (2002) 96 CA4th 1251, 1257, 117 CR2d 875, 880-881; *see ¶ 4:275.8*]

[4:276.1] ***Reserved.***

(1) [4:276.2] **Practical concerns for buyers and sellers:** "Exclusive negotiation" agreements have downsides for both buyers and sellers:

From the buyer's perspective, such agreements provide no assurance that the seller will ever accept the buyer's offer to purchase the property.

Conversely, from the seller's perspective, exclusive negotiation agreements may impose a heightened duty on the seller to negotiate "in good faith." [See *Edmond's of Fresno v. MacDonald Group, Ltd.* (1985) 171 CA3d 598, 607, 217 CR

375, 381—"violation of the covenant of good faith and fair dealing can occur … as long as one party to an agreement merely attempts to deprive another party of the benefits of the agreement"; *see also* ¶ *4:275.8 ff.*]

4. [4:277] **Comprehensive Purchase and Sale Agreements:** A comprehensive purchase and sale agreement drafted by an attorney (or use of a preprinted form agreement, filled out and amended by counsel, ¶ *4:278*) is the preferred method of documenting the purchase contract. If an escrow will be used, the purchase agreement should include escrow instructions, thus eliminating the need to prepare subsequent escrow instructions (¶ *4:583 ff.*).

• ***FORM:*** (Attorney-Drafted) Purchase and Sale Agreement and Joint Escrow Instructions, *see Form 4:H*.

5. [4:278] **Preprinted Form Agreements:** The California Association of Realtors (C.A.R.), American Industrial Real Estate Association, and many private real estate brokerage firms have promulgated standard form purchase and sale agreements. These forms, when properly executed, ordinarily constitute binding and enforceable contracts for the sale and purchase of property. [*Allen v. Smith* (2002) 94 CA4th 1270, 1280, 114 CR2d 898, 904; see also *Manderville v. PCG & S Group, Inc.* (2007) 146 CA4th 1486, 1492, 55 CR3d 59, 63 (discussing C.A.R. form vacant land purchase agreement (¶ *4:112 ff.*) and escrow instructions)]

(C.A.R.'s preprinted purchase and sale agreement is, according to C.A.R., the most frequently used form in California for the sale of residential property. It, and other C.A.R. forms, may be purchased online through C.A.R.'s subsidiary, the REBS Online Store, at *www.car.org*, or by contacting REBS Customer Service at (213) 739-8227.)

a. [4:278.1] **Pros and cons:** Generally speaking, C.A.R.'s forms are complete and evenly balanced. This is so because there is typically a broker representing each side in any transaction and the forms need to fit both party's needs. In addition, and at least for purposes of relatively simple residential (housing) sales, C.A.R.'s forms may be advantageous because:

• They generally include most issues buyers and sellers should consider.

• They sometimes are the most practical tool, since brokers (and often home buyers and sellers) are familiar (or seem to feel comfortable) with such forms. Extensive attorney-drafted purchase agreements may intimidate parties in what would otherwise be a fairly straightforward transaction.

• They save time and money—the parties need only fill in the blanks for the material terms (property description, price, etc.) and need not incur the time or expense of hiring lawyers to draft the contract language. [See *Behniwal v. Mix* (2005) 133 CA4th 1027, 1038, 35 CR3d 320, 328, fn. 12]

However, *every* preprinted form should be scrutinized to make certain it is appropriate for a particular transaction. Moreover, preprinted forms do not always include the specific mechanics and instructions for closing an escrow. Consequently, the parties will need to execute separate escrow instructions (¶ *4:583 ff.*). Also, as one case notes, "When things go wrong …, the nature of the forms can have the effect … of turning things into … a 'morass.' Instead of a clean exchange of forms the way attorneys would structure most deals (if they have the time), the forms and the labels tend to confuse the substance of what is going on." [*Behniwal v. Mix*, supra, 133 CA4th at 1038, 35 CR3d at 328, fn. 12]

➪ ***PRACTICE POINTERS***

• [4:278.2] ***Single-family residence purchase agreement:*** The C.A.R. form residential purchase agreement ("Residential Purchase Agreement and Joint Escrow Instructions") usually includes an attachment entitled "Buyer's Inspection Advisory," that simply advises the buyer of issues to consider when inspecting the property (*see* ¶ *4:348 ff.*).

• [4:278.3] ***Vacant land purchase agreement:*** C.A.R. also publishes a form purchase agreement for vacant land ("Vacant Land Purchase Contract and Receipt for Deposit").

• [4:278.4] ***Specialized forms for probate sales:*** Two C.A.R. forms—Probate Purchase Agreement (and Receipt for Deposit) and Probate Advisory—are helpful to use for probate, conservatorship or guardianship sales. Even when a prospective buyer presents the offer on a standard purchase agreement form, to avoid unnecessary difficulties, seller's counsel could insist on the buyer converting the offer to a Probate Purchase Agreement.

• [4:278.5] ***Modifying printed form agreements:*** Standard "form" purchase agreements rarely are completely suitable for every transaction (e.g., the parties may find certain covenants too narrow or too broad or otherwise objectionable, or may

want to add others). Like any "form" transactional document, these form purchase and sale agreements should be carefully reviewed and *modified* to fit the nuances of a particular transaction by interlineating *modifications*, *striking* objectionable language, and/or *attaching addendums*. Except to the extent modified by the parties, a standard form purchase and sale agreement "*means what it says*" and will be enforced accordingly. [See *Frei v. Davey* (2004) 124 CA4th 1506, 1520, 22 CR3d 429, 440-441 (prevailing party attorney fee provision in C.A.R. residential purchase agreement made prelitigation mediation a condition precedent to entitlement to attorney fees recovery)]

• [4:278.6] ***Review of attached broker forms:*** Some brokers may attach to preprinted form purchase agreements their own "self-serving" documents, such as releases and indemnifications (*¶ 4:461 ff.*) of the brokers by the parties. At this stage of the transaction, there generally is no reason for the parties to release or agree to indemnify the brokers. In any event, counsel should thoroughly review any of these documents.

6. [4:279] **Compare—Recording Memorandum of Agreement:** Upon execution of a formal purchase and sale agreement, some buyers may find it beneficial to record a "memorandum" of the agreement. This puts the "world" on notice of the buyer's right to purchase the property, thus precluding intervening BFP (bona fide purchaser/encumbrancer) rights (see generally, Civ.C. §§ 1213 ff.). [Cf. 87 Ops.Cal.Atty.Gen. 87—"memorandum of lease" that sets forth basic elements of a lease (minimally, the parties' identity, subject property and lease term), refers to a separate unrecorded document that contains complete lease terms, is signed and includes a certificate of acknowledgment by the parties, is recordable]

Recording the "memorandum" avoids the expense of recording the entire agreement and the disclosure of confidential and proprietary information, while at the same time providing constructive notice of the buyer's interest as if the entire agreement had been recorded. [87 Ops.Cal.Atty.Gen. 87; see also *Abers v. Rounsavell* (2010) 189 CA4th 348, 358, 116 CR3d 860, 867—there is a reason for recording critical documents concerning real property—i.e., interpreting a recorded real property document by its four corners "provides public notice that successors in interest and innocent third parties may need to rely on for centuries"]

On the other hand, such recordation clouds the seller's title and, if the transaction does not close, will usually require the seller to provide a title insurance company with a quitclaim or other recordable form release by the buyer. (As a practical matter, unless the transaction involves a particularly long-term escrow, it is not customary to record a memorandum of agreement.)

[4:279.1 - 4:279.4] ***Reserved.***

7. [4:279.5] **Special Rules Governing Home Equity Sales Contracts—Residential Property Purchases Pending Foreclosure:** The Home Equity Sales Contract Act (the "Act," Civ.C. §§ 1695-1695.17) governs purchases of residential property during the pendency of a foreclosure proceeding (i.e., at any time after a notice of default has been recorded against a residential real property consisting of one-to-four family dwelling units, one of which is owner-occupied as a principal residence). [See Civ.C. § 1695.1(b); *People v. Shetty* (2009) 174 CA4th 1488, 1491-1492, 95 CR3d 355, 357]

Purchase agreements subject to the Act must comply with special statutory provisions (¶ 4:279.10 ff.). Significant features of the Act are summarized at ¶ 4:279.6 ff.; for an expanded discussion, see *Segura v. McBride* (1992) 5 CA4th 1028, 7 CR2d 436.

a. [4:279.6] **Purpose of Act:** The Legislature enacted this statutory scheme in response to "fraud, deception, and unfair dealing" by purchasers of "home equity" interests from homeowners in foreclosure. "During the time period between the commencement of foreclosure proceedings and the scheduled foreclosure sale date, homeowners in financial distress … are vulnerable to the importunities of equity purchasers who induce homeowners to sell their homes for a small fraction of their fair market values through the use of schemes which often involve oral and written misrepresentations, deceit, intimidation, and other unreasonable commercial practices." [Civ.C. § 1695(a); *Spencer v. Marshall* (2008) 168 CA4th 783, 793, 85 CR3d 752, 758; see also *Capon v. Monopoly Game LLC* (2011) 193 CA4th 344, 354, 122 CR3d 536, 544 (recognizing California's express policy of preserving and guarding the "precious asset of home equity, and the social as well as the economic value of homeownership")]

The basic purpose of the Act is to provide homeowners with information necessary to make an "informed and intelligent decision" regarding the sale of their homes to equity purchasers and to prohibit misleading representations and unfair contract terms. [Civ.C. § 1695(d)(1); *Hoffman v. Lloyd* (9th Cir. 2009) 572 F3d 999, 1001 (applying Calif. law); see also

Schweitzer v. Westminster Investments (2007) 157 CA4th 1195, 1200, 69 CR3d 472, 475—Act helps protect homeowners facing foreclosure from "victimization"]

b. [4:279.7] **Nonwaivable:** The provisions of the Home Equity Sales Contract Act are *nonwaivable;* any purported waiver is void and unenforceable. [Civ.C. § 1695.10; see *Hoffman v. Lloyd* (9th Cir. 2009) 572 F3d 999, 1001-1003—general release of "known and unknown claims" that homeowner signed in unlawful detainer brought by foreclosure purchaser was ineffective as relinquishment of homeowner's right to cancel home equity sales contract under the Act because purchaser failed to give homeowner notice of right to rescind (*¶ 4:279.12*) in violation of the Act]

c. [4:279.8] **"Equity purchasers":** An "equity purchaser" within the meaning of the Act is any person who acquires title to a residence in foreclosure, except as noted at ¶ 4:279.9 ff. [Civ.C. § 1695.1; see *Spencer v. Marshall* (2008) 168 CA4th 783, 794, 85 CR3d 752, 759—Act regulates not only "archetypal predators" (business persons preying on distressed homeowners), but all equity purchasers as defined; *Segura v. McBride* (1992) 5 CA4th 1028, 1031, 7 CR2d 436, 437—except for persons exempted by statute, "the Act applies to *all* persons who purchase a residence subject to an outstanding notice of default, regardless of whether the purchaser routinely engages in such transactions, and regardless of whether the distressed buyer initiates the negotiations" (emphasis in original)]

(1) [4:279.9] **Exceptions:** A purchaser of a residence in foreclosure is *not* an "equity purchaser" subject to the Act if the purchaser acquires title:

- For the purpose of using the property as a *personal residence;*
- By deed in lieu of foreclosure of any voluntary lien or encumbrance of record;
- By deed from a trustee acting under a regularly conducted foreclosure sale;
- At any sale of property authorized by statute;
- By court order or judgment; or
- From a spouse (or registered domestic partner; see Fam.C. § 297.5(a)), blood relative or blood relative of a spouse/domestic partner. [Civ.C. § 1695.1(a); see also *Capon v. Monopoly Game LLC* (2011) 193 CA4th 344, 355, 122 CR3d 536, 544-545—person who acquires title *must* be same person who intends to use property as residence (corporate alter ego of person who intended to reside in property not only failed to qualify for exception but was, ironically, the "archetypal purchaser targeted by the Act")]

(a) [4:279.9a] **Rationale for exceptions:** The exceptions appear to reflect a legislative judgment that each presents a lesser concern regarding the "fraud, deception, and unfair dealings" that motivated enactment of the Act. [*Capon v. Monopoly Game LLC* (2011) 193 CA4th 344, 355, 122 CR3d 536, 544; see also *Spencer v. Marshall* (2008) 168 CA4th 783, 798, 85 CR3d 752, 762—Act's exceptions are "narrowly construed"]

(2) [4:279.9b] **"Representative" acting as equity purchaser's agent/employee:** The Act requires an equity purchaser's "representative," deemed to be the purchaser's agent and/or employee, to provide the equity seller with written proof and a written statement under penalty of perjury that the representative (a) has a valid, current California Real Estate Sales License; and (b) is bonded by an admitted surety insurer in an amount equal to twice the fair market value of the real property in foreclosure (*but see ¶ 4:279.9c*). [See Civ.C. §§ 1695.17 & 1695.15(b) (defining "representative" to include any person who, on behalf of purchaser, solicits, induces or causes property owner to transfer title to residence in foreclosure, or solicits any member of owner's family/household to induce or cause owner to transfer title)]

The written statement also must confirm that the seller has been provided with written proof of the representative's license and bond, and a copy of the statement must be given to all parties prior to transfer of any interest in the property. [Civ.C. § 1695.17]

(a) [4:279.9c] **Constitutional limitation—bond requirement:** The Act's bond requirement (*¶ 4:279.9b*) has been declared void for vagueness under the Due Process Clause and unenforceable. [See *Schweitzer v. Westminster Investments* (2007) 157 CA4th 1195, 1211, 69 CR3d 472, 484-485—Civ.C. § 1695.17 bond requirement provides no guidance as to amount, obligee, beneficiaries, terms and conditions, delivery and acceptance or enforcement mechanisms (i.e., persons of "ordinary intelligence" must guess at what statute requires)]

However, according to *Schweitzer*, supra, the "remainder of the statutory scheme remains valid" because the bond provisions are severable from the balance of the Act. [*Schweitzer v. Westminster Investments*, supra, 157 CA4th at 1212, 69 CR3d at 485]

(3) [4:279.9d] **Applicable to purchases in Chapter 13 bankruptcy:** The Act applies to the purchase of a residence in foreclosure when the debtor (seller) is in Chapter 13 bankruptcy. This is so even though the Bankruptcy Code permits debtors in bankruptcy to convey their property with the trustee's approval. [See *Spencer v. Marshall* (2008) 168 CA4th 783, 798-799, 85 CR3d 752, 762-763—licensed broker who purchased Chapter 13 seller's residence with trustee's approval still subject to Act]

d. [4:279.10] **Form of contract:** Every home equity sales contract must be in *writing,* in letters of a size equal to *10-point bold type,* in the same language principally used by the purchaser and seller to negotiate the sale, and must be completed, signed and dated by the seller and buyer *prior to* execution of any conveyancing instrument. [Civ.C. § 1695.2]

It is the *purchaser's* responsibility to provide and complete the contract pursuant to the statutory requirements. [Civ.C. § 1695.6(a); *Capon v. Monopoly Game LLC* (2011) 193 CA4th 344, 352, 122 CR3d 536, 542; *People v. Shetty* (2009) 174 CA4th 1488, 1491, 95 CR3d 355, 357—statute imposes disclosure and other requirements on home equity sales contracts]

e. [4:279.11] **Terms of contract:** The contract must contain the parties' entire agreement and, at a minimum, include the following terms (Civ.C. § 1695.3; see *Capon v. Monopoly Game LLC* (2011) 193 CA4th 344, 352, 122 CR3d 536, 542):

• Purchaser's name, business address and telephone number (Civ.C. § 1695.3(a));

• Address of the subject property (Civ.C. § 1695.3(b));

• The total consideration to be given by the purchaser (Civ.C. § 1695.3(c));

• A complete description of the terms of payment (or other consideration), including any services the purchaser represents will be performed for the seller (before or after the sale) (Civ.C. § 1695.3(d));

• The time at which possession is to be transferred to the purchaser (Civ.C. § 1695.3(e));

• The terms of any rental agreement (Civ.C. § 1695.3(f));

• A notice of the seller's right to cancel (Civ.C. § 1695.5(a), ¶ *4:279.13*);

• A notice of cancellation pursuant to Civ.C. § 1695.5(b) (¶ *4:279.14*) (Civ.C. § 1695.3(g)); *and*

• A notice in at least 14-point bold type (printed contracts) or capital letters (typed contracts) and completed with the purchaser's name, immediately above the Civ.C. § 1695.5 notice of right to cancel (¶ *4:279.13*), as follows (Civ.C. § 1695.3(h)):

"NOTICE REQUIRED BY CALIFORNIA LAW

Until your right to cancel this contract has ended, … (purchaser) or anyone working for … (purchaser) CANNOT ask you to sign or have you sign any deed or any other document."

(1) [4:279.11a] **Limitation on mandatory arbitration:** Any provision in a home equity sales contract that attempts or purports to require arbitration of any dispute arising under the Act is void at the seller's option upon grounds that exist for the revocation of contracts generally. [Civ.C. § 1695.16(a)]

f. [4:279.12] **Seller's right to cancel ("cooling off period"):** *In addition to any other right of rescission*, the equity seller has the right to *cancel* the home equity sales contract until the *earlier of* midnight of the fifth business day following the day on which the seller signs a contract that complies with the Act or 8 a.m. on the day scheduled for the foreclosure sale. [Civ.C. § 1695.4(a)]

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Further, *until* the equity purchaser complies with Civ.C. § 1695.5 (requiring a prescribed notice of cancellation rights to be included in the contract, along with a cancellation form, ¶ 4:279.13), the seller retains a right to cancel the contract at any time. [Civ.C. § 1695.5(d); *Hoffman v. Lloyd* (9th Cir. 2009) 572 F3d 999, 1001 (applying Calif. law)]

(1) [4:279.13] **Notice of cancellation rights in sales contract:** The sales contract must contain "in immediate proximity" to the space reserved for the seller's signature a "conspicuous statement" in minimum 12-point bold type (printed contracts) or capital letters (typed contracts) a notice of the seller's right to cancel as follows:

> "You may cancel this contract for the sale of your house without any penalty or obligation at any time before … (date and time). See the attached notice of cancellation form for an explanation of this right." [Civ.C. § 1695.5(a)—purchaser "shall accurately enter the date and time of day on which the rescission right ends"]

However, notwithstanding an equity buyer's failure to comply with the § 1695.5(a) notice of cancellation requirements (above), the Act does *not* provide grounds for rescinding a transaction *after* the deed is recorded. [*Schweitzer v. Westminster Investments* (2007) 157 CA4th 1195, 1213, 69 CR3d 472, 486]

(2) [4:279.14] **Notice of cancellation form to be attached to contract:** Also, the contract must be *accompanied by* a "Notice of Cancellation" form as prescribed by Civ.C. § 1695.5(b). [See Civ.C. § 1695.5(b)]

As stated, the seller retains a right to cancel until the purchaser complies with Civ.C. § 1695.5. [Civ.C. § 1695.5(d)]

(3) [4:279.15] **How cancellation effected:** Cancellation of the contract occurs when the seller personally delivers written notice of cancellation to the address specified in the contract or sends a telegram indicating cancellation to that address. [Civ.C. § 1695.4(b)]

The notice of cancellation need not be in the form provided with the contract (Civ.C. § 1695.5(b), ¶ 14:279.14); it is effective so long as it indicates the seller's intention not to be bound by the contract. [Civ.C. § 1695.4(c)]

Within 10 days after receipt of the notice of cancellation, the purchaser must return (without condition) the original contract and any other documents signed by the seller. [Civ.C. § 1695.6(c)]

g. Prohibited acts by purchaser

(1) [4:279.16] **During "cooling off period":** Until expiration of the time allowed for cancellation of the contract (*¶ 4:279.11*), the purchaser *cannot do any of the following* (Civ.C. § 1695.6(b)):

• Accept from the seller (or induce the seller to execute) any instrument conveying an interest in the residence;

• Record with the county recorder any document signed by the equity seller;

• Transfer or encumber (or purport to transfer or encumber) any interest in the residence to any third party (except a transfer to a bona fide purchaser or encumbrancer for value who is without notice of a violation of the Act and was without knowledge that the property was otherwise subject to the Act); or

• Pay the seller any consideration. [Civ.C. § 1695.6(b)]

(2) [4:279.17] **Untrue/misleading statements:** In addition, the purchaser is prohibited from making any untrue or misleading statements regarding:

• the value of the residence in foreclosure;

• the amount of proceeds the seller will receive after foreclosure;

• any contract term;

• the seller's rights or obligations arising out of the sale transaction;

• the nature of any document the purchaser induces the seller to sign; or

• "any other untrue or misleading statement concerning the sale …" [Civ.C. § 1695.6(d)]

(3) [4:279.18] **Encumbering residence where seller has option to repurchase:** If the purchaser purports to hold title through an instrument that appears to be an absolute conveyance and the seller reserves or is given by the purchaser an *option to repurchase* the residence, the purchaser cannot encumber or grant any interest in the property to any other person *without the seller's written consent*. [See Civ.C. § 1695.6(e)]

(But this provision does not preclude the application of Civ.C. § 1695.6(b)(3), which protects the rights of a bona fide purchaser or encumbrancer for value. See Civ.C. § 1695.6(e); *and* ¶ *4:279.16*.)

[4:279.19 - 4:279.24] ***Reserved.***

h. Consequences of purchaser's violation

(1) [4:279.25] **Criminal penalties (fines/imprisonment):** A purchaser convicted for violating Civ.C. § 1695.6 (regarding prohibited acts, ¶ 4:279.16 ff.), or for engaging in any practice that operates as a fraud or deceit upon the seller, *shall be* fined up to $25,000 and/or imprisoned in county jail for up to one year or in state prison *for each violation*. [Civ.C. § 1695.8; see also *People v. Shetty* (2009) 174 CA4th 1488, 1491-1492, 95 CR3d 355, 357—§ 1695.8, being an alternative felony misdemeanor statute, is subject to same statute of limitations applicable to felony violations (4 years for felony charges involving fraud)]

(2) [4:279.26] **Damages liability to seller:** Additionally, for a violation of Civ.C. § 1695.6 (regarding prohibited acts) or Civ.C. § 1695.13 (prohibition on taking "unconscionable advantage" of the property owner in foreclosure), the seller may bring a civil action against the purchaser for damages or equitable relief. The purchaser is liable for the seller's actual damages, plus reasonable attorney fees and costs; and is also exposed to *exemplary* (punitive) damages. [See Civ.C. § 1695.7—4-year statute of limitations; *Capon v. Monopoly Game LLC* (2011) 193 CA4th 344, 358, 122 CR3d 536, 547—seller entitled to restoration of home equity value at or near sale date (actual damages), plus reasonable attorney fees and costs]

(a) [4:279.27] **Damages caused by purchaser's "representative":** The purchaser also is liable for all damages caused by the purchaser's "representative" (¶ *4:279.9b*). [Civ.C. § 1695.15(a)]

Any provision in the sales contract that limits a purchaser's liability under Civ.C. § 1695.15 is void, renders the entire contract void at the seller's option, and exposes the purchaser to liability for all damages proximately caused thereby. [See Civ.C. § 1695.16(a)]

(3) [4:279.28] **Other rights, remedies and penalties:** The Act's criminal penalties and civil remedies are *in addition to* any other rights, remedies and penalties provided by law. [Civ.C. § 1695.9]

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Chapter 4. Purchase and Sale Agreement

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[4:280] This section discusses the various essential and nonessential (optional) terms to be included in a purchase and sale agreement. Most of the provisions discussed at ¶ 4:281 ff. are included in the Purchase and Sale Agreement reproduced at the close of this Chapter as *Form 4:H*.

Cross-refer—home equity sales contracts: Certain statutory terms and conditions *must* be included in contracts to purchase a residential property pending foreclosure ("home equity sales contracts" governed by Civ.C. § 1695 et seq.). These requirements are separately discussed at *¶ 4:279.5 ff.*

1. Dates

a. [4:281] **Date of contract:** The contract should bear a specific date, even if designated only "for reference (or identification) purposes" and even though the parties may actually sign it on a different date (or dates). (It is important to have a contract date both for purposes of identifying the document and as evidence of the date the contract was entered into.)

b. [4:282] **Performance deadlines:** To avoid confusion or dispute, deadlines for the performance of various acts under the agreement should be stated in terms of *specific dates*. Thus, whenever possible, a fixed calendar deadline should be used instead of a specified number of days. For example, instead of providing that "escrow shall close 45 days after all parties have deposited signed escrow instructions with the escrow holder," indicate a specific date certain for closing ("escrow shall close by … , …").

(1) [4:282.1] **Compare—reasonable where agreement silent:** If the agreement is silent concerning the time for performance, a "reasonable time" will be implied. [Civ.C. § 1657; *Patel v. Liebermensch* (2008) 45 C4th 344, 346, 351, 886 CR3d 366, 368, 371—Civ.C. § 1657 applies insofar as escrow period effectively determines time of payment (i.e., purchase price is deemed payable upon delivery of deed); see also *Conservatorship & Estate of Buchenau* (2011) 196 CA4th 1031,

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1039, 127 CR3d 109, 115—where no "time of essence" clause (¶ *4:535*), "reasonable time" may be allowed for performing escrow conditions even after scheduled closing date has passed (¶ *4:628.4*); *see further discussion at ¶ 11:56 ff.*]

A reasonable time will not be implied, however, simply because the deadline stated in the agreement is indefinite. [*Resolution Trust Corp. v. First American Bank* (9th Cir. 1998) 155 F3d 1126, 1128 (applying Calif. law)—agreement stating act should be done "as soon as possible" was *not* silent as to time for performance and thus did *not* trigger Civ.C. § 1657 implied "reasonable time"]

(2) [4:282.2] **Cross-refer—"time of essence" clause:** If a deadline for performance is intended to be a *material* term of the contract (the breach of which *might* excuse the other party's performance), express "time is of the essence" language should be included. *See discussion at ¶ 4:535 ff.*

c. [4:283] **Holidays and weekends:** When any act of performance of a "secular nature" falls on a weekend or holiday, it may be performed on the next business day. [Civ.C. § 11]

• [4:283.1] **Comment:** This statutory provision becomes important should the parties (or their attorneys) erroneously pick a closing date (and/or other deadlines for performance of certain contract obligations) that lands on a weekend or legal holiday. Of course, the most prudent approach is always to check your calendar to make certain the selected closing date is one on which banks, title insurance companies and the county recorder's offices are open.

2. [4:284] **Recitals:** Opening recitals, typically found in various contracts, are not essential. But they are often helpful (a) as an introduction or summary of the transaction, making the document more readable and understandable; (b) as a vehicle for a definitional section, giving the reader a preliminary dictionary of various terms used in the agreement (*see ¶ 4:552*); and (c) to highlight and emphasize important or critical terms. However, to the extent recitals contain important terms, they should expressly be incorporated as part of the agreement (*see ¶ 4:554*). (See also Ev.C. § 622—"facts recited in a written instrument are conclusively deemed to be true as between the parties thereto.")

3. [4:285] **Covenant to Buy and Sell:** The heart of the agreement is, of course, the companion obligations to sell and buy real property. The contract should therefore contain a specific covenant by the seller to sell the property and a corresponding covenant by the buyer to purchase the property.

4. [4:286] **Property Description:** The agreement should identify *all* property to be conveyed (the subject realty, fixtures and tangible and intangible personal property, as the case may be; ¶ *4:20 ff.*). To ensure an enforceable contract, however, the realty must be *adequately described*.

A legal description is advisable, as it is the most precise. But legal descriptions frequently are not readily available at the time a purchase agreement is executed; and the agreement is valid even though lacking a legal description (*see ¶ 4:270.7*).

➪ [4:286.1] ***PRACTICE POINTER:*** When a legal description is not yet available, the written agreement should describe the property as explicitly as possible—whether by street address, approximate acreage or reference to immediately adjacent property—so as not to run afoul of the statute of frauds (omitted essential term cannot be supplied by parol evidence, ¶ *4:270 ff.*). When a correct legal description is obtained, the parties should approve and confirm it in writing. Although not essential, the contract may include a clause that the parties will execute an *exhibit* (or amendment) upon obtaining the complete legal description.

5. [4:287] **Purchase Price:** The purchase price is, of course, an essential term. The agreement must indicate both the *amount* and the *method of payment*, with or without financing.

a. Amount

(1) [4:287.1] **Fixed price:** A purchase and sale for a fixed price need simply be stated by a sum certain and the date on which payment is due.

(2) [4:287.2] **Flexible price:** Sometimes the price is subject to computation, is unknown, or is made subject to conditions; i.e., the purchase price can be tied to the amount of acreage, the number of subdivided lots, the date of closing, or any other variable. The contract is enforceable so long as the price is certain or reasonably capable of being made certain by reference to the terms of the contract (*see ¶ 4:270.6*).

(a) Application

• [4:287.3] It is appropriate to agree upon a price per acre or per square foot of the property, so long as there is an objective, independent method for determining the precise size before the closing. Similarly, the total purchase price may be left for future calculation after deducting certain improvement costs to be agreed upon, so long as the contract provides an objective basis for determining those costs. [See *Larwin-Southern Calif., Inc. v. JGB Invest. Co., Inc.* (1979) 101 CA3d 626, 642-644, 162 CR 52, 61-62]

• [4:287.4] If the property is to become the subject of a new subdivision before the closing, the buyer may only be willing to pay a fixed amount per subdivided lot (or condominium) that is actually approved by the necessary governmental entities as of the closing date (see *Larwin-Southern Calif., Inc. v. JGB Invest. Co., Inc.* (1979) 101 CA3d 626, 642, 162 CR 52, 61). In such case, the seller may still want to provide for a minimum (and the buyer a maximum) purchase price, regardless of the actual number of units or lots approved.

• [4:287.5] Or, if the buyer is given the option of closing earlier (or later) than the scheduled closing date, the parties may want to include a provision adjusting the price accordingly (typically upward if the closing date is extended and downward if the closing occurs sooner).

➪ [4:287.6] ***PRACTICE POINTER:*** When a "flexible" purchase price is used, make certain that the *exact* price can be ascertained by an objective standard stated in the contract; otherwise, an essential term may be missing, rendering the contract vulnerable to a statute of frauds defense (*¶ 4:270 ff.*) or otherwise not specifically enforceable because fatally vague and uncertain.

b. Payment of purchase price

(1) [4:288] **All cash or cash plus note:** Unless the seller is providing financing, the agreement should state that the purchase price is to be paid "all in cash." In a seller-financed transaction, the purchase price should be reflected as an aggregate, with two components: the amount of the cash payment and the amount of the promissory note.

• [4:288.1] **Comment:** Many purchase agreements provide that the price will be paid partly in cash and partly "by a loan" (from a third party). This is actually incorrect since it does not matter to the seller that the buyer is procuring funds from a lender—the payment is still *all cash* to the seller.

(2) [4:289] **Deposits:** The buyer customarily makes a cash deposit upon execution of the contract (commonly referred to as a "good faith deposit"), which is usually held in escrow until the closing. However, most purchase agreements provide for a contingency period during which the buyer conducts inspections, investigations and various so-called "due diligence"; therefore, the deposit made upon signing is often minimal, and seller's counsel should consider requiring an increase in the deposit upon expiration of the contingency period.

(In residential transactions, the total deposit is usually limited to 3% of the purchase price, since that is generally the maximum permissible amount of liquidated damages; *see ¶ 4:321*.)

(a) [4:290] **"Downpayment" distinguished:** A "downpayment" is popularly used to describe that portion of the purchase price that is not procured from a loan. The buyer's cash deposit is not itself the "downpayment," although it becomes part of the downpayment and applies toward the purchase price.

➪ [4:291] ***PRACTICE POINTER:*** To protect the buyer's interests, the agreement should clearly state that the deposit is fully refundable during the "due diligence" period.

It should also designate whether the deposit is to be placed in an interest-bearing account and, if so, to whom the interest is to be credited (*see ¶ 4:599 ff.* regarding escrow holder's obligations).

(b) [4:291.1] **Transfer of title:** In the absence of escrow instructions to the contrary, title to a deposit vests in the seller when the seller accepts the underlying contract. [See *Rutherford Holdings, LLC v. Plaza Del Rey* (2014) 223 CA4th 221, 233-234, 166 CR3d 864, 874—deposit tendered directly to mobile home park vendor rather than placed in escrow resulted in transfer of title to vendor after sale did not close]

(3) [4:292] **Payments outside escrow:** There are two schools of thought as to whether any payments toward the purchase price should be made directly to the seller outside of escrow before the closing. Sellers contend that their property is being tied up during the term of the contract and (at least after the contingency period expires) the seller should therefore be

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entitled to an advance on the purchase price. Buyers, on the other hand, typically argue there is no reason to pay anything directly to the seller since the seller has not performed (i.e., seller has not yet conveyed title or delivered possession).

Conventional wisdom probably favors the buyer's position. In any event, however, monies released to the seller prior to closing should be deemed an "advance"; and the seller's obligation to repay (or credit the amount against the purchase price) should be secured by a deed of trust on the property in favor of the buyer. (The buyer should also obtain a lender's policy of title insurance.) In this manner, the buyer will (a) have secured the buyer's advance to the seller, and (b) have the threat of foreclosure hanging over the seller if the seller refuses to close. Such a deed of trust also inhibits the seller from further encumbering the property prior to closing.

(4) [4:293] **Existing financing:** The parties may wish to have the buyer take over existing financing on the property. Because the precise amount of the outstanding balance of existing financing may not be known to the parties at the time the purchase agreement is signed (or may change by reason of the seller's interim installment payments before the closing date), the purchase agreement should clarify that the cash portion of the purchase price will be adjusted depending on the amount of the outstanding balance of the loan as of the closing date.

(a) [4:294] **Advantages of existing financing:** The buyer's taking over existing financing offers these advantages:

• It may permit the seller to avoid prepayment penalties (which savings can be shared with the buyer);

• The terms of the existing financing may be more favorable than then-existing mortgage loan rates;

• The buyer may avoid the delay and cost in obtaining a new loan (*see ¶ 6:314 ff. & 6:325 ff.*).

(b) [4:295] **"Subject to" vs. "assumption of" existing financing:** The buyer may purchase the property "subject to" existing financing or may specifically "assume" existing financing. These are two completely different concepts and are frequently confused (*see detailed discussion at ¶ 6:313 ff. & 6:325 ff.*):

1) [4:296] **"Subject to":** When property is purchased "subject to" existing financing, the buyer makes no arrangements with the existing lender to contractually take over the loan. The loan still remains a lien against the property and the buyer simply starts making payments to the existing lender after the closing. Most significantly, the buyer has *no independent liability* to the lender since not in any contractual relationship with the lender. [*Cornelison v. Kornbluth* (1975) 15 C3d 590, 596-597, 125 CR 557, 561]

➪ [4:297] ***PRACTICE POINTER:*** The absence of personal liability to the lender may make the "subject to" alternative attractive to buyers. But it leaves the seller (as the original contracting borrower) open to potential residual liability on the loan. At a minimum, the seller risks a negative impact on the seller's credit rating should the buyer fail to make loan payments.

Moreover, many trust deeds in favor of institutional lenders contain a "due-on-sale" clause (*see ¶ 6:388 ff.*). Such a clause permits the lender to accelerate the loan upon a sale of the encumbered property to a new party unless the lender gives specific written approval of the buyer. While it is not illegal to purchase property subject to an existing deed of trust that contains a due-on-sale clause, the buyer runs the risk that the loan will be accelerated in the event the lender discovers the transfer.

2) [4:298] **Assumption:** Many existing loans may be specifically *assumed* by the buyer upon the lender's approval of the buyer's credit and the payment of a fee. A buyer's assumption is subject to the statute of frauds and, therefore, must be in writing. [Civ.C. § 1624(a)(6), ¶ *6:323*]

Unlike the "subject to" transaction (¶ 4:296), an assumption renders the buyer *contractually liable* to the lender. At the same time, the seller also remains liable as a "surety." [*Birkhofer v. Krumm* (1935) 4 CA2d 43, 48-49, 40 P2d 553, 556; see also Civ.C. § 2832 re positions of sureties]

Of course, the obligations of the seller and assuming purchaser are subject to antideficiency laws. (*See ¶ 6:510 ff.*)

➪ [4:299] ***PRACTICE POINTER:*** If the buyer desires to assume the loan, the purchase agreement should specify who is obligated to pay the assumption fee (if any).

➪ [4:300] ***PRACTICE POINTER:*** Buyers and sellers often provide that the buyer will "assume" an existing loan, but do not contemplate what happens should the lender refuse to give its approval. If the buyer cannot assume the loan, the parties should have negotiated whether (i) the buyer nonetheless remains obligated to purchase the property and pay off the existing financing (together with any prepayment penalty), or (ii) the buyer can, at its

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election, terminate the purchase agreement. In either event, the buyer should, at a minimum, be required to use good faith efforts to make application to assume the existing financing.

3) [4:301] **Beneficiary statement:** In either case (buyer *assuming* existing financing or taking *subject to* existing financing), a "beneficiary statement" (or other form of "estoppel certificate") should be obtained from the existing lender. [Civ.C. § 2943]

The owner (seller) and certain other "entitled persons" (see Civ.C. § 2943(a)(4)) may compel a lender to deliver a written statement providing the following information about the loan:

• The amount of the unpaid loan balance and the interest rate;

• The amount of overdue installments (principal and/or interest);

• The amount of periodic payments;

• The date on which the obligation matures;

• The date to which real property taxes and special assessments have been paid to the extent known by the lender;

• The amount of hazard insurance in effect and the term and premium therefor to the extent known by the lender;

• The amount in any impound account for the payment of property taxes and insurance premiums;

• The nature and, if known, the amount of any additional charges, costs or expenses paid or incurred by the lender that have become a lien on the property; and

• Whether the secured obligation may be transferred to a new borrower. [See Civ.C. § 2943(a)(2)]

(The above information is statutorily-required; but most lenders will supply additional information if requested.)

a) [4:302] **Impact:** A beneficiary statement "may be relied upon by the entitled person or his or her authorized agent in accordance with its terms …" [Civ.C. § 2943(d)(1)] Thus, a current beneficiary statement may be the basis upon which the parties make their allocations at the closing between the cash portion of the purchase price and the amount of the then-existing financing.

However, a beneficiary statement does not itself amount to a representation that may be relied upon as establishing the amount necessary to *pay off* the secured obligation. For that purpose, the parties must request a *payoff demand statement* (*see ¶ 4:304.1 ff.*). [Civ.C. § 2943(d)(1)]

b) [4:303] **Time-frame:** The beneficiary statement must be provided by the trust deed beneficiary within 21 days after written request therefor. [Civ.C. § 2943(b) & (e)(4); *Venhaus v. Shultz* (2007) 155 CA4th 1072, 1080, 66 CR3d 432, 437—trust deed holder's failure to timely provide property owner with beneficiary statement deemed sufficiently wrongful to support negligent interference with prospective economic relations claim]

➪ [4:304] ***PRACTICE POINTER:*** Because it often takes lenders more than 21 days to respond (particularly private lenders), a beneficiary statement is one of the first matters that should be pursued after execution of the purchase agreement.

If it is impossible to obtain a beneficiary statement by the closing date, the buyer may wish to rely on the seller's representation and warranty as to the outstanding balance of existing financing (*¶ 4:450*).

c) [4:304.1] **"Payoff demand statement" distinguished; significance:** "Entitled persons" (including the obligor and authorized escrow holders; see Civ.C. § 2943(a)(4)) also have the right, upon written request, to be furnished with the secured lender's "payoff demand statement." [Civ.C. § 2943(c)—payoff demand statement to be delivered within 21 days of receipt of request]

The request for and delivery of a payoff demand statement typically happens through escrow (*¶ 4:604*). The statement is significant because, unlike a beneficiary statement (¶ 4:301 ff.), it may be relied upon by the *borrower* "for the purpose of *establishing the amount necessary to pay the [secured] obligation in full*." [Civ.C. § 2943(d)(1) (emphasis added); *California Nat'l Bank v. Havis* (2004) 120 CA4th 1122, 1134-1135, 16 CR3d 245, 253—

lender's letter provided to escrow agent stating it had received payoff funds, but not informing borrower of amount necessary to satisfy loan, could not be relied upon as basis for extinguishing lender's lien on property]

In effect, therefore, Civ.C. § 2943(d) puts the responsibility for calculating the amount needed to satisfy the secured loan on the *lender* (trust deed beneficiary/mortgagee)—not the debtor (trustor/mortgagor). [*Cathay Bank v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 266, 271, 53 CR2d 595, 598]

In this regard, the lender may *amend* a payoff demand statement that sets forth incomplete or erroneous information. If notice of any such amendment is not given in writing, a written amendment must be delivered to the "entitled person" or their authorized agent *no later than the next business day* after notification. [Civ.C. § 2943(d)(2); *California Nat'l Bank v. Havis* (2004) 120 CA4th 1122, 1136, 16 CR3d 245, 255—lender's declaration purportedly memorializing oral amendment to letter containing payoff information improperly excluded in summary judgment proceeding because letter *not* payoff demand statement (see above) and Civ.C. § 2943(d)(2) (requiring amendment to be in writing) is not a rule of evidence under which declaration testimony could be excluded]

1/ [4:304.2] **"Reliance" date:** In connection with a *voluntary* transaction, the statement may be relied upon as of the *earlier* of the (i) close of escrow, (ii) transfer of title, or (iii) recordation of a lien. [Civ.C. § 2943(d)(3)(A)]

With regard to *foreclosure* transactions, the statement may be relied upon as of the date of acceptance of the "last and highest bid" at the foreclosure sale. [Civ.C. § 2943(d)(3)(B)]

2/ [4:304.3] **Result if payoff demand statement understated:** Amounts that were due but not included in the payoff demand statement (or any amended statement, *see ¶ 4:304.1*) remain recoverable by the lender pursuant to the original note … but only as an *unsecured* obligation. [Civ.C. § 2943(d)(3)]

In other words, amounts erroneously omitted from the payoff demand statement are *not secured* by the deed of trust after the entitled person changes their position in reliance on the statement (e.g., by closing escrow and paying off the lender's demand on the assumption it completely discharges the note). [See *Cathay Bank v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 266, 271, 53 CR2d 595, 598]

[4:304.4] ***Reserved.***

d) [4:304.5] **Ambiguous requests for statement treated as request for payoff demand statement:** Where a request for a Civ.C. § 2943 statement does not specify a beneficiary statement or payoff demand statement, the trust deed beneficiary (lender) "shall treat the request as a request for a payoff demand statement." [Civ.C. § 2943(e)(1)]

e) [4:304.6] **Maximum fee:** The lender may charge a maximum $30 fee for furnishing a beneficiary statement or payoff demand statement. [Civ.C. § 2943(e)(6) (inapplicable to mortgages or deeds of trust insured by Federal Housing Administrator or guaranteed by Administrator of Veterans Affairs)]

f) [4:304.7] **Penalty for failure to provide statement:** Willful failure to prepare and deliver a beneficiary statement or payoff demand statement within 21 days after receipt of written request therefor renders the beneficiary (lender) liable to the "entitled person" for (i) all damages the entitled person may suffer, *plus* (ii) a $300 penalty (whether or not the entitled person sustains actual damages). [See Civ.C. § 2943(e)(4)—"willful" failure means intentional noncompliance with Civ.C. § 2943 "without just cause or excuse"]

6. [4:305] **Tax Allocations:** For tax purposes, it is sometimes advantageous to allocate the property (and therefore the purchase price) between personal and real property. Personal property may occasionally be depreciated faster than real property.

On the other hand, there may be other reasons why more of the purchase price should be allocated to the real property. This is essentially a tax question; but counsel should be aware of the following issues:

a. [4:306] **Documentary transfer tax:** A "documentary transfer tax" (payable to the County Tax Assessor) is an excise tax imposed by counties and some municipalities in connection with the recordation of deeds or other documents evidencing transfers of ownership of real property within the county or municipality. [See Rev. & Tax.C. § 11911; *926 North Ardmore Ave., LLC v. County of Los Angeles* (2017) 3 C5th 319, 332, 219 CR3d 695, 704, fn. 13—transfer tax is excise tax on privilege of conveying real property by means of written instrument; see also *Ashford Hospitality v. City & County of San Francisco* (2021) 61 CA5th 498, 505-509, 275 CR3d 672, 677-680—city transfer tax with tiered or graduated rates did not violate U.S. Constitution's Equal Protection Clause; *Fielder v. City of Los Angeles* (1993) 14 CA4th 137, 142, 146, 17 CR2d 630, 633,

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635—upholding constitutionality of Los Angeles City ordinance imposing transfer tax of $2.25 for each $500 of purchase price for real property sold and rejecting state law preemption challenge thereto]

The documentary transfer tax rate is lower than the personal property sales tax rate. [See Rev. & Tax.C. § 11911]

(1) [4:306a] **Taxable transfers; "realty sold":** Counties and municipalities are authorized to impose documentary transfer taxes when there is "realty sold." [Rev. & Tax.C. § 11911(a)]

"Realty sold" is not defined in Civ.C. § 11911 (above), so courts look to the "sufficiently similar" phrase "change in ownership" (Rev. & Tax.C. § 60 et seq.; *¶ 13:66 ff.*) to determine whether a particular transaction qualifies as "realty sold." [*731 Market Street Owner, LLC v. City & County of San Francisco* (2020) 50 CA5th 937, 944-945, 264 CR3d 490, 495—after sale and transfer of underlying property, city and county could not impose transfer tax on commercial lease with remaining term of more than 35 years because no change occurred in leasehold's ownership]

(2) [4:306.1] **Based on "consideration or value":** Documentary transfer taxes may be based either on *consideration* (purchase price) or property *value.* [See Rev. & Tax.C. § 11911; *Brown v. County of Los Angeles* (1999) 72 CA4th 665, 668, 85 CR2d 414, 415—no authority to base tax on amount of unpaid debt]

(a) [4:306.2] **"Consideration" as basis:** The transfer tax *must* be based upon the purchase price (consideration) where that amount is definite or may be definitely determined. [*Brown v. County of Los Angeles* (1999) 72 CA4th 665, 668-669, 85 CR2d 414, 415-416]

(b) [4:306.3] **"Value" as basis:** On the other hand, where the purchase price (consideration) is indefinite or contingent on future occurrences, the tax may be based upon the property's net value. [*Brown v. County of Los Angeles* (1999) 72 CA4th 665, 669, 85 CR2d 414, 416]

1) [4:306.4] **Excluding value of personal property:** But the portion of the property's "value" representing personal property and/or intangible assets must be *excluded*. [*County of Los Angeles v. Southern Calif. Edison Co.* (2003) 112 CA4th 1108, 1122, 5 CR3d 575, 586-587]

➪ [4:306.5] ***PRACTICE POINTER:*** Third parties can determine the purchase price of property by the amount of documentary transfer tax set forth on the face of the recorded deed. Hence, your client may wish to file a separate, unrecorded statement evidencing the documentary transfer tax paid. Title companies can provide you with the appropriate form.

[4:306.6 - 4:306.9] ***Reserved.***

(3) [4:306.10] **Statutory exemptions:** The statutes authorizing local imposition of a documentary transfer tax also provide numerous exemptions from the tax (Rev. & Tax.C. §§ 11921-11930). Notably, the federal government and its agencies, and any state government or "political subdivision" thereof, are exempt from paying the tax when acquiring title to real property. [Rev. & Tax.C. § 11922; see 85 Ops.Cal.Atty.Gen. 235—exempt "political subdivision" includes cities]

(4) [4:306.11] **Legal entity transfers:** Generally, the transfer of an interest in a legal entity does not result in a change in ownership of the entity's real property (Rev. & Tax.C. § 64(a)). Under Rev. & Tax.C. § 11911, however, a transfer tax may be imposed whenever the transfer results in a change in ownership of real property within the meaning of Rev. & Tax.C. § 64(c) or (d) (distinguishing between "true" changes in ownership and "paper" ones). This is so provided there is a written instrument reflecting a sale of the property for consideration. [See *926 North Ardmore Ave., LLC v. County of Los Angeles* (2017) 3 C5th 319, 338, 219 CR3d 695, 700, 709 (transfer tax upheld)—written instruments not only reflected transfer of beneficial ownership in building, but other evidence demonstrated two family member trusts paid another family member's subtrusts for interests acquired in building, constituting consideration for sale]

b. [4:307] **Real property tax assessment:** Real property taxes are based on the purchase price of the property (*¶ 13:65*). Allocating a low number to the real property can thus keep the real property tax down.

c. [4:308] **Tax basis:** On the other hand, allocating a low number to the real property reduces the tax basis of the property for income tax purposes (*¶ 13:4 ff.*). In turn, when the property is sold, the taxable gain (income tax due in respect of the sale) will be higher (*¶ 13:301 ff.*).

Cross-refer: For a comprehensive treatment of tax issues in real property purchase and sale transactions, *see Ch. 13*.

[4:309] ***Reserved.***

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7. [4:310] **Liquidated Damages:** To avoid uncertainty and litigation should a breach occur, the parties may wish to add a liquidated damages provision fixing the amount of damages in advance. [See *Allen v. Smith* (2002) 94 CA4th 1270, 1278, 114 CR2d 898, 903; *El Centro Mall, LLC v. Payless Shoesource, Inc.* (2009) 174 CA4th 58, 63, 94 CR3d 43, 47—objective is to stipulate to "pre-estimate of damages" so parties can know with reasonable certainty extent of liability in event of breach]

Liquidated damages clauses may be included for either party's benefit. However, real property transactions typically liquidate only the *seller's* damages.

a. Pros and cons for seller

(1) [4:311] **Advantages:** For the buyer's breach of an agreement to purchase real property, the seller is entitled to recover the "excess, if any, of the amount which would have been due to the seller under the contract over the value of the property to him or her, consequential damages according to proof, and interest." [Civ.C. § 3307] This is basically the difference between the fair market value of the property on the scheduled closing date and the contract price—i.e., a "benefit of the bargain" measure of recovery (*see detailed discussion at ¶ 11:101 ff.*). [*Kuish v. Smith* (2010) 181 CA4th 1419, 1425-1426, 105 CR3d 475, 480 (also noting considerations of good and bad faith are not required in determining seller's damages)]

However, if the contract includes a valid liquidated damages provision (in an amount sufficient to compensate the seller), the seller's lawsuit for buyer's breach will be much simpler: The seller still must prove a breach, but will not have to obtain appraisals (*¶ 6:650 ff.*) or introduce other proof of damages. Moreover, in an appreciating market, the seller will be entitled to receive liquidated damages and perhaps still sell the property to a new buyer for an even higher price … a result not possible under Civ.C. § 3307 (of course, the seller will no longer be entitled to Civ.C. § 3307 "benefit of the bargain" damages). [See *Kuish v. Smith*, supra, 181 CA4th at 1426, 105 CR3d at 480]

(2) [4:312] **Disadvantages:** From the seller's perspective, there are two potential disadvantages to a liquidated damages provision: (a) In a depreciating market, the seller's actual damages could exceed the agreedupon liquidated amount (but even then, such a clause may still be advantageous because it eliminates the cost and uncertainty of proving damages in litigation); and (b) in residential transactions, liquidated damages generally cannot exceed 3% of the purchase price (*¶ 4:321*), whereas there is no ceiling on the recovery of nonliquidated damages (Civ.C. § 3307).

b. Pros and cons for buyer

(1) [4:313] **Advantage:** In agreeing to liquidated damages payable to the seller, buyers are able to fix the amount of their "downside" exposure. (Conceptually, liquidated damages are similar to option payments: As with an option to purchase, the buyer is entitled to tie up the property for a certain period of time, but may "walk away" from the deal for the price of the option payments. *See Ch. 8 for a thorough discussion of options*.)

(2) [4:314] **Disadvantages:** A disadvantage, of course, is that the buyer will be required to pay the liquidated damages even if the property has appreciated in value from the time the contract price was set. Also, the seller's burden in the event of a lawsuit will be far simpler, because the seller will not have to prove damages suffered (*¶ 4:311*); and when the seller's lawsuit is easier, it is more likely the seller will bring one. (Sellers who have to prove *both* breach and damages may be less inclined to sue at all.)

c. Validity

(1) [4:315] **Generally valid unless "unreasonable":** Generally, a liquidated damages provision is valid unless the contesting party shows the provision was "unreasonable under the circumstances existing at the time the contract was made." [Civ.C. § 1671(b); see Civ.C. § 1676—provisions for liquidated damages to seller if buyer breaches real property purchase agreement are valid subject to Civ.C. §§ 1671 and 1677 (*¶ 4:315.1 ff.*); *Vitatech Int'l, Inc. v. Sporn* (2017) 16 CA5th 796, 805, 224 CR3d 691, 698; *Allen v. Smith* (2002) 94 CA4th 1270, 1278, 114 CR2d 898, 903; see also *Hong v. Somerset Assocs.* (1984) 161 CA3d 111, 112, 207 CR 597, 598—$25,000 liquidated damages for buyer's breach of agreement to purchase $1,320,000 apartment complex held reasonable under circumstances]

(a) [4:315.1] **Presumption of validity:** Civ.C. § 1671(b) (¶ 4:315) effectively states a *presumption of validity*, placing the burden on the party who seeks invalidation to show the liquidated damages clause was unreasonable when the contract was executed. [*Californians For Population Stabilization v. Hewlett-Packard Co.* (1997) 58 CA4th 273, 288, 67 CR2d

621, 629 (abrogated on other grounds by *Cortez v. Purolator Air Filtration Products Co.* (2000) 23 C4th 163, 171-173, 96 CR2d 518, 524); see also *Krechuniak v. Noorzoy* (2017) 11 CA5th 713, 721, 217 CR3d 740, 747; *El Centro Mall, LLC v. Payless Shoesource, Inc.* (2009) 174 CA4th 58, 63, 94 CR3d 43, 46]

(Amounts approximating 2% of the purchase price as liquidated damages have been deemed "standard" in commercial real estate transactions. See *Hong v. Somerset Assocs.* (1984) 161 CA3d 111, 116, 207 CR 597, 600, fn. 7.)

(b) [4:316] **Reasonableness determination:** Civ.C. § 1671(b) gives contracting parties considerable leeway in liquidating damages for a breach. In litigation over the validity of the provision, all circumstances existing at the time the contract was executed are considered. [See Cal. Law Rev. Comm'n comment to West's Ann. Civ.C. § 1671; *Californians For Population Stabilization v. Hewlett-Packard Co.* (1997) 58 CA4th 273, 288, 67 CR2d 621, 629 (abrogated on other grounds by *Cortez v. Purolator Air Filtration Products Co.* (2000) 23 C4th 163, 171-173, 96 CR2d 518, 524); *Roodenburg v. Pavestone Co., L.P.* (2009) 171 CA4th 185, 195, 89 CR3d 558, 566; *El Centro Mall, LLC v. Payless Shoesource, Inc.* (2009) 174 CA4th 58, 63, 94 CR3d 43, 46]

The factors generally considered include:

- the relationship that the liquidated damages bear to the range of harm that reasonably could be anticipated at the time of the making of the contract (*see ¶ 4:316.6*);
- the parties' relative bargaining power;
- whether the parties were represented by counsel when the contract was made;
- the parties' anticipation that proof of actual damages would be costly or inconvenient;
- the difficulty of proving causation and foreseeability; and
- whether the liquidated damages clause is included in a form contract (and thus not the product of negotiation). [Cal. Law Rev. Comm'n comment to West's Ann. Civ.C. § 1671; *Weber, Lipshie & Co. v. Christian* (1997) 52 CA4th 645, 654-655, 60 CR2d 677, 681-682; see also *El Centro Mall, LLC v. Payless Shoesource, Inc.*, supra, 178 CA4th at 63, 94 CR3d at 46-47—liquidated damages amount must represent "reasonable endeavor" by parties to estimate fair average compensation for any loss sustained (so-called "reasonable endeavor test")]

In the context of a real property purchase agreement, courts evaluating reasonableness consider, among other things, the amount of the liquidated damages in relation to the total purchase price, how long the seller commits to taking the property off the market, what other obligations the seller agrees to before the closing date, and the parties' relative sophistication. [See *Hong v. Somerset Assocs.* (1984) 161 CA3d 111, 116, 207 CR 597, 600]

1) [4:316.1] **Damages actually suffered irrelevant:** Since "reasonableness" is judged as of the time the contract was made, the amount of damages actually suffered has no bearing on the validity of a liquidated damages provision. [*Hong v. Somerset Assocs.* (1984) 161 CA3d 111, 115, 207 CR 597, 600; *El Centro Mall, LLC v. Payless Shoesource, Inc.* (2009) 178 CA4th 58, 63, 94 CR3d 43, 46]

2) [4:316.2] **Effect as inducement to perform irrelevant:** Nor is a liquidated damages clause invalid simply because it operates to encourage performance, so long as it represents a reasonable attempt to anticipate the losses to be suffered in the event of a breach. [*Californians For Population Stabilization v. Hewlett-Packard Co.* (1997) 58 CA4th 273, 289, 67 CR2d 621, 629 (abrogated on other grounds by *Cortez v. Purolator Air Filtration Products Co.* (2000) 23 C4th 163, 171-173, 96 CR2d 518, 524)]

[4:316.3 - 4:316.5] ***Reserved.***

(c) [4:316.6] **Invalid penalty distinguished—disproportionate to anticipated harm:** A liquidated damages clause generally will be considered unreasonable, and thus an *unenforceable* penalty under Civ.C. § 1671(b), if it bears no reasonable relationship to the range of actual damages the parties could have anticipated would flow from a breach. [*Ridgley v. Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 977, 73 CR2d 378, 382—6-month interest "prepayment charge" in loan agreement was invalid liquidated damages clause as applied to borrower's late monthly payment; see also *Vitatech Int'l, Inc. v. Sporn* (2017) 16 CA5th 796, 806, 808-811, 224 CR3d 691, 699, 701-703 (noting

amounts disproportionate to anticipated damages equal penalties)—stipulated judgment for more than four times amount manufacturer agreed to accept as full settlement of its claims deemed unenforceable penalty for buyer's breach of settlement agreement; *Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc.* (2015) 232 CA4th 1332, 1337, 182 CR3d 235, 240-242 (applying general rule to contractual conditions agreed to by "sophisticated" parties)—excusing commercial tenant from opening store or paying rent in absence of anchor store imposed unenforceable penalty/ forfeiture on landlord, but allowing tenant to terminate lease after 12 months without anchor store did not; *Purcell v. Schweitzer* (2014) 224 CA4th 969, 975-976, 169 CR3d 90, 95—settlement agreement provision reinstating *full, original* amount owed if borrower made one late payment constituted unenforceable penalty because provision bore no reasonable relationship to damages lender might be expected to actually suffer from borrower's breach (¶ *6:233.3*); compare *Creditors Adjustment Bureau, Inc. v. Imani* (2022) 82 CA5th 131, 135-137, 298 CR3d 228, 230-231—stipulated judgment for *actual, agreed* upon damages caused by lessee's failure to pay amounts owed on ten-year commercial lease was neither unenforceable penalty/forfeiture nor liquidated damages provision and therefore fully enforceable against lessee; *JJD-HOV Elk Grove, LLC v. Jo-Ann Stores, LLC* (2022) 80 CA5th 409, 421, 426, 295 CR3d 725, 733, 737, rev.grntd. 10/12/22 (Case No. S275843), cited for persuasive value pursuant to CRC 8.1115 (declining to follow *Grand Prospect Partners*)—commercial lease provision varying tenant's rent based on shopping center's occupancy level or number of anchor stores deemed enforceable against landlord]

1) Application

• [4:316.7] A settlement agreement provision requiring forfeiture of a home buyer's $31,000 deposit due to a three-week delay in delivering a quitclaim deed was an invalid penalty. There was no evidence of reasonably anticipated damages even though the delay kept the subject property off the market for three weeks. [*Timney v. Lin* (2003) 106 CA4th 1121, 1128, 131 CR2d 387, 391-392, fn. 3]

• [4:316.8] That part of a real property purchase agreement permitting the seller to retain a defaulting buyer's down payment was deemed an invalid penalty during a period of rising property values and thus not enforceable as a valid liquidated damages clause:

> "Although such a provision [for liquidated damages] in a contract for the sale of real property is presumptively valid, if the down payment is reasonable in amount [citations], when as in this case the evidence establishes that it would not 'be impracticable or extremely difficult to fix the actual damages' [citation], such a provision may not be enforced as one for liquidated damages [citations]." [*Freedman v. Rector, Wardens & Vestrymen of St. Mathias Parish* (1951) 37 C2d 16, 23, 230 P2d 629, 633; see also *Kuish v. Smith* (2010) 181 CA4th 1419, 1425-1429, 105 CR3d 475, 480-483—"nonrefundable deposit" provision in real property purchase agreement, even if construed as liquidated damages provision, constituted invalid forfeiture during rising market]

• [4:316.9] A commercial lease provision allowing the landlord to collect double rent if the tenant breached the lease in any manner was an invalid penalty. The double-rent provision lacked a proportional relationship to the actual damages likely to be suffered. [*Harbor Island Holdings, L.L.C. v. Kim* (2003) 107 CA4th 790, 797, 132 CR2d 406, 410]

• [4:316.10] A commercial lease provision charging a retail tenant 10 cents per square foot per day in the event of a breach was an unenforceable penalty to the extent it was used as the basis for estimating percentage rental damages. Another section of the lease provided a readily ascertainable basis for calculating percentage rental damages, rendering the liquidated damages clause unnecessary except to penalize the tenant. (The provision was presumptively valid, however, as to damages for loss of synergy, goodwill and patronage.) [*El Centro Mall, LLC v. Payless Shoesource, Inc.* (2009) 174 CA4th 58, 64, 94 CR3d 43, 47]

• [4:316.11] A contractual provision appearing at first glance to be an unenforceable penalty may instead be a provision that *permissibly* calls for alternative performance by the obligor. Thus, "[w]here the contract clearly reserves to the owner the power to make a realistic and rational choice in the future with respect to the subject matter of the contract, a valid alternative performance provision will be found." [See *McGuire v. More-Gas Investments, LLC* (2013) 220 CA4th 512, 514, 523, 163 CR3d 225, 228, 235 (internal quotes omitted)—summary judgment reversed where movant failed to eliminate possibility contractual provisions in two real estate purchase contracts were valid alternative performance provisions]

2) [4:316.12] **Compare—canceling discount for late payments:** A lender may agree to deduct a certain amount from a borrower's total debt contingent on the borrower making timely installment payments. If the borrower fails to do so, however, canceling the discount and requiring the borrower to pay back the entire amount of the original debt does not constitute an unenforceable penalty. Rather, the discount amount is part of the lender's actual damages because it was a portion of the existing debt. [*Jade Fashion & Co., Inc. v. Harkham Indus., Inc.* (2014) 229 CA4th 635, 648-649, 177 CR3d 184, 196—supplier's agreement to deduct $17,500 from buyer's total debt if buyer made timely installment payments did not constitute unenforceable penalty when supplier refused to allow deduction after buyer paid five installments late]

By the same token, a purported discount can be an unenforceable penalty if it increases the amount of the original debt owed. [See *Red & White Distribution, LLC v. Osteroid Enterprises, LLC* (2019) 38 CA5th 582, 584, 588-589, 251 CR3d 400, 402, 405-406—settlement agreement provision allowing lender to file stipulated judgment for $700,000 more than settlement amount if borrower breached agreement was unenforceable penalty; *Harbor Island Holdings, L.L.C. v. Kim* (2003) 107 CA4th 790, 793, 798-799, 132 CR2d 406, 407, 411—provision in commercial lease extension that conditionally "deferred" half of monthly rent payments was unenforceable penalty because it effectively tripled amount of rent owed in event of any breach]

[4:316.13 - 4:316.14] ***Reserved.***

3) [4:316.15] **Whether commercial or consumer transaction:** The same standards apply in both consumer and commercial transactions. Despite an "arm's-length commercial transaction," parties are entitled to Civ.C. § 1671's protection against unreasonable penalties. [See *Ridgley v. Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 981, 73 CR2d 378, 385, fn. 5; *Harbor Island Holdings, L.L.C. v. Kim* (2003) 107 CA4th 790, 799, 132 CR2d 406, 411-412]

Cross-refer: Invalidation as a "penalty" more commonly occurs in the context of financing transactions and, in particular, with contractual late payment and prepayment charges. *See* ¶ *6:230 ff., 6:259 ff.*

➪ [4:317] ***PRACTICE POINTER:*** To help ensure the enforceability of a liquidated damages provision, it can't hurt to recite some "magic words" reflecting the factors courts look to when reasonableness is contested. For instance, the contract might recite that in fixing the liquidated amount, the parties considered the actual harm likely to be suffered in the event of a breach and that they agree the liquidated sum is "fair and reasonable" under the circumstances.

[4:318] ***Reserved.***

(2) [4:319] **Formality requirements:** No provision *obligating the buyer* to pay liquidated damages to the seller is valid unless (a) separately signed or initialed by both buyer and seller; and (b) if included in a printed contract, set out either in minimum 10-point bold type or minimum 8-point bold contrasting red print. [Civ.C. § 1677(a) & (b); see *Kuish v. Smith* (2010) 181 CA4th 1419, 1429, 105 CR3d 475, 483—nonrefundable deposit provision in real property purchase agreement could not be construed as liquidated damages provision because, among other things, it failed to meet Civ.C. § 1677 signature requirement]

(These requirements are intended to make it more likely that the parties will appreciate the consequences of a liquidated damages clause. See *Allen v. Smith* (2002) 94 CA4th 1270, 1283, 114 CR2d 898, 907; *Hong v. Somerset Assocs.* (1984) 161 CA3d 111, 115, 207 CR 597, 599-600.)

(a) [4:319.1] **Substantial compliance sufficient:** *Substantial compliance* with the Civ.C. § 1677 requirements is sufficient to validate a liquidated damages clause where the circumstances "make it likely that the parties appreciate[d] the consequences" of agreeing to such a clause. [*Allen v. Smith* (2002) 94 CA4th 1270, 1282-1283, 114 CR2d 898, 907; *Guthman v. Moss* (1984) 150 CA3d 501, 511, 198 CR 54, 61—substantial compliance with § 1677 even though liquidated damages clause not initialed but appeared on same page as parties' signatures, and contesting party drafted the clause as amendment to escrow instructions]

(b) [4:320] **Distinguish—liquidating damages to *buyer:*** Section 1677 applies *only* to provisions liquidating the *seller's* damages. [Civ.C. § 1677] A liquidated damages clause in the *buyer's* favor is subject only to the Civ.C. § 1671 "reasonableness" limitation. [Civ.C. § 1679]

(3) Limitations re residential property

(a) [4:321] **3% ceiling:** For a buyer's breach of an agreement to purchase residential property (defined as a dwelling containing not more than four residential units, where the buyer intends to occupy one or more of the units as the buyer's residence, Civ.C. § 1675(a)), liquidated damages for the benefit of the seller generally cannot exceed *3%* of the purchase price. [Civ.C. § 1675(c) & (d); *Timney v. Lin* (2003) 106 CA4th 1121, 1126, 131 CR2d 387, 390, fn. 2]

1) [4:322] **"Reasonableness" exception:** Even a 3% liquidated damages clause is invalid to the extent "unreasonable." Conversely, a more-than-3% liquidated damages clause is valid if "reasonable." [Civ.C. § 1675(c) & (d)]

"Reasonableness" for this purpose is determined in reference to (i) the circumstances existing when the contract was made; and (ii) the price and other terms and circumstances of any subsequent sale or contract to sell and purchase the same property if that sale or contract is made within six months of the buyer's default. [Civ.C. § 1675(e)]

➪ [4:322.1] ***PRACTICE POINTER:*** Despite the validity of "reasonable" liquidated damages clauses for more than 3% (¶ 4:322), common practice, and the better view, limits liquidated damages to a maximum 3%, thus avoiding future disputes as to whether a greater amount is "reasonable." [See *Allen v. Smith* (2002) 94 CA4th 1270, 1282, 114 CR2d 898, 906—liquidated damages provision in real property purchase contract stated "the amount retained shall be no more than 3% of the purchase price. Any excess shall be returned to Buyer"]

[4:323] ***Reserved.***

2) [4:323.1] **Special rules re purchase agreement for newly-constructed condominium (10 units or more):** Special rules apply when the buyer of a newly-constructed attached condominium unit (as defined by Civ.C. § 783) located within a structure of 10 or more units breaches a purchase agreement and the amount *actually paid* to the seller pursuant to the agreement's liquidated damages provision exceeds 3% of the unit's purchase price (Civ.C. § 1675(f)):

a) [4:323.2] **Accounting required:** The seller is required to perform an accounting of its costs and revenues related to and fairly allocable to the construction and sale of subject unit, as well as to any delay caused by the buyer's default, within *60 calendar days* after the final close of escrow for the unit. [Civ.C. § 1675(f)(1)(A)]

1/ [4:323.3] **Earlier accounting for "new qualified buyer":** If the default is by a "new qualified buyer" (below), the seller must perform the accounting (¶ 4:323.2) within 60 calendar days after the buyer *entered into* the agreement. [Civ.C. § 1675(f)(5)]

A "new qualified buyer" is a buyer who has been issued a loan commitment satisfying the agreement's loan contingency provision, and who has agreed to pay a purchase price greater than or equal to the price agreed to be paid by the *original* buyer of the unit. [Civ.C. § 1675(f)(7)]

b) [4:323.4] **Possible refund to buyer:** The seller must make reasonable efforts to mitigate any damages arising from the buyer's default. In addition, the seller is required to *refund* to the buyer any amounts retained as liquidated damages in excess of the greater of either 3% of the originally agreed-upon purchase price of the unit, or the amount of the seller's losses resulting from the buyer's default, as calculated by the accounting described at ¶ *4:323.2*. Any such refund shall be made within *90 days* after the close of escrow for the sale *or* lease of *all* of the units within the condominium structure. [Civ.C. § 1675(f)(1)(B), (2)]

c) [4:323.5] **Less-than-3% liquidated damages presumed valid:** If the amount of liquidated damages retained by the seller after the accounting does not exceed 3% of the unit's purchase price, the amount is valid *unless* the buyer establishes it is unreasonable under the Civ.C. § 1675(e) criteria (¶ *4:322*). [Civ.C. § 1675(f)(3)]

(b) [4:324] **Multiple liquidated damages payments:** If more than one payment by the buyer is to constitute liquidated damages under Civ.C. § 1675 (re residential property purchase agreements, ¶ 4:321 ff.), the amount of any payment after the first payment is valid as liquidated damages only if (i) the *total* of all such payments satisfies Civ.C. § 1675 (generally, does not exceed 3% of purchase price); and (ii) a *separate* liquidated damages provision satisfying Civ.C. § 1677 (¶ *4:319*) is *separately* signed or initialed by each party for each of the subsequent payments. [Civ.C. § 1678]

1) [4:324.1] **Substantial compliance sufficient:** *Substantial compliance* with the Civ.C. § 1678 requirements is sufficient to validate multiple liquidated damages payments where the circumstances show the parties' awareness that additional payments were to be subject to the liquidated damages clause. [*Allen v. Smith* (2002) 94 CA4th

1270, 1282-1283, 114 CR2d 898, 907—increased deposit in counteroffer valid liquidated damages even though not specifically referred to as "liquidated damages" since buyer's agent wrote the language in the counteroffer signed by both parties; *see also ¶ 4:319.1*]

(4) [4:325] **Exception for "real property sales contracts":** The liquidated damages rules described at ¶ 4:321 ff. (Civ.C. §§ 1675 et seq.) do *not* apply to "real property sales contracts" (land sale contracts) under Civ.C. § 2985. [Civ.C. § 1681]

d. [4:326] **Practical enforcement problems:** The full amount of agreed-upon liquidated damages is often placed in escrow as the buyer's "good faith deposit"; but the seller is not entitled to receive that amount unless and until the buyer's breach occurs and some action is taken by both parties to cause the escrow holder to release the monies.

This is so even though the purchase agreement (and/or separate escrow instructions) states that the liquidated damage amount is to be paid to the seller by the escrow holder automatically and without further consent of the buyer upon the buyer's breach. As a practical matter, escrow holders generally refuse to release monies in dispute (*see ¶ 4:633 ff.*). Indeed, most preprinted escrow instructions provide that the escrow holder is not obligated to disburse disputed funds, but may interplead them in court—with *buyer and seller paying the escrow holder's attorney fees and litigation expenses* (*see ¶ 4:647*).

8. [4:327] **Condition of Title:** The purchase agreement should carefully set forth the condition of title required to be conveyed by the seller and accepted by the buyer.

a. [4:328] **"Marketable title":** Although the terms "marketable title" and "insurable title" are frequently used to describe the condition of title to be conveyed, they are usually *inadequate* to precisely describe the seller's and buyer's obligations.

In legal effect, "marketable title" means "a title which a reasonable purchaser, well informed as to the facts and their legal bearings, willing and anxious to perform his contract, would, in the exercise of that prudence which business men ordinarily bring to bear on such transactions, be willing and ought to accept." More simply, "marketable title" is generally defined as one that is free from reasonable doubt in law or fact; one that may readily be sold to a reasonably prudent purchaser. A mere suspicion or speculative possibility of a future defect in title does *not* render it unmarketable. [*Mertens v. Berendsen* (1931) 213 C 111, 113, 1 P2d 440, 441; *Mortgage Assocs., Inc. v. Fidelity & Dep. Co. of Maryland* (2002) 105 CA4th 28, 37, 129 CR2d 365, 371; see *Mellinger v. Ticor Title Ins. Co. of Calif.* (2001) 93 CA4th 691, 695, 113 CR2d 357, 360—triable issue whether reasonable purchaser would buy property knowing encroachment affected small portion of property (*¶ 3:102 ff.*)]

Given the highly technical, legal definition, title could be "marketable" (or "insurable") yet be unacceptable to the buyer. For example, a seller arguably holds marketable title even though it may be subject to a third party's recorded option to purchase at a lower price. Or, the property may be encumbered by a long-term ground lease yielding a very low rent, or by extremely restrictive covenants effectively precluding development. These restrictions may still render title "marketable," but hardly what the buyer bargained for.

b. Practical considerations

(1) [4:329] **Seller's perspective:** Sellers are concerned that their obligations to deliver title are clear and somewhat limited; significantly, they typically do not want to be bound to deliver title free of those encumbrances which may be costly, time-consuming or impossible to remove. (Encumbrances and liens are also referred to as "exceptions to title" or "title exceptions" in preliminary title reports or title policies—i.e., exceptions to title insurance coverage; *see* ¶ *3:210 ff., 3:236 ff.*)

Ideally, the seller should only agree to deliver title subject to such exceptions as those in existence at the time of signing the purchase agreement (other than monetary liens which the seller should remove at closing).

(2) [4:330] **Buyer's perspective:** Buyers are principally concerned that they not be required to purchase the property subject to title exceptions they have not reviewed and approved. Therefore, the buyer should always be entitled to review a current title report and complete copies of the title exceptions.

➪ [4:331] ***PRACTICE POINTER:*** A title report only *lists* the exceptions to title; it does not include or attach copies of the exceptions. Indeed, descriptions in the title report do not necessarily correctly or adequately describe their substance. Thus, reviewing *actual copies* of the exceptions to title is essential to ascertain the full condition of title.

[4:332 - 4:333] ***Reserved.***

c. [4:334] **Preliminary report; preliminary title report:** The easiest way for sellers to verify the condition of title is to review a current "preliminary report" (also referred to as a "preliminary title report"). Time and expense permitting, it is beneficial to order the report early in the negotiations so that the parties will know the condition of title upon signing the purchase agreement. In this manner, they will not later be surprised by discovery of a judgment lien, mechanic's lien or other involuntary lien (of which the seller was unaware) or a voluntary lien, encumbrance or deed restriction (that the seller may have forgotten about). [See *Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.* (2009) 171 CA4th 1356, 1389, 124 CR3d 271, 301—buyer who receives and reads preliminary title report has actual notice of any revealed deed restrictions]

➪ [4:335] ***PRACTICE POINTER:*** When ordering a preliminary report before entering into a purchase agreement, it makes sense to use a well-known title company that would be acceptable to most buyers. This will avoid the possibility of having to switch title companies at a later date (which, in turn, would require the purchase of a second title report).

(1) [4:336] **Delivery to buyer:** The preliminary report and copies of all exceptions to title should be delivered to the buyer as soon as possible. The buyer should then be given a certain period of time to approve or disapprove the report (*see ¶ 4:404 ff.*).

(2) [4:337] **Use as exhibit to contract:** The title report can be attached as an exhibit to (or otherwise identified and incorporated by reference in) the purchase agreement. Also, the agreement should identify those exceptions to title that will, and will not, be removed as of the closing.

Cross-refer: Preliminary reports are discussed in detail in *Ch. 3*; *see, in particular, ¶ 3:200 ff.*

d. Removal of title exceptions

(1) [4:338] **Nonmonetary exceptions:** Most sellers prefer not to have any obligation to remove nonmonetary exceptions to title (e.g., easements bordering the property, or covenants, conditions and restrictions affecting the property). However, to circumvent any buyer's right to terminate the contract, it may be beneficial for the seller to have the *right*—at the seller's *election*—to remove those nonmonetary title exceptions of which the buyer disapproves. Therefore, consider providing in the purchase agreement that, if the buyer disapproves a particular exception to title, the seller will have the right—but not the obligation—to remove the exception within a specified period of time.

(2) [4:339] **Monetary liens:** The agreement should require the seller to remove all *monetary* liens *other than* (a) financing that the buyer agrees to take over; (b) current taxes constituting a "lien not yet due and payable" at the closing (however, current real estate taxes are usually prorated as of the closing, *¶ 4:612 ff.*); and (c) bonds or assessments to be allocated between buyer and seller as of the closing (*¶ 4:617*).

e. [4:340] **Method of conveyance:** In connection with the condition of title, it is also advisable (though not essential) to specify the method of conveyance. Typically, this will be a grant deed (*but see* ¶ *4:38, 4:41* re conveyancing instruments for personal and intangible property).

f. [4:341] **Statutory implied covenants relating to title:** Whether or not expressed in the purchase agreement, two important covenants regarding the condition of title are implied in a real property conveyance (Civ.C. § 1113, *¶ 4:37.1*): Unless otherwise expressly provided in the conveyancing instrument, by executing a conveyance using the word "grant" (e.g., a grant deed), the grantor impliedly covenants that:

- Prior to the time of execution of the deed, the grantor has not conveyed the grantor's estate in the property, or any right, title or interest therein, to any other person (Civ.C. § 1113(1)); and

- At the time of execution of the deed, the conveyed estate is free from encumbrances made or suffered by the grantor or any person claiming under the grantor (Civ.C. § 1113(2)).

  These implied covenants (but no others) may be sued upon in the same manner as if they had been expressly inserted in the conveyance. [Civ.C. § 1113]

g. [4:342] **Title insurance:** The seller has *no* implied obligation to provide title insurance. [See *Seymour v. Shaeffer* (1947) 82 CA2d 823, 825, 187 P2d 95, 97 (disapproved on other grounds by *Ellis v. Mihelis* (1963) 60 C2d 206, 216, 32 CR 415, 421)] Thus, the same section of the agreement addressing the condition of title should also specify that title insurance will be

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issued at, and *as a condition of*, the closing, insuring that title is in the condition called for by the agreement. The agreement should further identify which party is responsible for the costs of procuring the insurance.

(1) [4:343] **CLTA or ALTA:** The purchase agreement must state whether the title insurance is to be a CLTA Standard (California Land Title Association), ALTA Owner's (American Land Title Association) or CLTA/ALTA Homeowner's policy (*see ¶ 3:75 ff.*). If ALTA coverage is required, the agreement should indicate who has the obligation to procure and pay for the survey.

➪ [4:344] ***PRACTICE POINTER:*** A survey may disclose exceptions to title that are not reflected in the preliminary report. These additional title exceptions should be handled the same way as recorded exceptions—i.e., the buyer will want the right, within a specified period of time, to approve or disapprove such exceptions.

(2) [4:344.1] **Mandatory disclosure statement in escrow if no title insurance to be issued:** If, in an escrow transaction, a title insurance policy will *not* be issued to the buyer at, or as a condition of, the closing, a mandatory disclosure statement regarding the advisability of obtaining title insurance must be provided to the buyer (Civ.C. § 1057.6). *See ¶ 4:601.1*.

9. Physical Condition of Property and Inspections/Investigations

a. [4:345] **Practical considerations:** Those sections of the purchase agreement addressing the physical condition of the property, and rights of inspection and investigation, are a reflection of several important concerns for the parties:

[4:346] *Reserved.*

(1) [4:347] **Seller's concerns:** The seller has three main concerns with respect to the physical condition of the property:

- Compliance with statutory written disclosure requirements (Civ.C. § 1102 et seq.; *see ¶ 4:354 ff.*);
- Avoiding potential liability for fraud or negligent misrepresentation arising out of the failure to disclose known defects;
- Disclaiming or limiting any other implied or express representations, so that the conveyance is otherwise an "as is" sale (*¶ 4:351*).

(2) [4:348] **Buyer's concerns:** The buyer, in contrast, has these two principal concerns:

- Maximizing the buyer's recourse against the seller by requiring specific representations and warranties concerning the physical condition of the property;
- Entering into the transaction with full knowledge about the physical condition of the property by ensuring a right, mechanism and time period to conduct inspections, investigations, studies and other "due diligence" concerning the physical condition.

[4:349] *Reserved.*

b. [4:350] **Buyer's inspection rights:** Most purchase agreements should allow the buyer a broad right to inspect the physical condition of the property; and should provide the buyer with *sufficient time and access* to the property to perform all the buyer's "due diligence" inspections, investigations and analyses. (Generally, the only situation where a buyer is not given time to inspect the physical condition of the property is where the buyer is an existing tenant—who presumably knows all the pertinent information.)

- **Checklist:** A checklist for the buyer's inspection ("due diligence") is set forth at *¶ 4:367 ff.*

➪ [4:350a] ***PRACTICE POINTERS FOR SELLERS:*** A clause should also be added to the agreement, for the *seller's benefit*, stating that the buyer will rely on its own inspection and that, except as otherwise stated, neither the seller nor seller's agents makes any express or implied representations concerning the physical condition of the land or improvements.

Additionally, sellers should insist on the buyer's agreement to *indemnify* the seller for any loss, damage or injury to the property resulting from the buyer's (or buyer's agent's) inspections. (When there is significant concern about potential damage from a buyer's inspections, the seller may also want the buyer to name the seller as an additional insured on the

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buyer's insurance policies. However, such a provision is unusual because neither party wants to delay commencement of inspections while the buyer attempts to procure further insurance coverage. And, in any event, the seller's insurance usually will cover any such damage.)

(1) [4:350.1] **"Home inspection" regulation:** Many residential property buyers hire a home inspection service to conduct a thorough physical inspection of the prospective property. "Home inspections" and "home inspectors," as defined at ¶ 4:350.2, are subject to statutory regulation to ensure that consumers can rely upon the competence of home inspectors. [Bus. & Prof.C. § 7195 et seq.]

(a) [4:350.2] **Definitions—which home inspections, inspectors and reports:** A "home inspection" for this purpose is a "noninvasive, physical examination, performed for a fee, in connection with a transfer … of [one to four dwelling units], of the mechanical, electrical, or plumbing systems or the structural and essential components of [the dwelling] designed to identify material defects in those systems, structures, and components." [Bus. & Prof.C. § 7195(a) & (e)]

A "home inspector" is any individual who performs a "home inspection" (above). [Bus. & Prof.C. § 7195(d)]

A "home inspection report" is any written report prepared for a fee following a home inspection. [Bus. & Prof.C. § 7195(c)—for dwellings with pools/spas, report must identify which, if any, of seven drowning prevention safety features (as defined) the pool/spa is equipped with and state if pool/spa has fewer than two; see also Bus. & Prof.C. § 7196.2 (requiring inspector's observation of "any shade of yellow corrugated stainless steel tubing" be included in report along with statutorily-prescribed notification re manufacturers' safety recommendations)]

A "material defect" within the meaning of these statutes is any condition that significantly affects the value, desirability, habitability or safety of the dwelling. [Bus. & Prof.C. § 7195(b)—"style or aesthetics shall not be considered in determining whether a system, structure, or component is defective"]

(b) [4:350.3] **Inspector's duty of care:** A home inspector who is not a licensed contractor, structural pest control operator, architect or registered engineer has a duty "to conduct a home inspection with the degree of care that a reasonably prudent home inspector would exercise." [Bus. & Prof.C. § 7196; *Moreno v. Sanchez* (2003) 106 CA4th 1415, 1435, 131 CR2d 684, 699; *Leko v. Cornerstone Bldg. Inspection Service* (2001) 86 CA4th 1109, 1116, 103 CR2d 858, 863-864]

The duty is more precisely clarified by an uncodified statement of legislative intent: "[I]n ascertaining the degree of care that would be exercised by a reasonably prudent home inspector … , the court may consider the standards of practice and code of ethics of the California Real Estate Inspection Association, the American Society of Home Inspectors, or other nationally recognized professional home inspection association." [Stats. 1996, Ch. 338, § 1]

1) [4:350.4] **Liability:** A home inspector or home inspection company that negligently fails to discover and/or disclose defects in real property it inspects may be liable to clients who purchase the property for breach of the common law or statutory duty to exercise due care in inspecting the property and preparing a home inspection report. [*Moreno v. Sanchez* (2003) 106 CA4th 1415, 1436, 131 CR2d 684, 699—inspector liable in tort despite written contract; *Leko v. Cornerstone Bldg. Inspection Service* (2001) 86 CA4th 1109, 1119, 103 CR2d 858, 866]

To the extent the home inspector's breach of duty overlaps with a *broker's* duty to inspect and disclose, the liability is *joint and several*. [*Leko v. Cornerstone Bldg. Inspection Service*, supra, 86 CA4th at 1116, 1119, 103 CR2d at 864, 866; *see discussion at ¶ 2:157.16*]

a) [4:350.5] **Liability to remote purchasers:** In certain circumstances, a home inspector's liability may even extend to *subsequent purchasers* (*nonclients*).

A home inspector who negligently prepares an inspection report directly for a broker and/or buyer, knowing with "substantial certainty" that the report may also be provided to future purchasers, can be held liable to those future purchasers who rely on the report to their detriment. [*Leko v. Cornerstone Bldg. Inspection Service* (2001) 86 CA4th 1109, 1120-1121, 103 CR2d 858, 866-867]

2) [4:350.6] **Waiver or liability limits invalid:** Contractual provisions purporting to waive the Bus. & Prof.C. § 7196 duty, or to limit a home inspector's liability to the cost of the home inspection report, are invalid as contrary to public policy. [Bus. & Prof.C. § 7198]

3) [4:350.7] **Accrual of cause of action; statute of limitations:** The statute of limitations on an action for breach of duty arising from a home inspection report is normally four years from the date of the inspection. [Bus. & Prof.C. § 7199] The cause of action accrues (commencing the limitations period) not on the date of the inspection, but when

the homeowner *discovers*, or with the exercise of reasonable diligence *should have discovered*, the breach (so-called "delayed discovery rule"). [*Moreno v. Sanchez* (2003) 106 CA4th 1415, 1432, 131 CR2d 684, 696]

The written contract may provide for a *shorter limitations period*, but it *cannot* shorten the *accrual period*. [*Moreno v. Sanchez*, supra, 106 CA4th at 1432-1434, 131 CR2d at 696-698—contract substituting "straight one-year statute of limitations" for "delayed discovery" accrual unenforceable]

[4:350.8 - 4:350.9] ***Reserved.***

(c) [4:350.10] **Unfair business practices:** It is an unfair business practice for a home inspector, or any company employing an inspector, or any company that has control of or a financial interest in such company to (Bus. & Prof.C. § 7197):

• Perform (or offer to perform) for an additional fee any repairs to a structure on which the inspector (or inspector's company) has prepared a home inspection report in the past 12 months;

• Inspect for a fee any property in which the inspector (or inspector's company) has a financial interest or interest in the transfer of the property;

• Offer or deliver compensation to the owner, broker or agent of the inspected property for the referral of business to the inspector or inspection company;

• Agree to make an inspection or prepare a report when the employment or fee is contingent upon the conclusions in the report, preestablished findings, or the close of escrow. [See Bus. & Prof.C. § 7197(a)-(d) (exempting licensed roof contractors, as defined, who perform repairs for purposes of providing roof certifications if specified conditions are met)]

c. Impact of "as is" sale

(1) [4:351] **Implied warning to buyers:** Many real property sales are made on a so-called "as is" basis. The term is not well-defined by law. "[A]n 'as is' provision in any sale puts potential buyers on notice that the seller makes no warranty about the quality or condition of the thing sold. In practice it serves as a kind of 'red flag' warning the buyer that the goods or property to be sold may not be in perfect condition or of ideal quality." [*Shapiro v. Hu* (1986) 188 CA3d 324, 333, 233 CR 470, 475; see also *Loughrin v. Sup.Ct. (Barr)* (1993) 15 CA4th 1188, 1195, 19 CR2d 161, 164—"as is" sale simply means buyer "accepts the property in the condition visible or observable by him"]

(a) [4:351.1] **Special caveat for buyers of tax-defaulted property:** Tax-defaulted real property is usually sold on an "as is" basis at public auction (Rev. & Tax.C. § 3691 et seq.). Bidders are impliedly, if not expressly, warned to thoroughly research the value and condition of the property, as common law contract remedies (e.g., rescission or damages) are *not available* (*but see ¶ 4:351.1a*). [*Ribeiro v. County of El Dorado* (2011) 195 CA4th 354, 356-357, 125 CR3d 577, 578-579—investor who mistakenly bought real estate from public entity at tax sale without knowing bond arrearage amount was limited to statutory remedies and not entitled to rescind; *Van Petten v. County of San Diego* (1995) 38 CA4th 43, 50-51, 44 CR2d 816, 821 (buyer who purchased in reliance on grossly overinflated assessed value had no remedy) —exclusive remedies are refund of purchase money paid and only where court determines tax deed is void (Rev. & Tax.C. § 3729) or property "should not have been sold" (Rev. & Tax.C. § 3731)]

In effect, the doctrine of "caveat emptor" applies at tax sales, and absent an explicit statutory remedy, the buyer has no remedy. [See *Craland, Inc. v. State of Calif.* (1989) 214 CA3d 1400, 263 CR 255]

1) [4:351.1a] **Contra authority:** One earlier case holds otherwise—i.e., the contractual remedy of rescission is available in connection with the purchase of tax-defaulted property because the Revenue & Taxation Code does not state its remedies are exclusive. [See *Schultz v. County of Contra Costa* (1984) 157 CA3d 242, 247, 203 CR 760, 763]

Schultz, supra, however, has been criticized and probably was not decided correctly. [See *Ribeiro v. County of El Dorado* (2011) 195 CA4th 354, 367, 125 CR3d 577, 586—"we decline to follow *Schultz* and conclude that the holdings in *Craland* and *Van Petten* were correct"; *Van Petten v. County of San Diego* (1995) 38 CA4th 43, 50, 44 CR2d 816, 821—"We follow the well-settled rule … that purchasers of property at a tax sale are limited to

statutory remedies and reject *Schultz's* holding to the contrary"; *Craland, Inc. v. State of Calif.* (1989) 214 CA3d 1400, 1407, 263 CR 255, 260—"We disagree with *Schultz* ..."]

(b) [4:351.2] **Special caveat re property bought at execution/foreclosure sales:** The principal of "caveat emptor" is particularly apt when buying real property at an execution or foreclosure sale because there may be no opportunity to fully inspect the property before purchase. [See *Washington Mut. Bank v. Jacoby* (2009) 180 CA4th 639, 643-647, 103 CR3d 245, 248-251—despite unknown damage to property's interior, buyer not entitled to excess funds from sheriff's sale and fire insurance policy paid to lender in satisfaction of note secured by trust deed (insurance policy is personal contract between named insured and company that does *not* run with land)]

(2) [4:352] **Seller's disclosure obligations and potential liability notwithstanding:** Neither an "as is" sale nor the buyer's right of inspection exonerates the seller from (a) the obligation to make *written disclosures* required by Civ.C. § 1102 et seq. (*¶ 4:354 ff.*), or (b) liability for failure to disclose *known defects* in the property (i.e., intentional misrepresentation or fraudulent concealment; *see* ¶ *4:353 ff., 11:350 ff.*). [See Civ.C. § 1102.1(a) & (b)—delivery of real estate transfer disclosure statement or manufactured home/mobilehome transfer disclosure statement "may not be waived in an 'as is' sale"; *Shapiro v. Hu* (1986) 188 CA3d 324, 333-334, 233 CR 470, 476; but see *Heliotis v. Schuman* (1986) 181 CA3d 646, 650-651, 226 CR 509, 511-512—seller's *attorney* not obligated to disclose property defects to purchaser]

d. [4:353] **Common law disclosure requirements:** The seller has a common law obligation to disclose any facts within the seller's knowledge that materially affect the value or desirability of the property if the seller also is aware that those facts are not known to the buyer or within reach of the buyer's "diligent attention and observation." [*Lingsch v. Savage* (1963) 213 CA2d 729, 735, 29 CR 201, 204; *Shapiro v. Sutherland* (1998) 64 CA4th 1534, 1544, 76 CR2d 101, 107—sellers had duty to disclose neighborhood noise problem; see also *Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.* (2009) 171 CA4th 1356, 1389-1393, 124 CR3d 271, 301-304—mere recording of affordable housing deed restriction did not relieve sellers of duty to disclose its existence (defrauded buyers are not charged with constructive notice of public records)]

A fact is "material" for this purpose if it would have a significant and measurable effect on the property's market value. [*Calemine v. Samuelson* (2009) 171 CA4th 153, 161, 89 CR3d 495, 501; *Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 410, 98 CR2d 176, 182; see also *Holmes v. Summer* (2010) 188 CA4th 1510, 1518-1519, 1528, 116 CR3d 419, 424-425, 432—monetary liens and encumbrances may affect value and desirability of residential properties (seller's broker had duty to disclose substantial risk that overencumbered residential property could not be freely transferred, rendering broker potentially liable to buyer on negligence theory), *discussed further at ¶ 2:170.9*]

(1) [4:353.1] **Applicable to residential *and commercial transactions:*** The seller's common law duty to disclose undiscoverable material facts applies in *commercial* as well as residential real estate transactions. [See *Stevenson v. Baum* (1998) 65 CA4th 159, 165, 75 CR2d 904, 907 (mobilehome park)—seller "does not contend that there is a different or lesser duty to disclose in a commercial real estate transaction … than in a residential real estate transaction, *and we have found no California case law so holding*" (emphasis added)]

(2) [4:353.2] **Effect of obvious defects:** The common law obligation does not apply when a defect is *obvious* (or should be obvious upon a buyer's reasonably prudent inspection). In such cases, the seller has no duty to bring the defect to the buyer's attention *except* as required by Civ.C. § 1102 et seq. (residential real estate transactions, *¶ 4:354*).

Thus, a buyer who through "diligent attention and observation" could have discovered the adverse condition will be hard-pressed to convince a trier of fact that the seller's nondisclosure amounted to fraud or misrepresentation. [See *Pagano v. Krohn* (1997) 60 CA4th 1, 10, 70 CR2d 1, 5]

➪ [4:353.3] ***PRACTICE POINTER:*** The issue of what is or is not an "obvious" defect can be debatable. Thus, the better approach is to enumerate in the purchase agreement any known defects in the property and have the buyer acknowledge and accept them.

(3) [4:353.4] **Disclosure of "essential facts" sufficient:** The seller has not failed to disclose material facts when the buyer is aware of the "essential facts" concerning a particular condition. [*Pagano v. Krohn* (1997) 60 CA4th 1, 10, 70 CR2d 1, 5; see also *Calemine v. Samuelson* (2009) 171 CA4th 153, 161, 89 CR3d 495, 502—once "essential facts" are disclosed, seller has no duty to provide details that would merely elaborate on disclosed facts]

• [4:353.5] Seller's disclosure of a general water intrusion problem at the condo development satisfied Seller's duty since Seller's particular unit was not affected by the water intrusion. [*Pagano v. Krohn* (1997) 60 CA4th 1, 10, 70 CR2d 1, 5]

• [4:353.5a] Similarly, Seller's duty regarding water intrusion in and around a condo development's slabs and sidewalks was satisfied once he provided Buyer with a general outline of the completed repairs and recommended obtaining a physical inspection. [*Calemine v. Samuelson* (2009) 171 CA4th 153, 164, 89 CR3d 495, 503-504—details regarding type and scope of repairs falls within "elaboration" category that is not part of seller's disclosure duty]

• [4:353.6] Seller's disclosure of the existence of an easement was sufficient where the true nature of the easement (for pipeline running beneath mobilehome spaces) could have been discovered by a search of the public records. [*Stevenson v. Baum* (1998) 65 CA4th 159, 165, 75 CR2d 904, 907]

• [4:353.7] Seller who disclosed to a condo buyer that the project's homeowner's association had sued the developer for construction defects and that the litigation had settled was not further bound to investigate and disclose the details of the lawsuit (buyer could have examined the court file). [*Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 411, 98 CR2d 176, 183; but see also *Calemine v. Samuelson* (2009) 171 CA4th 153, 166, 89 CR3d 495, 505—seller's duty to disclose "essential facts" extends to *previous* as well as pending lawsuits]

[4:353.8 - 4:353.9] ***Reserved.***

(4) [4:353.10] **Disclosure of opinions re value not required:** The seller's duty of disclosure does *not* include a duty to disclose *opinions* learned from others concerning how the practical ramifications of disclosed facts might adversely impact the property's value. [*Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 411-412, 98 CR2d 176, 183-184; *see also* ¶ *2:170.9*]

e. [4:354] **Statutory disclosure requirements (residential property; manufactured homes/mobilehomes):** By statute (Civ.C. § 1102 et seq.), sellers of *single-family residential* property (including leases with an option to purchase same) are required to make several written disclosures to prospective buyers regarding the physical condition of the property; and similar statutory disclosure requirements apply to resales of manufactured homes and mobilehomes (as defined in Health & Saf.C. §§ 18007 & 18008, respectively). [See Civ.C. § 1102(a); Bus. & Prof.C. § 10018.08 (defining "single-family residential property" as (i) real property improved with one to four dwelling units, including any leasehold exceeding one year's duration of such, (ii) a unit in a residential stock cooperative, condominium or planned unit development, and (iii) mobile/manufactured homes offered for sale or sold through real estate brokers pursuant to Bus. & Prof.C. § 10131.6); Health & Saf.C. §§ 18025(c) & 18046(c)—sales of used manufactured homes/mobilehomes by licensed real estate brokers and salespersons are subject to Civ.C. § 2079; Civ.C. § 798.74.4 (requirements include use of Civ.C. § 1102.6d Manufactured Home and Mobilehome Transfer Disclosure Statement; ¶ 2:185.3); *Realmuto v. Gagnard* (2003) 110 CA4th 193, 200-201, 1 CR3d 569, 574-575 (decided under former law) (discussing purposes of Civ.C. § 1102 et seq.); *Richman v. Hartley* (2014) 224 CA4th 1182, 1184, 169 CR3d 475, 477 (decided under former law)—transfer disclosure requirements apply even to "mixed-use" properties if they contain up to four dwelling units (¶ *2:185.1*)]

The § 1102 et seq. "transfer disclosure" requirements are *nonwaivable*, even in an "as is" sale (¶ *4:352*). [Civ.C. §§ 1102(c), 1102.1(a) & (b); *Realmuto v. Gagnard*, supra, 110 CA4th at 201-202, 1 CR3d at 575—nonwaiver provision not limited to particular form of waiver]

Indeed, when the property is otherwise within the ambit of the disclosure statutes, the disclosure requirements apply notwithstanding the buyer's stated intent not to use it as a residence. [*Realmuto v. Gagnard*, supra, 110 CA4th at 203, 1 CR3d at 577]

➪ [4:354.1] ***PRACTICE POINTER:*** Remember that the Civ.C. § 1102 et seq. obligations are in *addition to*—not in lieu of—the parties' and agents' obligations to disclose any fact "materially affecting the value and desirability of the property, including … the physical conditions of the property and previously received reports of physical inspections …" [Civ.C. § 1102.1(a) & (b); *see* ¶ *2:186*]

Indeed, the statutory scheme even more broadly states that the identification of items for disclosure in Civ.C. § 1102 et seq. "does not limit or abridge *any obligation for disclosure* created by any other provision of law or which may exist in order to avoid fraud, misrepresentation, or deceit in the transfer transaction." [Civ.C. § 1102.8 (emphasis added)]

(1) [4:355] **Form of transfer disclosure statement:** For *single-family residential property* sales, the statutory disclosures must be made on the form prescribed by Civ.C. § 1102.6 ("Real Estate Transfer Disclosure Statement"). [Civ.C. §§ 1102.1(a), 1102.6]

Mobilehome/manufactured home resales: A separate, but parallel transfer disclosure statement is prescribed by Civ.C. § 1102.6d for resales of manufactured homes or mobilehomes used for residential purposes. [See Civ.C. §§ 1102.1(b) & (c), 1102.6d ("Manufactured Home and Mobilehome Transfer Disclosure Statement")]

(a) [4:356] **"Good faith" requirement:** Each of the required disclosures (and each act that may be performed in making the disclosures) must be made in "good faith"—i.e., "honesty in fact in the conduct of the transaction." [Civ.C. § 1102.7; *Shapiro v. Sutherland* (1998) 64 CA4th 1534, 1545, 76 CR2d 101, 107]

(b) [4:357] **Unavailable information:** If an item of information required to be disclosed is unknown or unavailable to the seller (or agent) at the time the disclosures are required to be made, and the seller (or agent) has made a "reasonable effort" to ascertain it, the seller may instead use an "approximation of the information"; but the approximation must be identified as such, must be "reasonable" and based on the best information "reasonably available" to the seller (or agent), and cannot be used for purposes of circumventing or evading Civ.C. § 1102 et seq. [Civ.C. § 1102.5—disclosure requirements in effect on date all parties enter contract/agreement are requirements that apply]

(c) [4:357.1] **Special disclosure notice if property subject to continuing lien securing special tax levy:** *See discussion at ¶ 2:197.*

(2) Delivery

(a) Time for delivery

1) [4:358] **Section 1102.6 transfer disclosure statement (residential property):** In the case of an outright sale of any single-family real property, the completed Civ.C. § 1102.6 transfer disclosure statement must be delivered to the prospective buyer "as soon as practicable before transfer of title." [Civ.C. § 1102.3(a)]

In the case of sale by a real property sales contract (as defined by Civ.C. § 2985), or a lease with an option to purchase, or a ground lease coupled with improvements, the completed § 1102.6 statement must be delivered "as soon as practicable before execution of the contract." [Civ.C. § 1102.3(b)]

The seller must indicate compliance with the delivery requirement on the real property sales contract, the lease "or any addendum attached thereto or on a separate document." [Civ.C. § 1102.3(c)]

2) [4:358.1] **Section 1102.6d transfer disclosure statement (manufactured home/mobilehome resales):** In the case of a sale or lease with option to purchase of a manufactured home or mobilehome involving an agent, the Civ.C. § 1102.6d transfer disclosure statement must be delivered to the prospective buyer "as soon as practicable" but, at the latest, by the close of escrow. [Civ.C. § 1102.3a(a)(1)]

If no agent is involved in the sale (or lease with option to purchase), the § 1102.6d statement must be delivered "at the time of execution of any document by the prospective transferee with the transferor for the purchase of the manufactured home or mobilehome." [Civ.C. § 1102.3a(a)(2)]

The seller must indicate compliance with the delivery requirement either on the transfer disclosure statement, an addendum thereto, or on a separate document. [Civ.C. § 1102.3a(b)]

(b) [4:359] **Method of delivery:** The requisite transfer disclosure statement must be transmitted to the buyer by personal delivery or to a prospective buyer by mail. (Unless the contract otherwise states, delivery to the transferee's spouse (or registered domestic partner, see Fam.C. § 297.5(a)) suffices.) [Civ.C. § 1102.10]

(c) [4:359.1] **Condition precedent to buyer's performance of purchase contract:** The seller's delivery of the transfer disclosure statement is a *nonwaivable condition precedent* to the buyer's duty to perform the purchase contract. "The Legislature plainly contemplated that buyers would never be irrevocably committed to performing the contract without having received the required disclosures." [*Realmuto v. Gagnard* (2003) 110 CA4th 193, 201, 1 CR3d 569, 575—seller's failure to deliver transfer disclosure statement was fatal to suit against buyer for specific performance of contract to purchase seller's home where seller sued buyer for specific performance; *see also* ¶ 11:80.5 ff., 11:88.2]

(d) [4:359.2] **Buyer's right to terminate/rescind if delivered after offer executed:** If any disclosure, or material amendment of disclosure, required by Civ.C. § 1102 et seq. is delivered "after the execution of an offer to purchase," the prospective buyer has (i) three days after delivery in person, (ii) five days after delivery by deposit in the mail, or (iii) five days after delivery of an electronic record, as statutorily specified, to "*terminate the offer*" by delivering a written notice of termination to the seller or seller's agent. The period of time the prospective buyer has in which to terminate their

offer commences when Sections I, II and, if the seller is represented by an agent in the transaction, then also Section III, of the Civ.C. § 1102.6 form are completed and delivered to the buyer or buyer's agent. A real estate agent may complete their own portion of the required disclosure by providing all the information on the agent's inspection disclosure set forth in said form. [Civ.C. §§ 1102.3, last para. (emphasis added), 1102.3a(c)]

Although the statute refers to the buyer's right to terminate their "offer," it is generally understood as giving the buyer the right to *rescind the contract* if the buyer's offer is accepted before delivery of the transfer disclosure statement. [See *Realmuto v. Gagnard* (2003) 110 CA4th 193, 201, 1 CR3d 569, 575]

[4:359.3 - 4:359.4] ***Reserved.***

(3) [4:359.5] **Amendments:** Disclosures made pursuant to Civ.C. § 1102 et seq. may be amended in writing by the seller (or the seller's agent); but amendments are subject to Civ.C. §§ 1102.3 or 1102.3a (buyer's right to terminate offer if material amendment delivered after execution of offer, ¶ 4:359.2). [Civ.C. § 1102.9]

(4) [4:360] **Impact:** The statutory disclosures are *not warranties* by the seller or seller's agent; nor are they a substitute for warranties or inspections that the parties actually obtain. Further, the seller's Civ.C. § 1102.6 (or § 1102.6d) disclosures are *not intended to be part of the purchase contract* between the buyer and seller. [See Civ.C. §§ 1102.6, 1102.6d; *Brasier v. Sparks* (1993) 17 CA4th 1756, 1760, 22 CR2d 1, 3—in their breach of contract, misrepresentation and negligence suit against seller, buyers could not rely, as part of purchase contract, on seller's statement in § 1102.6 form that seller was unaware of building code violations]

Rather, the purpose of the statutory scheme is to make "specific and clear" disclosures otherwise required by the common law and thereby assist prospective buyers in reaching an informed decision whether to purchase the property. [See *Calemine v. Samuelson* (2009) 171 CA4th 153, 162, 89 CR3d 495, 502]

(a) [4:361] **Potential fraud exposure:** Nonetheless, the seller remains exposed to liability for *knowing false representations or omissions* in the disclosure statement. This result is implicit in Civ.C. § 1102.4, which provides that the seller (or seller's or buyer's agent) incurs no liability for any "error, inaccuracy, or omission" of information in the statement if the error, inaccuracy or omission was "not within the personal knowledge of the seller or that listing or buyer's agent, was based on information timely provided by public agencies or by other persons providing information as specified … , and ordinary care was exercised in obtaining and transmitting it." [See Civ.C. § 1102.4(a); *Shapiro v. Sutherland* (1998) 64 CA4th 1534, 1547, 76 CR2d 101, 108]

Moreover, Civ.C. § 1102.8 expressly provides that the seller's potential liability for fraud, misrepresentation or deceit is unaffected by the statutory transfer disclosure statement requirements (*see ¶ 4:354.1*).

1) [4:361.1] **Liability to remote purchasers ("indirect deception doctrine"):** In certain circumstances, the seller's potential fraud liability may even extend to *subsequent purchasers*. Under the so-called "indirect deception doctrine," a seller who makes a fraudulent misrepresentation (or omission) to a direct buyer while *intending or having reason to expect* it will be relied and acted upon by a third person (subsequent buyer) is liable to the third person for loss suffered in justifiable reliance thereon. [*Shapiro v. Sutherland* (1998) 64 CA4th 1534, 1548, 76 CR2d 101, 109-110 (relying on Rest.2d Torts § 533)]

Thus, a subsequent buyer who relies on a prior seller's Civ.C. § 1102.6 disclosure statement may have an action for deceit against the prior seller even though the two were not in contractual privity. [*Shapiro v. Sutherland*, supra, 64 CA4th at 1550, 76 CR2d at 111—when seller sold property to relocation company whom seller *knew would immediately resell,* seller's failure to disclose known neighborhood noise problem to relocation company supported fraud cause of action by relocation company's buyer against seller]

Cross-refer: A seller's fraud liability to remote purchasers is discussed further at *¶ 11:355.1 ff.*

(5) [4:362] **Exemption for certain transfers:** Certain single-family residential property (or manufactured home/ mobilehome) transfers are *exempt* from the § 1102 et seq. disclosure statement requirements. [Civ.C. §§ 1102(a), 1102.2]

Among the several exemptions, the statutory disclosures are not required for:

- Sales or transfers pursuant to court order (in probate, by a trustee in bankruptcy, pursuant to writ of execution or decree for specific performance, etc.). [Civ.C. § 1102.2(b)]

- Sales or transfers to a mortgagee or trust deed beneficiary upon the mortgagor's/trustor's default, or by foreclosure sale after default, or by a mortgagee or trust deed beneficiary who acquired the property by foreclosure sale. [Civ.C. § 1102.2(c); see *Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 409, 98 CR2d 176, 182 (condo acquired by nonjudicial foreclosure)]

- Sales or transfers by a fiduciary in the course of administration of a decedent's estate, guardianship, conservatorship or trust (except that this exemption does not apply if the trustee is a natural person who is sole trustee of a revocable trust and either owned or occupied the property within the preceding year). [Civ.C. § 1102.2(d)]

- Sales or transfers between co-owners. [Civ.C. § 1102.2(e)]

- Sales or transfers to a spouse or registered domestic partner (see Fam.C. § 297.5(a)) or person(s) in the line of consanguinity of a transferor; or between spouses or registered domestic partners (see Fam.C. §§ 297.5(b), 299(d)) pursuant to a judgment of dissolution or legal separation or property settlement agreement incident thereto. [Civ.C. § 1102.2(f) & (g)]

- Transfers or exchanges to or from a governmental entity. [Civ.C. § 1102.2(j)]

- Sales or transfers of any portion of property not constituting single-family residential property. [Civ.C. § 1102.2(k)]

- The sale, creation, or transfer of any lease of any duration, except a lease with an option to purchase or a ground lease coupled with improvements. [Civ.C. § 1102.2(*l*)]

➪ [4:362.1] ***PRACTICE POINTER:*** As discussed, the Civ.C. § 1102 et seq. disclosure requirements do *not* displace the seller's (and seller's agent's) *common law* disclosure obligations (¶ *4:353 ff., 4:354.1*; *see* ¶ *2:186*). Thus, even if a transfer falls within one of the statutory exemptions (¶ 4:362 ff.), a Transfer Disclosure Statement (or other similar written document) should still be delivered to the prospective buyer if there are known defects in the property.

(6) [4:363] **Statutory remedy for noncompliance:** The validity of a sale subject to Civ.C. § 1102 et seq. is not affected by the seller's failure to provide the statutory disclosure statement. However, willful or negligent noncompliance when the sale has been completed (*see* ¶ *11:361.1*) renders the seller liable for the buyer's "actual damages." [Civ.C. § 1102.13; *Shapiro v. Sutherland* (1998) 64 CA4th 1534, 1545, 76 CR2d 101, 107-108; but see also *Loken v. Century 21-Award Properties* (1995) 36 CA4th 263, 274, 42 CR2d 683, 690—Civ.C. § 2079.4 *2-year statute of limitations* applies to buyer's cause of action alleging seller's broker's "per se violation" of § 1102 because it stems from broker's Civ.C. § 2079 inspection disclosure duty (*discussed at* ¶ *2:180.1 ff.*)]

(The seller is not in noncompliance if information properly disclosed is subsequently rendered inaccurate because of any act, occurrence or agreement after delivery of the required disclosures. See Civ.C. § 1102.5(a).)

(a) [4:363.1] **Compare—common law liability despite exempt transactions:** In exempt transactions (¶ *4:362*), a seller cannot incur liability under Civ.C. § 1102.13 for failure to deliver the transfer disclosure statement. However, the seller may still be liable under the *common law duty of disclosure* (¶ *4:353*). [See *Loughrin v. Sup.Ct. (Barr)* (1993) 15 CA4th 1188, 1195, 19 CR2d 161, 164]

[4:363.2 - 4:363.4] ***Reserved.***

(7) [4:363.5] **Seller's disclosure obligations ordinarily inapplicable to homeowners' associations:** Unless it acts as the seller, is a party to the sale contract or otherwise has assumed a fiduciary or "special" relationship with the buyer, a *homeowner's association* has *no duty* to disclose to prospective purchasers facts affecting the value or desirability of the property being sold. (The association has a fiduciary relationship with the seller and other association members, *not* with prospective purchasers.) [*Kovich v. Paseo Del Mar Homeowners' Ass'n* (1996) 41 CA4th 863, 866, 48 CR2d 758, 760]

Nor does a homeowner's association have a duty to monitor the seller for compliance with the seller's statutory and common law disclosure obligations. [*Kovich v. Paseo Del Mar Homeowners' Ass'n*, supra, 41 CA4th at 869, 48 CR2d at 762]

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Thus, e.g., a homeowner's association has no obligation to inform a prospective purchaser in the common interest development about construction defects in individual units or the existence of litigation against the developer to repair the defects. The *seller* is charged with the responsibility of disclosing that information, not the homeowner's association with whom the buyer has no fiduciary or contractual relationship. [*Kovich v. Paseo Del Mar Homeowners' Ass'n*, supra, 41 CA4th at 865, 48 CR2d at 759]

f. [4:364] **Additional disclosure requirements:** Provisions scattered through various state codes and federal statutes require additional disclosures in connection with the sale of specified property:

(1) [4:365] **"Natural hazard" areas:** If the property is located within a specified "flood hazard area" designated by the Federal Emergency Management Agency, an "area of potential flooding" shown on an inundation map prepared pursuant to Water Code § 6161, a "very high fire hazard severity zone" designated pursuant to Gov.C. § 51178, a "wildland" fire area designated pursuant to Pub.Res.C. § 4125 (substantial forest fire risks), an "earthquake fault zone" designated pursuant to Pub.Res.C. § 2622, or a "seismic hazard zone" designated pursuant to Pub.Res.C. § 2696, the seller or seller's agent must, in addition to the Civ.C. § 1102.6 (or Civ.C. § 1102.6d) transfer disclosure statement, deliver to prospective buyers a statutory "Natural Hazard Disclosure Statement" advising of the hazardous condition. [Civ.C. § 1103 et seq.; see Civ.C. § 1103.3 re time for delivery]

The Civ.C. § 1103 et seq. disclosure requirements are *nonwaivable*. [Civ.C. § 1103(d)—waiver "void as against public policy"]

(a) [4:365.1] **Which types of property:** Civ.C. § 1103 et seq. applies to sales, exchanges, real property sales contracts as defined in Civ.C. § 2985, leases with options to purchase, any other options to purchase, and ground leases coupled with improvements, of any "single-family residential real property." Section 1103 et seq. also applies to resales of manufactured homes or mobilehomes used as a residence. [See Civ.C. § 1103(b); Bus. & Prof.C. § 10018.08 (defining "single-family residential real property" as (i) real property improved with one to four dwelling units, including any leasehold exceeding one year's duration of such, (ii) a unit in a residential stock cooperative, condominium or planned unit development, and (iii) mobile/manufactured homes when offered for sale or sold through real estate brokers per Bus. & Prof.C. § 10131.6)]

Comparable provisions applicable to transfers of all other types of property are contained in Gov.C. §§ 8589.3, 8589.4, 51183.5; and Pub.Res.C. §§ 2621.9, 2694, 4136.

Several types of transfers, however, are *exempt* from the Civ.C. § 1103 et seq. disclosure requirements. [See Civ.C. § 1103.1; *and* ¶ *2:187.13*] (The exemptions are similar to the exemptions applicable to the real estate transfer disclosure requirement, ¶ *4:362*.)

(b) [4:365.2] **Form of statement; impact:** The form of the natural hazard disclosure statement is prescribed by Civ.C. § 1103.2. Like the Civ.C. § 1102.6 (and Civ.C. § 1102.6d) disclosure statement (¶ *4:360*), it is not a warranty. Its purpose is to enable prospective buyers to rely on the information in deciding whether and on what terms to purchase the property. The statement also warns buyers that the identified hazards may limit their ability to develop the property, to obtain insurance or to receive disaster assistance. [See Civ.C. § 1103.2(a)]

1) [4:365.3] **Other disclosure obligations unaffected:** As under Civ.C. § 1102 et seq. (transfer disclosure statement), the identification of items for disclosure in Civ.C. § 1103 et seq. neither limits nor abridges the seller's (and agent's) disclosure obligations under other law that may exist to avoid fraud, misrepresentation or deceit in the sale transaction. Quite apart from Civ.C. § 1103 et seq., sellers and their agents *remain bound* to disclose facts materially affecting the value and desirability of the property. [Civ.C. § 1103.8; *see also* ¶ *2:187.14*]

Cross-refer: The natural hazard disclosure requirements are quite complex. They are discussed in greater detail at ¶ *2:187 ff.*

(2) [4:366] **Certain industrial use zoning:** *See discussion at* ¶ *2:199.4*.

(3) [4:366.1] **Hazardous materials:** Sellers must disclose the existence of hazardous substances. [Health & Saf.C. § 78700 (added Stats. 2022, Ch. 257; eff. 1/1/24), *and* ¶ *2:192 ff.*]

(a) [4:366.2] **Lead-based paint in pre-1978 residential structures:** Federal law requires sellers of "target housing" (most residential properties *constructed before 1978*, see 42 USC § 4851b(27)) to disclose the presence of known lead-based paint and lead-based paint hazards (see 42 USC § 4851b(14) & (15)) in the housing *before the buyer*

becomes obligated under the purchase contract. [42 USC § 4852d; 24 CFR Part 35 (HUD regulations) & 40 CFR Part 745 (parallel EPA regulations); see 24 CFR § 35.88]

Additionally:

• [4:366.3] “Target housing” sellers must provide their prospective purchasers with a federally-approved *lead-based paint hazard information pamphlet* (an EPA pamphlet entitled “Protect Your Family From Lead in Your Home” or a state promulgated equivalent; see 24 CFR § 35.88). [24 CFR § 35.88(a)(1)]

• [4:366.4] Sellers must also furnish to prospective “target housing” purchasers available records and reports on lead-based paint and lead-based paint hazards within the housing or common areas. A list of the records or reports provided to the purchaser must be *included in the purchase contract* or by attachment thereto; and if no such records or reports are available, the contract must so indicate. [24 CFR §§ 35.88(a)(4), 35.92(a)(3)]

• [4:366.5] Before becoming obligated under the purchase contract, the purchaser must be given a 10-day opportunity to conduct a risk assessment or inspection for lead-based paint and lead-based paint hazards (unless the parties mutually agree in writing upon a different period of time or the purchaser waives the risk assessment/inspection right in writing). [42 USC § 4852d(a)(2)(C); 24 CFR § 35.90]

1) [4:366.6] **Exempt housing:** Certain pre-1978 housing is exempt from the disclosure/warning requirements: e.g., housing for the elderly or persons with disabilities (unless any child under age six resides or is expected to reside in the housing); and 0-bedroom dwellings (studio apartments, dormitory housing, etc.). [See 42 USC § 4851b(27); 24 CFR §§ 35.82(b), (c), (d) & 35.86]

2) [4:366.7] **Agent's obligations:** The seller's *real estate agent*, if any, is required to inform the seller of the lead-based paint disclosure obligations and to ensure the seller's compliance. The agent is personally responsible for making the disclosures if the seller fails to do so. [42 USC § 4852d(a)(4); 24 CFR § 35.94; *see also ¶ 2:195.1*]

3) [4:366.8] **Prescribed form of disclosures/warnings:** Specific disclosure and warning language must be included in the purchase contract or in an attachment thereto. [See 42 USC § 4852d(a); 24 CFR §§ 35.88(a), 35.92(a)]

4) [4:366.9] **Acknowledgment and certification; retention of records:** Sellers must obtain the purchaser's acknowledgment of receipt of the required disclosures and information. The seller, purchaser and any participating real estate agent must sign a certification of accuracy of the seller's disclosure and the purchaser's acknowledgment, and the seller must keep a copy of the completed certification for at least three years after the sale is consummated. [24 CFR § 35.92(a)(4), (7) & (c)(1)]

5) [4:366.10] **Penalties for noncompliance:** Sellers and their agents who knowingly violate the disclosure requirements are subject to civil or criminal fines of up to $10,000 per violation and/or imprisonment for up to one year; and may be enjoined. The violator also faces *treble damages liability* to the purchaser in a private civil suit (three times the amount of the lessee's actual damages caused by the failure to disclose), along with the purchaser's costs, attorney fees and expert witness fees incurred in the civil action. [See 42 USC §§ 3545, 4852d(b); 24 CFR § 35.96]

(b) [4:366.11] **Disclosure by providing DRE environmental hazards booklet:** A consumer information booklet entitled “Environmental Hazards: A Guide for Homeowners, Buyers, Landlords and Tenants,” published by the Department of Real Estate and available through the California Association of Realtors, describes common environmental hazards (including asbestos, lead-based paint and mold) that can affect real property. The seller's delivery of this booklet to the buyer “is deemed to be adequate to inform” the buyer of common environmental hazards that can affect the property. [Civ.C. § 2079.7(a)]

➪ [4:366.11a] ***PRACTICE POINTER:*** Notwithstanding delivery of the booklet to the buyer, prudence suggests that the seller explicitly disclose in writing any *known* environmental hazard conditions on the property. [See Civ.C. § 2079.7(b)—nothing in Civ.C. § 2079.7(a) alters seller's/broker's duty “to disclose the existence of known environmental hazards on or affecting the real property”]

Cross-refer: For further discussion of hazardous materials disclosure requirements in real property sales transactions, *see ¶ 2:192 ff.* And for a comprehensive treatment of environmental hazards liabilities, *see Ch. 5*.

[4:366.12 - 4:366.14] ***Reserved.***

(4) [4:366.15] **Home roof warranties:** Sellers of newly-constructed residential structures must provide their buyers with copies of roof warranties. [Civ.C. §§ 1797.90-1797.96]

(5) [4:366.16] **Anchoring water heaters:** All new and replacement water heaters and all existing residential water heaters must be braced, anchored or strapped to resist displacement in an earthquake. (At a minimum, water heaters must be secured in accordance with the California Plumbing Code or a municipality's modifications thereto made pursuant to Health & Saf.C. § 17958.5.) [Health & Saf.C. § 19211(a)]

Sellers of any real property containing a water heater must provide their prospective purchasers with written certification of compliance with this requirement. The certification may be included in the transactional documents, the Homeowner's Guide to Earthquake Safety (Bus. & Prof.C. § 10149), the real estate sales contract or receipt for deposit, or the Civ.C. § 1102.6/§ 1102.6a Real Estate Transfer Disclosure Statement. [Health & Saf.C. § 19211(b)]

(6) [4:366.17] **Proximity of registered sex offenders:** Contracts for the sale of single-family residential real property must contain a statutory notice, in at least 8-point type, advising that (i) law enforcement maintains for public access a data base of information about the location of registered sex offenders (applicable to contracts entered into on or after 7/1/99 and before 9/1/05); or (ii) the Department of Justice maintains for public access an "Internet Web site at www.meganslaw.ca.gov" containing the addresses where registered sex offenders reside or the "community of residence and ZIP Code" in which the offenders reside (applicable to contracts entered into on or after 4/1/06). A contract entered into on or after 9/1/05 and before 4/1/06, must contain one or the other of these notices. (see Civ.C. § 2079.10a(a) (also applicable to residential lease or rental agreements))]

(a) [4:366.18] **Notice "deemed" adequate:** Unless otherwise required by an existing duty (statutory or common law), no further information is required from the seller regarding the proximity in the neighborhood of registered sex offenders —i.e., delivery of the statutory notice (¶ 4:366.17) is "deemed" adequate. [Civ.C. § 2079.10a(b), (c)]

(b) [4:366.19] **Statutory immunity:** Registered sex offenders have *no* cause of action against the disclosing party based on information contained in a Civ.C. § 2079.10a notice. [Civ.C. § 2079.10a(b)]

(7) [4:366.20] **Toxic mold on nonresidential property:** *See discussion at ¶ 2:195.10*.

(8) [4:366.21] **Continuing lien securing special tax levy, assessment installments:** *See discussion at ¶ 2:197 ff.*

(9) [4:366.22] **Supplemental property tax bills:** *See discussion at ¶ 2:198.*

(10) [4:366.23] **Transfer fees:** Sellers of residential property are required to notify buyers of any fees that must be paid upon transfer or sale of the property. [Civ.C. §§ 1098, 1098.5 & 1102.6e]

(The above statutory provisions also apply to transfers of all other types of properties except that the requisite disclosure statements need not provide actual dollar-cost examples of the transfer fees; *¶ 4:366.23b*.)

(a) [4:366.23a] **Defined:** Subject to specified exceptions (below), a "transfer fee" includes any required payment imposed by a covenant, restriction or condition contained in a deed, contract, security instrument or other document affecting the transfer or sale of, or interest in real property. [Civ.C. § 1098]

A transfer fee does *not* include, among other charges, governmentally imposed taxes; mechanics' lien fees; fees incurred pursuant to court-ordered transfers, payments or judgments; and fees incurred in connection with marital separation/dissolution agreements or estate or trust administrations. [See Civ.C. § 1098(a)]

(b) [4:366.23b] **Recorded disclosure statement by entity imposing fee:** As a condition of payment of the transfer fee, the person or entity imposing the fee must record with the county recorder for the county where the property is located, concurrently with the instrument creating the transfer fee requirement, a document titled "Payment of Transfer Fee Required" that sets forth, in at least 14-point boldface type, all of the following:

• Current owners, legal description and assessor's parcel number;

• Fee amount (if flat), percentage of sales price constituting fee, or method for calculating same;

• Actual dollar-cost examples of fees for homes priced at $250,000, $500,000 and $750,000;

• Date/circumstances under which transfer fee requirement expires, if any;

• Purpose for which funds from fee will be used;

• Entity to which funds from fee will be paid and specific contact information regarding where funds are to be sent;

• Signature of authorized representative of entity to which funds from fee will be paid; *and*

• Subject to specified exceptions under federal regulations, private transfer fees created *on or after 2/8/2011* must contain an additional notice in at least 14-point boldface type disclosing the fact that federal housing agencies are prohibited from dealing in mortgages on properties encumbered by private transfer fee covenants that do not provide a "direct benefit" to the real property encumbered, and persons who want to purchase such properties may have difficulty obtaining financing. [See Civ.C. § 1098.5(a), (b); compare *Fowler v. M & C Ass'n Mgmt. Services, Inc.* (2013) 220 CA4th 1152, 1156-1157, 163 CR3d 717, 719-721—title transfer fees that do not exceed association's actual cost of changing records fall within Davis-Stirling Common Interest Development Act exception to recording requirement] *Caution:* Excepted transfer fee covenants are *not* required to comply with the above additional notice requirement; see Civ.C. § 1098.6, ¶ 4:366.24.

(c) [4:366.23c] **Seller's disclosure statement for buyer:** In addition, for properties transferred on or after 1/1/08 that are subject to a transfer fee, the seller must provide the buyer, *at the same time* the Civ.C. § 1102.6 Transfer Disclosure Statement (*¶ 4:355*) is provided, an additional disclosure statement containing all the following information:

• Notice that payment of transfer fee is required upon property's transfer;

• Amount of fee required for asking price of real property and description of how that fee is calculated;

• Notice that final fee amount may be different if fee is based upon percentage of final sale price;

• Entity to which funds from fee will be paid;

• Purposes for which funds from fee will be used; and

• Date or circumstances under which obligation to pay transfer fee expires, if any. [Civ.C. § 1102.6e]

(d) [4:366.24] **Transfer fees *created on or after 1/1/19 prohibited; exceptions:*** Other than excepted transfer fee covenants as defined under federal regulation, transfer fees *created* on *or after 1/1/19* are prohibited. Any transfer fee created in violation of the foregoing prohibition is "void as against public policy." Also, effective 1/1/19, excepted transfer fee covenants are not required to comply with Civ.C. § 1098.5(b)(2)(H)'s additional notice requirement (¶ 4:366.23c). [Civ.C. § 1098.6]

(11) [4:366.25] **Lawsuits or claims that threaten or affect property:** *See discussion at ¶ 2:212.*

(12) [4:366.26] **Water-conserving plumbing fixtures:** *See discussion at ¶ 2:213.*

(13) [4:366.27] **Energy use; nonresidential buildings:** Regulations adopted by the California Energy Commission require commercial building owners to disclose a building's energy use over the past 12 months to prospective buyers, lessees and lenders. Nonresidential buildings must comply with these regulations at staggered dates based on a building's square footage. [See 20 CCR § 1680 et seq.]

(14) [4:366.28] **Miscellaneous statutory disclosures:** Sellers and/or brokers are subject to many other statutory disclosure requirements. For further discussion, *see ¶ 2:170 ff.*

g. [4:367] **Buyer's "due diligence" (investigation) checklist:** The nature and scope of a buyer's inspection and investigation naturally varies with the type and extent of real and personal property being conveyed. The most common items are noted in the checklist at ¶ 4:368 ff.

As a general rule, however, all investigations should be conducted with an eye toward both the *current* use of the property *and* the buyer's (or subsequent user's) intended *future* use. Also, the buyer should be cognizant of a *lender's* concerns (e.g., although the buyer might not care that the property is in violation of certain laws or encroaches on other property, a lender might be unwilling to finance the purchase under such circumstances).

➪ [4:367.1] ***PRACTICE POINTER FOR BUYER:*** Preprinted form purchase agreements may contain an "automatic approval" clause stating that all matters are *deemed approved* unless the buyer specifically disapproves of a matter in writing. To protect against inadvertent waivers, buyers may want to consider modifying the agreement to require *written notice* of the buyer's approval of all due-diligence items.

(1) [4:368] **Geological:** A geological investigation is essential when the property is unimproved or in a hillside or slide area or other area of unstable soil.

(2) [4:369] **Seismic:** A seismic investigation is particularly important if the structure is old. In any event, many municipalities now require compliance with specific seismic safety standards.

(3) [4:370] **Toxic/environmental:** Some type of investigation for toxic and environmental violations is critical.

For instance, a buyer who thoroughly investigates the environmental condition of the property prior to closing of the transaction is positioned to qualify for the “contiguous property owner” or “bona fide potential purchaser” exemption from, or to assert the “innocent landowner” defense to, CERCLA liability. *See* *¶ 5:235 ff.* for detailed discussion of buyer's environmental “due diligence.”

(4) [4:371] **Engineering:** An engineering investigation should cover both the existing improved structures and the buyer's proposed development of the property.

(5) [4:372] **Building:** Every structure should be inspected by a knowledgeable professional to determine (at a minimum) the condition of:

• The foundation;

• The roof;

• Plumbing;

• Electrical (wiring, outlets, etc.);

• Heating, ventilating and air conditioning systems;

• Elevators;

• Security system; and

• Pools and spas.

(Of course, all of the above should pass inspection for compliance with applicable building and other Code requirements.)

(6) [4:373] **Survey:** In older, established neighborhoods, a survey (or at least a boundary survey) is beneficial to determine whether there are any encroachments, unrecorded rights of way, etc. As a practical matter, however, surveys are rarely conducted for other improved residential structures, and smaller commercial and industrial properties. (This is simply a matter of custom arising from the cost-benefit analysis of procuring a survey.)

On the other hand, an ALTA/American Congress on Surveying and Mapping Land Title (ACSM) survey of the property (ALTA Survey) is almost always required for ALTA title insurance coverage.

(a) [4:373.1] **Benefits of ALTA survey:** Some of the benefits of an ALTA survey include:

• The buyer can determine the exact location and boundaries of the property to be purchased. It is often difficult from the “metes and bounds” legal description for nonsurveyors to make such a determination.

• An ALTA survey provides the precise location of easements and physical encumbrances described in the title insurance exception schedules and physical improvements located on the property. Again, it is sometimes difficult to determine the exact location of easements from the “metes and bounds” descriptions in the public records.

• An ALTA survey may disclose physical encroachments not indicated in the title commitment, such as boundary fences that do not correspond with the true boundaries, or potential prescriptive easements, thereby reducing the possibility of subsequent litigation. [Cf. *Martin v. Van Bergen* (2012) 209 CA4th 84, 87-88, 146 CR3d 667, 668-669—fence erected on neighboring properties by parties' predecessors in interest without benefit of any survey did not correspond to true boundary, resulting in defendants ultimately losing 8% to 10% of their almond orchard]

(7) Plans and specifications

(a) [4:374] **Generally:** Buyers should consider reviewing the architectural plans and specifications for all improvements on the property. (Preferably, these should be "as built" plans and specifications—i.e., reflecting the improvements as actually built, not as they were proposed to be built.) However, most sellers are understandably reluctant to certify the accuracy or completeness of plans and specifications prepared by a third party. And, in any event, they should be reviewed with a degree of circumspection, as they may be out of date or incorrect.

(b) [4:375] **Tenant improvement/build-out plans and specifications:** Buyers purchasing *commercial rental* property should consider obtaining copies of the plans and specifications for any substantial tenant improvement work that has been completed or is in the process of being completed.

(8) [4:376] **Status of permits:** The buyer may want to review those governmental permits that are applicable to the property and relate to both the property's current and intended future use (e.g., zoning permits, building permits, conditional use permits, etc.).

(9) [4:376.1] **Regulations affecting intended use:** Similarly, the buyer should investigate whether there are any governmental land use regulations affecting the intended use of the property (e.g., building moratoriums on beachfront property; condominium conversion limitations, etc.). (Even in the face of known preexisting land use regulations, certain language can be added to the purchase and sale agreement that may help the buyer successfully pursue a possible "takings" cause of action.) *See further discussion at ¶ 4:408 ff.*

[4:376.2 - 4:376.4] ***Reserved.***

(10) [4:376.5] **ADA compliance:** Title III of the Americans with Disabilities Act (ADA Title III, 42 USC § 12181 et seq.) broadly prohibits private entities from discriminating on the basis of disability in "places of public accommodation" (places open to the public, including places of lodging, food and drink establishments, sales and entertainment facilities, private schools, etc., 42 USC § 12181(7)) and in "commercial facilities" (nonresidential places that, although not open to the public, affect commerce, including factories, warehouses and office buildings, 42 USC § 12181(2)). The purpose is to ensure that these properties are readily accessible to and usable by disabled persons. [42 USC § 12181 et seq.]

If the property to be purchased is a "place of public accommodation" or a "commercial facility" subject to the ADA, an inspection of the premises will be crucial to assess the facility's current ADA compliance and to identify those areas that may require immediate ADA compliance measures (*see ¶ 4:376.6 ff.*). If the buyer intends to use the property in a business that will be serving the public, it may be advisable to conduct the inspection with an *architect* knowledgeable about ADA compliance.

(a) [4:376.6] **Mandatory retrofitting in places of public accommodation:** As to "places of public accommodation," ADA Title III generally *mandates retrofitting* (removing architectural barriers to handicapped access) in existing structures (facilities occupied before 1/26/93) and *precludes alterations or new construction* that could create obstacles to handicapped access (42 USC §§ 12182 & 12183). [See *Pinnock v. International House of Pancakes Franchisee* (SD CA 1993) 844 F.Supp. 574—upholding constitutionality of ADA retrofitting requirements (neither a "taking" nor unconstitutionally void for vagueness, etc.)]

1) [4:376.7] **Scope of retrofitting:** ADA retrofitting or remedial action ("barrier removal," see 42 USC § 12182(b)(2)(A)(iv) & (v)) may impose a broad range of compliance obligations—e.g., (i) *installing ramps* and making curb cuts in sidewalks and entrances, (ii) *widening doors* and installing *accessible door hardware*, (iii) *repositioning* furniture, shelves and telephones, (iv) adding *raised markings on elevator buttons*, (v) installing *flashing alarm lights*, (vi) installing *grab bars* in toilet stalls and *raised toilet seats*, (vii) creating specially-designated and accessible *handicapped parking spaces*, (viii) *removing high-pile, low-density carpeting*, etc.

2) [4:376.7a] **Ongoing obligation:** The duty to remove architectural access barriers at places of public accommodation (¶ 4:376.6 ff.) extends beyond initial construction and significant alterations of existing structures. A place of public accommodation must remove architectural barriers "where such removal is readily achievable." [42 USC § 12182(b)(2)(A)(iv); see also 28 CFR § 36.304(a)—removal is "readily achievable" if it is "easily accomplishable and able to be carried out without much difficulty or expense"; *Madden v. Del Taco, Inc.* (2007) 150 CA4th 294, 296, 301-304, 58 CR3d 313, 314-315, 318-321—restaurant had duty to remove concrete trash container blocking wheelchair access to its entrance, even if there was "no significant alteration to its building" since its construction]

3) [4:376.7b] **Compare—compliance with state access standards:** California's disability access standards do not apply to an entire building or facility constructed prior to July 1, 1970. California's disability access standards apply to (i) public accommodations or facilities constructed on or after July 1, 1970, and (ii) areas where "alterations, structural repairs or additions are made" to existing public accommodations constructed prior to July 1, 1970. [Health & Saf.C. §§ 19955 & 19959]

a) [4:376.7c] **"Public accommodation or facilities" defined:** "Public accommodation or facilities" means "a building, structure, facility, complex, or improved area which is used by the general public," and includes "auditoriums, hospitals, theaters, restaurants, hotels, motels, stadiums, and convention centers." [Health & Saf.C. § 19955—"hospitals" includes, but is not limited to, hospitals, nursing homes, and convalescent homes]

b) [4:376.7d] **No ongoing obligation:** Unlike the ADA (¶ 4:376.7a), California does not impose an ongoing obligation for existing public accommodations or facilities to remove access barriers. Public accommodations are required to comply with California's disability access standards only if the facility is newly constructed or being repaired or altered (and, if so, only to the specific area being repaired or altered). [*Skaff v. Rio Nido Roadhouse* (2020) 55 CA5th 522, 536-538, 269 CR3d 578, 587-589 (reversing judgment for plaintiff on Health & Saf.C. § 19955 claim because plaintiff did not present evidence that restaurant and bar made any alterations that would trigger compliance with state disability access standards)]

(b) [4:376.8] **No new barriers to handicapped access in commercial facilities:** "Commercial facilities" are not subject to ADA Title III provisions regarding barrier removal (¶ 4:376.6 ff.). But such facilities cannot alter existing structures or construct new buildings in a manner that would impede handicapped access. [See 42 USC § 12183]

(c) Particular due diligence concerns for buyers

1) [4:376.9] **Changing uses:** Buyers should keep in mind that a property's ADA compliance level may change after the sale transaction closes. If the buyer intends to *alter the type of business* conducted at the facility or the nature of public accessibility, new and additional retrofitting/remediation may be required under Title III.

2) [4:376.10] **Rental properties:** Where there are tenants on the property, the buyer's compliance survey should include an *examination of the leases* to identify whether ADA compliance responsibility has been allocated between landlord and tenants; if so, the buyer should inspect the premises to determine whether the seller (landlord) and tenants have satisfied (or are satisfying) their ADA obligations.

If the leases do not address ADA compliance responsibilities, the buyer may want to negotiate with the seller to ensure compliance as of the closing (e.g., adding a *contingency* for the buyer's benefit that the seller complete ADA compliance measures as of a specified date); and should consider obtaining a seller's *indemnification* that will survive the closing.

➪ [4:376.11] ***PRACTICE POINTER—SELLER'S WARRANTIES/REPRESENTATIONS*:** Although it makes sense to ask for a seller's warranty that the property complies with ADA Title III, many sellers will be reluctant to provide such warranties because of the quagmire of ambiguities involved in Title III. The next best thing is for the buyer to insist upon a representation that, to the seller's *best knowledge*, there are no Title III violations.

(11) [4:377] **Tangible personal property:** To the extent items of tangible personal property are being conveyed with the real property, they should be appropriately inspected (specifically, e.g., lighting fixtures, power generation systems, laundry equipment, etc.).

h. Pest control

(1) Inspection report

(a) [4:378] **Seller's obligation to deliver to buyer:** If a structural pest control inspection report (pursuant to Bus. & Prof.C. § 8516) is required by the purchase and sale agreement or as a condition of financing the transaction, the seller must deliver to the buyer a copy of the report "[a]s soon as practical before transfer of title … or the execution of a real property sales contract" (land sale contract). [Civ.C. § 1099(a)] Either personal or mail delivery to the buyer, buyer's agent or spouse (or registered domestic partner; see Fam.C. § 297.5(a)) is authorized. [See Civ.C. § 1099(c)]

➪ [4:378.1] ***PRACTICE POINTER:*** Since a duty to prepare the report arises from the *lender's* financing conditions or the *parties' contractual conditions*, the associated expense should also be negotiated by the parties.

[4:379] ***Reserved.***

(2) [4:380] **Provision for correction of defects:** In drafting an applicable provision in the purchase agreement for pest control work, it is customary that only "curative work" (not "preventive work") be performed by the seller. (See also Civ.C. § 4780(a) regarding condominium projects: Unless otherwise provided in CC&Rs, homeowner's association is responsible for repair and maintenance of common areas occasioned by presence of wood-destroying pests or organisms.)

i. [4:381] **"Good working order":** Many purchase agreements require the seller to provide the electrical, plumbing and other "systems" in "good working order" at the close of the transaction. This is particularly true in residential sales.

j. [4:382] **Local laws:** State law and local ordinances require that certain safety mechanisms, such as smoke alarms and sprinkler systems, be installed on the property. [See, e.g., Health & Saf.C. § 13113.8 (smoke alarms)] The purchase agreement should require the seller to comply with such laws (or alternatively, give the buyer a monetary credit in lieu of compliance).

k. [4:383] **Final inspection:** Residential buyers in particular often desire the right of a final "walk-through" shortly before the closing (usually, to inspect for the correction of defects brought to the seller's attention and/or to conduct one last review for prior undetected problems in the physical condition of the property). However, a provision for the seller's benefit should be included specifying that the buyer's "satisfaction" with the condition of the property at the final walk-through stage is not a condition or "contingency"; and that the buyer will nevertheless be obligated to purchase the property on the terms set forth in the purchase agreement.

(Of course, the buyer's obligation *should be* contingent upon the seller's performing any *agreed-upon* repairs and corrections.)

➪ [4:384] ***PRACTICE POINTER:*** "Personal satisfaction" conditions are a real *trap* for sellers: They may give buyers an easy way out of the transaction by permitting the buyer (arguably, without good cause) to determine the property is "unsatisfactory" and thus elect to terminate the purchase agreement (or sue for breach). Thus, it is in the seller's best interest that the final walk-through be viewed as a mere courtesy; and the requisite physical condition of the property as of the closing date be measured by an ascertainable, objective standard.

A well-drafted purchase agreement should reflect that the property will be transferred in the same condition as of the date of the purchase agreement, with the exception of ordinary wear and tear and specifically agreed-upon required repairs.

10. [4:385] **Contingencies (Conditions) to Closing and Parties' "Due Diligence":** Both buyer and seller may desire to have certain conditions precedent (often referred to as "contingencies" or "conditions") to their respective obligations to buy and sell the property. Sometimes, the contingencies are structured as conditions precedent to the "effectiveness" of the purchase agreement—i.e., the agreement does not take effect until the contingencies are satisfied. More often, however, the contract is "effective" upon execution and each party's respective obligations to close the transaction are subject to, and conditioned upon, satisfaction of specified contingencies. [See *Steiner v. Thexton* (2010) 48 C4th 411, 419, 106 CR3d 252, 258—common form of real estate contract binds both parties at outset, while including contingency (e.g., loan or inspection contingency) that allows one or both parties to withdraw if contingency fails]

a. In general

(1) [4:386] **Nature of contingencies:** Obviously, certain basic contingencies and conditions are implicit in every contract (e.g., buyer clearly is not obligated to pay the purchase price unless seller tenders the deed and possession; and vice-versa). However, most buyers and sellers insist on identifying particular contingencies tailored to their intentions.

For example, the buyer generally requires a certain amount of time to investigate the property and otherwise conduct "due diligence" to determine whether the buyer even wants to purchase the property. The buyer is typically given a specified period within which to make such investigations and, if not satisfied, to elect to terminate the agreement.

(2) [4:387] **Seller's concerns:** Although sellers should be willing to accommodate the buyer's contingency concerns, contingencies are naturally against the seller's interests because they leave the deal "hanging." Thus, sellers should strive to ensure that (a) all contingencies are limited in scope and specifically identified, (b) the contingency periods are as short as

possible, and (c) the buyer is required to give specific written notice of an election to terminate the agreement or otherwise be deemed to have approved and/or waived the contingencies.

(3) [4:388] **Covenants distinguished:** Care must be taken to identify contingencies as *conditions* rather than covenants. A "covenant" is a *promise* or obligation. "A condition is an event, not certain to occur, which must occur, unless nonoccurrence is excused, before performance under a contract becomes due." [Rest.2d Contracts §§ 224, 225]

The consequences of characterizing a "condition" as a "covenant" can be disastrous: The failure of a *condition excuses* a party's performance under the contract. But the nonperformance of a *covenant* gives rise to an action for *breach of contract*.

➪ [4:389] ***PRACTICE POINTER:*** Neither party should "covenant" to perform that which may be expensive, impractical or impossible to perform. Such events should, at best, be made *contingencies*. In short, neither party should promise to do anything over which the party has no direct control.

Cross-refer: For a more detailed discussion of breach of covenants vs. satisfaction of conditions, *see ¶ 11:70 ff.*

b. [4:390] **Identifying benefited parties:** Contingencies for the buyer's benefit should be separately identified as being "solely for the benefit of the buyer." Conversely, contingencies for the seller's benefit should be identified as "solely for the benefit of the seller." In this way, there will be no room for dispute as to who, as between buyer and seller, has the right to invoke the contingency to withdraw from the contract or, instead, to waive the contingency and proceed with the transaction notwithstanding its nonoccurrence. [See *WYDA Assocs. v. Merner* (1996) 42 CA4th 1702, 1714, 50 CR2d 323, 330—where contract was silent on issue, court determined, under the facts, financing contingency was for buyer's benefit, but contingency *period* (time allotted buyer to obtain financing) was for *seller's* benefit]

c. [4:391] **Discretion in approving satisfaction of contingencies:** The party for whose benefit a contingency exists will generally want the broadest latitude in determining whether it has been satisfied. The other party, of course, will want to limit the benefited party's discretion to approve or disapprove satisfaction of a contingency.

On this issue, there are several alternatives:

- The benefited party may be given the right to disapprove a contingency in its sole and absolute discretion (obviously a disadvantage for the other party).

- Alternatively, the benefited party may be given the right to disapprove a contingency in its "reasonable" discretion (which could then lead to dispute over what is "reasonable").

- Or, the parties can set specific or identifiable *objective* standards for approving or disapproving a condition. For example, if the buyer's obligation to purchase the property is contingent upon obtaining financing, the parties might agree that this condition will be deemed satisfied if the buyer can obtain a loan at (or less than) a specified interest rate for a term of a specific (or minimum) number of years.

d. [4:392] **Checklist of contingencies for seller's benefit:** These are some of the contingencies commonly included for the seller's benefit:

(1) [4:393] **Co-owners' consent:** When the property is co-owned, one owner may have authority to sign for the others (e.g., partners, board of directors, cotrustees, spouse or registered domestic partner), but may also be required (or may simply prefer) to obtain the co-owners' consent. In this situation, the signing seller may require a contingency period to obtain the requisite consents.

(2) [4:394] **Lender's consent:** When a lender holding a lien against the property must approve the sale, the seller will require a contingency to obtain the lender's consent. (This most often happens when the buyer intends to purchase the property subject to an existing loan that includes a "due-on-sale" clause (*see* ¶ *4:296 ff., 6:388*); or if the lender has the right to approve any proposed sale as a profit or equity participant in the property (*see ¶ 6:60 ff.*).)

(3) [4:394.1] **Verification of buyer's authority:** It might be important to verify the authority of the prospective buyer. This is especially so where the buyer is a partnership, corporation or other business entity; the seller wants to be assured that the individuals with whom it is negotiating and who will be executing the agreement have *authority to bind* the entity. The seller, therefore, may want to make the deal contingent on proof that the entity is duly formed and its constituents are officers empowered to conclude the transaction on the entity's behalf. (*See* ¶ *4:203 ff., 4:242 ff.* re statement of partnership/statement of partnership authority, etc.; *see also ¶ 4:436* re warranty of authority.)

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(4) [4:395] **Approval of buyer's financial condition:** In seller-financed transactions, the seller will want to review and approve the buyer's financial statement (and perhaps other financial information) before determining whether it is obligated to sell. Such a contingency may also be desirable in transactions not involving seller financing, to enable the seller to determine if the buyer has the financial capability to close. This is especially important when a particularly long escrow period is contemplated … because, during that time, the seller will be rendering the property unmarketable based on the assumption the buyer has the financial strength to close.

(5) [4:396] **Counsel's review and approval of agreement:** When a purchase agreement is reached without counsel's involvement, the parties may sometimes provide that the contract is contingent on their respective attorneys' review and approval.

➪ [4:397] ***PRACTICE POINTER:*** Such a contingency can create serious potential for dispute, litigation or at least renegotiation. Because every contract carries with it an implied covenant of good faith and fair dealing (*¶ 4:275.5*), the lawyers may not have much leeway for disapproving or modifying an agreement already signed by the parties.

For this reason, the better practice is *not* to sign a purchase agreement *until* the lawyers have reviewed and approved it.

e. [4:398] **Checklist of contingencies for buyer's benefit:** The following are some of the more common contingencies that buyers typically attempt to negotiate (but because each buyer and property are unique, not all will be reasonable or applicable under a given set of circumstances):

(1) [4:399] **Co-owners' consent:** *See ¶ 4:393* (the same applies when several buyers are purchasing the property as co-owners).

(2) [4:400] **Counsel's review and consent:** *See ¶ 4:396 ff.*

(3) [4:401] **Financing:** This is perhaps the most critical contingency for buyers because they must have time and discretion to obtain acceptable financing. Although the time-frame for obtaining a loan will vary depending on market conditions and the size and complexity of the financing, even in a straightforward residential transaction 30-45 days is usually required to secure a written loan commitment and fund the loan.

➪ [4:402] ***PRACTICE POINTER FOR SELLERS:*** The seller can retain some control over the buyer's discretion in satisfying this contingency by requiring the buyer to obtain a loan at the "then-prevailing interest rate and then-prevailing terms and conditions for comparable loans secured by comparable property."

It is also in the seller's interest to set a definite time period for the buyer to obtain suitable financing (e.g., 60 or 90 days). The specified contingency *period* is for the *seller's benefit*—i.e., it ensures the seller will not have to keep their property off the market indefinitely while the buyer looks for funding. [See *WYDA Assocs. v. Merner* (1996) 42 CA4th 1702, 1714, 50 CR2d 323, 330]

(4) [4:403] **Physical inspection:** Most buyers want broad discretion in their approval or disapproval of the physical condition of the property (including geological, soil and environmental conditions, and, if applicable, ADA compliance (*¶ 4:376.5*)). As indicated earlier, it is to the seller's advantage not to condition approval on the buyer's personal satisfaction but, instead, to tie approval to some *objective standard* (*see ¶ 4:384*).

In addition, a condition of the closing should be that the property is in the same physical condition as when the purchase agreement was signed (except for reasonable wear and tear and specifically agreed-upon required repairs, *¶ 4:384*).

(5) [4:404] **Condition of title:** Information pertinent to the condition of title that comes from *outside* the recorded chain of title may place the buyer on reasonable *inquiry notice* (constructive notice) of possible clouds on title (such as judgment liens; see *Marriage of Cloney* (2001) 91 CA4th 429, 441-442, 110 CR2d 615, 625—purchaser had constructive notice from escrow agent's knowledge). Therefore, buyers should *thoroughly research the condition of title* to the property to be purchased.

In this regard, buyers should always insist on the right to review a preliminary title report, as well as copies of all of the title exceptions set forth therein (*¶ 4:334 ff.*). If a survey will be procured, a review of the condition of title should also include the buyer's right to review the survey. In addition, the purchase agreement should specify that a condition of the closing will be issuance of a title insurance policy showing only those title exceptions permitted by the purchase agreement.

➪ ***PRACTICE POINTERS***

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• [4:405] **For buyer's counsel:** Again, remember to clarify the buyer's right to review actual copies of exceptions to title; the title report is an abbreviated description of the documents of record and thus may not itself be sufficient to determine the condition of title. (*See ¶ 4:331*.)

• [4:405.1] **For lienholders' counsel:** Make sure all information lienholders include in a recorded instrument is accurate to ensure their liens are in the property's chain of title and will appear during a "reasonable inquiry." [See *Vasquez v. LBS Fin'l Credit Union* (2020) 52 CA5th 97, 108, 113-114, 265 CR3d 78, 86, 90-91—buyers owned property free and clear of judgment liens against seller due to lienholder incorrectly using seller's middle name as first name on recorded abstracts of judgment]

(a) [4:406] **Election to terminate in event of title exception:** Even if a title insurance company is willing to issue an endorsement or otherwise insure against enforceability of certain title exceptions, it may be in the buyer's interest to expressly reserve a right to terminate the agreement if a title exception exists (other than as agreed in the purchase contract).

➪ [4:407] ***PRACTICE POINTER:*** A title insurance policy only provides coverage in the amount of the premium. If buyers will incur additional development expenses, they may not want to run the risk of a future claim despite the existence of title insurance. Title insurance is simply "insurance"; it does not eliminate the cost, delay and aggravation of a lawsuit. (*See more detailed discussion at ¶ 3:6 ff.*)

In short, it may be immaterial to the buyer that the title company does not consider the potential claim serious. In evaluating an exception to title contingency, consider whether your client is willing to take the risk that a title exception will result in a third party claim.

(6) [4:408] **Feasibility of property for development or buyer's intended use:** Buyers intending to develop the property or vary its existing use may require time to make various studies and investigations to determine whether the contemplated development or use is legally permitted and physically and/or practically feasible. There should, of course, be a deadline for the buyer to complete the necessary investigation. However, a condition to the closing should also be included to the effect that no new law, moratorium, ordinance or regulation is adopted or enacted that would make the buyer's development or intended use unlawful.

➪ [4:408.1] ***PRACTICE POINTER RE PREEXISTING LAND USE REGULATIONS AFFECTING INTENDED USE*:** Some buyers may want to go forward with a real estate purchase notwithstanding known existing land use regulations that could impede the intended use, hoping they can successfully challenge the regulations or obtain a variance. When representing a buyer who anticipates challenging existing governmental regulations affecting the plans for the property, the purchase and sale agreement should include language expressly defining the *buyer's expectations* with regard to the contemplated use despite knowledge of the land use regulations—i.e., "Buyer is acquiring the same rights as Seller, *including the right to challenge the validity or application of any existing regulations*." If the buyer's plans are ultimately thwarted by the regulations, such language may make it easier for the buyer to prevail in a damages suit for an unlawful "taking." [See *Palazzolo v. Rhode Island* (2001) 533 US 606, 635-636, 121 S.Ct. 2448, 2467]

(7) [4:409] **Review of third party contracts:** In commercial and rental property transactions there are invariably several third party contracts the buyer should review—e.g., contracts for janitorial service, security service, air conditioning service, landscaping service, property management; fire and liability insurance policies; employment agreements; personal property leases; and other agreements affecting use or operation of the property. The buyer will want to approve these contracts as a condition to the obligation to purchase the property.

(8) [4:410] **Rental property—review of leases and rent roll:** Buyers purchasing rental property naturally need a right to review the leases and/or a "rent roll"; and, if there will be a particularly long period of time before closing, the buyer may also want a right to review subsequent rent rolls received up until the closing date. Additionally, the buyer may want to prohibit the seller from entering into any new leases during the term of the purchase agreement unless they are acceptable to the buyer or each lease is on terms satisfying certain specific parameters.

Reviewing rent rolls associated with *commercial* property is particularly important to prospective buyers because the property's value is quite often based, at least in part, on its rental history. [See *Enea v. Sup.Ct. (3-D)* (2005) 132 CA4th 1559, 1568, 34 CR3d 513, 519, fn. 4]

As with other third party agreements, the buyer's review and approval of leases and a rent roll is typically a condition to the obligation to purchase the property.

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(a) [4:411] **Pertinent lease items:** All leases should be carefully examined by buyer's counsel since an assignment of a lease may also carry with it the specific assumption of liabilities. Aside from verifying rents and security deposits, counsel should:

- Make certain the buyer has received complete copies of all leases and amendments thereto (together with an appropriate representation and warranty by the seller; *see* *¶ 4:441*).
- Verify whether there is any *prepaid rent*; and, if so, ensure the buyer receives an appropriate credit at the closing (*¶ 4:609*).
- Verify the terms of each lease, including any options to extend or renew.
- Determine whether any tenant has an option to lease additional space or right of first refusal to lease additional space.
- Ascertain whether any tenant has an option to purchase the property or a right of first refusal to purchase (*see Ch. 8*).
- Determine whether any tenant has exclusive use rights (i.e., exclusive right to operate a particular type of business on the property).
- Ascertain the landlord's rights upon damage, destruction or condemnation of the leased spaces and whether all the leases for the project are consistent with respect to those issues and other landlord rights.

Should damage, destruction or condemnation occur, serious problems may arise if different tenants are to be treated differently. For example, under some leases, the landlord might be obligated to rebuild (and the tenants would be obligated to continue their leases); but, under other leases, damage or destruction may give the tenants a right to terminate their leases. Clearly, the landlord would prefer consistency in its (and the tenants') obligations upon damage to or destruction of the premises.

- Verify the landlord's rights and remedies under each lease in the event of a tenant's default in payment of rent.
- Determine whether any real estate broker commissions may be due in respect to the lease for the balance of the term or for any extension of the term (buyers may be deemed to have assumed such commission obligations even though they did not actually execute a listing agreement with the broker).
- Determine whether the landlord has any obligation to make additional improvements to the building or any tenant's premises.
- Ascertain whether there are any tenant credits or allowances outstanding (e.g., tenant improvement allowances, rent concessions, etc.).
- Determine whether there is a tenants' association (such as a merchants' association) in existence or to be formed and whether the landlord is required to contribute any sums to the association.
- Verify whether the leases are subordinate to future financing; if not, the buyer may have difficulty refinancing the property prior to or after the closing. (However, this is not an issue in transactions involving residential leases.)
- Determine whether there are any common area or other shared expenses by the tenants; and, if so, whether the sharing of expenses is consistent among all tenants (landlords often charge certain tenants for certain common area expenses, but not other tenants).
- Determine whether any tenant uses or stores hazardous materials on the property (*see Ch. 5*).
- Identify the ownership of various improvements on and installations made to the premises.

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• Determine whether there are any parking problems.

• In residential properties, determine whether unlawfully excessive security deposits are being held by the seller (Civ.C. § 1950.5 (amended Stats. 2023, Ch. 733; eff. 7/1/24) sets maximum limits for residential units); and, if the property is in a rent control jurisdiction, whether the rents charged and collected are within applicable rent control limits.

• Verify which expenses are paid by the tenant and which by the landlord (*see* ¶ *7:32 ff.* for discussion of costs allocation between landlord and tenant).

• Carefully review any lease guaranties.

Cross-refer: These and other issues are covered in depth in Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG).

(b) [4:412] **Postclosing lease issues:** A variety of postclosing lease matters must also be considered:

1) [4:413] **Tenant defaults:** If a tenant is in default at the time of closing, determine who has the right to collect rent arrearages that came due in the preclosing period. Typically, the seller will want the right to recover rent arrearages owing before the closing. While this makes sense conceptually, it does *not* make sense to bifurcate two different landlords' claims (the buyer's and the seller's) against the tenant. Instead, the buyer should agree that, to the extent past-due rent is recovered after the closing, the buyer will rebate to the seller that amount attributable to the preclosing rental period.

• [4:414] **Comment:** Some practical problems in implementing such a "rebate" obligation should also be addressed in the agreement. Notably, a judgment does not often state the months to which the back-due rent applies. Moreover, if there is a settlement, it may be difficult or impossible to determine how the settlement amount is to be allocated between pre-closing and post-closing rental periods. In any event, it is in the buyer's interest *not* to agree to any obligation to pursue a defaulting tenant (whether by litigation or otherwise).

➪ [4:415] ***PRACTICE POINTER:*** It is in the buyer's interest to include a provision in the contract to the effect that, in the event the buyer commences litigation against defaulting tenants, any recovered amounts owing the seller should be deemed reduced by the cost of the litigation (attorney fees and other litigation expenses).

2) [4:416] **Application of security deposits:** The parties should also carefully negotiate the manner in which tenant security deposits are to be applied. In other words, tenant security deposits should be transferred (or credited) to the buyer to the extent there are no preclosing tenant defaults; but the seller should have the right to apply each preclosing defaulting tenant's security deposit to the respective default, thereby reducing the aggregate amount of security deposits to be transferred (or credited) to the buyer at the closing.

(On the seller's postclosing statutory obligations re tenant security deposits, *see* ¶ *4:421*.)

3) [4:417] **Payment of operating costs:** Many commercial leases require the prepayment (or post-payment) of common area maintenance (or "operating") costs. Buyer and seller should agree on some method of accounting for tenant payments of these costs.

For example, operating costs are typically estimated at the beginning of each year and there is an adjustment at the end of the calendar year when actual expenses are known. Tenants then pay the shortfall (or are rebated or credited for excess payments made during the preceding year). The seller will want a credit for any additional sums that may be due from a tenant. Because the precise figures are usually unknown at the closing date, and because there is a certain benefit in not making any postclosing calculations, it is advisable simply to estimate the amount and make that the "agreed-upon amount" for purposes of buyer and seller prorations.

4) [4:417.1] **Change of ownership notice to tenants:** At or immediately after the closing, a letter signed by the seller should be sent to all tenants advising them that the property, and (to the extent applicable) all security deposits, have been transferred to the new owner (*see* ¶ *4:421*), and stating that all future rent should be paid to the new owner (as specified).

(9) Rental property—receipt of satisfactory estoppel certificates

(a) [4:418] **Estoppel certificates (nonresidential property):** Buyers purchasing rental property (as well as lenders financing the purchase of such property) are concerned that the leases and rent roll provided by the seller are correct and that the tenants have no claims of landlord breach under their leases. Buyers (and lenders) are also concerned about any waivers by the seller of rights against a tenant (these are not necessarily reflected in the lease but are binding on the buyer). [See *Doll v. Maravilas* (1947) 82 CA2d 943, 949, 187 P2d 885, 888; and Civ.C. § 823—tenant has same rights against buyer after closing that tenant held against seller before closing]

Therefore, when feasible, an "estoppel certificate" from each tenant (or "offset statement") satisfactory to the buyer (and lender) should be required. An estoppel certificate typically includes a certification as to the date of the lease; the parties to the lease; any amendments to the lease; the lease commencement and termination dates; whether the tenant has any rights of first refusal or options to purchase the property or to lease additional space; whether the landlord is in default under the lease; the amount of the security deposits; and the amount of rent. [See *Robert T. Miner, M.D., Inc. v. Tustin Avenue Investors, LLC* (2004) 116 CA4th 264, 273, 10 CR3d 178, 183—"By providing independent verification of the presence or absence of any side deals, estoppel certificates prevent unwelcome post-transaction surprises that might adversely affect the building's income stream"]

(For those nonresidential properties where it is not feasible to obtain tenant estoppel certificates, *see* ¶ *4:420*.)

• ***FORM:*** Tenant Estoppel Certificate, *see Form 4:J*.

1) [4:418.1] **Binding effect:** Tenants are bound by the representations contained in their estoppel certificates. [*Plaza Freeway Ltd. Partnership v. First Mountain Bank* (2000) 81 CA4th 616, 619, 628-629, 96 CR2d 865, 867, 874—tenant bound by lease termination date stated in estoppel certificate provided to property's buyer; *see more detailed discussion at* ¶ *7:292.2 ff.*]

➪ [4:418.2] ***PRACTICE POINTER FOR BUYER'S COUNSEL:*** It is good practice for buyer's counsel to compare each lease with the corresponding estoppel certificate to make sure the two are consistent and the certificate does not contain any ambiguities.

That way, should it be necessary later for the buyer to use the certificate as evidence against the tenant (e.g., in an eviction proceeding), there will be no dispute as to what the tenant intended to represent in the certificate.

2) [4:419] **Compare—residential property:** Buyers generally do not insist on estoppel certificates in residential rental (i.e., apartment project) transactions since they are extremely difficult and cumbersome to obtain. Moreover, the buyer's concerns can usually be alleviated by the seller's representation and warranty that the leases and rent rolls are complete and correct; that there are no outstanding tenant defaults; and that the tenants have not claimed any defaults by the seller. (Although the tenants will not be bound by the seller's representations, the seller will remain liable to the buyer for breach of such representations; *see* ¶ *4:420.1*.)

(b) [4:420] **Alternative to estoppel certificates:** Although many commercial leases require tenants to deliver an estoppel certificate (and may permit the landlord to deliver one on behalf of tenants who fail to do so), some leases are silent on the subject. In the latter case, the purchase agreement should provide some mechanism to fill the gap.

1) [4:420.1] **Seller's estoppel certificate; buyer's right to rely thereon:** One alternative is to allow the *seller* to deliver its own estoppel certificate that will constitute a representation and warranty as to the statements therein (duration of leases, amount of rents, etc.). Of course, this does not bind the individual tenants; but if the representations therein are false, it will give the buyer the right to sue the seller for a breach of the purchase agreement. [See *Linden Partners v. Wilshire Linden Assocs.* (1998) 62 CA4th 508, 531, 73 CR2d 708, 722]

When a seller executes an estoppel certificate on a tenant's behalf, the buyer has *no duty* to investigate the accuracy of representations therein—even if there are avenues of knowledge available to the buyer which, if pursued, would reveal the falsity of the seller's representations. [*Linden Partners v. Wilshire Linden Assocs.*, supra, 62 CA4th at 529, 73 CR2d at 720-721—sellers' estoppel certificate overstating tenant's current monthly rent breached purchase agreement, giving buyers damages remedy (buyers had no duty to undertake independent investigation as to correct method for computing tenant's rent and amount thereof)]

(10) [4:421] **Rental property—disposition of tenant security deposits:** Notwithstanding a sale, the seller (landlord) remains *personally liable* for tenant security deposits *unless* the seller *either* (a) transfers the security deposits to the buyer and notifies the tenants of the transfer (and of any claims made against the security) and provides the tenants with

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specified additional information; or (b) returns the security deposits to the tenants (after lawful deductions) together with an accounting. Compliance with either alternative may be made a contingency in the purchase agreement. [Civ.C. §§ 1950.5(g) (residential property), 1950.7(d) (commercial property); and see detailed treatment in Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 2E]

(11) [4:422] **Income and expense statements:** The buyer may want to review and approve the seller's recent income and expense statements for the property (typically, back two or three years immediately preceding the date of the purchase agreement). This should include a review of the recent property tax bill.

(12) [4:423] **Subdivision, zoning and use:** It is in the buyer's interest to ascertain whether the land and improvements are in compliance with land use laws and regulations. This will entail verification of compliance with state and local zoning laws (Subdivision Map Act, etc.). [See *Sixells, LLC v. Cannery Business Park* (2008) 170 CA4th 648, 652, 88 CR3d 235, 238—contract that allowed purchaser of property to "waive" recording of final map violated Subdivision Map Act and was therefore void]

(A certificate of compliance may be obtained; see Gov.C. § 66499.35.)

The buyer may also want to verify the existence of permits, such as certificates of occupancy and building permits. Occasionally, the buyer may desire a contingency period to obtain a rezoning (or subdivision) of the property or permits to change the property's legally-permitted use.

(13) [4:424] **Residential property—sale of buyer's residence:** A contingency tied to sale of the buyer's residence is common in residential transactions. Buyers naturally may want to be relieved of any purchase obligation if unable to sell their existing house.

(14) [4:425] **Changes in condition:** A "catch-all" contingency should be included to ensure there are no material, adverse changes in the property, its management or operation, its revenues (e.g., rental income) or expenses, its physical condition, or its zoning between the date of execution of the purchase agreement and the closing. If such conditions have changed, the buyer will want either a right to terminate the agreement or an appropriate adjustment in the purchase price.

f. Consequences of failure/disapproval of contingency

(1) [4:426] **Termination or adjustment of contract:** When contingencies are tied to a party's approval or disapproval, *disapproval* typically triggers the benefited party's right to terminate the purchase agreement. However, this is not necessarily so upon the *failure* of a contingency; in that case, the remedy may instead be an appropriate adjustment in the contract price. For example, the parties can provide that if rental income for the property falls below a certain level, the purchase price will be automatically reduced to reflect a multiple of the actual rental income in existence as of the closing date.

Alternatively, the contract may give the party for whose benefit the contingency operates the *option* of either terminating the agreement or adjusting the obligation accordingly in the event of a specified failure of conditions. [See, e.g., *Galdjie v. Darwish* (2003) 113 CA4th 1331, 1338, 7 CR3d 178, 182—buyer's failure to remove lender approval contingency (*¶ 4:394*) justified seller's cancellation of agreement]

(2) [4:427] **Contract not revived by retraction of disapproval:** Once the purchase agreement is terminated by a party's disapproval of a contingency, the benefited party cannot thereafter revive the contract by retracting the disapproval. [*Beverly Way Assocs. v. Barham* (1990) 226 CA3d 49, 56, 276 CR 240, 244—buyer's disapproval of survey, approval of which was condition precedent to purchase obligation, terminated contract: buyer could not later waive condition and specifically enforce contract]

(3) [4:428] **Exercise of benefited party's rights:** If a contingency is not fulfilled, the benefited party should be required to give *express written notice* thereof to the other party (and escrow holder if an escrow has been opened). If notice is not given, the purchase agreement should provide for one of two alternatives: that the conditions are deemed either (a) automatically approved and satisfied; or (b) automatically disapproved and unsatisfied (and the parties' respective obligations to buy and sell automatically terminated).

➪ [4:428.1] ***PRACTICE POINTER:*** In some instances, the other party may wish to have the right to rectify or otherwise satisfy the failure of a condition. For example, if a buyer disapproves a particular exception to title, the seller may want the right—but not the obligation—to clear the disapproved exception within a certain period of time. Such rights should be clearly specified in the agreement.

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(4) [4:429] **Return of documents and monies upon termination:** The purchase agreement should provide that, if it is terminated pursuant to a failure of condition, all monies and documents are to be returned (by the escrow and parties, respectively) to the party who originally deposited same. However, this obligation is typically made subject to the right to retain certain monies to offset miscellaneous escrow and title charges incurred to date; and the purchase agreement should specify how those costs will be shared and paid.

Cross-refer: On cancellation of an escrow, *see ¶ 4:633 ff.*

11. [4:430] **Maintaining Property Prior to Closing:** Whether characterized as a condition or covenant, the buyer customarily requires that the physical condition of the property, condition of title, and revenues from (and management of) the property be the same (or substantially the same) on the closing date as on the date the purchase agreement is signed. The buyer will thus want to establish specific guidelines for the leasing, management and/or operation of the property (depending on the type of property involved) during the term of the purchase agreement; and/or the buyer may want to have the right to approve any new leases or change in operation or management of the property prior to the closing. A plan for continued operation of the property is therefore beneficial, particularly if a long-term escrow is contemplated.

12. Representations and Warranties

a. General considerations

(1) [4:431] **Competing objectives:** Representations and warranties are usually intensely negotiated by attorneys. At one end of the spectrum is the seller, who takes the position that the buyer is capable of learning as much about the property as it needs to know, independent of any seller representations, and who will therefore argue that no seller representations or warranties are required. The buyer, in contrast, contends that much of the information about the property is uniquely within the seller's knowledge or, in any event, that it would simply be more expedient for the seller to disclose information about the property in the form of representations and warranties.

(2) [4:432] **No avoidance of certain seller disclosure obligations:** Notwithstanding a provision expressly stating the seller makes *no* representations or warranties, the seller *cannot* avoid its common law and statutory obligations to disclose certain matters affecting the property (*see ¶ 4:351 ff.*).

(3) [4:433] **Distinction between "representation" and "warranty":** Lawyers typically lump "representations" and "warranties" together as if they amounted to one and the same. But there is a technical difference between the terms: A representation is deemed to be antecedent, and as an inducement to, a contract but not part of the contract. A warranty is given contemporaneously with, and as part of, the contract. [See Black's Law Dictionary]

Even so, in most purchase and sale agreements, this is a distinction without much of a difference: Representations and warranties are rarely divided into "antecedent" representations and "contemporaneous" warranties. In either case, the *substance* of the representation or warranty is the primary concern.

The sections at ¶ 4:436 ff. highlight the most important representations and warranties that should be considered in any purchase and sale agreement.

(4) [4:434] **Impact:** For so long as they remain in existence, representations and warranties are independent obligations, the breach of which may draw a lawsuit and resulting liability. However, representations and warranties may be deemed *merged into the deed*, and are thereby *extinguished* by the conveyance, *unless* the parties expressly agree they will "*survive the closing*." [See *Linden Partners v. Wilshire Linden Assocs.* (1998) 62 CA4th 508, 524, 73 CR2d 708, 717—agreement obligated sellers to deliver "true, accurate and complete copies of all leases and other contracts" containing "no untrue statement of material fact" and further provided sellers' representations and warranties in connection therewith "shall survive the close of escrow" (buyers thus had breach of contract remedy after escrow closed when sellers' estoppel certificate re tenant rent proved inaccurate); *Western Filter Corp. v. Argan, Inc.* (9th Cir. 2008) 540 F3d 947, 952 (applying Calif. law); but see also *Ram's Gate Winery, LLC v. Roche* (2015) 235 CA4th 1071, 1079-1081, 185 CR3d 935, 940-942 (limiting doctrine's applicability to cases where contractual terms are *inconsistent* with deed or where parties clearly intend all contractual obligations to be subsumed in recorded deed's recitals); *and* ¶ *4:16, 4:454*]

[4:435] ***Reserved.***

b. Buyer's and seller's authority and performance

(1) [4:436] **Authority of signing parties:** If the transaction is between entities, each will want the signing parties to specifically represent they have the authority to bind their respective corporate, partnership, trust or other entity to the purchase agreement.

➪ [4:437] ***PRACTICE POINTER:*** Occasionally, this point may be a source of contention as where, e.g., a junior officer of a corporation does not wish to make any individual representations. The dilemma can sometimes be solved by a party delivering specific corporate resolutions or, in the case of a partnership, limited liability company or trust, by providing the other party with a copy of the partnership agreement, articles of organization or declaration of trust demonstrating the signing party's authority. Alternatively, a written opinion of counsel as to the authority of the signing party might suffice to resolve the issue.

(2) [4:438] **Performance:** Hand in hand with the warranty of authority is a representation from each party that they have the ability to perform the purchase agreement in accordance with its terms.

In particular, the buyer may insist on the seller's representation that there are no outstanding agreements or restrictions that would preclude or impair the seller's ability to convey the property in accordance with the purchase agreement.

• [4:438.1] **Comment:** Such a seller's warranty may be superfluous because the seller has already obligated itself to convey the property in accordance with the purchase contract; a representation that it can do so would not seem to add much. In any event, a covenant to the same effect is implied in the grant deed; *see* ¶ *4:37.1, 4:341*.

c. [4:439] **Condition of title:** Sellers are often reluctant to make any representation concerning the condition of title (other than that they hold title). In any event, such representations really are not necessary because the buyer is given the right to review a title report and thereafter receive a title insurance policy.

(1) [4:439.1] **Encumbrances:** Sellers should beware of making any broad representation that the property is "free and clear from all encumbrances." As applied to an estate in land, an "encumbrance" may include "*whatever* charges, burdens, obstructs, or impairs [the property's] use or impedes its transfer"; even encroachments unknown to or unanticipated by the seller may breach such a warranty or representation if they impair the property's use and transferability. [See *Johnson v. Bridge* (1923) 60 CA 629, 632, 213 P 512, 513 (emphasis added)—encroachment of house on adjoining property was an encumbrance that breached seller's warranty of delivery to buyer "free and clear of all encumbrances"; *Quality Wash Group V, Ltd. v. Hallak* (1996) 50 CA4th 1687, 1694-1695, 58 CR2d 592, 597—encroachment of leasehold's fixtures and improvements (car wash) onto adjoining property breached seller's warranty that title was "free from any liens and/or encumbrances"]

d. [4:440] **Maintaining property and business before closing:** Sellers should represent that they will maintain the property, and its operation and use, in a manner substantially similar to that in existence at the time of signing the purchase agreement. (The mirror image of such representation may also be reflected in a contingency for the buyer's benefit; *see* ¶ *4:425*.)

e. [4:441] **Rental property—leases and rent roll:** In rental property transactions, the seller at a minimum should represent the completeness and accuracy of the leases and rent roll, including whether any tenant is in default. Depending in part on whether tenant estoppel certificates are obtained (¶ *4:418*), the buyer might also insist on a seller's representation that neither the tenants nor seller are in default in their respective lease obligations. (*See also* ¶ *4:420.1* re seller's estoppel certificate.)

f. [4:442] **Zoning and other regulatory matters:** Buyers often want assurances that the property's usage and all structures are in compliance with applicable zoning laws and that all building and other legally-required permits have been obtained. However, knowing that their buyers can usually ascertain these facts by investigation, sellers may be reluctant to give such representations.

(In any event, most buildings have at least a few minor violations of state or local building codes. Therefore, a blanket representation regarding the property's compliance with law would probably be untrue.)

g. [4:443] **Reports, surveys, etc. in seller's possession:** The buyer may wish to review geological reports, surveys, plans and specifications, traffic studies, feasibility studies, environmental reports, and the like which are in the seller's possession. The seller should make certain that any such documents are delivered "as a courtesy only" and with the stipulation that "seller makes no representation or warranty as to the completeness or correctness thereof."

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h. [4:444] **Condemnation:** Buyers often want to know whether a condemnation proceeding is presently pending *and* whether there is any "threatened or pending condemnation, street widening or other public taking" affecting the property. The latter is not necessarily an appropriate representation for sellers to make. While it is easy for sellers to know (and represent) whether a condemnation proceeding has commenced (since the seller would presumably be a party, or at least have been notified in writing), sellers may be unaware of whether a condemnation proceeding has been threatened or is pending. Moreover, the words "threatened or pending" are inherently vague (*see ¶ 4:456* re "knowledge").

i. [4:445] **Litigation:** Likewise, the disclosure of existing, pending or threatened litigation affecting the property is naturally important to buyers. As with potential condemnation proceedings (¶ 4:444), however, the concept of "pending or threatened" is similarly—and perhaps more—vague in the context of litigation.

For example, if a tenant or adjoining landowner has sent a letter to the seller demanding that the seller perform some act and indicating the tenant/adjoining landowner will enforce their rights or take appropriate steps to resolve the problem, is that "threatened" litigation? What if the letter was sent three months ago; is the "threatened" litigation still "pending"? (*See ¶ 4:456* re "knowledge.")

j. [4:446] **Ownership of personal and intangible property:** Even if the buyer conducts a UCC search (*see ¶ 4:36*), the buyer may require a separate representation by the seller as to the seller's ownership of the personal property to be conveyed. If a bill of sale from the seller is to be used, this representation should be set forth in that document (*see Form 4:C*).

k. [4:447] **Third party rights to use and possess property:** In addition to identifying all leases affecting rental property, the buyer may want a representation that "no other parties have any right to use, occupy or possess the property."

➪ [4:448] ***PRACTICE POINTER:*** Such a representation presents serious risks for sellers: It may effectively amount to an "insurance policy" for the buyer's benefit that any claims by third parties, no matter how unsupported or frivolous, will be defended by the seller after the closing.

l. [4:449] **Contracts affecting property:** The buyer may want the seller's representation that there are only certain identified third party contracts affecting the property, and no others.

m. [4:450] **Outstanding financing after closing:** If the buyer is purchasing the property "subject to" an existing loan, and no beneficiary statement will be obtained (*see ¶ 4:301 ff.*), the seller should be required to represent the material terms of the loan, its then-outstanding balance, and that neither borrower nor lender are then in default.

n. [4:451] **Buyer's financial condition/statement:** Because the buyer's sole obligation typically is only to pay the purchase price, sellers generally do not require much in the way of representations and warranties by the buyer. However, in seller-financed transactions, the seller will usually require the buyer to represent the accuracy of the financial statement and any other financial information provided by buyer to seller. (*See also ¶ 4:436 ff.* re buyer's representation concerning authority.)

o. [4:452] **Hazardous materials:** Though sometimes difficult to negotiate, buyers may insist on a representation that the property is free of hazardous materials. (*See Ch. 5*.)

p. [4:452.1] **No terrorist activity?** As an alternative, or in addition, to checking the USA Patriot Act's "Specially Designated Nationals" (SDN) List (¶ *1:126.1, 4:460.2*), the parties may wish to include a clause warranting that they are not on the list, not barred from doing business under antiterrorism laws, and, in consummating the transaction, neither they nor any entity with whom they will or may do business will violate those laws.

q. [4:453] **General provisions pertaining to all representations and warranties:** Certain "catch-all" closing provisions should be included that pertain to all specifically-enumerated representations and warranties:

(1) [4:454] **Survival of representations and warranties:** The duration for which the representations and warranties exist should be identified. Unless expressly provided otherwise, they may be deemed merged into the deed and therefore terminated upon the conveyance (i.e., they do not survive and thus cannot be sued on after) the closing. [See *Western Filter Corp. v. Argan, Inc.* (9th Cir. 2008) 540 F3d 947, 952 (applying Calif. law)—closing date itself triggers contractual limitation on liability unless parties agree to survival clause; but see also *Ram's Gate Winery, LLC v. Roche* (2015) 235 CA4th 1071, 1079-1081, 185 CR3d 935, 940-942 (limiting doctrine's applicability to cases where contractual terms are *inconsistent* with deed or where parties clearly intend all contractual obligations to be subsumed in recorded deed's recitals); *and* ¶ *4:16, 4:434*]

Also, the parties may find it desirable to specify a short limitations period for bringing suit based on the breach of any representation. Although legal, contractual stipulations to shorten statutes of limitations must be "clear and explicit," as they are disfavored and construed strictly against the party invoking them. [See *Western Filter Corp. v. Argan, Inc.*,

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supra, 540 F3d at 953 (applying Calif. law)—stock purchase agreement provision allowing claims to survive closing date for one year deemed too ambiguous to override and reduce longer limitations periods fixed by statute]

(2) [4:455] **“True and correct as of the closing”:** The parties' representations should be true and correct as of the closing date. If any representation, which was true when made, later becomes untrue by reason of a change in circumstances, the party making the representation should be obligated to disclose that development; and, if a material change, the other party may want the right to terminate or otherwise modify the purchase agreement.

(3) [4:456] **“Knowledge” and “best of knowledge”:** In legal terms, “knowledge” may refer to “actual” and “constructive” knowledge—i.e., both that which a party actually knows *and should have known* under the circumstances. Thus, it is advisable to negotiate the definition of “knowledge” in each context.

For example, suppose a seller warrants that, to the seller's knowledge, there is no “pending or threatened” litigation or condemnation proceeding affecting the property. Without further clarification, a telephone call from a tenant to the on-site property manager complaining about the condition of the property and threatening to report the matter to a regulatory agency (or threatening to “consult with my lawyer about a lawsuit”) may be a “threatened litigation” to the seller's “knowledge.” And a notice of a public hearing to discuss a street widening may be “knowledge” of a “pending condemnation.” Accordingly, sellers may want to limit their “knowledge” to those matters for which they have received “actual, formal, written notice.”

Another way to resolve these issues is to limit the parties' representations to “the best of their knowledge, but without making any independent investigation thereof.”

[4:457 - 4:459] ***Reserved.***

13. [4:460] **“Due Diligence” Issues:** The term “due diligence” is just another way of referring to an investigation by the parties. In other words, “conducting due diligence” is a somewhat fanciful way of referring to conducting an investigation or doing research with respect to particular issues. (However, the term “due diligence” has now become somewhat of a term of art in purchase and sale transactions.)

a. [4:460.1] **Checklist for buyers and sellers:** Consult the earlier sections of this Chapter discussing conditions and contingencies (*¶ 4:392 ff.*) and representations and warranties (*¶ 4:436 ff.*) for a checklist of “due diligence” issues to be reviewed by buyer and seller.

b. [4:460.2] **Obligations under USA Patriot Act:** Although the rules and regulations are still being promulgated, real estate attorneys *may* eventually be brought under the umbrella of § 352 of the USA Patriot Act and subject to its investigation obligations regarding “anti-money laundering” procedures. Also, under a Presidential Executive Order issued after September 11, 2001, real estate attorneys involved in closings must check the names of buyers and sellers against the federal government's Specially Designated Nationals (SDN) List. *See* ¶ *1:126 ff. and 4:452.1*.

14. [4:461] **Indemnification:** Upon a breach of the purchase agreement, the injured party will be entitled to recover consequential damages under basic contract principles (see generally, Civ.C. § 3300—those damages which “in the ordinary course of things, would be likely to result” from the breach); and/or, in some cases of breach of representation, under tort principles (see generally, Civ.C. § 3333—damages compensating for all detriment proximately caused “whether it could have been anticipated or not”). (*Damages are discussed in detail in Ch. 11*.)

However, the parties may want to negotiate a separate *indemnification provision*.

a. [4:462] **In general:** “Indemnity” is statutorily defined as “a contract by which one engages to save another from a legal consequence of the conduct of one of the parties, or of some other person.” [Civ.C. § 2772; *Wilshire-Doheny Associates, Ltd. v. Shapiro* (2000) 83 CA4th 1380, 1396, 100 CR2d 478, 490; see also *Hot Rods, LLC v. Northrop Grumman Systems Corp.* (2015) 242 CA4th 1166, 1179, 196 CR3d 53, 62—although indemnity provisions typically refer to third party claims, they may encompass direct claims if the parties so intend (*¶ 4:465*)]

In effect then, an indemnification agreement may protect the indemnitee (benefited party) against liability caused by the indemnitor (obligated party), a third party, or even the indemnitee's own negligence. [See generally, *Heppler v. J.M. Peters Co., Inc.* (1999) 73 CA4th 1265, 1275-1276, 87 CR2d 497, 507-508; *Building Maint. Service Co. v. AIL Systems, Inc.* (1997) 55 CA4th 1014, 1029, 64 CR2d 353, 362]

However, an agreement to indemnify a person for their *own negligence* will be upheld only if clear and explicit; and such agreement is strictly construed against the indemnitee. [*Goldman v. Ecco-Phoenix Elec. Corp.* (1964) 62 C2d 40, 44, 41 CR 73, 75; *Peter Culley & Assocs. v. Sup.Ct. (Park Hill Joint Venture)* (1992) 10 CA4th 1484, 1492, 13 CR2d 624, 629; see *Rooz v. Kimmel* (1997) 55 CA4th 573, 583, 585-587, 64 CR2d 177, 183, 185-186 (indemnity against "any and all liabilities" absolved escrow company from its own "active" negligence in failing to record deed of trust); but see also Civ.C. § 2782—provision in *construction contract* to indemnify indemnitee for indemnitee's own negligence *unenforceable* as violative of public policy]

(1) [4:462.1] **Guaranty compared:** A guaranty is a promise "to answer for the debt, default, or miscarriage of another" (Civ.C. § 2787). It is distinct from an indemnity in that a guarantor promises to *perform* the principal's obligation should the principal fail to perform, while an indemnitor promises to *reimburse* the indemnitee for losses suffered. [*Trust One Mortg. Corp. v. Invest America Mortg. Corp.* (2005) 134 CA4th 1302, 1309, 37 CR3d 83, 88-89]

Cross-refer: Guarantees are discussed in detail at *¶ 6:580 ff.*

b. [4:463] **Scope of indemnity provisions:** The nature and breadth of an indemnification agreement are negotiable by the parties; except to the extent limited by public policy (e.g., Civ.C. § 2782 re construction contracts, *¶ 4:462*), the parties have great freedom in allocating liability risks. [*Heppler v. J.M. Peters Co., Inc.* (1999) 73 CA4th 1265, 1277, 87 CR2d 497, 508]

The agreement may be narrow in scope—e.g., obligating the indemnitor only for specified liabilities and only if the liability is predicated on a judgment against the indemnitee. Or the agreement may be sweeping in scope, obligating the indemnitor to pay all claims against the indemnitee for damage to persons or property based on the commission of (or failure to perform) specified acts, *and* to *pay the costs of defending* the indemnified party in litigation (or arbitration) of third party claims through trial and appeal. [*Carr Business Enterprises, Inc. v. City of Chowchilla* (2008) 166 CA4th 14, 20, 82 CR3d 128, 132—clause containing words "indemnify" and "hold harmless" is indemnity provision generally obligating indemnitor to reimburse indemnitee for any damages indemnitee becomes obligated to pay third persons]

The agreement may require negligence by the indemnitor as a condition to indemnification, or may impose a broader obligation, requiring full indemnification even if the indemnitor is not negligent (or otherwise at fault). [*Heppler v. J.M. Peters Co., Inc.,* supra, 73 CA4th at 1277, 87 CR2d at 509]

➪ [4:464] ***PRACTICE POINTER:*** *Avoid* general "boilerplate" indemnification language such as "saves, indemnifies and holds harmless from and against liability on all claims arising out of …" Such language is itself likely to result in litigation because ambiguous on the scope of the indemnification obligation. (For example, is the indemnitor obligated to pay for the costs of the indemnitee's defense or only on claims reduced to judgment? If obligated to pay for the indemnitee's attorney fees and costs, does the indemnitor have the right to select counsel and control litigation strategy, decision-making and settlement of the case?) [See *Heppler v. J.M. Peters Co., Inc.* (1999) 73 CA4th 1265, 1278, 87 CR2d 497, 509—"To obtain greater indemnity, more specific language must be used" (internal quotes and citation omitted)]

In any event, such general language is not itself enough to create an obligation to indemnify for the indemnitee's own negligence. Specific and unequivocal language to that effect is required. [*Goldman v. Ecco-Phoenix Elec. Corp.* (1964) 62 C2d 40, 44, 41 CR 73, 75; *Heppler v. J.M. Peters Co., Inc.,* supra, 73 CA4th at 1278, 87 CR2d at 509]

The parties may want to consider obtaining *contractual liability insurance* to back up any indemnity given in the purchase and sale agreement.

(1) [4:465] **Rules of interpretation:** Whether an indemnity provision covers a given case turns primarily on rules of contract interpretation. Thus, first and foremost, the parties' mutual intent as expressed in the agreement controls (Civ.C. § 1636). [*Rossmoor Sanitation, Inc. v. Pylon, Inc.* (1975) 13 C3d 622, 633, 119 CR 449, 456; *Peak-Las Positas Partners v. Bollag* (2009) 172 CA4th 101, 105, 90 CR3d 775, 781; see also *Hot Rods, LLC v. Northrop Grumman Systems Corp.* (2015) 242 CA4th 1166, 1179-1182, 196 CR3d 53, 62-65 (concluding parties' broad indemnity provision, when read in conjunction with rest of buy-sell agreement, was meant to apply to both first and third party claims)—buyer of environmentally compromised real property entitled under indemnity provision to sue seller directly for buyer's own damages]

Also, indemnification provisions are construed strictly *against the indemnitee*. [*Rossmoor Sanitation, Inc. v. Pylon, Inc.,* supra, 13 C3d at 632, 119 CR at 455 (especially where issue is whether indemnitor is responsible for indemnitee's negligent acts); see *Heppler v. J.M. Peters Co., Inc.* (1999) 73 CA4th 1265, 1278, 87 CR2d 497, 509]

Absent clear intent to the contrary in the indemnification agreement, indemnity provisions are interpreted under the rules set forth in Civ.C. § 2778:

(a) [4:466] **“Indemnity against liability”** (or equivalent terms) means the indemnitee is entitled to recover “upon becoming liable.” [Civ.C. § 2778(1)]

(b) [4:467] **“Indemnity against claims, or demands, or damages, or costs”** (or equivalent terms) means the indemnitee is not entitled to recover without payment thereof. [Civ.C. § 2778(2)]

(c) [4:468] **“Indemnity against claims, or demands, or liability”** includes the costs of defending such claims, demands or liabilities “incurred in good faith, and in the exercise of a reasonable discretion.” [Civ.C. § 2778(3); but see also *Carr Business Enterprises, Inc. v. City of Chowchilla* (2008) 166 CA4th 14, 20, 82 CR3d 128, 132—third-party-claim indemnity provisions that include attorney fees as loss items *not* tantamount to provision for attorney fees award in contract action triggering Civ.C. § 1717 (*discussed at ¶ 11:138.5*); and *Rideau v. Stewart Title of Calif., Inc.* (2015) 235 CA4th 1286, 1298, 185 CR3d 887, 894 (*discussed at ¶ 4:644.2*)]

(d) [4:469] **Right to conduct defense:** Upon the indemnitee's request, the indemnitor is bound to defend actions or proceedings against the indemnitee respecting matters covered by the indemnity; but the indemnitee has the right to conduct the defense if the indemnitee so chooses. [Civ.C. § 2778(4)]

(e) [4:470] **Conclusive obligation if indemnitor refuses defense:** If after the indemnitee's request, the indemnitor “neglects” to defend the indemnitee, a recovery against the indemnitee “suffered by him in good faith” is *conclusive* against the indemnitor. [Civ.C. § 2778(5); see *Peter Culley & Assocs. v. Sup.Ct. (Park Hill Joint Venture)* (1992) 10 CA4th 1484, 1495-1496, 13 CR2d 624, 631—“recovery” against indemnitee within meaning of § 2778(5) refers only to recovery *by judgment* (not settlement); *Heppler v. J.M. Peters Co., Inc.* (1999) 73 CA4th 1265, 1285, 87 CR2d 497, 514]

(f) [4:471] **Presumptive obligation if indemnitor not on notice of litigation or denied right to control defense:** If the indemnitor is not given reasonable notice of the action or proceeding against the indemnitee, or is not allowed to control the indemnitee's defense, judgment against the indemnitee is only “presumptive evidence” against the indemnitor. [Civ.C. § 2778(6)]

(g) [4:472] **Stipulation to conclusive effect of judgment:** A stipulation that a judgment against the indemnitee shall be conclusive upon the indemnitor is inapplicable if the indemnitee has a “good defense upon the merits” that the indemnitee failed to establish in the action “by want of ordinary care.” [Civ.C. § 2778(7)]

[4:473] ***Reserved.***

c. [4:474] **Subjects covered by indemnification provisions:** Indemnification provisions in real property purchase agreements typically cover these areas:

- Any breach by the seller of the purchase agreement;

- Any liability or obligation of the seller under various third party contracts assumed by the buyer (including leases);

- The inaccuracy or breach of any representation or warranty made by the seller (see *Quality Wash Group V, Ltd. v. Hallak* (1996) 50 CA4th 1687, 1695, 58 CR2d 592, 597—seller liable to buyer under provision agreeing to hold buyer harmless (indemnify) from any damage resulting from falsity of representation that leasehold estate and fixtures were free from encumbrances); and

- Any other act or omission to act of the seller (or seller's agents) before the close of escrow that causes the buyer damage or loss.

[4:474.1 - 4:474.4] ***Reserved.***

15. [4:474.5] **Assumption of Liabilities:** It is sometimes advisable to include a provision in the purchase agreement stating that the buyer will assume all obligations pertaining to the property after the closing date, but that the seller is liable for all obligations pertaining to the property up to the closing date. This approach clarifies who is liable to pay maintenance and operating expenses, insurance, taxes, etc., even though appropriate changes have not yet been made in billing records.

16. [4:475] **Risk of Loss (Damage, Destruction or Condemnation Before Closing):** All purchase and sale agreements should include a "risk of loss" provision. Its purpose is to define the rights and obligations of buyer and seller in the event that, prior to closing, the property is damaged, destroyed or taken (or designated to be taken) by eminent domain. The parties are free to contract on this issue without statutory interference (*¶ 4:480*). But absent a contractual agreement, the parties' rights and obligations are governed by the Uniform Vendor and Purchaser Risk Act (Civ.C. § 1662; *¶ 4:476 ff.*).

a. [4:476] **Statutory rules (no contractual provision on the subject):** These rules apply pursuant to the Uniform Vendor and Purchaser Risk Act, *unless the contract otherwise provides:*

(1) Burden of loss follows transfer of title or possession

(a) [4:477] **Seller's burden *before transfer:*** The *seller* bears the risk of loss until *transfer of legal title or possession*. "If, when neither the legal title nor the possession of the subject matter of the contract has been transferred, all or a material part thereof is destroyed without fault of the purchaser or is taken by eminent domain, the vendor cannot enforce the contract, and the purchaser is entitled to recover any portion of the purchase price that he has paid." [Civ.C. § 1662(a)]

• [4:477.1] **Comment:** Civ.C. § 1662 does not define what constitutes the loss or destruction of a "material part" of the property so as to render the contract unenforceable by the seller; nor is there any known case law on point. The statute is also silent as to the parties' rights upon a "nonmaterial" loss or destruction. Thus, even when they intend to be governed by the Uniform Act, it behooves the parties to define these points.

(b) [4:478] **Buyer's burden *after transfer:*** Conversely, the *buyer* bears the risk of loss *following* transfer of legal title or possession. "If, when either the legal title or possession of the subject matter of the contract has been transferred, all or any part thereof is destroyed without fault of the vendor or is taken by eminent domain, the purchaser is not thereby relieved from any duty to pay the price, nor is he entitled to recover any portion thereof that he has paid." [Civ.C. § 1662(b); see, e.g., *Long v. Keller* (1980) 104 CA3d 312, 317, 163 CR 532, 534—buyer in possession as lessee]

(2) [4:479] **Transfer of "possession":** Under Civ.C. § 1662 (¶ 4:476 ff.), the risk of loss follows the transfer of legal title *or possession*. Thus, if the parties elect to defer to the Uniform Act in lieu of a contract provision apportioning the risk of loss, they should take care to specify what constitutes "possession."

Clearly, the buyer has possession when the buyer physically moves in and assumes sole use of the property. However, the parties might contractually agree that the mere moving of personal property to the realty before the closing amounts to a transfer of "possession" as well. Conversely, to narrow the opportunity for future dispute, it may be prudent to specify that the buyer's (or buyer's agent's) mere entering upon the property (for any period of time) strictly for the purpose of making various inspections will *not* be deemed tantamount to "possession" for purposes of shifting the risk of loss. [See *MacKintosh v. Agricultural Fire Ins. Co.* (1907) 150 C 440, 444, 89 P 102, 104—prospective buyer with option to purchase not in "possession" where merely given possession to test premises for slag and ore, subject to owner's management and free access]

b. [4:480] **Contract provision:** Because the Uniform Act (¶ 4:476 ff.), does not provide a comprehensive resolution of risk of loss issues, it is wise to address the subject through a separately-negotiated contract provision. Indeed, a risk of loss provision in the purchase agreement makes sense for both parties because (1) the buyer does not want to be obligated to purchase the property if it is not in the condition anticipated when the agreement was executed; and (2) the seller does not want the buyer to be able to invoke some preclosing "minor" damage to the property as a ground for terminating the contract.

Accordingly, the parties should both (1) negotiate a definition of the event triggering a risk of loss provision (e.g., the closing date rather than the transfer of "possession"); and (2) strive to set parameters on the degree of damage (or condemnation) that will trigger specified risk of loss consequences. These are a few of the alternatives:

(1) [4:481] **Right to terminate and/or reduction in purchase price:** One possibility is to provide that if the cost to repair the preclosing damage exceeds a certain dollar amount, or the square footage destroyed before closing exceeds a specified amount, the buyer will not be obligated to purchase the property. If the cost of repair or percentage of property damage is less than the agreed-upon maximum, the buyer would be required to purchase but entitled to a corresponding reduction in the purchase price.

Alternatively, the buyer's rights can be tied to the reduction in value of the property by reason of the damage or a condemnation. For example, if a critical accessway to a retail property is taken by eminent domain, the square footage

percentage of the property taken may be small, but the effect on the value of the property may be quite substantial. In such a case, reduction in market value would be an appropriate measuring stick for reducing the purchase price.

(2) [4:482] **Disposition of insurance proceeds and condemnation award:** If the buyer elects to purchase the property notwithstanding the degree of damage or condemnation, the buyer will want either a credit against the purchase price or payment of the insurance proceeds (or condemnation award). The parties should anticipate this possibility and agree that, in the event the buyer is obligated or elects to purchase the property, the seller will *assign* to the buyer (a) the insurance proceeds (*plus* some credit for both the deductible amount and any uninsured damage); and (b) the condemnation award.

(3) [4:483] **Buyer obtaining insurance:** Another alternative is for the buyer simply to arrange for insurance to cover the buyer's rights under the purchase agreement prior to the closing. This may be accomplished either by purchasing a separate policy of insurance with the appropriate coverage, or becoming an additional insured under the seller's policy.

➪ [4:484] ***PRACTICE POINTER:*** If the parties opt for this alternative, the purchase agreement should provide that the buyer's mere purchasing of insurance does not thereby shift the risk of loss to the buyer. This is important because, even if the buyer has insurance coverage, the buyer may still wish to preserve a right to terminate the agreement in the event of damage, destruction or condemnation.

17. [4:485] **Arbitration/Mediation vs. Litigation:** The parties may wish to provide that in the event of any dispute under the contract, they will submit the matter to mediation or binding or nonbinding arbitration (as specified). There is a vast diversity of opinion among attorneys as to the wisdom of such a provision. It is generally agreed, however, that the less complex the case, the less money involved and the quicker the resolution desired, the greater the advantage of mediation, arbitration or another ADR process over full-blown litigation.

a. [4:486] **Litigation:** Unless the parties contract for enforceable arbitration or another ADR mechanism, or agree to arbitrate after a disagreement arises, litigation is the only method of resolving their contract disputes. In weighing the litigation vs. ADR alternatives, these are some of the pros and cons on the litigation side:

[4:487] ***Reserved.***

(1) [4:488] **Advantages of litigation:** Although the benefits may vary for plaintiffs and defendants, litigation generally offers the advantages of:

• Full discovery rights;

• Motion practice permissible;

• Right to jury trial;

• Right of postjudgment appeal;

• An experienced judge instead of a private arbitrator or mediator (although retired judges are often used in arbitrations and mediations and now offer a full range of “alternative dispute resolution” services).

(2) [4:489] **Disadvantages of litigation:** On the downside, litigation is generally more *expensive* and more *protracted* than arbitration or mediation. [See *Frei v. Davey* (2004) 124 CA4th 1506, 1512, 22 CR3d 429, 434 (in noting that “[h]undreds of thousands of dollars in attorney fees have been spent and the parties have litigated through two trials and three appeals,” court commented that home buyers' suit for specific performance of purchase agreement was “a graphic illustration of a case that should have been mediated at an early stage”)]

[4:489.1 - 4:489.4] ***Reserved.***

(3) [4:489.5] **Judicial reference alternative:** As an alternative to traditional litigation, the parties may provide for lawsuits arising out of the agreement to be resolved by judicial reference pursuant to CCP § 638 et seq. The reference may be binding—in which case judgment is entered on the referee's decision; or it may be advisory only—in which case the referee reports its findings and recommendations to the court for the court to consider and accept or reject. A judicial reference proceeding is conducted like a trial but is not heard by a jury. The parties also retain their appellate rights. [See generally,

Trend Homes, Inc. v. Sup.Ct. (Azperren) (2005) 131 CA4th 950, 954-956, 964, 32 CR3d 411, 413-414, 421 (disapproved on other grounds by *Tarrant Bell Property, LLC v. Sup.Ct. (Abaya)* (2011) 51 C4th 538, 545, 121 CR3d 312, 318, fn. 5); and *Woodside Homes of Calif., Inc. v. Sup.Ct. (Fogler)* (2003) 107 CA4th 723, 727, 132 CR2d 35, 38]

Like arbitration provisions (¶ 4:490.5), judicial reference clauses may be subject to challenge for "unconscionability" (*see* ¶ *7:73.5, 11:36*). [*Trend Homes, Inc. v. Sup.Ct. (Azperren)*, supra; *Pardee Const. Co v. Sup.Ct. (Rodriguez)* (2002) 100 CA4th 1081, 1091-1092, 123 CR2d 288, 296]

Cross-refer: Judicial reference is discussed in detail in Knight, Chernick, Quinn & Gupta, *Cal. Prac. Guide: Alternative Dispute Resolution* (TRG), Ch. 6.

b. Arbitration

(1) [4:490] **Right to elect arbitration:** The parties are fully entitled to provide for arbitration of their disputes; and an agreement to arbitrate is generally valid, enforceable and irrevocable. [CCP § 1281; but see CCP § 1298, ¶ *4:493*]

(a) [4:490.1] **Scope:** An arbitration provision in a real estate contract may be worded broadly enough to encompass virtually *any dispute* arising from any *transaction* relating to the agreement. [See *Johnson v. Siegel* (2000) 84 CA4th 1087, 1094, 101 CR2d 412, 416-417—where arbitration clause in purchase agreement was broadly worded to apply to *any dispute arising out of the agreement or any resulting transaction*, parties required to arbitrate dispute over seller's alleged omissions in Civ.C. § 1102 Transfer Disclosure Statement]

1) [4:490.2] **Limitation—bodily injury, wrongful death and property damage claims:** A real estate purchase and sale agreement cannot mandate binding arbitration of bodily injury, wrongful death or property damage claims arising out of the transaction (e.g., causes of action arising from patent or latent defects in the property). [CCP § 1298.7; see *Gravillis v. Coldwell Banker Residential Brokerage Co.* (2006) 143 CA4th 761, 773-780, 49 CR3d 531, 539-545—arbitration exclusion for "bodily injury" does not include purely emotional distress claims; *but see also* ¶ *4:496.1b* re potential FAA preemption]

➪ [4:490.3] ***PRACTICE POINTER:*** Should your client wish to arbitrate *any* dispute arising from a purchase and sale agreement, the arbitration provision should include the words "any claim arising from or related to this agreement." Using narrower language, such as "any claim arising from or related to *the construction and application of any provision of* the agreement," will not give your client the broad coverage it wants. [See *Bono v. David* (2007) 147 CA4th 1055, 1067, 54 CR3d 837, 845-846]

(b) [4:490.4] **Fraud in the inducement defense to enforcement:** Contractual arbitration is properly refused where a party to the contract establishes they were fraudulently induced to enter into the *agreement to arbitrate*. But fraud in the inducement of the *underlying contract* (the purchase and sale agreement itself) is *not* sufficient to defeat an arbitration clause (the arbitrator is competent to decide that issue). [See CCP § 1281; see also *Johnson v. Siegel* (2000) 84 CA4th 1087, 1094-1095, 101 CR2d 412, 417—purchaser attempting to avoid arbitration unsuccessfully alleged underlying purchase agreement rather than arbitration clause was rescinded due to fraud]

(c) [4:490.5] **"Unconscionability" defense to enforcement:** Contractual arbitration also may properly be refused upon a showing of both procedural and substantive *unconscionability*. [See *Sanchez v. Valencia Holding Co., LLC* (2015) 61 C4th 899, 906, 910, 912, 190 CR3d 812, 817, 820, 822 (comprehensive discussion of unconscionability defense); see also *AT & T Mobility LLC v. Concepcion* (2011) 563 US 333, 340, 131 S.Ct. 1740, 1745-1746 (recognizing courts may, under California law, refuse to enforce any contract "found to have been unconscionable at the time it was made," while simultaneously holding FAA preempts California's judicial rule regarding unconscionability of class arbitration waivers in consumer actions)]

Cross-refer: The unconscionability defense is treated in detail in Knight, Chernick, Quinn & Gupta, *Cal. Prac. Guide: Alternative Dispute Resolution* (TRG), Ch. 5.

(2) Pros and cons

(a) [4:491] **Advantages of arbitration:** In contrast to litigation, arbitration generally is faster (no motion practice and limited discovery), less expensive (expeditious resolution usually means lower attorney fees and costs), and private (most arbitration proceedings are conducted in private and parties can maintain results in confidence).

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Moreover, arbitrators may award the full range of relief available in litigation, including specific performance, injunctions and, in an appropriate case, even punitive damages. [See *Social Services Union/American Fed. of Nurses, SEIU Local 535, AFL-CIO v. Alameda County Training & Employment Bd.* (1989) 207 CA3d 1458, 1464, 255 CR 746, 749 (injunctive relief); *Baker v. Sadick* (1984) 162 CA3d 618, 627, 208 CR 676, 682 (punitive damages)]

(b) [4:492] **Disadvantages of arbitration:** But the parties should also weigh these disadvantages:

- An agreement to *binding arbitration* forfeits the right to a jury trial.
- Arbitration awards are not self-executing: If the award is not paid or specifically performed (as the case may be), the prevailing party must commence a court action.
- As a practical matter, arbitration rarely allows the parties extensive discovery comparable to that available in litigation (see CCP §§ 1283, 1283.05).
- There is only a very limited right of judicial review of the arbitrator's award (CCP §§ 1286.2 (grounds for vacating award), 1286.6 (grounds for correcting award)).

(3) [4:493] **Statutory formalities—"real estate contract arbitration":** A provision for binding arbitration of any dispute under a contract to convey real property (or contemplating same) is enforceable only if the following requirements are met (CCP § 1298):

- The provision must be clearly titled "ARBITRATION OF DISPUTES." [CCP § 1298(a)]
- If included in a printed contract, the provision must be set out in at least 8-point bold type or in contrasting minimum 8-point red type; and if included in a typed contract, the provision must appear in capital letters. [CCP § 1298(a)]
- Immediately before the line or space provided for the parties to indicate their assent or nonassent to the arbitration provision, and immediately following that provision, the following language must appear:

> "NOTICE: BY INITIALLING IN THE SPACE BELOW YOU ARE AGREEING TO HAVE ANY DISPUTE ARISING OUT OF THE MATTERS INCLUDED IN THE 'ARBITRATION OF DISPUTES' PROVISION DECIDED BY NEUTRAL ARBITRATION AS PROVIDED BY CALIFORNIA LAW AND YOU ARE GIVING UP ANY RIGHTS YOU MIGHT POSSESS TO HAVE THE DISPUTE LITIGATED IN A COURT OR JURY TRIAL. BY INITIALLING IN THE SPACE BELOW YOU ARE GIVING UP YOUR JUDICIAL RIGHTS TO DISCOVERY AND APPEAL, UNLESS THOSE RIGHTS ARE SPECIFICALLY INCLUDED IN THE 'ARBITRATION OF DISPUTES' PROVISION. IF YOU REFUSE TO SUBMIT TO ARBITRATION AFTER AGREEING TO THIS PROVISION, YOU MAY BE COMPELLED TO ARBITRATE UNDER THE AUTHORITY OF THE CALIFORNIA CODE OF CIVIL PROCEDURE. YOUR AGREEMENT TO THIS ARBITRATION PROVISION IS VOLUNTARY.
>
> "WE HAVE READ AND UNDERSTAND THE FOREGOING AND AGREE TO SUBMIT DISPUTES ARISING OUT OF THE MATTERS INCLUDED IN THE 'ARBITRATION OF DISPUTES' PROVISION TO NEUTRAL ARBITRATION." [CCP § 1298(c)]

If included in a printed contract, the above language must be set out in at least 10-point bold type or contrasting minimum 8-point bold red type; and if included in a typed contract, it must appear in capital letters. [CCP § 1298(c); see also *Villacreses v. Molinari* (2005) 132 CA4th 1223, 1232, 34 CR3d 281, 287—§ 1298(c) "advisory" language is "accompaniment" to arbitration provision and not intended to be the arbitration agreement itself]

(a) [4:494] **Initialing provision indicates assent:** As the statute states, by initialing the arbitration provision, a party indicates its assent to be bound thereby. [CCP § 1298(c); *Johnson v. Siegel* (2000) 84 CA4th 1087, 1095, 101 CR2d 412, 417; *Woodside Homes of Calif., Inc. v. Sup.Ct. (Fogler)* (2003) 107 CA4th 723, 729, 132 CR2d 35, 40—residential property buyers made aware of judicial reference provision in purchase agreement because they had to initial paragraph separately; compare *Bruni v. Didion* (2008) 160 CA4th 1272, 1293, 73 CR3d 395, 413 (*discussed at ¶ 4:495*)]

1) [4:494.1] **Mutual assent required?** There is a split of authority whether an arbitration provision is enforceable if lacking the parties' *mutual* assent (e.g., seller who did not initial the provision attempts to enforce it against buyer who did initial):

• [4:494.2] One case holds that *all parties* must affirmatively assent to the arbitration clause (*separately initialed*). [See *McAvoy v. Hilbert* (2009) 172 CA4th 707, 711-712, 91 CR3d 437, 441—arbitration provision in open listing agreement unenforceable because, among other things, not initialed by both parties]

Another case reaches the same result applying general contract principles: Unless *all parties* assent, the arbitration provision operates only as an *unaccepted offer* to submit disputes to binding arbitration (at least where the arbitration provision lists the parties in the conjunctive—e.g., "Buyer, Seller and Agent Agree … "). [*Marcus & Millichap Real Estate Invest. Brokerage Co. v. Hock Invest. Co.* (1998) 68 CA4th 83, 89-91, 80 CR2d 147, 150-151 (declining to decide whether mutuality of arbitral obligation is always required); compare *Laymon v. J. Rockcliff, Inc.* (2017) 12 CA5th 812, 824, 219 CR3d 185, 195-196 (citing *Marcus & Millichap* in finding no lack of mutuality)—provision relating to arbitration with *nonparty* brokers, when initialed by their buyers or sellers, constituted *accepted offer* to arbitrate (provision stated broker accepted offer by agreeing in writing to arbitrate); *Westra v. Marcus & Millichap Real Estate Invest. Brokerage Co., Inc.* (2005) 129 CA4th 759, 764-765, 28 CR3d 752, 755-756—arbitration provision enforceable by nonsignatory real estate agent where both buyer and seller initial it (*discussed at ¶ 4:495.5 ff.*)]

• [4:494.3] Yet another case, however, disagrees: CCP § 1298 does *not* require mutuality of remedy—i.e., an arbitration provision in a real estate contract may be enforceable against the party who assented thereto even though it would not be enforceable against the other party who did not assent. [*Grubb & Ellis Co. v. Bello* (1993) 19 CA4th 231, 238-240, 23 CR2d 281, 284-285—written assent of other party is not "necessary, essential, natural or proper" to accomplish statutory goals]

a) [4:494.4] **Comment:** The *Grubb & Ellis* view is questionable. The court confined its analysis strictly to the language of CCP § 1298(c) and did not consider general contract principles. [See *Stirlen v. Supercuts, Inc.* (1997) 51 CA4th 1519, 1538-1539, 60 CR2d 138, 150—"To the extent *Grubb & Ellis* suggests mutuality of arbitral obligation is not required, we question the court's analysis … which has never been relied upon by other courts and is hard to reconcile with other pertinent cases requiring mutuality of the arbitral obligation"; see also *Marcus & Millichap Real Estate Invest. Brokerage Co. v. Hock Invest. Co.* (1998) 68 CA4th 83, 91, 80 CR2d 147, 151—"We agree with the criticism of [*Grubb & Ellis*]"]

Moreover, dispensing with a mutuality of remedy requirement could give the seller—who is usually the offeree in real estate sales transactions—an unfair advantage: Once the buyer initialed the arbitration provision (which would normally occur upon submission of the offer), the seller would have no incentive to affix the seller's initials and thereby bind itself to arbitrate; the seller "could have its cake and eat it too"—i.e., the seller could force the buyer to arbitrate when in the seller's best interests and could refuse to arbitrate if it believed arbitration would be disadvantageous. [See *Marcus & Millichap Real Estate Invest. Brokerage Co. v. Hock Invest. Co.*, supra, 68 CA4th at 91, 80 CR2d at 151, fn. 6]

2) [4:495] **Assent may be *inferred although initials absent:*** A party's failure to initial an arbitration provision does *not necessarily* show the party did not agree to the provision. The underlying circumstances (e.g., clerical error) may provide the basis for a reasonable inference that the party intended to be bound by the provision. [*Basura v. U.S. Home Corp.* (2002) 98 CA4th 1205, 1215-1216, 120 CR2d 328, 335—fact builder initialed arbitration provisions in 20 out of 48 real estate contracts permitted reasonable inference builder intended to be bound by arbitration clause under all contracts; compare *Bruni v. Didion* (2008) 160 CA4th 1272, 1293, 73 CR3d 395, 413—no assent implied

from unsigned one-page arbitration provision contained in 30-page booklet, printed in single-spaced 10-point type and buried in "voluminous" stack of purchase and sale documents]

[4:495.1 - 4:495.4] ***Reserved.***

3) [4:495.5] **Compare—enforcement by nonsignatory agent:** A nonsignatory real estate broker (sued by the buyer or seller) may be entitled to enforce the agreement's arbitration provision in its capacity as *agent* to one or more of the signatory parties (i.e., the buyers and/or sellers). "A nonsignatory to an agreement to arbitrate may be required to arbitrate, and may invoke arbitration against a party, if a *preexisting confidential relationship, such as an agency relationship between the nonsignatory and one of the parties* to the arbitration agreement, makes it equitable to impose the duty to arbitrate upon the nonsignatory." [*Westra v. Marcus & Millichap Real Estate Invest. Brokerage Co., Inc.* (2005) 129 CA4th 759, 765, 28 CR3d 752, 756 (emphasis added)]

• [4:495.6] A nonsignatory broker could compel arbitration of a buyer's fraud claims against the broker and seller pursuant to the purchase agreement's provision initialed only by the buyer and seller. Reason: The broker had a preexisting relationship as the agent to both parties to the agreement. [See *Westra v. Marcus & Millichap Real Estate invest. Brokerage Co., Inc.*, supra, 129 CA4th at 766, 28 CR3d at 756-757—also noting provision clearly stated buyer, seller and broker agreed to arbitrate disputes involving purchase agreement subject matter; see also *Laymon v. J. Rockcliff, Inc.* (2017) 12 CA5th 812, 824, 219 CR3d 185, 195-196—arbitration provision enforceable by *nonparty* brokers when initialed by their buyers or sellers (¶ 4:494.2)]

• [4:495.7] Nonsignatory "cooperating" brokers could compel arbitration of their principal's (i.e., the buyer's) failure to disclose claims against the cooperating and listing brokers pursuant to the purchase agreement's arbitration provision initialed only by the buyer and seller. However, the cooperating brokers could *not* compel the listing brokers (i.e., seller's agents) also to arbitrate the claim. Reason: The listing brokers were nonsignatories to the arbitration agreement and did *not* have a preexisting, confidential or contractual relationship with the cooperating brokers. [*Nguyen v. Tran* (2007) 157 CA4th 1032, 1038-1039, 68 CR3d 906, 910-911—nonsignatory may not invoke arbitration clause against another nonsignatory]

(b) [4:496] **Federal Arbitration Act preemption (contracts affecting commerce):** The Federal Arbitration Act (FAA, 9 USC §§ 1-14) governs contractual arbitration under written contracts involving interstate or foreign commerce (or maritime transactions). [9 USC §§ 1, 2; see also *AT & T Mobility LLC v. Concepcion* (2011) 563 US 333, 344, 131 S.Ct. 1740, 1748—FAA's "principal purpose" is to ensure private arbitration agreements are enforced according to their terms]

Because it embodies a strong federal policy favoring arbitration, and to assure uniform results as to arbitrability of disputes within its scope, the FAA *preempts* conflicting state law under the Supremacy Clause. [*Southland Corp. v. Keating* (1984) 461 US 1, 12, 104 S.Ct. 852, 859—FAA governs arbitrability in "either state or federal court"; see also *AT & T Mobility LLC v. Concepcion*, supra, 563 US at 341, 131 S.Ct. at 1747—FAA displaces state law that "prohibits outright" arbitration of particular type of claim; *Allied-Bruce Terminix Cos., Inc. v. Dobson* (1995) 513 US 265, 270-271, 115 S.Ct. 834, 838—FAA was enacted to overcome state courts' "ancient hostility" to arbitration and refusal to enforce arbitration agreements]

1) [4:496.1] **Application to real property purchase agreements "involving commerce":** The words "involving commerce" under the FAA (9 USC § 2) are broadly defined as the functional equivalent of "affecting commerce": i.e., the FAA applies if the underlying contract facilitates interstate (or foreign) commercial transactions *or directly or indirectly* affects commerce between states; the transaction need not literally be in the flow of interstate commerce. [See *Allied-Bruce Terminix Cos., Inc. v. Dobson* (1995) 513 US 265, 277, 115 S.Ct. 834, 841; *Citizens Bank v. Alafabco, Inc.* (2003) 539 US 52, 56-57, 123 S.Ct. 2037, 2040—economic activity in question must represent "general practice" subject to federal control that bears on interstate commerce in "*substantial way*" (emphasis added); *Shepard v. Edward Mackay Enterprises, Inc.* (2007) 148 CA4th 1092, 1097, 56 CR3d 326, 329—"involving commerce" ordinarily signals "broadest permissible exercise of Congress' commerce clause power"]

Moreover, the parties need not have contemplated "substantial interstate activity" when they entered into the underlying agreement. For an agreement to "involve commerce" for purposes of the FAA, the underlying transaction need only *ultimately* involve interstate commerce. [*Shepard v. Edward Mackay Enterprises, Inc.*, supra, 148 CA4th at 1097, 56 CR3d at 329]

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Additionally, the dispute need not arise from the *particular part of the transaction* involving interstate commerce; the FAA applies if the underlying transaction *as a whole* involved interstate commerce. [*Shepard v. Edward Mackay Enterprises, Inc.*, supra, 148 CA4th at 1101, 56 CR3d at 332]

In real estate practice, perhaps surprisingly, many seemingly "routine" purchase and sale contracts may be construed as "involving commerce" within the meaning of the FAA.

• [4:496.1a] A contract for the purchase of a single family residence that anticipated the use of HUD *federal financing*, when coupled with the parties' use of *copyrighted transaction forms* promulgated by the *National Association of Realtors* for members' exclusive use, was held to evidence a transaction involving commerce within the meaning of the preemptive FAA, *rendering CCP § 1298 inapplicable*. [*Hedges v. Carrigan* (2004) 117 CA4th 578, 586-587, 11 CR3d 787, 793-794; see also *Pinnacle Museum Tower Ass'n v. Pinnacle Market Develop. (US), LLC* (2012) 55 C4th 223, 232, 234, 145 CR3d 514, 519, 521—FAA applicable because materials and products incorporated into condominium project were manufactured in other states; *Westra v. Marcus & Millichap Real Estate Invest. Brokerage Co., Inc.* (2005) 129 CA4th 759, 764, 28 CR3d 752, 755 (citing *Hedges*)—real estate agent's failure to initial purchase agreement's arbitration clause as required by CCP § 1298 "would appear to be beside the point" (on issue whether agent was a party to principals' arbitration agreement) because "at least one court has held that section 1298 is preempted by federal law"]

a) [4:496.1b] **FAA preemption of CCP § 1298.7 bodily injury, wrongful death and property damage exclusion?** As noted earlier, California law prohibits real estate purchase and sale agreements from mandating binding arbitration of bodily injury, wrongful death and property damage claims arising out of the transaction (CCP § 1298.7, ¶ *4:490.2*). However, at least two cases address potential FAA preemption of this provision. [See *Gravillis v. Coldwell Banker Residential Brokerage Co.* (2006) 143 CA4th 761, 780, 49 CR3d 531, 544-545 (suggesting § 1298.7 *may* be preempted by the FAA when the agreement involves interstate commerce) (dictum); see also *Pinnacle Museum Tower Ass'n v. Pinnacle Market Develop. (US), LLC* (2012) 55 C4th 223, 235, 145 CR3d 514, 522—"even assuming" § 1298.7 extended to recorded condominium declaration, FAA would have preempted its application to construction defect case involving interstate commerce because § 1298.7 discriminates against arbitration (dictum)]

2) [4:496.2] **Generally applicable contract law not preempted:** The FAA prohibits states from conditioning the enforceability of arbitration agreements on compliance with special requirements (9 USC § 2). Thus, statutes subjecting arbitration agreements to requirements *not applicable to contracts generally* are preempted with respect to agreements "involving commerce." [*Doctor's Assocs., Inc. v. Casarotto* (1996) 517 US 681, 687, 116 S.Ct. 1652, 1656—FAA preempted Montana statute requiring enforceable arbitration clauses to be typed in underlined capital letters on first page; see also *Sanchez v. Valencia Holding Co., LLC* (2015) 61 C4th 899, 923-924, 190 CR3d 812, 831-832; *Basura v. U.S. Home Corp.* (2002) 98 CA4th 1205, 1214, 120 CR2d 328, 334—FAA preempts CCP § 1298.7 that allows new home purchaser to pursue construction and design defect action against developer despite having signed arbitration clause]

On the other hand, the FAA does *not* displace state law requirements applicable to *all* contracts (9 USC § 2)—i.e., requirements concerning the validity, revocability and enforceability of *contracts generally*. [*Doctor's Assocs., Inc. v. Casarotto*, supra, 517 US at 686-687, 116 S.Ct. at 1656]

• [4:496.3] When a contract provision contemplates that an arbitration clause will be effective only if both parties (buyer and seller) assent by initialing it, there is no enforceable agreement to arbitrate absent the parties' mutual assent. "The FAA does *not preempt* this analysis which is based on California law concerning the formation and interpretation of contracts generally." [*Marcus & Millichap Real Estate Invest. Brokerage Co. v. Hock Invest. Co.* (1998) 68 CA4th 83, 92-93, 80 CR2d 147, 152 (emphasis added); see also *Mitchell v. American Fair Credit Ass'n, Inc.* (2002) 99 CA4th 1345, 1357, 122 CR2d 193, 201-202 (statute mandating arbitration requirement to be signed by both parties not preempted)]

• [4:496.4] Likewise, generally applicable contract defenses, such as fraud, duress and unconscionability, may be applied to invalidate arbitration agreements without regard to the FAA. [*Doctor's Assocs., Inc. v. Casarotto* (1996) 517 US 681, 687, 116 S.Ct. 1652, 1656; *Hedges v. Carrigan* (2004) 117 CA4th 578, 583-584, 11 CR3d 787, 791; *Flores v. Transamerica HomeFirst, Inc.* (2001) 93 CA4th 846, 856, 113 CR2d 376, 384 (unconscionability)]

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[4:496.5] ***Reserved.***

3) [4:496.6] **Choice of law governing how arbitration conducted not preempted:** The FAA does not prevent the enforcement of agreements to arbitrate under state rules *different* from those set forth in the FAA itself. When the parties agree to abide by *state* rules of arbitration, enforcing those rules according to the terms of the agreement is consistent with the goals of the FAA, even if the result is that arbitration may be stayed where the FAA would otherwise permit it to proceed. [*Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.* (1989) 489 US 468, 478-479, 109 S.Ct. 1248, 1255-1256—pursuant to choice-of-law clause, Calif. law governed whether arbitration required; *Warren-Guthrie v. Health Net* (2000) 84 CA4th 804, 812-816, 101 CR2d 260, 266-269 (disapproved on other grounds by *Cronus Investments, Inc. v. Concierge Services* (2005) 35 C4th 376, 393, 25 CR3d 540, 554, fn. 8)—pursuant to choice-of-law clause, Calif. law governed *how* arbitration is conducted as opposed to *whether* arbitration is required]

However, the parties' agreement must clearly evidence their intent to be bound by state law arbitration rules; a general choice-of-law clause will not trump the presumption that the FAA supplies the rules for arbitration. [*Sovak v. Chugai Pharmaceutical Co.* (9th Cir. 2002) 280 F3d 1266, 1269-1270; but see *Mount Diablo Med. Ctr. v. Health Net of Calif., Inc.* (2002) 101 CA4th 711, 722-726, 124 CR2d 607, 614-618—“generic” choice-of-law provision requiring application of California law sufficient to avoid FAA's procedural provisions; *Valencia v. Smyth* (2010) 185 CA4th 153, 167-168, 110 CR3d 180, 190-191 (citing *Mount Diablo* with approval)]

• [4:496.7] A standard form Residential Purchase Agreement choice-of-law provision expressly incorporating the CAA for purposes of deciding disputes provided a trial court with authority to stay or deny arbitration where (i) some of the parties were not parties to the arbitration agreement; and (ii) proceedings in different forums—arbitral and judicial—could have resulted in conflicting rulings on common issues of fact or law. [*Gravillis v. Coldwell Banker Residential Brokerage Co.* (2006) 143 CA4th 761, 782-784, 49 CR3d 531, 546-548 (interpreting 2000 version of CAR standard form Residential Purchase Agreement)]

• [4:496.8] A standard form Residential Purchase Agreement provision adopting the FAA for purposes of “contract interpretation,” did not displace the parties' choice-of-law provision expressly incorporating the CAA for purposes of deciding disputes: “Both the FAA and the CAA employ the *same* principles of contract interpretation. Thus, regardless of which act governs the interpretation of the Agreement, the result is the same: Under the ‘plain meaning’ rule, the Agreement's choice-of-law provision requires the application of the CAA's procedural provisions.” [*Valencia v. Smyth* (2010) 185 CA4th 153, 157, 110 CR3d 180, 182 (emphasis in original) (interpreting 2002 version of CAR standard form Residential Purchase Agreement)]

[4:496.9] ***Reserved.***

➪ [4:496.10] ***PRACTICE POINTER:*** It can be far more costly and difficult to litigate whether the purchase agreement “involves” or “affects” interstate commerce so as to be governed by the FAA than it is to adhere to the CCP § 1298 formality requirements in drafting an arbitration clause. Consequently, the most prudent approach at the drafting stage is to assume California law fully applies and follow the mandates of § 1298 (¶ *4:493 ff.*).

(4) [4:497] **Arbitration mechanics:** The Code of Civil Procedure provides generally for the conduct of arbitration proceedings (see CCP § 1282 et seq.); however, those provisions are not exhaustive. It therefore behooves the parties to delineate basic rules and procedures in their agreement (failure to do so may lead to unnecessary delay and disagreement over what was intended to be an expedited method of dispute resolution).

➪ [4:498] ***PRACTICE POINTER:*** Many private arbitration organizations have their own rules and procedures. Thus, by selecting a particular organization (¶ *4:500*), you may also be agreeing to be bound by its arbitration rules and procedures. If that is not the desired result, the agreement should so specify.

(a) [4:499] **Issues to be addressed:** At a minimum, the arbitration provisions should address the following issues with respect to arbitration mechanics:

• Whether arbitration is mandatory or simply an option: i.e., whether either party may elect arbitration or, instead, whether arbitration will be automatically required to the exclusion of litigation.

- A method for picking the arbitrator (and the arbitration association from which the arbitrator will be chosen), as well as the qualifications for the chosen arbitrator.

- Time-frame—how soon the arbitration hearing will be held.

- Rules of discovery.

- Payment and award of arbitration costs.

- Arbitrator's powers.

- That the award shall be valid, binding and enforceable.

(b) [4:500] **Arbitration organizations:** Some of the more popular arbitration organizations to choose from are:

- JAMS (Judicial Arbitration and Mediation Services, LLC): JAMS is made up of retired judges and has its own set of arbitration rules and procedures (see Knight, Chernick, Quinn & Gupta, *Cal. Prac. Guide: Alternative Dispute Resolution* (TRG)).

- AAA (American Arbitration Association): The AAA is made up of retired judges, practicing attorneys and nonattorney experts. It has detailed rules for selecting arbitrators and conducting arbitrations in various types of disputes. (See Knight, Chernick, Quinn & Gupta, *Cal. Prac. Guide: Alternative Dispute Resolution* (TRG).)

- County bar associations (many local bar associations have lists of arbitrators for particular types of disputes).

[4:500.1 - 4:500.4] ***Reserved.***

(c) [4:500.5] **Statutory limitation re "consumer arbitrations" under agreement providing for prevailing party fees and costs recovery:** Most residential real estate purchase and sale agreements, including the California Association of Realtors' preprinted form (*¶ 4:278 ff.*), include a provision that, if initialed by the parties, requires disputes under the agreement to be submitted to binding arbitration (*¶ 4:494*). These agreements also usually provide that the prevailing party in any arbitration under the agreement can recover fees and costs (*see ¶ 4:513 ff.*). These provisions may be affected, however, by a California statute barring neutral arbitrators and private arbitration companies from administering "consumer arbitrations" under any agreement requiring the "consumer" to pay the opposing party's arbitration fees and costs if the consumer does not prevail. [CCP § 1284.3(a)]

It is unclear whether CCP § 1284.3 applies to contractual arbitrations under a residential purchase agreement, because the statute does not define "consumer arbitrations" or "consumer." Guidance indicating the statute does not apply in this context may come from the definitions adopted by the Judicial Council in its "ethics standards for neutral arbitrators in contractual arbitration." [See CRC Ethics Standards, Standard 2(d) & (e)—"consumer arbitration" is "an arbitration conducted under a predispute arbitration provision contained in a contract" with a "consumer party"; and "consumer party" includes a party who seeks or acquires "goods or services primarily for personal, family, or household purposes"]

➪ [4:500.6] ***PRACTICE POINTER:*** Nothing in § 1284.3(a) indicates the statute is nonwaivable. Thus, pending judicial or legislative clarification of the issue, parties to a residential purchase and sale agreement who want to ensure arbitrability of their disputes before a "neutral arbitrator" or "private arbitration company" should consider adding to the arbitration provisions language expressly waiving CCP § 1284.3(a); and the "consumer" should separately initial the waiver clause.

Cross-refer: For a comprehensive treatment of contractual arbitration provisions and proceedings, see Knight, Chernick, Quinn & Gupta, *Cal. Prac. Guide: Alternative Dispute Resolution* (TRG), Ch. 5.

c. [4:501] **Mediation:** As another litigation alternative, the parties may wish to provide for mediation of claims related to the agreement. Indeed, standard residential purchase agreements often contain such a provision, requiring the parties to mediate any dispute arising out of the agreement before resorting to arbitration or court action; and they even make mediation a

condition precedent to the right to recover prevailing party attorney fees in litigation arising out of the agreement. [See *Cullen v. Corwin* (2012) 206 CA4th 1074, 1079, 142 CR3d 419, 423—fact that buyers initiated court action before requesting mediation did not allow prevailing sellers to reject buyers' mediation request and still recover fees under standard form purchase agreement (nor were sellers entitled to condition mediation on receipt of discovery responses); *Lange v. Schilling* (2008) 163 CA4th 1412, 1416-1418, 78 CR3d 356, 359-360—prevailing buyer not entitled to Civ.C. § 1717 attorney fees in action against sellers for failure to disclose, etc., where buyer did not attempt mediation before commencing litigation in violation of purchase agreement; *Frei v. Davey* (2004) 124 CA4th 1506, 1520, 22 CR3d 429, 440-441—prevailing sellers in buyers' action for specific performance not entitled to contractual attorney fees award because sellers refused to mediate dispute as required by purchase agreement; *and ¶ 11:138.16a*]

Cross-refer: Mediation processes are discussed in detail in Knight, Chernick, Quinn & Gupta, *Cal. Prac. Guide: Alternative Dispute Resolution* (TRG), Ch. 3.

[4:502 - 4:504] ***Reserved.***

18. [4:505] **"Like-Kind" (Tax-Deferred) Exchange:** Either buyer or seller may want to effectuate a "like-kind" (tax-deferred) exchange under IRC § 1031. If so, the purchase agreement should include a provision on point and should specify that the party who accommodates the other party's exchange "shall not be at any expense or liability, whether actual or contingent" in connection therewith. However, because of broad potential environmental liability (*see Ch. 5*), many parties are unwilling to take title to property in order to accommodate the other's tax-deferred exchange.

Cross-refer: "Like-kind" exchanges pursuant to IRC § 1031 are discussed in detail in *Ch. 13; see ¶ 13:304 ff.*

19. Buyer's Remedy of Specific Performance

a. [4:506] **Waiver by buyer:** Any dispute under the purchase agreement could result in the buyer's filing suit for specific performance—with concurrent recordation of a lis pendens (*¶ 11:300 ff.*). Until the lis pendens is expunged, or the seller wins the lawsuit, the property may effectively be rendered unmarketable. With this in mind, many sellers require the buyer to waive their right to seek specific performance.

• [4:507] **Comment:** Buyers generally are unwilling to agree to such a waiver (or, for that matter, to any waiver of rights in the event of the seller's breach). But sellers counter that such a waiver is, at least arguably, in the nature of a liquidated damages provision for the seller's benefit: i.e., if the buyer can limit its dollar amount of liability through a liquidated damages provision, the seller (the argument goes) should similarly be able to limit its liability by narrowing the buyer's remedies. The buyer can presumably be made whole with money damages. (Although all real property is generally considered unique, that can be disproved at trial. See *Trapasso v. Sup.Ct. (Majdali)* (1977) 73 CA3d 561, 567, 140 CR 820, 823-824; *Empfield v. Sup.Ct. (Spicka)* (1973) 33 CA3d 105, 108, 108 CR 375, 377; *Real Estate Analytics, LLC v. Vallas* (2008) 160 CA4th 463, 474, 72 CR3d 835, 842; Civ.C. § 3387; *and ¶ 11:220 ff.*)

b. [4:508] **Acknowledgment of buyer's right:** Specific performance is available only if the property is considered "unique" and not all real property is deemed "unique" (*see ¶ 4:507*). Knowing this, buyers may want the seller to expressly acknowledge that the property is unique and the buyer is therefore entitled to all equitable relief, including specific performance, in the event of the seller's breach. Mutuality of remedies is not required—i.e., even though the seller's sole remedy may be liquidated damages, the buyer may seek specific performance. [See *Bleecher v. Conte* (1981) 29 C3d 345, 353, 213 CR 852, 856; and Civ.C. §§ 3386, 3389]

➪ [4:509] ***PRACTICE POINTER:*** In drafting such an acknowledgment clause, buyer's counsel should be careful not to limit the buyer's rights to specific performance; the agreement should preserve the remedies of both specific performance and the recovery of money damages.

Cross-refer: The specific performance remedy is discussed in detail at *¶ 11:150 ff.* (seller's specific performance action) *and ¶ 11:210 ff.* (buyer's specific performance action).

20. [4:510] **Compliance With Tax Withholding Laws:** Subject to certain exceptions, federal and state tax laws require buyers to withhold a specified portion of the sale price for payment as a tax if the seller is located in another state or country.

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a. [4:510.1] **Foreign Investment in Real Property Tax Act (FIRPTA):** Buyers who purchase United States real property from a seller who is a "foreign person" ("any person other than a United States person"; IRC § 1445(f)(3)) must deduct and withhold from the seller's proceeds 10% of the gross sales price. [IRC § 1445(a); but see IRC § 1445(e)—other withholding requirements in cases of foreign partnership or corporation sellers]

Accordingly, a provision requiring the seller to deliver an affidavit or certification that the seller is *not* a "foreign person" should be included in the agreement (or separate escrow instructions). [See IRC § 1445(b)(2)—10% tax inapplicable if transferor furnishes transferee with affidavit stating under penalty of perjury transferor's U.S. taxpayer i.d. number and that the transferor is not a foreign person] Otherwise, 10% of the gross sales price should be withheld.

➪ [4:510.2] ***PRACTICE POINTER:*** There are certain exemptions from the IRC § 1445 withholding requirement (see IRC § 1445(b))—e.g., where buyer purchases the property to use as a residence for a price not exceeding $300,000 (IRC § 1445(b)(5)). Nonetheless, to ensure compliance, buyers are still advised to obtain the seller's affidavit or certification.

b. [4:510.3] **California tax withholding requirements:** Buyers of California real property interests (except those purchasing from a partnership or corporation that has a permanent place of business in California after the transfer of title) for a price exceeding $100,000 generally must withhold and pay to the Franchise Tax Board 3 1/3% of the sales price. The tax must be withheld regardless of whether the proceeds will be distributed locally or out of state. [Rev. & Tax.C. § 18662(e)(1)-(2)(A), (3)(A)]

Other withholding rates, specified as a percentage of the gain, may apply to sales of California real property by non-California partnerships and non-California "S" Corporations. [See Rev. & Tax.C. § 18662(e)(2)(B)]

The statute exempts several types of transactions, however—including a sale of the seller's principal residence. Thus, where an exemption is applicable, the purchase agreement (or separate escrow instructions) should require an affidavit attesting to compliance with the exemption's underlying conditions (e.g., an affidavit from the seller that the subject property is the seller's principal residence and not a second or vacation home; see Rev. & Tax.C. § 18662(e)(3)(D)).

Cross-refer: The federal and California tax withholding requirements and their respective exemptions are discussed further at *¶ 13:520 ff.*

21. Broker Disclosures

a. [4:511] **Disclosure of real estate licensee status:** If either party to the transaction is a licensed real estate broker (or salesperson), disclosure of that fact should be made to the other party. [See 10 CCR § 2785(a)(17), (18) (Rules of the Real Estate Commissioner)] Although disclosure only seems to be required if the broker is receiving a commission (*Whitehead v. Gordon* (1969) 2 CA3d 659, 663, 82 CR 778, 780; *Estrin v. Watson* (1957) 150 CA2d 107, 108, 309 P2d 506, 507), it is prudent to disclose a party's status as broker (or salesperson) in any event.

A broker's (or salesperson's) failure to make the requisite status disclosure could result in penalties or discipline under the Real Estate Licensing Law (Bus. & Prof.C. §§ 10176, 10177) and/or liability for breach of fiduciary duty (*see ¶ 2:155 ff.*).

- *Cross-refer:* A number of broker disclosures are statutorily required in residential real property transactions (Civ.C. §§ 2079.12-2079.24). *See detailed discussion at ¶ 2:170 ff.*

b. [4:512] **Disclosure and indemnity regarding broker commissions:** Real estate broker commissions can be the subject of substantial dispute and litigation. It is therefore important to identify which broker has represented which party and to provide cross-indemnities by seller and buyer.

To avoid creating third party beneficiary rights in favor of brokers within the purchase agreement, it is usually prudent not to include any statement affirmatively requiring the payment of broker commission (*see ¶ 4:256*). However, each party should acknowledge the broker who represented them and agree to indemnify the other for (1) any claim made by the indemnifying party's broker; and (2) any claim made by a broker who alleges entitlement to a commission by or through the indemnifying party.

22. [4:513] **Attorney Fees:** Except as otherwise agreed by the parties or expressly provided by statute, attorney fees are not recoverable in litigation. [CCP § 1021; *California Union Square L.P. v. Saks & Co. LLC* (2021) 71 CA5th 136, 141-142, 286 CR3d 115, 119-120 (conflicting attorney fee provisions in commercial lease); *Pacific Custom Pools, Inc. v. Turner Const.*

Co. (2000) 79 CA4th 1254, 1267, 94 CR2d 756, 765 (attorney fee provision in construction subcontract); *Wilshire-Doheny Associates, Ltd. v. Shapiro* (2000) 83 CA4th 1380, 1396, 100 CR2d 478, 489-490 (indemnity provisions authorizing attorney fee recovery)]

Moreover, there is no specific statute that provides for the recovery of attorney fees in an action for breach of, or an action arising out of, a real property purchase agreement. Thus, an attorney fee provision should be included in the purchase agreement if the parties wish to have the right to a prevailing party fee award in the event of such an action. The provision may be made subject to specified restrictions and conditions (*see* ¶ *11:138.15*). And, under a properly-worded attorney fee provision, attorney fees may be recoverable in a *contract* action *or* in a *tort* action arising out of the purchase and sale agreement (¶ *4:518*).

Compare: Statutes that govern specific types of property (e.g., the Davis-Stirling Common Interest Development Act and Mobilehome Residency Law) may provide an independent basis for recovering attorney fees; *see* ¶ *4:518.13*.

a. [4:514] **Civ.C. § 1717 reciprocal prevailing party fee recovery right in contract actions:** In any *action on a contract*, where the contract specifically provides that attorney fees and costs incurred to enforce the contract are to be awarded to either party or the prevailing party, the party determined to be the prevailing party on the contract (whether or not that party is specified in the contract) "shall be entitled to reasonable attorney's fees in addition to other costs." [Civ.C. § 1717(a); see *Khan v. Shim* (2016) 7 CA5th 49, 55-57, 212 CR3d 292, 297-298 (summarizing applicable law)]

In effect then, even if the contract provides that only one party may recover attorney fees in litigation on or to enforce the contract, it will be read as creating *reciprocal* rights in favor of the prevailing party, regardless of which party initiates the action. [Civ.C. § 1717(a); see *Pacific Custom Pools, Inc. v. Turner Const. Co.* (2000) 79 CA4th 1254, 1269-1270, 94 CR2d 756, 766-767; *Berkla v. Corel Corp.* (9th Cir. 2002) 302 F3d 909, 919 (applying Calif. law)—§ 1717(a) enacted "to limit the ability of a dominant contracting party to provide for a right to attorney's fees on only one side of an agreement"; *Jackson v. Homeowners Ass'n Monte Vista Estates-East* (2001) 93 CA4th 773, 779, 113 CR2d 363, 366—§ 1717(a) reciprocal remedy triggered by attorney fee provision in CC&Rs]

(1) [4:514.1] **Applies only in actions "on the contract":** The reciprocal right to prevailing party attorney fees applies *only* in an *action on the contract* or to *enforce the contract* containing the attorney fees provision. [Civ.C. § 1717(a); *Khan v. Shim* (2016) 7 CA5th 49, 56, 212 CR3d 292, 298; see also *Mountain Air Enterprises, LLC v. Sundowner Towers, LLC* (2017) 3 C5th 744, 747, 220 CR3d 650, 653—although affirmative defenses do not constitute "actions" for purposes of recovering fees, defendant nonetheless entitled to fees where its assertion of option contract as affirmative defense triggered said agreement's attorney fee provision (*see* ¶ *11:138.4*); compare *Hart v. Clear Recon Corp.* (2018) 27 CA5th 322, 327, 237 CR3d 907, 911 (unsuccessful action to prevent foreclosure filed by borrower's nonsignatory family members based on intra-family title dispute)—lender could not recover attorney fees against borrower's family members by invoking trust deed's collateral protection provision since said provision fell outside § 1717 's ambit (¶ 6:417.8)]

By contrast, there is *no* prevailing party reciprocal right to fees under Civ.C. § 1717 when the underlying cause of action (as to which the fee claimant "prevails") sounds in *tort* rather than contract. [*Xuereb v. Marcus & Millichap, Inc.* (1992) 3 CA4th 1338, 1342, 5 CR2d 154, 157; see *Gil v. Mansano* (2004) 121 CA4th 739, 743-745, 17 CR3d 420, 423-425—party does not prevail in "action on a contract" by successfully asserting contract defense to *tort* action; *Exxess Electronixx v. Heger Realty Corp.* (1998) 64 CA4th 698, 708-709, 75 CR2d 376, 383—lessee who prevailed in tort action (failure to disclose defects) not entitled to § 1717 fees under lease provision authorizing fee award in action "to enforce the terms of the contract"]

Whether an action is based on contract or tort depends on the nature of the right sued upon, not the form of the pleading or relief demanded. If the action is based on breach of promise, it is contractual; if based on breach of a noncontractual duty, it is tortious. "If *unclear*, the action will be considered based on *contract* rather than tort." [*Kangarlou v. Progressive Title Co., Inc.* (2005) 128 CA4th 1174, 1178, 27 CR3d 754, 756 (emphasis added; internal quotes omitted)]

(2) [4:514.2] **Prevailing party:** The party entitled to recover Civ.C. § 1717 fees is the one "who recovered a greater relief in the action on the contract." By the same token, the court may determine there is no prevailing party. [Civ.C. § 1717(b)(1)]

An "action on the contract" (above) refers to the whole lawsuit, including both trial and appeal. Thus, § 1717 does not apply to discrete proceedings or separate phases within a lawsuit. [See *de la Carriere v. Greene* (2019) 39 CA5th 270, 273, 276-277, 251 CR3d 795, 798, 800 (finding defendant recovered "greater amount" on contract action both before

and after appeal)—defendant who voluntarily dismissed appeal challenging his damage award remained "prevailing party," resulting in plaintiff losing her bid for appellate attorney fees]

Cross-refer: For a detailed discussion of Civ.C. § 1717 "prevailing party" determinations, *see ¶ 11:139 ff.*

(3) [4:515] **"Magic words" not required:** No statutory "form" language is required to trigger Civ.C. § 1717. The statute comes into play so long as the contract authorizes an award of attorney fees incurred to enforce the contract. [*International Billing Services, Inc. v. Emigh* (2000) 84 CA4th 1175, 1183-1184, 101 CR2d 532, 537—words "promise to reimburse Company for any legal fees …" did *not* make provision an indemnity agreement rather than fee award clause]

(4) [4:516] **Recovery generally not limited to particular kinds of claims under the contract:** Generally, the parties cannot limit a Civ.C. § 1717 fee recovery to a particular type of claim under the contract: A contractual provision for attorney fees in an action to enforce the contract "shall be construed as applying to the *entire contact*, unless each party was represented by counsel in the negotiation and execution of the contract, and the fact of that representation is specified in the contract" (Civ.C. § 1717(a), 2nd para. (emphasis added)). [*Paul v. Schoellkopf* (2005) 128 CA4th 147, 152-153, 26 CR3d 766, 769-770; *Kangarlou v. Progressive Title Co., Inc.* (2005) 128 CA4th 1174, 1178, 27 CR3d 754, 756; see also *Andrade v. Western Riverside Council of Governments* (2024) 99 CA5th 1020, 1026-1027, 318 CR3d 396, 401-402 (finding Civ.C. § 1717 's goal is to avoid "lopsided arrangements" where one party can limit other party's attorney fee recovery to particular claims)—error to deny § 1717 fees to homeowner seeking to rescind loan agreements that impermissibly limited fee provisions to judicial foreclosure actions (¶ 11:138, 11:138.2a)]

(5) [4:517] **Not limited to recovery by individuals:** Again, the "fundamental policy" underlying Civ.C. § 1717 is to "prevent unfair litigation tactics through one-sided attorney fee provisions" (¶ 4:516). As such, the § 1717 reciprocal right to prevailing party attorney fees "applies to *business entities* as well as to individuals." [*ABF Capital Corp. v. Grove Properties Co.* (2005) 126 CA4th 204, 223, 23 CR3d 803, 816 (emphasis added)]

b. [4:518] **CCP § 1021 fee recovery in tort actions ("arising out of" fee provisions):** Provided the contractual attorney fee provision is worded broadly enough, "prevailing party" fees may be awardable under the general authority of CCP § 1021 even though not awardable under Civ.C. § 1717 (because not an "action on the contract" or because otherwise barred by § 1717).

Pursuant to § 1021, "parties may validly agree that the prevailing party will be awarded attorney fees incurred in *any litigation* between themselves, whether such litigation sounds in tort or contract." [*Santisas v. Goodin* (1998) 17 C4th 599, 608, 71 CR2d 830, 836 (emphasis added; internal quotes omitted) (real estate purchase agreement provided for prevailing party fee recovery in actions "arising out of the execution of the agreement or the sale")]

(1) Contracts providing basis for fee recovery

• [4:518.1] A broadly-worded fee clause stating the prevailing party shall be entitled to recover its attorney fees and costs in "any lawsuit or other legal proceeding *to which this agreement gives rise*" provides a basis for the prevailing party's fee recovery in *any suit* (contract *or tort*) arising from the parties' underlying transactional relationship. [*Xuereb v. Marcus & Millichap, Inc.* (1992) 3 CA4th 1338, 1342-1343, 5 CR2d 154, 157-158 (emphasis added)—CCP § 1021 fees recoverable in tort action alleging brokers failed to conduct competent inspection of property (court concluded dispute arose out of real estate purchase agreement containing fee recovery provision); see also *Palmer v. Shawback* (1993) 17 CA4th 296, 299-300, 21 CR2d 575, 576]

• [4:518.2] A clause in the purchase and sale agreement providing for prevailing party attorney fees and costs "in any action, proceeding, or arbitration between Buyer and Seller *arising out of this Agreement*" entitles the successful party to a fee award in a tort action arising out of the real estate transaction. [*Johnson v. Siegel* (2000) 84 CA4th 1087, 1100-1102, 101 CR2d 412, 421-422—sellers who prevailed on summary judgment in buyer's suit for fraud and misrepresentation (nondisclosure of flood and drainage problems) entitled to fee award; see also *Childers v. Edwards* (1996) 48 CA4th 1544, 1548-1549, 56 CR2d 328, 330-331 (same attorney fee clause); *Lerner v. Ward* (1993) 13 CA4th 155, 160-161, 16 CR2d 486, 489 (similar attorney fee clause)]

• [4:518.3] Similarly, a seller who successfully defended against the buyer's tort action (alleging breach of various duties under Calif. law concerning sale of building containing asbestos) was entitled to CCP § 1021 fees where the underlying purchase agreement provided for a fee recovery in favor of the party who prevailed in "any suit or other proceeding *with respect to the subject matter or enforcement of this Agreement*." [*3250 Wilshire Blvd. Building v. W.R. Grace &*

Co. (9th Cir. 1993) 990 F2d 487, 489 (emphasis added); see also *Khan v. Shim* (2016) 7 CA5th 49, 55, 59-62, 212 CR3d 292, 297, 300-303 (applying Civ.C. § 1021 and CCP §§ 1032 & 1033.5)—contractual fee provision covering any litigation or arbitration between parties concerning agreement's "*terms, interpretation or enforcement or the rights of any party in relation thereto*" deemed broad enough to cover seller's fees for successful defense of buyer's tort claims (emphasis in original)]

(2) Contracts not providing basis for fee recovery

• [4:518.4] Where the attorney fee provision only authorized fees in an action "to enforce the terms of the contract," the prevailing party on a tort cause of action (failure to disclose defects) was *not* entitled to fees. [*Exxess Electronixx v. Heger Realty Corp.* (1998) 64 CA4th 698, 708-709, 75 CR2d 376, 383; see also *Gil v. Mansano* (2004) 121 CA4th 739, 743, 17 CR3d 420, 423]

• [4:518.5] Likewise, CCP § 1021 fees were not recoverable in a *professional negligence (attorney malpractice) action* where the underlying contract authorized fees in an action "to enforce the terms of the parties' agreement." Such a narrowly-drawn provision "cannot be read as a contractual agreement to award fees in an action brought for legal malpractice" which, like a fiduciary duty or fraud cause of action, sounds in *tort*. [*Loube v. Loube* (1998) 64 CA4th 421, 429-430, 74 CR2d 906, 911]

[4:518.6 - 4:518.10] ***Reserved.***

(3) [4:518.11] **Limitation—no fee recovery "reciprocity" under § 1021:** CCP § 1021, unlike Civ.C. § 1717, does not contain a "reciprocity" provision. Thus, where the party claiming fees prevails on a *tort* (rather than a contract) cause of action, so that CCP § 1021 (and not Civ.C. § 1717) applies, the right to an attorney fee award may only be based on the *terms of the underlying contract*. If the contract only gives one party the right to an attorney fee award should that party prevail in litigation, the *unnamed* party does *not* have a reciprocal right to a fee award in the event the unnamed party prevails. [*Moallem v. Coldwell Banker Comm'l Group, Inc.* (1994) 25 CA4th 1827, 1831-1833, 31 CR2d 253, 255-256—despite attorney fee clause in underlying brokerage agreement, tenant who prevailed only on *tort* claims in action arising out of real estate transaction could not recover fees against real estate agent because attorney fee clause ran only in named agent's favor]

➪ [4:518.12] ***PRACTICE POINTER:*** Where a dispute arises out of a purchase and sale transaction, it is not uncommon for the aggrieved party to pursue *both* contract *and* tort (fraud, etc.) causes of action. A *broadly-worded* prevailing party fee recovery provision (*see ¶ 4:518.1 ff.*) should trigger entitlement to an attorney fee recovery no matter *which* cause of action (tort or contract) the aggrieved party prevails on. (But again, since there is no "reciprocal" right to fees under CCP § 1021, make sure the attorney fee clause is drafted to benefit *whichever party* prevails, rather than only a particular named party.) *See Form 4:H.*

On the other hand, if you want to restrict the fee recovery right to litigation related to a contract cause of action, a narrowly-worded provision limiting attorney fees to actions "on the contract" or "to enforce the contract" is recommended. [See *Exxess Electronixx v. Heger Realty Corp.* (1998) 64 CA4th 698, 708-709, 75 CR2d 376, 383 & fn. 17 (citing text)]

c. [4:518.13] **Fee recovery under other statutes:** Some types of real property (e.g., common interest developments and mobilehomes) may be governed by specific statutes that allow parties to recover attorney fees and costs if they prevail in litigation involving alleged violations of those statutes, or that otherwise arise out of the statutes. [See *Tract 19051 Homeowners Ass'n v. Kemp* (2015) 60 C4th 1135, 1138-1139, 1143-1144, 184 CR3d 701, 703, 707 (suit alleging development tract was common interest development and defendant/homeowner was violating its restrictions)—defendant/homeowner awarded prevailing party attorney fees under Davis-Stirling Common Interest Development Act even though court ultimately determined development tract did not qualify as common interest development; *Canyon View Ltd. v. Lakeview Loan Servicing, LLC* (2019) 42 CA5th 1096, 1099, 1114, 1118-1119, 256 CR3d 233, 235-236, 246-247, 251—mobilehome park owner who successfully quieted title to multiple mobilehomes purchased at proceedings regulated by Mobilehome Residency Law entitled to attorney fees and costs under said law]

d. [4:519] **Effect of assignment:** If either party's rights under the contract are assigned, the assignee should explicitly agree to assume the assignor party's attorney fee obligation; otherwise, the attorney fee provision is not enforceable against the

assignee. [See *Glynn v. Marquette* (1984) 152 CA3d 277, 280, 199 CR 306, 307—intervening buyer who did not specifically assume contract obligations not subject to attorney fee provision]

[4:519.1 - 4:519.4] ***Reserved.***

e. [4:519.5] **Recovery in arbitration proceedings:** Contractual provisions for fee awards in any "suit" or "action" on, or "arising out of," the contract have been held to authorize a prevailing party fees and costs award in arbitration proceedings. [See *Harris v. Sandro* (2002) 96 CA4th 1310, 1314, 117 CR2d 910, 914; *Tate v. Saratoga Sav. & Loan Ass'n* (1989) 216 CA3d 843, 856-857, 265 CR 440, 447-448 (abrogated on other grounds by *Advanced Micro Devices, Inc. v. Intel Corp.* (1994) 9 C4th 362, 376-377, 36 CR2d 581, 589-590); but see *Corona v. Amherst Partners* (2003) 107 CA4th 701, 703-704, 706-707, 132 CR2d 250, 251-252, 254—arbitration fees and costs not awardable by court on petition to confirm award where party never requested arbitrator to decide the issue although within scope of arbitrable disputes]

Nonetheless, to leave no room for doubt on the subject, if the agreement calls for arbitration (instead of litigation), the attorney fee provision should be modified to authorize a prevailing party fee recovery in the event of arbitration under the contract (*see ¶ 4:518.2*).

(1) [4:519.6] **"Consumer arbitration" limitation:** This may be affected by a statute that bars neutral arbitrators and private arbitration companies from administering a consumer arbitration under a contract requiring the losing consumer to pay the opposing party's fees and costs. [See CCP § 1284.3(a), *discussed at ¶ 4:500.5 ff.*]

Cross-refer: Civ.C. § 1717 and CCP § 1021 attorney fee awards in purchase and sale litigation (including the issue of "prevailing party" determinations) are discussed in greater detail in *Ch. 11; see* ¶ *11:136 ff. and 11:392 ff.*

23. Assignment

a. [4:520] **Contract assignable unless otherwise agreed:** Unless otherwise agreed, real property purchase agreements are generally assignable. [See Civ.C. § 1458—"right arising out of an obligation is the property of the person to whom it is due, and may be transferred as such"; and *Farmland Irrig. Co. v. Dopplmaier* (1957) 48 C2d 208, 222, 308 P2d 732, 740—agreement assignable unless assignment would impair party's chances of obtaining performance expected from other party]

However, absent the other party's consent, an assignment does not release the assignor from the assignor's *obligations* under the contract. [See Civ.C. § 1457—"burden of an obligation" can only be transferred with consent of party entitled to its benefit; and *Britschgi v. McCall* (1953) 41 C2d 138, 144, 257 P2d 977, 980]

➪ [4:521] ***PRACTICE POINTER FOR SELLERS:*** Sellers may have good reason to insist on a provision against assignment (or, at least, a provision conditioning assignment on the seller's prior consent). This is particularly so where the seller is providing financing to the buyer or where the purchase agreement contemplates substantial interaction between buyer and seller before closing; simply stated, the seller may not want to do business with a stranger.

➪ [4:522] ***PRACTICE POINTER FOR BUYERS—"DOUBLE" OR "BACK-TO-BACK" ESCROWS*****:** Buyers can often avoid nonassignability provisions by setting up a second escrow in which they sell to their intended assignees immediately after acquiring title from the seller. The second escrow closes immediately after the first.

But caveat: If there is seller financing, the transfer to the second buyer may violate a due-on-sale clause in the seller's deed of trust. (*See ¶ 4:297; and more detailed discussion at ¶ 6:388 ff.*)

(1) [4:523] **Impact of "or nominee" designation in contract:** Many purchase agreements state the buyer's name but also include the term "or nominee" (i.e., "… (buyer) or buyer's nominee"). This may indicate an intent to make the buyer's rights assignable to a third party. However, the word "nominee" connotes only the delegation of authority to the nominee in a representative or "nominal" capacity—*not* a transfer or assignment to the nominee of any property in or ownership of the rights of the person nominating them. It follows that, without a *formal assignment* to the nominee, the contract may be too "uncertain" to be specifically enforceable at the nominee's behest. [See *Cisco v. Van Lew* (1943) 60 CA2d 575, 583, 141 P2d 433, 438—third party "nominees," who did not expressly assume buyer's obligation, could not specifically enforce purchase agreement]

b. [4:524] **Issues of assumption (by assignee) and exoneration (of assignor):** As noted, an assignment generally does not itself relieve the assignor of the assignor's obligations under the contract (*¶ 4:520*), although the assignee's acceptance of benefits under the contract can be deemed an assumption of the assignor's contractual obligations (see Civ.C. § 1589).

Notwithstanding these general rules, it is to the seller's benefit to specify that the assignor buyer will still *remain liable* under the contract. It is also prudent to provide that the buyer's assignment will not be permitted unless the assignee (new buyer) executes a specific assumption of all of the original buyer's (assignor's) obligations under the purchase agreement. Any such provision should also clearly state that the assignee's assumption does *not exonerate* the assignor buyer.

24. [4:525] **No Third Party Beneficiaries:** Contracts made *expressly* for the benefit of a *third person* are enforceable by the third person (at any time before the parties thereto rescind the agreement; see Civ.C. § 1559). On the other hand, third parties who are only *incidentally* or *remotely* benefited by performance of a contract are *not* entitled to enforce it. [*Prouty v. Gores Technology Group* (2004) 121 CA4th 1225, 1232-1233, 18 CR3d 178, 183-184; *Bancomer, S.A. v. Sup.Ct. (Reilly)* (1996) 44 CA4th 1450, 1458, 52 CR2d 435, 440]

Generally, it is a question of fact whether a particular third person is an intended or simply incidental beneficiary to the contract; the decision requires a construction of the *contracting parties' intent*, "gleaned from reading the contract as a whole in light of the circumstances under which it was entered." [*Bancomer, S.A. v. Sup.Ct. (Reilly)*, supra, 44 CA4th at 1458, 52 CR2d at 440; *Prouty v. Gores Technology Group*, supra, 121 CA4th at 1233, 18 CR3d at 184; see *Steinberg v. Buchman* (1946) 73 CA2d 605, 609-610, 167 P2d 207, 209—prospective buyer did not intend seller's broker (claiming commissions from prospective sale proceeds) to be third party beneficiary of purchase agreement and thus was not liable to broker in refusing to complete purchase]

It need not be demonstrated that *both* contracting parties intended to benefit the third party but, rather, that the *promisor understood that the promisee had such intent*. [*Schauer v. Mandarin Gems of Calif., Inc.* (2005) 125 CA4th 949, 958, 23 CR3d 233, 239]

Disputes over third party beneficiary rights (e.g., broker claiming commission as third party beneficiary of purchase agreement) can complicate a purchase and sale transaction. Therefore, since the parties' intent is a decisive factor (above), it is advisable to include a provision expressly stating that only the parties executing the agreement are parties to the agreement and no third party shall have any rights thereunder.

25. [4:526] **Joint and Several Liability:** By statute, obligations imposed on several persons generally are presumed to be joint and several (rather than several). [See Civ.C. §§ 1431, 1659, 1660] Nonetheless, contracts involving multiple parties on a side of the transaction often include a provision expressly stating the obligations of the parties are joint and several.

26. [4:527] **Integration ("Entire Agreement") Provision and Amendment Requirements:** To minimize potential future dispute over what the parties agreed to, only those terms within the "four corners" of the document should constitute the purchase agreement. This result may be achieved through an "integration clause," specifying that: (a) The purchase agreement signed by the parties constitutes their *entire and sole agreement;* and (b) no party has relied on any representations, warranties, statements or inducements of the other party (or their brokers or other representatives) that are not specifically set forth in the purchase agreement. [See *EPA Real Estate Partnership v. Kang* (1992) 12 CA4th 171, 176-177, 15 CR2d 209, 212—evidence of prior agreement between parties inadmissible when purchase contract contains integration provision; but see also *Ron Greenspan Volkswagen, Inc. v. Ford Motor Land Develop. Corp.* (1995) 32 CA4th 985, 987, 38 CR2d 783, 784—contract clause stating parties relied only on express representations in contract does *not*, as a matter of law, bar action for fraud based on representations outside contract]

Similarly, the parties should include language prohibiting any amendment to the purchase agreement unless in writing and signed by both parties.

➪ [4:528] ***PRACTICE POINTER:*** By the same token, to ensure the parties are bound by applicable *escrow instructions*, care should be taken to *include* any escrow instructions (which may be separately executed) as part of the purchase agreement.

a. [4:529] **Admissibility of extrinsic evidence:** Notwithstanding an "integration clause" (¶ 4:527), extrinsic evidence may be admissible in litigation over the contract. Under the parol evidence rule, terms set forth in a writing that is intended by the parties as "a final expression of their agreement with respect to such terms" may not be contradicted by evidence of any prior or contemporaneous oral agreement. [CCP § 1856(a); *EPA Real Estate Partnership v. Kang* (1992) 12 CA4th 171, 175, 15 CR2d 209, 211]

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However, extrinsic evidence may be considered to explain an ambiguity, interpret terms of the agreement, or establish an "illegality or fraud." [CCP § 1856(g); see also CCP § 1856(a)-(h); *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Ass'n* (2013) 55 C4th 1169, 1172, 151 CR3d 93, 94-95 (overruling prior contrary authority)—extrinsic evidence of fraudulent promises at variance with writing's terms admissible; *WYDA Assocs. v. Merner* (1996) 42 CA4th 1702, 1710-1711, 50 CR2d 323, 327-328 (ambiguous financing contingency in purchase and sale agreement); *and* ¶ *4:270.4, 11:355.10 ff.*]

b. [4:530] **Dealing with preliminary agreements and memoranda:** The parties may have signed some form of preliminary written agreement or memorandum of intent before consulting counsel and/or with the intent that the preliminary writing be superseded by a formal purchase agreement (¶ *4:275 ff.*). In such cases, the final purchase agreement should provide either that (1) the initial written agreement is *entirely superseded*; or (2) in the event of any inconsistency between the two agreements, the latter prevails.

27. Notice Provision

a. [4:531] **Purpose:** Various notices between the parties may be permitted or required by the agreement. Unless the agreement identifies the manner and time-frame for giving such notice, either party may find a "way out" of its obligations on the ground of defective notice. To eliminate these concerns, it is strongly recommended that the agreement include a notice provision, specifying: (1) the *form* of notice required (oral or written); (2) the *addresses* to which notices are to be given; (3) the *manner* in which notice may be given (e.g., by personal delivery, certified mail, regular mail, air courier, fax transmission, etc.); and (4) the *time* the notice becomes effective (e.g., upon receipt, proper transmission, etc.). The parties may also wish to specify that notices will not be effective unless also given in writing to the parties' legal counsel and, perhaps, other designated persons.

➪ [4:531.1] ***PRACTICE POINTER:*** Though the parties are of course free to agree that oral notice will suffice, that invites later dispute and possible parol evidence problems. Thus, all notices should be required to be in *writing*.

b. [4:532] **Notice to escrow holder:** Typically, any notice required to be given to the escrow holder is also intended to be given to the other party. Because there can be a delay in transmission from the time the escrow holder receives notice and then notifies the other party, any notice to be given to the escrow holder should concurrently be given to the other party.

For example, if the buyer is required to give notice to the escrow holder of its disapproval of a contingency by a certain deadline, as a matter of prudence, the notice should be given to *both* the escrow holder and the seller *at the same time*.

c. [4:533] **Effective date:** Generally, notice that is hand-delivered or transmitted by fax should be effective upon receipt. Notices sent by mail can generally be deemed effective within an agreed-upon number of days after deposit in the ordinary course of mail (typically, 48 or 72 hours after mailing).

d. [4:533.1] **Compare—constructive notice:** Under certain circumstances, a party may be *deemed* by law to have notice although no formal notice was transmitted or received. Such "constructive notice" exists when a person "has actual notice of circumstances sufficient to put a prudent person *upon inquiry* as to a particular fact …" [Civ.C. § 19 (emphasis added); see *Marriage of Cloney* (2001) 91 CA4th 429, 436-437, 110 CR2d 615, 621]

Moreover, a letter correctly addressed and properly mailed is *presumed* to have been received by its addressee in the ordinary course of the mail. [Ev.C. § 641]

28. [4:534] **Severability:** Formal contracts often contain a "severability" clause, indicating that if any provision of the agreement is deemed void or unenforceable, the balance will remain enforceable and not affected thereby. Such "severability" language generally is effective, although, if the unlawful portion of the contract is the "essence" of the parties' agreement, the entire agreement will be unenforceable. [*Keene v. Harling* (1964) 61 C2d 318, 321-322, 38 CR 513, 516; see also *Baeza v. Sup.Ct. (Castle & Cooke Calif., Inc.)* (2011) 201 CA4th 1214, 1230, 135 CR3d 557, 568—severance appropriate where illegal provision collateral to contract's main purpose; *Persson v. Smart Inventions, Inc.* (2005) 125 CA4th 1141, 1153-1154, 23 CR3d 335, 344-345 (distinguishing prohibited "partial rescission" of contract (¶ *11:475*) from set-aside of unenforceable severable provision)]

• [4:534a] A provision in a real estate purchase and sale agreement purporting to limit the damages recoverable by buyers should the developer be in breach was deemed "separate and independent" and therefore severable from other provisions requiring the buyers to comply with certain nonadversarial prelitigation procedures before proceeding with their construction

defect action against the developer: "[The] allegedly unlawful provision … is collateral to the main purpose of the contract [i.e., the sale and purchase of real property, a lawful purpose], and may be severed from it without interfering with enforcement of the lawful provisions of the contract." [*Baeza v. Sup.Ct. (Castle & Cooke Calif., Inc.)* (2011) 201 CA4th 1214, 1231, 135 CR3d 557, 569]

➪ [4:534.1] ***PRACTICE POINTER:*** Severability language can, of course, be included in a purchase and sale agreement. Bear in mind, however, that this is a boilerplate provision requiring particularly careful consideration in each transaction to determine whether severability is advisable (i.e., either party may not want to go through with the deal if certain parts thereof are held void).

29. [4:535] **"Time of the Essence":** A provision stating that all time periods and deadlines are "of the essence" is advisable. Violation of such a provision may amount to a breach of the contract and excuse the other party's obligation to perform. [See *Galdjie v. Darwish* (2003) 113 CA4th 1331, 1337-1338, 7 CR3d 178, 182; *Pittman v. Canham* (1992) 2 CA4th 556, 560, 3 CR2d 340, 342—buyer's failure to pay purchase price by specified date terminated seller's obligation to convey; *Consolidated World Investments, Inc. v. Lido Preferred, Ltd.* (1992) 9 CA4th 373, 380-382, 11 CR2d 524, 528-529—buyer's failure to request opening of escrow within specified time period for closing of escrow terminated seller's obligation to convey; *but see also* ¶ *4:537*]

Compare: If no time is specified for the performance of an obligation under the contract, "a reasonable time is allowed" (*see* ¶ *4:282.1 and 11:56 ff.*). [Civ.C. § 1657; see also *Conservatorship & Estate of Buchenau* (2011) 196 CA4th 1031, 1039, 127 CR3d 109, 115 (no "time of essence" clause)—public guardian's 19-day delay in delivering all documents necessary to transfer title to purchaser of property at auction not unreasonable under the circumstances (noting also, however, that an *essential* time for performance may be implied when so required); *Katemis v. Westerlind* (1953) 120 CA2d 537, 543, 261 P2d 553, 558, app. after new trial (1956) 142 CA2d 799, 299 P2d 383—buyer's two-day delay in paying balance due under sale contract was at most a "technical and unintentional" default that did *not* defeat buyer's right to specific performance where "time of essence" clause *not included* in contract]

a. [4:536] **Waiver by conduct:** Despite an agreement that "time is of the essence," the parties can *waive* such a provision by conduct indicating time might not really be "of the essence." [See *Galdjie v. Darwish* (2003) 113 CA4th 1331, 1339-1340, 7 CR3d 178, 183-184—trial court properly found that seller waived agreement's time provisions by continuing to deal with buyer after dates specified in agreement; *Johnson v. Goldberg* (1955) 130 CA2d 571, 577, 279 P2d 131, 135—seller waived 10-day alleged "time of essence" condition for buyer to make deposit with title company]

b. [4:536.1] **Estoppel to assert "time of the essence" provision:** Similarly, under appropriate circumstances, either party may be *estopped*, by his or words or conduct, to assert a "time of the essence" provision in defense to enforcement of the agreement (Ev.C. § 623—one party's deliberate inconsistent words or conduct to the detriment of the other party who acted, or failed to act, in reliance thereon). [See *McCown v. Spencer* (1970) 8 CA3d 216, 224, 87 CR 213, 218—seller estopped to assert buyer's failure to timely perform]

➪ [4:537] ***PRACTICE POINTER:*** One party's failure to timely perform does *not* result in an "automatic discharge" of the agreement (it may not amount to a "material" breach, or it may be the subject of a waiver or estoppel, ¶ 4:536 ff.), and therefore may not necessarily excuse timely performance by the other. [See *MacFadden v. Walker* (1971) 5 C3d 809, 815-816, 97 CR 537, 540-541—buyer's default in installment payments under *land sale contract* does not give vendor absolute right to terminate contract (equities weighed in favor of avoiding forfeiture); *Galdjie v. Darwish* (2003) 113 CA4th 1331, 1341-1343, 7 CR3d 178, 185-186—where seller waived buyer's failure to timely obtain loan approval, buyer's default did not automatically terminate agreement and seller's obligation to provide termite report to escrow; see also *Katemis v. Westerlind* (1953) 120 CA2d 537, 543, 261 P2d 553, 558 (¶ *4:535*)]

Thus, the "nondefaulting" party should nonetheless tender full performance whenever practical. For example, even if the buyer does not timely deliver the purchase price at closing, the seller should demonstrate the seller's readiness, willingness and ability to perform by delivering the deed and other required closing documents to the escrow holder (or any other designated intermediary); failure to do so could put the seller in breach.

c. [4:537.1] **Application to option agreements:** A "time of the essence" clause in an option agreement is of *no effect*. "[S]uch considerations have nothing to do with options … Rather, on the lapse of the option period the matter is completely ended

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and the offer is withdrawn." [*Allen v. Smith* (2002) 94 CA4th 1270, 1282, 114 CR2d 898, 905 (internal quotes and citations omitted); *see discussion at ¶ 8:100 ff.*]

Cross-refer: These principles are discussed in greater detail in *Ch. 11* in connection with breach of contract remedies and, specifically, conditions precedent vs. conditions concurrent. *See ¶ 11:70 ff.*

30. [4:538] **Delivery of Possession:** The contract should specify the date the seller is obligated to deliver possession to the buyer. This will almost always be the closing date.

a. [4:539] **Lease in event of preclosing or delayed transfer of possession:** If the buyer is to take possession before the closing or the seller is to remain in possession for some time after the closing, it is advisable to create a *lease*, either within the purchase agreement or by separate instrument. By so doing, the owner (buyer or seller, as the case may be) will be guaranteed the expeditious remedy of unlawful detainer should possession be wrongfully withheld.

Any such lease will usually be abbreviated; but it should always specify the rental amount and a definite date for the end of its term. (See comprehensive treatment of leases and rental agreements in Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 2B.)

31. Further Acts

a. [4:540] **General provision:** The parties may wish to include a "further acts" provision, requiring buyer and seller to take those steps and execute such documents as may be reasonably necessary to carry out the provisions of the purchase agreement (and transactions contemplated by the agreement).

➪ [4:541] ***PRACTICE POINTER:*** Think carefully about including such a provision; it may invite disputes as to what is "reasonably necessary." Also, since the buyer's obligation is generally confined to paying the purchase price, a "further acts" provision typically benefits the buyer alone; sellers, therefore, should avoid a broadly-worded, "further acts" clause.

After reflection, the parties may deem it more prudent to rely strictly on the implied covenant of good faith and fair dealing (*¶ 4:275.5*) to ensure that each will do what is necessary to perform the contract; or, alternatively, to *specify* what *particular* "further acts" are contemplated. [See also Civ.C. § 1656—necessary incidents to contract implied]

b. [4:542] **Execution of specific documents:** Occasionally, and particularly when the buyer wishes to process various permit or development applications, it will be advisable to identify with some degree of specificity the kinds of documents the seller must execute to facilitate the processing of permits and other development approvals. In this situation, the seller should also include a statement indicating the seller is not obligated to pay any fees and incurs no liability for having executed these documents.

32. [4:543] **No Transfer During Escrow:** It is sometimes beneficial to add a provision barring the seller from selling, encumbering or marketing the property during the term of the purchase agreement. (Of course, such action may in any event violate an express representation or warranty or otherwise breach the implied covenant of good faith and fair dealing, giving the buyer a cause of action for breach.)

33. Governing Law and Venue

a. [4:544] **Choice of law:** Rules on interpretation and enforceability of contracts vary from state-to-state. Thus, the parties should designate which state's laws will govern the transaction in the event of a dispute.

(1) [4:544.1] **Enforceability of choice of law provisions:** Generally, contractual choice of law provisions, agreed to in an arm's length transaction, will be respected and enforced by California courts. In testing the validity of such provisions, California courts apply the principles set forth in Rest.2d Conflict of Laws § 187, "which reflect a strong policy favoring enforcement." [*Nedlloyd Lines B.V. v. Sup.Ct. (Seawinds Ltd.)* (1992) 3 C4th 459, 464-465, 11 CR2d 330, 333; see also *Washington Mut. Bank, FA v. Sup.Ct. (Briseno)* (2001) 24 C4th 906, 916-917, 103 CR2d 320, 328; *Gramercy Investment Trust v. Lakemont Homes Nevada, Inc.* (2011) 198 CA4th 903, 909, 130 CR3d 496, 501]

Under the Restatement approach, the court first must determine whether (a) the chosen state has a "substantial relationship" to the parties or their transaction or (b) there is any other "reasonable basis" for the parties' choice of law.

If neither of these tests is met, the inquiry ends; and the court need not enforce the parties' choice of law. [*Nedlloyd Lines B.V. v. Sup.Ct. (Seawinds Ltd.),* supra, 3 C4th at 466, 11 CR2d at 334; see also *Gramercy Invest. Trust v. Lakemont Homes Nevada, Inc.,* supra, 198 CA4th at 909-910, 130 CR3d at 501-502—New York choice of law provision contained in agreements to finance California real estate project deemed unenforceable because, among other things, New York had insufficient contacts with transaction (*discussed further at ¶ 6:273.1b*)]

If, however, either test is met, the court must next determine whether the chosen state's law is contrary to a "fundamental policy" of California. Absent such conflict, the court must enforce the parties' choice of law. Conversely, if there is such a conflict, the court must determine whether California has a "materially greater interest" than the chosen state in determining the particular issue; if not, the chosen state's law will be applied. [*Nedlloyd Lines B.V. v. Sup.Ct. (Seawinds Ltd.)*, supra; *Washington Mut. Bank, FA v. Sup.Ct. (Briseno)*, supra, 24 C4th at 916-917, 103 CR2d at 328; see *ABF Capital Corp. v. Grove Properties Co.* (2005) 126 CA4th 204, 217-219, 23 CR3d 803, 810-812—because Calif. fundamental policy mandates reciprocal treatment of unilateral contractual attorney fee provisions vis-à-vis business entities, Calif. rather than N.Y. law applied to determine prevailing parties' entitlement to attorney fees]

(a) [4:544.2] **Enforcement despite contract of adhesion:** The same enforceability analysis applies even though the choice of law clause is contained in a contract of adhesion. The *Nedlloyd* (Rest.2d) analysis "contains safeguards to protect contracting parties, including consumers, against choice-of-law agreements that are unreasonable or in contravention of a fundamental California policy." [*Washington Mut. Bank, FA v. Sup.Ct. (Briseno)* (2001) 24 C4th 906, 917-918, 103 CR2d 320, 329 (provision in standard nonnegotiable deed of trust)]

➪ [4:545] ***PRACTICE POINTERS:*** If the parties intend the transaction to be governed by out-of-state law, the form and substance of the agreement should be approved in writing (before signing) by local counsel. Certain provisions may be unenforceable in other jurisdictions; and the mechanics of closing may be entirely different in other states.

Further, if the parties want to reserve the right to litigate any *tort* claims arising from their agreement, they should choose a state (within the limits allowed by choice of law rules, *¶ 4:544.1*) with laws that govern contract *and* tort claims arising from a contractual relationship. California law so provides, but the laws of other states frequently used in choice of law provisions (such as New York, Delaware and Illinois) do not.

b. [4:546] **Venue (forum-selection clause):** It may also be desirable to designate the court in which any suit on the transaction must be brought (particularly if the transaction involves out-of-state or multi-state contacts)—e.g., if a state action, in the superior court of the State of California for the county where the property is located; or, if a federal action, in the United States District Court for the appropriate federal judicial district of California.

(1) [4:546.1] **Enforceability:** Generally, the same liberal approach to the enforceability of contractual choice of law clauses (¶ 4:544 ff.) applies to the enforceability of contractual forum-selection clauses. Thus, so long as freely and voluntarily agreed to in arm's length negotiations, the parties' contractual selection of a particular forum to litigate their disputes will normally be given effect. [See *Nedlloyd Lines B.V. v. Sup.Ct. (Seawinds Ltd.)* (1992) 3 C4th 459, 464, 11 CR2d 330, 332-333; *Smith, Valentino & Smith, Inc. v. Sup.Ct. (Life Assur. Co. of Penn.)* (1976) 17 C3d 491, 495-496, 131 CR 374, 377; *CQL Original Products, Inc. v. National Hockey League Players' Ass'n* (1995) 39 CA4th 1347, 1353, 46 CR2d 412, 415 (enforcing forum-selection clause designating Ontario, Canada as jurisdictional situs for claims arising under licensing agreement)]

(a) [4:546.2] **Enforcement despite contract of adhesion:** A forum-selection clause contained in a contract of adhesion is enforceable so long as the clause "provided adequate notice to the party that he was agreeing to the jurisdiction cited in the contract." [*Intershop Communications, AG v. Sup.Ct. (Martinez)* (2002) 104 CA4th 191, 201-202, 127 CR2d 847, 855—"A finding of adhesion merely begins another inquiry—whether a particular provision within the contract should be denied enforcement on ground that it defeats the expectations of the weaker party or it is unduly oppressive or unconscionable"]

(b) [4:546.3] **Reasonableness factor:** Although forum-selection clauses are presumed valid and therefore enforceable, they will *not* be enforced if shown to be "unreasonable under the circumstances of the case." For example, "when a party, under the terms of a forum selection clause, has the option to litigate in more than one forum, that party cannot choose to extensively litigate in the original forum … and then decide to enforce the right it otherwise would have had to compel the other party to litigate in a different forum. Such circumstances make enforcement of the forum selection clause unreasonable as a matter of law." [*Trident Labs, Inc. v. Merrill Lynch Commercial Finance Corp.* (2011) 200

CA4th 147, 157, 132 CR3d 551, 558-559—by exercising its "sole discretion" under forum-selection clause to litigate extensively in California for over 19 months, lender forfeited its right to later invoke the clause for purpose of changing venue to Illinois]

(c) [4:546.4] **Distinguish—"permissive" forum-selection clause:** A contractual clause designating a specific court where any suit on the transaction *must* be brought is a "mandatory" forum-selection clause, subject to the enforceability analysis set forth at *¶ 4:546.1 ff.* [See *Animal Film, LLC v. D.E.J. Productions, Inc.* (2011) 193 CA4th 466, 471, 123 CR3d 72, 76—mandatory clauses ordinarily are given effect without any analysis of convenience, only question being whether enforcement is unreasonable]

On the other hand, a clause that simply provides for submission to a particular court's jurisdiction without ruling out other jurisdictions is a "*permissive*" forum-selection clause. Its enforceability turns on traditional forum non conveniens analysis. [*Intershop Communications, AG v. Sup.Ct. (Martinez)* (2002) 104 CA4th 191, 196-197, 127 CR2d 847, 850-851; see also *Animal Film, LLC v. D.E.J. Productions, Inc.*, supra, 193 CA4th at 472, 123 CR3d at 77—forum-selection clause deemed permissive in nature because it merely provided for submission to Texas jurisdiction rather than mandating litigation exclusively in Texas]

Cross-refer: For a detailed discussion of forum-selection clauses and the doctrine of forum non conveniens, see Weil & Brown et al., *Cal. Prac. Guide: Civ. Pro. Before Trial* (TRG), Ch. 3.

➪ [4:547] ***PRACTICE POINTER:*** If the sufficiency of "contacts" with California might be in doubt in the event a California choice-of-law and/or forum-selection clause is used, it may be helpful to include a recitation that the agreement has been "prepared, negotiated and executed" in California. [See generally, Civ.C. § 1646 (interpretation according to law and usage of place where contract to be performed or where it is made)]

34. [4:548] **Merger; Survival of Warranties:** As indicated earlier, execution of the deed *extinguishes* the contract and all its warranties and representations *unless otherwise agreed* (¶ *4:16, 4:434, 4:454*). Thus, to the extent consistent with the parties' desires (particularly the buyer's), it is advisable to add a catchall provision stating that all warranties, representations, covenants and other obligations of the parties shall survive the closing of the transaction and recordation and delivery of the deed. This will help ensure that *all* of the parties' obligations (including the seller's representations) remain actionable in the event of a breach after the sale becomes final.

35. [4:549] **Construction Against Draftsperson:** Under general rules of contract interpretation, contract language is construed most strongly against the party who caused the uncertainty to exist (i.e., the draftsperson). [Civ.C. § 1654; see also Civ.C. § 1442—forfeiture provisions strictly construed against benefited party; and CCP § 1864—when different constructions are otherwise equally proper, construction most favorable to party in whose favor provision was made prevails]

To overcome this result, the parties may deem it prudent to include a provision stating that the purchase agreement has been negotiated at arm's length, with each side represented by independent counsel, and that neither party should be construed as the draftsperson.

36. [4:550] **Counterparts:** Typically, the parties separately execute identical versions of their purchase agreement. A "counterpart execution" provision confirms that separate execution of identical copies is tantamount to the parties' signatures on the same copy.

37. [4:551] **No Waiver Provision:** In some cases, either party's failure to require strict adherence to a particular term in the contract may be construed as a waiver of the right to insist on future compliance. To help avoid this result, the parties may wish to include language indicating that the waiver of a right or failure to require strict compliance with the conditions of the agreement shall not be deemed to be a continuing waiver. (However, bear in mind that even a "no waiver" provision can be waived.)

38. [4:551.1] **No Joint Venture or Partnership:** The parties may want to add a provision stating that their relationship is solely that of buyer and seller, and no partnership, joint venture, agency or other relationship exists between buyer and seller. Generally, this provision is unnecessary; but it is sometimes included to defeat any claim that one party was, or was intended to be, a partner or agent of the other.

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39. [4:552] **Definitional Section:** Some attorneys believe a definitional section should be included at the beginning of the purchase agreement, setting forth an alphabetical dictionary of important terms. This approach ensures the parties have the same understanding of pivotal terms, thus narrowing potential points of dispute. By the same token, such provisions should be kept short, as they may otherwise complicate, rather than simplify, the terms.

40. [4:553] **Captions; Gender:** Many lawyers who draft contracts include “boilerplate” language stating that the captions, titles or headings shall have no meaning and that reference to “he” shall also mean “she” (and vice-versa) or, as appropriate, “it or them.” Such provisions are frequently superfluous; they really do nothing to ensure the validity or enforceability of purchase agreements and, thus, are not essential.

41. [4:554] **Incorporation of Recitals and Exhibits:** “Recitals” appearing at the beginning of a contract might appear to be merely prefatory, not an operative part of the purchase agreement; but recitals often contain important substantive provisions (or at least statements of agreed-upon facts). Therefore, it is advisable to include a separate paragraph specifically incorporating recitals as part of the contract. *See discussion at ¶ 4:284*.

Likewise, any exhibits to the agreement (including third party contracts related to the transaction), the terms of which are intended to be made a part of the agreement, must clearly be incorporated by reference. [See *Versaci v. Sup.Ct. (Palomar Community College Dist.)* (2005) 127 CA4th 805, 814, 26 CR3d 92, 98]

42. [4:555] **Attorney Signatures:** Frequently, signature blocks on contracts bear attorney signatures under the legend “approved as to form and content.” In so stating, counsel are simply asserting they are the attorneys for their *particular* clients and that the document is in proper form and embodies the deal that was made between the parties. [See *Freedman v. Brutzkus* (2010) 182 CA4th 1065, 1067, 1070, 106 CR3d 371, 372, 374—recital by itself does *not* operate as representation to opposing party's attorney that can provide basis for tort liability]

[4:556 - 4:559] ***Reserved.***

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Cal. Prac. Guide Real Prop. Trans. Ch. 4-F

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

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1. [4:560] **Overview:** Every purchase and sale involves the transfer of various documents and monies, as well as the coordination of several ancillary preclosing, closing and postclosing matters. Of course, buyers do not want to part with their money and sellers do not want to permit recordation of the deed until each is assured the other will perform. Thus, there must be some reliable mechanism for transferring title, documents and money.

a. [4:561] **"Sit-down closings" vs. escrow:** There are two basic mechanisms to effectuate the final transfers and ancillary closing steps: escrows and traditional (or so-called "sit-down") closings. In a traditional closing (still used in some states),

the parties (or their representatives) simply pass the documents and monies across the table. An outside party may be used to record the deed (and related documents). However, almost all of the closing paper work is handled directly by buyer and seller or their counsel.

In California, the use of an escrow as a central repository is considered to be the easiest, most efficient and inexpensive method of consummating a purchase and sale. There are many qualified escrow holders in this state and the fees are competitively priced (far less expensive than using attorneys). Thus, the parties typically opt for an escrow rather than a sit-down closing.

➪ [4:562] ***PRACTICE POINTER:*** Many clients oppose the use of an escrow because they do not trust an escrow officer to prepare certain documents and perform various other tasks, and they want to avoid escrow fees. Even so, the parties can always reserve to themselves those tasks they do not wish the escrow holder to handle; and escrows are almost always less expensive than employing attorneys to handle closing mechanics. On balance, there is little advantage in opting for a traditional nonescrow closing. An escrow makes sense even if the only thing required of the escrow holder is to record the deed and disburse the monies.

Moreover, some third party involvement usually is needed even in nonescrow closings. Typically, the money and deed will be delivered to a title insurance company, with express instructions to disburse the money to the seller only after recordation of the deed (and issuance of an appropriate title insurance policy). (Of course, it is possible simply to send the deed to the county recorder for recordation the day of the closing, while the parties sit around the table and wait for recording confirmation as the "go-ahead" for transferring the monies. But this is obviously not the safest or most efficient way to close the deal.)

b. Definitions

(1) [4:563] **Escrow:** An "escrow" is statutorily defined as "… any transaction in which one person, for the purpose of effecting the sale, transfer, encumbering, or leasing of real or personal property to another person, delivers any written instrument, money, evidence of title to real or personal property, or other thing of value to a third person to be held by that third person until the happening of a specified event or the performance of a prescribed condition, when it is then to be delivered by that third person to a grantee, grantor, promisee, promisor, obligee, obligor, bailee, bailor, or any agent or employee of any of the latter." [Fin.C. § 17003(a); see also Civ.C. § 1057; and *Summit Fin'l Holdings, Ltd. v. Continental Lawyers Title Co.* (2002) 27 C4th 705, 711, 117 CR2d 541, 545]

(With regard to Internet escrow companies, the statutory definition of "escrow" includes the transfer of the "Internet-authorized equivalent" of money. See Fin.C. § 17003(b).)

In practical effect, therefore, an escrow is the intermediary structure for effecting the final steps toward closing. The escrow holds the deed and money pending satisfaction of specified conditions, at which point the deed and money are transferred to the appropriate party and the transaction is closed. [See *Tribeca Cos., LLC. v. First American Title Ins. Co.* (2015) 239 CA4th 1088, 1109, 192 CR3d 354, 371]

(a) [4:563.1] **Only initial deposit required:** The existence of an escrow as defined by Fin.C. § 17003(a) does *not* require a *completed delivery* from escrow; it requires only that the transaction *contemplate* such delivery. The delivery that must occur for an escrow to exist under the statute is the *initial deposit*. [*Pasternak v. Boutris* (2002) 99 CA4th 907, 919, 121 CR2d 493, 502]

(2) [4:564] **Escrow agent:** An "escrow agent" is "any person engaged in the business of receiving escrows for deposit or delivery." [Fin.C. § 17004; see also Fin.C. § 17004.5 (same for "Internet escrow agent")]

Generally, an escrow agent's "limited role" in the transaction is "as an agent who carries out the escrow instructions"; the escrow agent's role ends upon the successful exchange of payments and instruments. [*Paul v. Schoellkopf* (2005) 128 CA4th 147, 154, 26 CR3d 766, 770 (internal quotes omitted); see also *Tribeca Cos., LLC. v. First American Title Ins. Co.* (2015) 239 CA4th 1088, 1109-1110, 192 CR3d 354, 371—escrow agent's failure to carry out any instruction it contracted to perform provides injured party with breach of contract cause of action (*¶ 4:581*)]

(3) [4:565] **Escrow vs. escrow holders:** The terms "escrow," "escrow holder" and "escrow agent" are sometimes used interchangeably. Technically, the "escrow" is the transaction or structure for the closing, whereas the "holder" or "agent" is the company handling the escrow transaction. The term "escrow officer" is commonly used to refer to the particular individual handling the escrow on behalf of the escrow holder or agent.

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c. [4:566] **Regulation of escrows:** Escrows and escrow holders are regulated by the Department of Corporations and the Commissioner of Corporations. Licensing, audits, posting of bonds, records, trust accounts and various other matters are subject to specific statutory provisions (Fin.C. § 17400 et seq.; and see 10 CCR §§ 1709-1769). Title insurance company escrows are subject to additional laws (see Ins.C. § 12404 et seq.).

2. [4:567] **Selecting Escrow Holder:** All persons or entities engaged in the business of being an escrow holder must meet specified qualifications (Fin.C. § 17200 et seq.—licensing requirements). But, among those of equal qualifications, there is great diversity in competence, cost and honesty. Escrow holders tend to fall into one of the following categories:

a. [4:568] **Title insurance company escrows:** Although an "underwritten title company" is in the business of preparing title searches, title reports, certificates and abstracts of title, it also may engage in the escrow business and act as an escrow agent by satisfying specific statutory requirements. [See Ins.C. §§ 12340.5, 12389; ¶ 3:28]

The advantage of using a title insurance company escrow is that it tends to have experienced escrow officers and can easily coordinate the escrow work with the title side of the transaction. As a result, the escrow officer and title officer can more easily work together (and often have worked together before); moreover, they are often located in the same building, facilitating communication and expeditious closing.

(1) [4:568.1] **Title insurer performing limited escrow functions:** Some title insurers act as a limited "subescrow," performing only basic escrow functions such as paying out funds and recording documents but not undertaking to prepare or review escrow documents or ensuring that the parties' escrow instructions are carried out. In that capacity, the title insurer cannot be held to any escrow "agency" duties with regard to functions beyond its limited undertaking. [See *In re Estates of Collins* (2012) 205 CA4th 1238, 1255, 141 CR3d 227, 240—when same entity acts as title insurer and escrow holder, knowledge obtained as *title insurer* is not imputed to escrow principal because title insurer is not principal's agent; *Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1193-1194, 54 CR2d 84, 91—title insurer engaged by escrow agent to hold and pay out loan proceeds on agent's command and ensure recording of deeds did not thereby become buyers' fiduciary for purposes of searching records or transmitting title information]

b. [4:569] **Escrow companies owned and operated by lending institutions:** These escrow holders also tend to be fairly experienced by reason of the sheer volume of their workload. If associated with a reputable lending institution, they are more readily perceived as coming from a position of financial strength and honesty.

c. [4:570] **Unaffiliated escrow companies:** There are many fine unaffiliated ("independent") escrow companies engaged solely in the escrow business. However, because they are independent, before employing one of these escrows, it is important to verify that the company is competent, legitimate and financially sound.

d. [4:571] **Attorney as escrow holder:** There is no *legal* reason why the parties cannot designate the buyer's or seller's attorney to act as escrow holder. [See Fin.C. § 17006—exempting licensed attorneys from escrow licensing requirement so long as client is principal in transaction and attorney not in escrow business; *Virtanen v. O'Connell* (2006) 140 CA4th 688, 697, 44 CR3d 702, 708]

However, prudent attorneys *generally avoid* acting as escrow holder because of the expanded liability risks and potential conflict of interests: In the attorney's capacity as escrow holder, the attorney owes duties to *all* parties to the escrow (*see* ¶ *4:580*). If there are conflicting demands from the attorney's client and another party to the escrow, the attorney cannot favor the client over the other party and "convert" the escrowed property for the client's use. [*Virtanen v. O'Connell*, supra, 140 CA4th at 692-693, 697, 44 CR3d at 705-706, 708-709—where attorney representing stock purchaser agreed to hold stock certificates in escrow, seller terminated sale and delivered rescission notice to attorney demanding return of certificates, and despite demand, attorney closed transaction and delivered certificates to transfer agent to effectuate share transfer, attorney liable to seller for breach of fiduciary duty, negligence and conversion; *see also* ¶ *4:644 ff.*]

➪ [4:571.1] ***PRACTICE POINTER:*** Attorneys who agree to assume such a "two-hat" role and then face conflicting demands in their capacity as escrow holder may consider *interpleading the escrowed property* to decrease the risk of potential liability. [See *Virtanen v. O'Connell* (2006) 140 CA4th 688, 693, 44 CR3d 702, 706; *and* ¶ *4:647*]

➪ [4:572] ***PRACTICE POINTERS RE CHOICE*:** Regardless of the kind of escrow holder to be selected, certain practical considerations should weigh heavily in the choice:

- ***Location:*** Choose a "geographically desirable" escrow holder. This will not necessarily be where the property is located. Rather, pick an escrow holder that is geographically convenient to expedite the delivery of documents, monies, etc.

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• ***Experience/competence:*** A competent escrow officer will lighten counsel's burdens and keep the client's legal bill down. Conversely, incompetent escrow holders can make the transaction a nightmare for the parties and their lawyers.

Fundamentally, therefore, choose an escrow holder (and a particular escrow officer) who is *experienced*. If appropriate, select one with whom you have previously worked and who has proved to be responsive and accommodating.

• ***Disciplinary record:*** In addition, you may consider checking to see if the escrow holder under consideration has been the subject of disciplinary action by the Department of Real Estate, the Department of Corporations and/or the Department of Insurance. State law requires each of those governmental agencies to maintain an internet website displaying a database of individuals who have been subjected to professional discipline related to the escrow industry. [Bus. & Prof.C. § 10176.1; Fin.C. § 17423.1; Ins.C. § 12414.31]

• ***Availability:*** Also, determine ahead of time if the desired escrow officer will be available to handle the transaction through the closing. If the officer has vacation plans or otherwise may be unavailable once the escrow opens, it may be best to select someone else. (It is always disconcerting to surprisingly discover after the fact that someone new has had to take over a complicated closing.)

• ***Cost:*** Escrow holders charge varying fees, but the fees are *negotiable*. The agreed-upon fees should reflect the amount of work the escrow holder is required to do (the parties may be doing a great deal of the work themselves, such as calculating prorations, preparing certain documents for recordation, etc.).

• ***Title issues:*** The escrow is often the intermediary in resolving a variety of title issues and frequently works extensively with the title insurance company. Thus, it makes sense to choose an escrow holder/officer who is somewhat schooled in title insurance issues.

• ***Financial strength and integrity:*** The escrow holder should have sufficient financial strength (in view of the magnitude of the transaction) to cover its potential liability in connection with the escrow (*¶ 4:644 ff.*). Of course, you should also strive to choose an escrow holder who presents the narrowest possible risk of potential liability: i.e., select one who has a reputation for honesty.

If you are unfamiliar with a particular escrow holder's financial strength and reputation, caution your clients accordingly.

• ***Be wary of broker-affiliated escrow holders:*** Real estate brokers frequently direct their clients to an escrow. However, some brokers own an interest in the escrow they recommend. Make certain the escrow holder is being chosen for the right reasons (experience, honesty, financial strength), not simply to further the broker's economic interest or working relationship.

3. Creating an Escrow

a. [4:573] **Contract required:** Escrow transactions are *contractual* in nature and, so, cannot be created without the agreement of seller, buyer and escrow holder. There must be a legally binding contract that specifically creates an escrow by designating an escrow holder and instructing the escrow appropriately. The mere delivery of documents without a corresponding contract does not suffice. [*Elliott v. Title Ins. & Trust Co.* (1923) 64 CA 508, 511, 222 P 175, 177; but see *Pasternak v. Boutris* (2002) 99 CA4th 907, 919-920, 121 CR2d 493, 502—cases standing for proposition that escrow requires binding contract antedate Fin.C. § 17003(a) (*¶ 4:563*)]

b. [4:574] **Delivery in escrow required:** By the same token, an effective escrow is created (escrow "opened") only when *all* the parties have delivered mutually consistent instructions (the contract) to the escrow holder. The delivery may be subject to certain conditions, but in any event there must be a delivery by which the grantor parts with "all future dominion and control" over the documents. [See *Kenney v. Parks* (1899) 125 C 146, 150, 57 P 772, 773; and Civ.C. § 1057 (essentially providing that escrow is created by deposit of "grant" with third party to be delivered on performance of a condition); *and ¶ 4:563.1*]

c. [4:575] **Escrow instructions:** In California, escrows are created by the execution and delivery of “escrow instructions” (the contract), sometimes referred to as “joint escrow instructions” (when given jointly by the parties). Despite the escrow's tri-party nature, the escrow holder rarely signs the instructions. (Indeed, most preprinted escrow instructions promulgated by escrow holders do not even contemplate the holder's execution of its own document.)

Practice varies between Northern and Southern California as to the form of instructions:

• In Southern California, buyer and seller typically execute and deliver to the escrow holder identical or “joint” escrow instructions at the inception of the transaction—i.e., either concurrently with execution of the purchase agreement or shortly thereafter.

• In Northern California, buyer and seller each give separate instructions to the escrow holder, typically just prior to the closing. While the seller's and buyer's instructions might not be identical, they will be substantially consistent.

4. Parties to Escrow

a. [4:576] **Escrow holder, buyer and seller:** Commonly, the only parties to the escrow are the seller, buyer and escrow holder. The obvious advantage in excluding others is that there are fewer people who can interfere with the purchase and sale. Most standard “general conditions” of escrow instructions permit the escrow holder to refrain from proceeding with the transaction in the event of conflicting demands (*see ¶ 4:591, and Form 4:K*); naturally, the fewer the parties, the less the likelihood of conflicting demands and, so, the less risk that the transaction will not be consummated. In any event, there is rarely a need to make anyone other than seller, buyer and escrow holder parties to the escrow.

b. [4:577] **Lenders:** Lenders who fund a portion of the purchase price do not typically become a party to the escrow. Rather, lender and borrower (buyer) create separate “loan escrow instructions” (typically, at the same escrow). These instructions provide the escrow holder with directions to record the loan documents and disburse the loan proceeds upon recordation of the deed and deed of trust (and upon recording or filing of any other specified instruments) and issuance of the lender's title insurance policy.

c. [4:578] **Real estate brokers:** Real estate brokers' commissions are customarily paid through the escrow out of the seller's proceeds. This is usually accomplished by means of the seller's written instruction authorizing disbursement. This may make the broker a third party beneficiary of the escrow, though not necessarily a *party* to the escrow. (Indeed, even without a broker disbursement instruction, a broker who has a separate written commission agreement *may* be able to claim a third party right to the commission portion of the seller's proceeds.)

➪ [4:579] ***PRACTICE POINTER:*** There are certain things you can do to minimize broker entanglement with an escrow:

• One possibility, of course, is for the seller simply to refuse to pay the broker through the escrow. (Many listing agreements do not specifically require payment through or by the escrow holder.) Broker commissions can simply be paid the day after the escrow closes.

• Alternatively, if a broker disbursement instruction is required (or desired), the seller may elect not to deliver the instruction to escrow until immediately before the closing. This will at least minimize (if not preclude) the broker's involvement in the escrow until the seller is relatively well-assured that the escrow is actually about to close.

5. [4:580] **Escrow Holder's Fiduciary Relationship to Principals:** An escrow holder is a *limited agent and fiduciary* to all parties to the escrow. [*Summit Fin'l Holdings, Ltd. v. Continental Lawyers Title Co.* (2002) 27 C4th 705, 711, 117 CR2d 541, 545; *Virtanen v. O'Connell* (2006) 140 CA4th 688, 703, 44 CR3d 702, 714]

As such, an escrow holder has a fiduciary duty to communicate to the principals knowledge acquired in the course of the agency with respect to material facts that might affect a principal's decision regarding the pending transaction. [*Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1193-1194, 54 CR2d 84, 91; *Vournas v. Fidelity Nat'l Title Ins. Co.* (1999) 73 CA4th 668, 674-675, 86 CR2d 490, 494-495 & fn. 8; see also *Kangarlou v. Progressive Title Co., Inc.* (2005) 128 CA4th 1174, 1178-1179, 27 CR3d 754, 756-757—escrow holder's fiduciary duty to communicate facts learned about broker's license arises out of its fiduciary duty to obtain evidence that broker is regularly licensed before delivering broker's compensation]

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On the other hand, an escrow holder "has no *general* duty to police the affairs of its depositors." [*Summit Fin'l Holdings, Ltd. v. Continental Lawyers Title Co.*, supra, 27 C4th at 711, 117 CR2d at 545 (emphasis added)]

a. Scope of agency

(1) [4:581] **Generally limited to escrow instructions:** The parameters of an escrow holder's agency and fiduciary obligations to the parties are set by the express provisions of the *escrow* instructions. Absent clear evidence of fraud, an escrow holder's relationship with the parties to the escrow is thus limited to complying *strictly with the parties' instructions*. [*Summit Fin'l Holdings, Ltd. v. Continental Lawyers Title Co.* (2002) 27 C4th 705, 711, 117 CR2d 541, 545; see also *Rideau v. Stewart Title of Calif., Inc.* (2015) 235 CA4th 1286, 1294, 185 CR3d 887, 891—injured party has breach of contract action if escrow holder fails to carry out instruction it contracted to perform; *Kangarlou v. Progressive Title Co., Inc.* (2005) 128 CA4th 1174, 1179, 27 CR3d 754, 757—escrow holder's fiduciary duty to strictly comply with escrow instructions is within its duties undertaken by agreeing to execute the escrow]

It follows that an escrow holder incurs no liability for the failure to do something not within the terms of the escrow or for a loss incurred while correctly following the escrow instructions. [*Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1194, 54 CR2d 84, 91—acting pursuant to instructions only as "subescrow" in paying out funds and recording documents, title insurer owed no duty to buyers to search records or transmit title information and thus was not liable to buyers for failure to disclose lien; see also *Tribeca Cos., LLC v. First American Title Ins. Co.* (2015) 239 CA4th 1088, 1107, 1110-1114, 192 CR3d 354, 369, 372-375—title company did not err in refunding third-party investor's $1 million deposit despite contrary instructions from investment firm that set up escrow account for joint venture that never materialized (instructions applied only to funds actually deposited by investment firm and did not entitle it to control disposition of funds deposited by "nonrelated" third party); *Blackburn v. McCoy* (1934) 1 CA2d 648, 655, 37 P2d 153, 155-156—escrow had no duty to inform purchaser of price optionee agreed to pay owners because instructions silent as to same]

[4:581.1 - 4:581.4] ***Reserved.***

(2) [4:581.5] **Limited dual agency at commencement of escrow:** At the inception of an escrow (upon delivery of documents and moneys), the escrow holder is a *dual agent* for both buyer and seller (and any other parties to the escrow). [*Vournas v. Fidelity Nat'l Title Ins. Co.* (1999) 73 CA4th 668, 674, 86 CR2d 490, 494]

However, the relationship is only one of a "*limited*" (not a general) agency in accordance with the escrow instructions, and the escrow holder's duties are limited accordingly. "The primary duty owed by an escrow holder is to strictly and faithfully perform the instructions given to it by the parties to the escrow." [*Vournas v. Fidelity Nat'l Title Ins. Co.*, supra, 73 CA4th at 674, 86 CR2d at 494; see *Siegel v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 1181, 1194, 54 CR2d 84, 91—acting pursuant to instructions only as "subescrow" in paying out funds and recording documents, title insurer owed no duty to buyers to search records or transmit title information and thus was not liable to buyers for failure to disclose lien]

(3) [4:581.6] **Separate agencies upon completion of escrow conditions:** When the conditions of the escrow are satisfied, the "dual agency" technically terminates. [See *Marriage of Cloney* (2001) 91 CA4th 429, 440, 110 CR2d 615, 623]

Thereafter, the escrow holder becomes an agent for each of the parties to the transaction "in respect to those things placed in escrow, to which each has thus become completely entitled." Accordingly, the escrow holder becomes the agent of the *buyer* with regard to transfer/recordation of the deed (as instructed) and the agent of the *seller* with regard to payment of the money (as instructed). [*Shreeves v. Pearson* (1924) 194 C 699, 707, 230 P 448, 451—once escrow closes, escrow holder not agent of buyer if escrow holder steals seller's proceeds]

(a) [4:581.7] **Compare—escrow holder also acting as lender's settlement agent:** An escrow holder who also acts as the lender's settlement agent owes the lender duties separate and apart from those owed the buyer and seller. Indeed, the settlement agent's responsibilities continue beyond the close of escrow—i.e., until the loan in fact closes. [See *Plaza Home Mortg., Inc. v. North American Title Co., Inc.* (2010) 184 CA4th 130, 136-140, 109 CR3d 9, 14-17—although escrow holder's duties vis-à-vis buyer and seller ended with close of escrow, its duty to disclose postescrow payoffs as settlement agent for lender continued until loan actually closed]

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b. [4:582] **Standard of care:** As agents, escrow holders owe a duty of good faith to their principals. They also owe a duty to exercise "ordinary skill and diligence" in their employment. Thus, they may be held liable not only for contract damages resulting from a violation of the escrow instructions, but *also* for *tort* damages proximately resulting from the negligent performance of their duties (*¶ 4:644 ff.*). [*Amen v. Merced County Title Co.* (1962) 58 C2d 528, 532, 25 CR 65, 67; *Common Wealth Ins. Systems, Inc. v. Kersten* (1974) 40 CA3d 1014, 1030, 115 CR 653, 664; see also *Woodworth v. Redwood Empire Sav. & Loan Ass'n* (1971) 22 CA3d 347, 366-367, 99 CR 373, 387]

(1) [4:582.1] **Distinguish—not a "trustee's" standard of care:** Curiously, although case law states that escrow holders are "fiduciaries" in the performance of their obligations (*¶ 4:580*), they are *not* held to the higher standard of care (duty of highest good faith and fair dealing) normally imposed upon fiduciaries in other contexts (e.g., under the trust law). Indeed, escrow holders are *not* trustees within the meaning of the trust law and do not have the powers or obligations of a true trustee. Rather, an escrow holder's "fiduciary relationship" is limited to exercising *ordinary care* in carrying out the escrow instructions. [See Prob.C. § 82(b)(14)—"trust" does not include "any arrangement under which a person is nominee or escrowee for another"; *Hannon v. Western Title Ins. Co.* (1989) 211 CA3d 1122, 1129, 260 CR 21, 25; *Lee v. Escrow Consultants, Inc.* (1989) 210 CA3d 915, 921, 259 CR 117, 121]

As a result, conduct which might give rise to a breach of fiduciary duty action against a *trustee* will not necessarily support a cause of action against an escrow holder. [See, e.g., *Hannon v. Western Title Ins. Co.*, supra, 211 CA3d at 1129, 260 CR at 25—seller's claim that escrow holder breached fiduciary duty by depositing escrow funds in noninterest bearing account in exchange for personal gratuities from bank not cognizable under Prob.C. § 16004 (prohibiting trustee's self-dealing with trust property)]

(2) [4:582.2] **Possible breach of duty even when escrow instructions followed?** It has been suggested that an escrow holder who strictly follows the escrow instructions may nonetheless be liable for breach of fiduciary duty when a party to the escrow is subjected to double payment of a loan because the escrow holder paid the wrong party. [*Summit Fin'l Holdings, Ltd. v. Continental Lawyers Title Co.* (2002) 27 C4th 705, 717, 117 CR2d 541, 550 (J. Werdegar concur.opn.)]

[4:582.3 - 4:582.4] ***Reserved.***

c. [4:582.5] **Knowledge within scope of agency imputed to principals:** Escrow holders are *presumed* to have fulfilled their fiduciary duty to disclose to the principals (buyer and seller) information obtained in the course of the agency that is material to the pending transaction (*¶ 4:580*). Consequently, information obtained by an escrow holder within the scope of the escrow is *imputed* to the principals. [See *California Nat'l Bank v. Havis* (2004) 120 CA4th 1122, 1138, 16 CR3d 245, 256—seller's lender's communication with escrow agent re deed of trust reconveyance imputed to buyer's lender; *Marriage of Cloney* (2001) 91 CA4th 429, 440, 110 CR2d 615, 623—information re seller's true full name obtained by escrow agent properly imputed to buyer even though agent failed to disclose information to buyer; *Triple A Mgmt. Co., Inc. v. Frisone* (1999) 69 CA4th 520, 534-535, 81 CR2d 669, 678]

(1) [4:582.6] **Imputed knowledge extends to documents:** Knowledge of information contained in *documents* provided to escrow is imputed from the escrow holder to the principals because the principals have a right to see all such documents. [*Marriage of Cloney* (2001) 91 CA4th 429, 440, 110 CR2d 615, 624, fn. 10]

(2) [4:582.7] **Escrow holder serving in multiple capacities:** The fact that an escrow holder was serving in multiple capacities when the escrow holder acquired information material to the pending transaction is irrelevant. So long as the escrow holder obtained the information within the course and scope of the escrow, the information is imputed to the principals. [*Marriage of Cloney* (2001) 91 CA4th 429, 443, 110 CR2d 615, 626—fact escrow agent was allegedly acting in notary public capacity when she learned about seller's correct name had no effect on imputing agent's knowledge to buyer; compare *In re Estates of Collins* (2012) 205 CA4th 1238, 1255, 141 CR3d 227, 240-241—knowledge obtained by title insurer also acting as escrow holder not imputed to principal/lender (insurer's escrow officer merely knew about defunct lis pendens from dismissed quiet title action that did not carry with it notice of forged deed)]

(3) [4:582.8] **Compare—information obtained outside course of agency:** The scope of the imputed knowledge, however, is directly related to the scope of the escrow agent's duties arising from the escrow instructions. Thus, information obtained by an escrow holder *outside* the scope of the limited agency is *not* imputed to either principal. [*Triple A Mgmt. Co., Inc. v. Frisone* (1999) 69 CA4th 520, 534-535, 81 CR2d 669, 678—knowledge escrow agent acquired in prior escrow not imputed to principal of current escrow who was not a party to prior escrow]

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6. [4:583] **Preparing Escrow Instructions:** Escrow instructions can be included within the purchase and sale agreement or may be created later by a subsequent instrument. Most practitioners prefer to include the instructions within the purchase agreement. But, because many purchase agreements are executed without reference to the mechanics of escrow (other than a statement that an escrow will be opened), escrow instructions are often prepared and executed after the purchase agreement is signed.

a. Form of instructions

(1) [4:584] **Preprinted instructions:** Every escrow company has its own preprinted form of escrow instructions. So long as they do not conflict with the underlying purchase agreement, using these form instructions will usually be an expeditious and cost-saving choice. (Under ordinary rules of contract interpretation, any uncertainty in the preprinted instructions will be construed against the escrow (the drafter). See Civ.C. § 1654; *Campbell v. Scripps Bank* (2000) 78 CA4th 1328, 1338, 93 CR2d 635, 644 (citing text); and *Francis v. Eisenmayer* (1959) 171 CA2d 221, 227, 340 P2d 54, 58.)

Many preprinted escrow instructions are simply stapled to the front of the previously-executed purchase and sale agreement, and incorporate all terms and conditions of the agreement.

(a) [4:584.1] **Combined "C.A.R." form (single family residential properties):** One section of the "Residential Purchase Agreement and Joint Escrow Instructions" form published by the California Association of Realtors (¶ *4:278, 4:278.2*) incorporates several paragraphs from the body of the agreement, making the document operative as both a purchase and sale agreement and joint escrow instructions (once the agreement is delivered to and accepted by the escrow). However, the escrow holder usually will require certain additional documents, including its "general conditions" or "general provisions" (¶ *4:591*). Also, buyer and seller can supplement the document with additional instructions as appropriate to their transaction.

➪ [4:584.2] ***PRACTICE POINTER:*** Of course, as with any standardized (preprinted) form, "form" escrow instructions should be carefully scrutinized before execution; and modifications should be made to fit the specifics of a particular transaction. *See* ¶ *4:278.5*.

(2) [4:585] **Attorney-drafted instructions:** Escrow instructions may, of course, be drafted by counsel in lieu of using the escrow's preprinted form (subject, however, to execution of the escrow's "general conditions" (¶ 4:591 ff.) and any other instruments it requires).

(a) [4:586] **Use simple "nonlegalese" language:** Attorney-drafted escrow instructions should use simple, lucid and unqualified language. Escrow officers are not lawyers and it should not be presumed that they will understand the full significance of legal terms.

(3) [4:587] **Oral instructions:** Written escrow instructions are not statutorily required; thus, principles of agency and contract law apply to make *oral* escrow instructions binding and enforceable. [*Zang v. Northwestern Title Co.* (1982) 135 CA3d 159, 168, 185 CR 176, 181—escrow and its agent liable for violating oral instruction to obtain deed of trust] In practice, however, escrow holders will not accept oral instructions.

➪ [4:588] ***PRACTICE POINTER:*** As noted at ¶ 4:581 ff., the scope of the escrow holder's agency and duties is limited by the terms of the escrow instructions. Therefore, prudence dictates that escrow instructions always be put in a signed writing, thus minimizing the potential for dispute over the extent of the escrow's obligations.

(4) [4:589] **Supplemental instructions from attorney:** During the course of an escrow, it is often necessary for one party to give notices or miscellaneous directions to the escrow holder (e.g., directions from buyer regarding approval of title report; or instructions from seller identifying where net proceeds should be delivered). Escrow holders frequently accept such supplemental written notices and directions from counsel on behalf of the client.

➪ [4:589.1] ***PRACTICE POINTER:*** If the escrow holder will accept supplemental directions only from the parties, counsel should make certain the client is available to sign such directions; or, have the client execute a limited power of attorney designating you as the client's attorney in fact for that purpose (*see* ¶ *4:225 ff.*).

(5) [4:590] **Amended instructions:** The parties may decide to change their instructions after the escrow is opened. However, to ensure that all parties have agreed to the change, it is advisable to provide in the initial written instructions that any subsequent amendment will be effective only if given in *writing and signed by both* buyer and seller. As a result, any act by the escrow holder pursuant to an amendment *not* signed by both parties would be invalid and thereby expose

the escrow to consequential liability. [See *Lee v. Escrow Consultants, Inc.* (1989) 210 CA3d 915, 924, 259 CR 117, 123 (amendment forged)]

(6) [4:590.1] **Mandatory statement for all *written escrow instructions:*** Although there are essentially no formalities for escrow instructions (again, they may even be oral), all *written* escrow instructions executed by a buyer or seller *must* contain a statement, in minimum 10-point type, that includes the *license name* and *name of the department issuing the license* or authority under which the escrow person is operating. [Civ.C. § 1057.7]

However, this statutory statement is not required in supplemental or amended escrow instructions. [Civ.C. § 1057.7]

b. [4:591] **“General conditions”:** Preprinted escrow instructions almost always contain so-called “general conditions” (or “general provisions”) of the escrow—i.e., various terms and conditions that escrow holders include to protect themselves. The general conditions deal with a host of issues, including the method for giving notice, attorney fees, right of the escrow holder to interplead disputed monies and documents, time for performance, and indemnity.

• ***FORM:*** Sample General Conditions of Escrow Holder, *see Form 4:K*.

➪ [4:592] ***PRACTICE POINTER:*** Read the general conditions carefully before signing the instructions. Many contain unreasonable exculpatory provisions exonerating the escrow from liability that may otherwise legally exist. You should negotiate these and other objectionable conditions in an effort to gain optimum protection for your clients.

➪ [4:593] ***PRACTICE POINTER:*** If the instructions are included in the purchase agreement, the agreement should contain a provision obligating the parties to execute the escrow's “general conditions” and whatever other instruments it may require.

c. [4:594] **“Memorandum with which escrow need not be concerned”:** This phrase is often used in escrow instructions to cover an issue that does not require the escrow to do anything, but which represents the parties' agreement in connection with a matter to be handled outside escrow or otherwise unrelated to the escrow. For example, “as a memorandum with which escrow need not be concerned, after the close of escrow seller shall repair all elevators to make them fully operational.”

Similar language also is commonly used in preprinted escrow instructions incorporated into a purchase agreement (as with the “C.A.R.” combined residential purchase agreement and joint escrow instructions, *¶ 4:584.1*) to identify material in the agreement that is not part of the instructions but simply for the escrow holder's information and with which the escrow need not be concerned.

• [4:594.1] **Comment:** Technically, use of the phrase “memorandum with which escrow need not be concerned” is unnecessary. However, escrow holders like to add that language to their instructions for the purpose of clarifying that the escrow has no obligation in respect to the designated matters.

d. [4:595] **Inconsistencies with underlying contract:** Where there is an apparent conflict or ambiguity in or between the escrow instructions and the underlying purchase agreement, the two will be read together to ascertain the parties' intent and fix their rights and obligations. [*Katemis v. Westerlind* (1953) 120 CA2d 537, 542, 261 P2d 553, 557; see also Civ.C. § 1642]

However, it is prudent practice to specifically state in separate escrow instructions that, in the event of inconsistencies, the instructions supersede the underlying purchase agreement (or vice-versa if that is the parties' desire).

(1) [4:595.1] **Compare—provisions *exclusive to escrow instructions:*** Wholly new rights and/or obligations under the purchase and sale agreement cannot be inferred from provisions exclusive to the escrow instructions.

For instance, a provision in the escrow instructions for the recovery of attorney fees in an action arising out of the escrow does not authorize an attorney fee award in a dispute over the purchase and sale agreement. The attorney fee provision in the escrow instructions addresses the rights and obligations of the escrow holder vis-à-vis the buyer and seller, whereas the purchase agreement relates to the rights and obligations between the buyer and seller. [See *Paul v. Schoellkopf* (2005) 128 CA4th 147, 152-154, 26 CR3d 766, 769-771]

e. [4:596] **Escrow holder's acceptance:** As earlier indicated, the parties rarely require the escrow holder to execute the escrow instructions. The escrow holder's acceptance of the instructions is generally considered to be its tacit (if not express) agreement to perform the specified obligations.

➪ [4:597] ***PRACTICE POINTER:*** Escrow holders naturally will have no hesitancy to accept their own preprinted instructions. However, if attorney-drafted instructions are used—and especially if the instructions are particularly unique or complicated—it makes sense to let the escrow holder review them before the parties sign. Don't assume that a designated escrow will accept your version of the functions to be performed by the escrow holder.

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7. [4:598] **Escrow Holder's Functions:** An escrow holder's specific acts and functions vary from case-to-case, depending on the idiosyncrasies of the transaction. In any event, they should be carefully spelled out in the escrow instructions.

Typical escrow functions are highlighted at ¶ 4:599 ff.:

a. [4:599] **Acceptance of buyer's initial deposit:** Usually, the escrow's preliminary function is to accept the buyer's initial deposit (downpayment). Unless the instructions expressly provide otherwise, the escrow holder has no duty to place the deposit in an interest-bearing account or otherwise to pay interest thereon (although many escrows routinely deposit monies in interest-bearing accounts). [*Hannon v. Western Title Ins. Co.* (1989) 211 CA3d 1122, 1128, 260 CR 21, 24]

Of course, any instruction requiring the payment of interest should also specify *to whom* the interest should be credited.

b. Title insurance matters

(1) [4:600] **Ordering preliminary title report (and copies of title exceptions) and arranging for delivery to buyer:** For a discussion of the need for a preliminary title report, and the importance of examining the title exceptions, *see ¶ 4:327 ff.*; and comprehensive treatment at *¶ 3:200 ff.* (Of course, if the parties have already obtained a preliminary title report, the escrow holder will not need to do so.)

(2) [4:601] **Arranging for buyer's "statement of information":** Every title insurance company requires the buyer to execute a "statement of information" (sometimes known as a "statement of identity"). The statement requests certain information about the buyer so that the title company may determine if any liens or other deficiencies in title will attach against the buyer's interest upon recordation of the deed. (This is important because the title company is being asked to insure that the buyer will hold title free of all encumbrances or claims except those appearing of record as of the closing; *see Ch. 3*.)

For example, if an abstract of judgment has been recorded against the buyer, it will (like any other "floating lien") attach to the purchased property immediately upon recordation of the deed.

(3) [4:601.1] **Mandatory disclosure statement if title insurance will not be issued:** In an escrow transaction, where a policy of title insurance will *not* be issued to the buyer, the following notice *must* be provided in a separate document to the buyer and must be signed and acknowledged by the buyer (Civ.C. § 1057.6):

> "IMPORTANT: IN A PURCHASE OR EXCHANGE OF REAL PROPERTY, IT MAY BE ADVISABLE TO OBTAIN TITLE INSURANCE IN CONNECTION WITH THE CLOSE OF ESCROW SINCE THERE MAY BE PRIOR RECORDED LIENS AND ENCUMBRANCES WHICH AFFECT YOUR INTEREST IN THE PROPERTY BEING ACQUIRED. A NEW POLICY OF TITLE INSURANCE SHOULD BE OBTAINED IN ORDER TO ENSURE YOUR INTEREST IN THE PROPERTY THAT YOU ARE ACQUIRING." [Civ.C. § 1057.6]

c. [4:602] **Preparing and recording grant deed and other documents:** Escrow holders typically prepare and record the grant deed. If the parties contemplate the escrow's preparation of additional documents (whether for recordation or otherwise), the instructions should so state.

d. [4:603] **Notification to parties:** Occasionally, the parties may want the escrow holder to advise them of various contingency deadlines or to provide other special notices. Any such special notice requirements should be specifically stated in the instructions. (Otherwise, escrow holders do not typically advise the parties of deadlines or even when, or whether, documents or monies have been received.)

e. [4:604] **Requesting payoff demand statements from existing lienholders:** The escrow holder should be instructed to obtain payoff demand statements from existing lienholders and to arrange for lien releases upon consummation of the payoff.

A secured lender's "payoff demand statement" is a written statement in response to a written request setting forth the amounts required as of the date of preparation of the statement to fully satisfy all obligations secured by the subject loan. The written statement will include a per diem accrual rate so that the escrow holder can calculate the precise amount due as of the closing. [See Civ.C. § 2943(a)(5) & (c)—lender must prepare payoff demand statement within 21 days after request; *California Nat'l Bank v. Havis* (2004) 120 CA4th 1122, 1133, 16 CR3d 245, 252—Civ.C. § 2943(a)(5) "sets forth the

necessary requirements of the payoff demand statement so that a *borrower* who desires to pay off a mortgage in full will know the exact amount due on the loan on a specific date" (emphasis in original)]

As earlier discussed, the lender's payoff demand statement *may be relied upon* as establishing the *full amount necessary* to discharge the secured obligation. Thereafter, any amounts owing which were mistakenly omitted from the lender's demand survive only as an *unsecured* obligation. [Civ.C. § 2943(d)(1), (3); see *Cathay Bank v. Fidelity Nat'l Title Ins. Co.* (1996) 46 CA4th 266, 271, 53 CR2d 595, 598; *and more detailed discussion at ¶ 4:304.1 ff.*]

(1) [4:604.1] **Compare—no duties re obtaining and recording reconveyance of trust deed:** The trustor under a deed of trust has a statutory right to full reconveyance of the trust deed when the obligation has been satisfied (*¶ 6:406*). The procedure for obtaining and recording a trust deed reconveyance is codified in Civ.C. § 2941 (*¶ 6:407 ff.*). Pursuant to the statute, duties regarding the reconveyance process are imposed only on the trust deed beneficiary and trustee; those duties do not "shift" at any time to the escrow holder. [*Markowitz v. Fidelity Nat'l Title Co.* (2006) 142 CA4th 508, 521-525, 48 CR3d 217, 226-229]

f. [4:605] **Coordinating with new lender for loan escrow instructions and issuance of lender's title insurance policy:** If a new loan will be recorded, the escrow will need to coordinate with the new lender, and arrange for the preparation of separate lender's escrow instructions and issuance of the lender's title insurance policy.

g. [4:606] **Confirming new hazard insurance or assigning and prorating existing insurance:** Any new lender will require the buyer to obtain appropriate hazard (casualty) insurance; and, in any event, it is always prudent for the buyer to procure such insurance. If the seller's existing coverage is not a blanket policy, the parties may be able to simply elect to assign the existing policy to the buyer and prorate the premiums; in that event, the instructions should specifically direct the escrow holder to compute any contemplated prorations (*¶ 4:607 ff.*).

h. [4:607] **Prorations:** Prorations are an extremely important part of the escrow's function. What to prorate, and the basis on which the proration is to be made, should be specifically delineated in the escrow instructions.

➪ [4:607.1] ***PRACTICE POINTERS:*** There is no requirement, of course, that prorations be computed by the escrow holder. The parties may wish to calculate their own prorations; this may be advisable with more complex issues … such as the application of security deposits to delinquent rents, or unbilled (or uncollected) tenant common area maintenance expenses. In cases where the parties wish to make their own calculations, they should simply deliver a mutually-approved written proration statement to the escrow holder prior to (and effective as of) the closing date.

[4:607.2] **Typical prorations:** Common items requiring proration include:

(1) [4:608] **Utility bills (electric, gas, water, telephone, etc.)**—i.e., ascertaining and apportioning preclosing utility expenses to the seller.

(a) [4:608.1] **Compare—buyer's utility security deposit and notice obligations:** Although it does not bear on utility bill prorations in escrow, buyers should be aware that they may be required, by local law, to give utility providers notice of the purchase and a security deposit (Gov.C. § 43008):

1) [4:608.2] **Notice of transfer:** A local municipality may require that, upon transfer of fee title (as evidenced by recordation) to a residential building of over four units that is provided with water and/or power by a municipal utility, the transferee *notify* the utility of the change in title *within 30 days of the transfer*. [Gov.C. § 43008(b)]

2) [4:608.3] **Security deposit:** The municipal utility may require the transferee to make a *security deposit* (up to six months' "estimated reasonable utility charges"), which may be held by the utility for up to two years (subject to an additional two-year extension in the event of delinquencies in paying utility charges). [See Gov.C. § 43008(b)]

(The utility has discretion to waive the security deposit based on the transferee's creditworthiness and "any other factors determined by the utility." Gov.C. § 43009.)

3) [4:608.4] **Utility's lien rights:** In the event the transferee fails to make the required deposit or to timely notify the utility of the transfer, the utility is entitled to *record a lien against the property* for the amount of the required deposit. (But the validity of the purchase and sale transaction is not affected; nor is the priority of all preexisting recorded liens on the property.) [Gov.C. § 43008(b)]

(2) [4:609] **Rents and security deposits:** Where the transaction involves rental property, the proration of tenant rents and security deposits can be particularly complex. For example, the application of security deposits to preclosing tenant defaults will not be known by the escrow officer unless there is a specific instruction from the parties. Also, the buyer

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should be given credit for any prepaid rents. The proration of rents and security deposits by an escrow (or any other third party) should be carefully monitored by the parties and their counsel.

(3) [4:610] **Interest on existing loans:** If the buyer is assuming or taking subject to an existing loan, the outstanding interest and principal balance must be prorated as of the closing date.

(4) [4:611] **Prepayment penalties:** If the sale will trigger any loan prepayment penalties, the escrow instructions (or purchase agreement) should identify who bears responsibility for the penalties or, if shared, how the amount will be prorated.

(5) [4:612] **Real property taxes:** Real property taxes are payable on a fiscal year basis of July 1 through June 30; and are due in two equal installments (unless the owner elects to pay the entire amount in a lump-sum on the first due date). But the tax bills are not sent until around November 1, covering the period from the preceding July 1 through June 30 of the following year. The first installment payment is due on December 10 of the current year; the second (relating to the period January 1 through June 30 of the following year) not until April 10. All of this means that for transactions closing after July 1, but before approximately November 1 (when the current tax bill is available), it is impossible to determine the precise property tax due as of the closing (for which the seller, of course, should bear responsibility). There are three ways to handle this problem:

(a) [4:613] **Prorate on basis of past bill:** One alternative is simply to prorate the property taxes based on the past bill; i.e., do not have any subsequent proration in the event the taxes go up or down.

This approach has the advantage of simplicity in that no one has to "chase" anyone else after the close of escrow to collect any difference between the estimated and actual tax bills. Moreover, if the property has not been sold since the last tax bill (or major improvements have not been made to the property in the interim), it is unlikely the current property taxes due will differ from the preceding year (except in cases of added bonds and assessments; *see* ¶ *4:617*).

(b) [4:614] **Reimbursement:** Provide that, to the extent the tax bill is higher or lower than estimated (based on the prior year's bill), the benefited party will reimburse the other upon a certain number of days' notice after the new tax bill is available.

Of course, the obvious disadvantage to this approach is the lack of "finality" to the transaction despite the closing of escrow; it necessarily leaves rights and obligations hanging in limbo for a period of time.

(c) [4:615] **Retain funds in escrow:** Withhold a certain amount of money in escrow to be used by the escrow holder to pay or refund any difference to the appropriate party based on the next tax bill (*see* ¶ *4:631*).

➪ [4:616] ***PRACTICE POINTER:*** In any event, remember that the escrow holder will only prorate based on the parties' instructions. Accordingly, unless new information is given, it will prorate based on the last available tax bill (and the last "available" tax bill may not reflect the taxes that will be due for the period).

(6) [4:617] **Bonds and assessments:** In addition to property taxes, special bonds or assessments may require prorations (these may be tacked on to the property tax bill). The same proration problems involved with real property taxes (¶ *4:613*) must be addressed here as well.

(7) [4:618] **Third party management and related contracts:** Payments due under various third party service contracts (e.g., for property management, garbage collection, air-conditioning service, landscaping maintenance) which the buyer will be taking over should be prorated as of the closing date.

(8) [4:619] **Lender's impound accounts (for taxes and insurance):** Also, proration may be required for monies withheld in lender impound accounts for taxes and insurance.

i. Tax withholding matters

(1) [4:620] **Preparing "FIRPTA" statement:** *See* ¶ *4:510.1 ff.*

(2) [4:620.1] **Notice of California tax withholding requirements; withholding taxes:** Escrow holders are required to provide written notification of the California requirements for withholding taxes under Rev. & Tax.C. § 18662(e) (¶ *4:510.3*). [See generally, Rev. & Tax.C. § 18662(e)(7)(C)]

At the parties' request, they may also withhold any such taxes and remit them to the Franchise Tax Board. [Rev. & Tax.C. § 18662(e)(7)(B)]

j. [4:621] **Execution and delivery of legally-required notices and filings:** Any documents required to be delivered by either party to local or state governmental entities (e.g., Notice of Change of Ownership) should be prepared by the escrow.

k. [4:622] **Transferring and delivering keys, documents and monies:** When and where the various documents and monies are to be delivered should be specified. As applicable to the nature of the transaction, the escrow instructions should identify and describe, e.g., the exact disposition of keys to the premises, licenses and permits, leases, third party contracts, tenant notification letters (i.e., letters notifying tenants of new owner), plans, drawings and any other documents which the escrow is to handle.

➪ [4:623] ***PRACTICE POINTER:*** Generally, it is better not to involve the escrow in the transfer of documents which it does not need to see or handle or would not even understand. Those items should simply be delivered between the parties outside of escrow, either directly or through their respective agents.

(1) [4:624] **Limitation re funds:** By statute, no title insurance company or "controlled escrow company" (see below) may disburse funds from an escrow account until the escrow is certain that the funds are actually available. [Ins.C. § 12413.1] (In other words, if a party delivers a check to the escrow or title company, the escrow holder must make certain the check is good before disbursing funds.)

A "controlled escrow company" is one which is controlled by, controls, or is under common control with, a title insurance company or underwritten title company. [See Ins.C. § 12340.6—"controlled escrow company" also means natural persons employed or controlled by title insurers or underwritten title companies] This law does not apply to independent escrows, although most have found it good practice to adhere to the statute nonetheless.

l. [4:625] **Preparing settlement statement:** *See discussion at ¶ 4:639 ff.*

[4:625.1 - 4:625.9] ***Reserved.***

m. [4:625.10] **Possible new duties under USA Patriot Act:** Although the rules and regulations are still being promulgated, like real estate attorneys, escrow companies *may* be brought under the umbrella of § 352 of the USA Patriot Act (*¶ 1:126*), requiring exhaustive steps to investigate and report "money laundering." "Financial institutions" subject to the Act expressly include "persons involved in real estate closings and settlements" (31 USC § 5312(a)(2)(U)), but the implementing Treasury regulations have not yet stated whether that language applies to *escrow companies* handling the closing of real estate transactions.

➪ [4:625.11] ***PRACTICE POINTER:*** If and when escrows become bound to follow (or voluntarily choose to follow) USA Patriot Act procedures, buyers' counsel will have to know how to respond when asked by the escrow agent about the source of funds to be deposited by the client into escrow. You may not be able to respond if you have not set up your own program to detect possible money laundering (*¶ 1:126*) or if the information is protected by the attorney-client privilege.

8. Closing and Termination of Escrow

a. [4:626] **Closing date:** The "close of escrow" typically occurs upon recordation of the deed (or other conveyancing instrument). The escrow instructions should identify the specific date for the close of escrow and instruct the escrow holder to record the deed on that date.

(1) [4:627] **Impact:** The purchase and sale are technically final with the close of escrow. However, the escrow holder must still complete a few other acts—preparation of the final version of the closing statement and disbursement of various documents and monies (*¶ 4:631*).

(2) [4:628] **Delivery of title policy:** The title insurance policy is effective as of the date of recordation of the conveyancing instrument. However, the policy is rarely delivered the day of closing; indeed, it is typically not sent until several days later.

(3) [4:628.1] **Return of recorded documents:** County recorders generally take some time to return the original recorded documents. In certain counties the recorded documents may not be returned for several weeks. (The return time for some documents, however, may be significantly shorter pursuant to California's Electronic Recording Delivery Act. The Act authorizes county recorders to establish a system for the electronic delivery, recording and return of specified instruments affecting a right, title or interest in real property. See Gov.C. § 27390 et seq.)

It is possible, however, to obtain a "conformed copy" of the instrument being recorded on the date of its recordation. The conformed copy is a duplicate of the original; it is stamped by the county recorder and bears the instrument number of the document that was actually recorded.

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➪ [4:628.2] ***PRACTICE POINTER:*** To obtain a conformed copy, you simply need to ask the escrow holder to do so. The county recorder will charge only a few dollars for each conformed copy.

(4) [4:628.3] **Effect of conflicting demands:** An escrow holder who, despite conflicting demands from the parties, closes the escrow and delivers the property to one of the parties instead of interpleading it, breaches their duties as an escrow holder (*¶ 4:647*).

(5) [4:628.4] **Failure to tender performance by closing date not necessarily fatal:** If it is not clearly specified that time is of the essence in the escrow transaction, a "reasonable time" may be allowed for performing escrow conditions even after the scheduled closing date has passed. [See *Conservatorship & Estate of Buchenau* (2011) 196 CA4th 1031, 1039, 127 CR3d 109, 115 (no "time of the essence" clause)—public guardian's 19-day delay in delivering all documents necessary to transfer title to purchaser of property at auction not unreasonable under the circumstances (noting also, however, that an *essential* time for performance may be implied when so required) (*discussed further at ¶ 4:634*)]

b. [4:629] **Closing costs:** "Closing costs" include, at a minimum, the escrow holder's fees (including so-called "document preparation fees"), recording fees, title insurance fees and documentary transfer taxes. The parties can negotiate the payment of closing costs any way they choose.

Discount escrow fees are permissible so long as they are related reasonably to the value of services actually performed (*¶ 4:642.5*).

However, by law, certain fees cannot be charged by escrows. [See, e.g., Rev. & Tax.C. § 18662(e)(7)—unlawful for real estate escrow person to charge fee for complying with state tax withholding requirements (*see ¶ 4:510.3*) unless escrow provides "assistance" with regard thereto—e.g., actually withholds and remits required tax to Franchise Tax Board or helps parties clarify with Franchise Tax Board whether withholding is required pursuant to Rev. & Tax.C. § 18662 (but, in that event, escrow's fee cannot exceed $45)]

➪ [4:630] ***PRACTICE POINTER:*** Often, the parties simply indicate that closing costs shall be paid "in accordance with customary practice." However, such language invites later dispute because "customary practices" vary across the state. Thus, if "customary practice" is to be the yardstick, at least designate *what* customary practice the parties are referring to —i.e., the practice where the property is located or, instead, where the escrow is located (or, perhaps, some other place).

(For example, in Southern California, the seller customarily pays the cost of the title policy; in Northern California, the buyer typically pays for its own title policy.)

c. [4:631] **Postclosing withholds:** Often, money will be left in escrow to pay off expenses that are either unknown or unresolved at the time of the closing (e.g., real property tax prorations, *¶ 4:615*; or state tax withholdings, see Rev. & Tax.C. § 18662(e)(4)(A)). Although the escrow may arguably have "closed" by its own terms, it remains open for the purpose of finalizing any unresolved issues or disbursing withheld funds.

➪ [4:632] ***PRACTICE POINTER:*** In any event, issues left to be resolved as of the closing should be subject to specific instructions so that the escrow holder is not left "hanging" on any matter. Remember, the escrow holder will only act in accordance with specific instructions and will not (and should not) make any substantive decisions outside the "four corners" of its instructions. If the instructions are not clear, the money will remain in escrow pending the parties' mutual directions.

d. [4:633] **Cancellation of escrow:** Depending on the terms of the purchase agreement (and escrow instructions), one party may be given the unilateral right to "cancel" the escrow (e.g., upon the failure of a contingency for one party's benefit). But, notwithstanding a right of unilateral cancellation, escrow holders are reluctant to disburse any remaining funds without both parties' written authorization; and this is so despite one party's clear right to the monies still on deposit.

(1) [4:634] **Effect on potential liabilities:** Cancellation of the escrow together with the return of funds deposited in escrow does not itself terminate the underlying purchase agreement or exonerate the parties from liability under the escrow instructions or purchase agreement … *unless* such cancellation is *specifically stated in writing* by the parties. [See Civ.C. § 1057.3(e); *Conservatorship & Estate of Buchenau* (2011) 196 CA4th 1031, 1039-1040, 127 CR3d 109, 115-116—buyers' purported cancellation of escrow via email deemed ineffective even though time for seller's performance technically had expired (buyers' refusal to consummate their contractual obligation considered breach of contract, authorizing seller to retain deposit); *Galdjie v. Darwish* (2003) 113 CA4th 1331, 1341-1343, 7 CR3d 178, 185-186—seller's cancellation of escrow for buyer's default in failing to timely obtain loan and subsequent waiver of such default did not preclude buyer

from suing seller for specific performance; *Cohen v. Shearer* (1980) 108 CA3d 939, 942, 167 CR 10, 12—parties' execution of agreement terminating escrow did not preclude buyers from maintaining suit for specific performance of sale contract]

(2) Return of escrow funds

(a) [4:635] **Duty to ensure return:** If the purchase transaction is not completed by the closing date (or any agreed-upon extension thereof) or the escrow is cancelled, buyer and seller are obligated to "ensure that all funds deposited into an escrow account are returned to the person who deposited the funds or who otherwise is entitled to the funds under the contract …" [Civ.C. § 1057.3(a); see also *Rutherford Holdings, LLC v. Plaza Del Rey* (2014) 223 CA4th 221, 233-234, 166 CR3d 864, 874—absent contrary escrow instructions, title to deposit vests in seller when seller accepts underlying contract (*¶ 4:291.1*)]

(b) [4:636] **Statutory penalties for noncompliance:** A buyer or seller who fails to execute any document required by the escrow holder to release such funds within 30 days after the other party's written demand "shall be liable" to the person making the deposit for *all* of the following (Civ.C. § 1057.3(b)):

• The amount of the funds on deposit not held in good faith to resolve a good faith dispute; plus

• Treble the above amount, but in no event less than $100 or more than $1,000; plus

• Reasonable attorney fees incurred in recovering the above penalties. [Civ.C. § 1057.3(b)]

1) [4:637] **Exception for "good faith" disputes:** There is no liability under Civ.C. § 1057.3 for failure to return escrow funds if the funds are withheld in order to resolve a "good faith dispute" between buyer and seller. "A party who is denied the return of the funds deposited in escrow is entitled to damages under this section only upon proving that there was no good faith dispute as to the right to the funds on deposit." [Civ.C. § 1057.3(c)]

A "good faith dispute" is one in which the trier of fact finds that the party refusing to return the deposited funds had a reasonable belief in their legal entitlement to the funds. [Civ.C. § 1057.3(f)(2)]

(c) [4:638] **Discharge of escrow liability by deposit in court:** Upon commencement of a cause of action to recover Civ.C. § 1057.3 penalties, the escrow holder is required to deposit the disputed funds into court, less any cancellation fee and charges incurred. At that point, the escrow holder is discharged of further responsibility for the funds. [Civ.C. § 1057.3(d); see also Civ.C. § 1057.3(g)—nothing in § 1057.3 restricts escrow holder's ability to file *interpleader* action in event of dispute over proper distribution of deposited funds; *and ¶ 4:647*]

9. Real Estate Settlement Procedures Act and Closing Statements

a. [4:639] **Nature and purpose of Act:** The Real Estate Settlement Procedures Act (RESPA, 12 USC § 2601 et seq.) requires uniformity in a closing (or "settlement") statement. Its general purpose is to ensure that home buyers are given full and timely information on the nature and costs of the closing process; and, more specifically, to (1) eliminate "kickbacks" or "referral fees" that tend to unnecessarily increase settlement costs (see 12 USC § 2607), and (2) reduce the amounts home buyers are required to place in escrow to ensure the payment of real estate taxes and insurance (see 12 USC § 2609). [12 USC § 2601(a) & (b); *Freeman v. Quicken Loans, Inc.* (2012) 566 US 624, 626-627, 132 S.Ct. 2034, 2037-2038; *Byars v. SCME Mortg. Bankers, Inc.* (2003) 109 CA4th 1134, 1141, 135 CR2d 796, 800]

The Act applies to real estate transactions involving "federally related mortgage loans." [12 USC § 2603] Technically, these are loans used to finance the purchase of one-to-four unit dwellings made by a particular category of lenders; but the breadth of the definition covers so many lenders that almost every escrow holder complies with RESPA in all one-to-four unit residential property sales (12 USC § 2602(1)). [See *Washington Mut. Bank, FA v. Sup.Ct. (Brown)* (1999) 75 CA4th 773, 779, 89 CR2d 560, 565]

(1) [4:639.1] **State law preempted only if inconsistent:** RESPA does not preempt or otherwise affect state laws on the same subject except to the extent those laws are inconsistent with the Act. A state law giving consumers *greater* protection is *not* inconsistent with RESPA. [See 12 USC § 2616; *Washington Mut. Bank, FA v. Sup.Ct. (Brown)* (1999) 75 CA4th 773,

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786-787, 89 CR2d 560, 570-571—state law private rights of action, including Bus. & Prof.C. § 17200 cause of action for "unfair and deceptive business practices," based on RESPA violations not preempted]

(2) [4:639.2] **One-year limitations period; equitable tolling:** Civil actions alleging illegal "kickbacks" or "unearned fees" in violation of RESPA must be brought within one year of the alleged violation (12 USC § 2614). Nonetheless, "the doctrine of equitable tolling may, in the appropriate circumstances, suspend the limitations period until the borrower discovers or had reasonable opportunity to discover the violation." [*Merritt v. Countrywide Fin'l Corp.* (9th Cir. 2014) 759 F3d 1023, 1036-1040 (internal quotes omitted)—error to dismiss RESPA claims as time-barred without first considering whether period could be equitably tolled to later date when borrowers received loan documents and discovered alleged violations]

b. [4:640] **Uniform settlement statement required:** Escrows handling residential transactions covered by the Act (¶ 4:639) must use a federally-prescribed standard form (known as the HUD-1 form) for the statement of settlement (closing) costs. [12 USC § 2603(a); see 24 CFR § 3500 et seq.; *Washington Mut. Bank, FA v. Sup.Ct. (Brown)* (1999) 75 CA4th 773, 779, 89 CR2d 560, 565]

(1) [4:641] **Contents:** RESPA directs the uniform settlement form to "conspicuously and clearly" itemize all charges imposed on the borrower (buyer) and seller in connection with the closing; and to indicate whether any title insurance premium included in the charges covers or insures the lender's interest in the property, the borrower's interest, or both. (Variations and deletions are permitted to reflect differing local practices.) [12 USC § 2603(a); see *Bloom v. Martin* (9th Cir. 1996) 77 F3d 318, 320-321—disclosure of postsettlement "demand fees" and "reconveyance fees" not required]

(2) [4:642] **When due:** The escrow holder must complete and make the settlement form available for the buyer's inspection "at or before" the closing (unless the buyer has waived this right or the particular locality has been exempted by the Secretary of Housing and Urban Development because a final settlement statement is not customarily provided at or before the closing or is otherwise impractical in that locality). Upon request, the buyer has the right to inspect the settlement form on the day before the closing. [12 USC § 2603(b)]

[4:642.1 - 4:642.4] ***Reserved.***

c. [4:642.5] **Discounts related to value of services performed permissible:** Escrow fee discounts do *not* constitute "kickbacks" in violation of RESPA (*¶ 4:639*) so long as the discounts are reasonably related to the value of services performed. [*Lane v. Residential Funding Corp.* (9th Cir. 2003) 323 F3d 739, 745; *see also ¶ 3:65.3*]

d. [4:642.6] **Yield spread premiums not per se illegal:** Yield spread premiums (YSPs) paid to mortgage brokers as bonuses for loans above par value are not necessarily illegal "kickbacks" or fees in violation of RESPA. Their legality depends on whether (1) services were actually performed; and (2) the bonuses received were reasonably related to the value of those services. [*Maganallez v. Hilltop Lending Corp.* (ND CA 2007) 505 F.Supp.2d 594, 603]

A mortgage broker's failure to adequately disclose a YSP bears on whether the premium violates RESPA. And, the fact a different broker in the same geographic market would not have been paid a similar amount is also a consideration. But RESPA requires more to support a violation—i.e., a loan-specific analysis of whether the total mortgage broker compensation from all sources is reasonable. [*Maganallez v. Hilltop Lending Corp.*, supra, 505 F.Supp.2d at 604]

e. [4:642.7] **Overcharges not prohibited:** Mere overcharges (e.g., unearned processing fees) do not violate RESPA, which bars giving or accepting any portion, split or percentage of a charge for real estate settlement services unless those services are actually performed (12 USC § 2607(b)): "[RESPA] was not intended to serve as a price cap for settlement services." [*Maganallez v. Hilltop Lending Corp.* (ND CA 2007) 505 F.Supp.2d 594, 604; see also *Freeman v. Quicken Loans, Inc.* (2012) 566 US 624, 631, 637-638, 132 S.Ct. 2034, 2040, 2044—RESPA does *not* prohibit *single* settlement-service provider's retention of unearned fee but, rather, bars provider from splitting fee with one or more persons; *Martinez v. Wells Fargo Home Mortg., Inc.* (9th Cir. 2010) 598 F3d 549, 558—RESPA's "clear and unambiguous" language does not reach practice of overcharging ($800 underwriting fee charged in exchange for settlement services did not violate RESPA)]

f. [4:642.8] **"Mark-ups" prohibited:** On the other hand, RESPA prohibits settlement services providers from charging for the services of a third party vendor (e.g., credit reports) and keeping a portion of the charge for themselves. [*Maganallez v. Hilltop Lending Corp.* (ND CA 2007) 505 F.Supp.2d 594, 605]

➪ [4:643] ***PRACTICE POINTER:*** Regardless of whether RESPA applies, it is advisable for someone (counsel, the parties or their representatives) to review the closing statement on behalf of buyer and seller to determine whether appropriate

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allocations, prorations, calculations and the like have been made. Escrow officers occasionally debit or credit the wrong account or simply make mathematical errors.

10. Escrow Holder Liability

a. To buyer and/or seller

(1) [4:644] **Contract damages:** The escrow instructions are a *contract* that the escrow holder is bound to follow as a party to the escrow. *Strict* compliance is required. If it disburses the property deposited in escrow in violation of the instructions or otherwise fails to comply with the instructions, the escrow holder is liable to the injured party for *breach of contract*. [*Summit Fin'l Holdings, Ltd. v. Continental Lawyers Title Co.* (2002) 27 C4th 705, 711, 117 CR2d 541, 545; *Amen v. Merced County Title Co.* (1962) 58 C2d 528, 531-532, 25 CR 65, 67; *Virtanen v. O'Connell* (2006) 140 CA4th 688, 703, 44 CR3d 702, 714—rule applies to attorney escrow holder; *see also* ¶ *4:571*]

(a) [4:644.1] **Limitation—*no transmutation of contract action into tort action:*** Parties to the escrow who sue an escrow agent for failing to perform as specified in the escrow instructions ordinarily cannot sue for tort damages. The "transmutation" of what is essentially a breach of contract into a tort cause of action has been rejected in favor of a general rule precluding tort recovery for noninsurance contract breaches, at least where bad faith denial of the existence of, or liability under, the breached contract is not at issue. [*Money Store Invest. Corp. v. Southern Calif. Bank* (2002) 98 CA4th 722, 732, 120 CR2d 58, 65 (dictum)—escrow party's negligence cause of action subject to summary adjudication because it was same as contract cause of action]

(b) [4:644.2] **Recovery of attorney fees:** If the escrow instructions contain an appropriate attorney fee provision, the party who prevails in an action arising from breach of the instructions is entitled to recover attorney fees (Civ.C. § 1717). [See *Kangarlou v. Progressive Title Co., Inc.* (2005) 128 CA4th 1174, 1178-1179, 27 CR3d 754, 756-757—buyer who prevailed in breach of fiduciary duty action against escrow holder (failure to obtain evidence that broker was regularly licensed before delivering broker compensation and failure to communicate same to buyer) entitled to § 1717 fees (suit was an action on the contract because fiduciary duties arose only by reason of the escrow contract); compare *Rideau v. Stewart Title of Calif., Inc.* (2015) 235 CA4th 1286, 1292, 1301-1302, 185 CR3d 887, 890, 897-898—buyer could not recover attorney fees against escrow holder based on escrow instruction's indemnity provision (clause as written provided escrow company with "one way" protection against third party lawsuits and did not apply to fees incurred in litigation between buyer and escrow holder based on their contract (¶ *11:138.5*))]

(2) [4:645] **Tort damages:** Buyers and sellers aggrieved by the escrow holder's breach of duties are not limited to contract damages. Because the escrow holder is a fiduciary and agent of the parties (¶ *4:580 ff.*), it is also exposed to *tort* liability (e.g., negligence liability for failure to exercise ordinary skill and diligence in the employment). [*Amen v. Merced County Title Co.* (1962) 58 C2d 528, 532, 25 CR 65, 67; and see *Virtanen v. O'Connell* (2006) 140 CA4th 688, 696, 44 CR3d 702, 708—negligence, breach of fiduciary duty and conversion; *Lee v. Escrow Consultants, Inc.* (1989) 210 CA3d 915, 924, 259 CR 117, 123—fraud and wrongful disbursement of escrow funds; *Francis v. Eisenmayer* (1959) 171 CA2d 221, 226, 340 P2d 54, 56-57—misrepresentation; compare *Lee v. Title Ins. & Trust Co.* (1968) 264 CA2d 160, 163, 70 CR 378, 380—no breach of fiduciary duty for failure to disclose information unrelated to specific escrow instructions]

(a) [4:645.1] **Failure to disclose:** When an escrow holder *knows* a party to the escrow is relying on it for protection as to facts learned by the escrow holder, the escrow holder can be held liable if it does not disclose those facts to the party. [*Vournas v. Fidelity Nat'l Title Ins. Co.* (1999) 73 CA4th 668, 674-675, 86 CR2d 490, 495—no escrow liability for failure to disclose need for beneficiary consent to trustee's sale of trust property because not part of escrow instructions and no evidence escrow holder knew trustee was unaware of beneficiary consent requirement; *Lee v. Title Ins. & Trust Co.* (1968) 264 CA2d 160, 163, 70 CR 378, 380—no breach of fiduciary duty for failure to disclose information unrelated to specific escrow instructions; see *Marriage of Cloney* (2001) 91 CA4th 429, 440, 110 CR2d 615, 624, fn. 10—in nontort action, escrow holder had duty to disclose to buyer that seller's actual name was different than that on deed]

(b) [4:645.2] **Foreseeable damages:** As in other tort cases, an escrow holder is only liable for reasonably foreseeable damages. An escrow holder is not liable if there was a "superseding cause," i.e., a reasonably unforeseeable independent intervening act that caused the plaintiff's damages. This is generally a question of fact. [See *Tung v. Chicago Title Co.*

(2021) 63 CA5th 734, 745-747, 278 CR3d 182, 189-191—question of fact whether seller's loss of use damages were foreseeable consequence of escrow holder's errors]

b. [4:646] **Generally *no liability to third parties:*** Escrow holders owe a duty of care only to the *parties to and* participants in the escrow. Consequently, escrow holders who follow their principals' instructions ordinarily *cannot* be held liable to *strangers* to the escrow on a negligence theory. [*Vournas v. Fidelity Nat'l Title Ins. Co.* (1999) 73 CA4th 668, 674-675, 86 CR2d 490, 494-495; see also *Alereza v. Chicago Title Co.* (2016) 6 CA5th 551, 559, 211 CR3d 469, 474—absent clear evidence of fraud, escrow holder's obligations are limited to compliance with parties' instructions]

(1) Application

- [4:646.1] Escrow Holder could not be held liable to Trust Beneficiaries, who were *nonparties* to the escrow, where Trustee sold the trust property in violation of a restriction in the trust instrument requiring the beneficiaries' consent. There was no reference to the need for beneficiary consent in the escrow instructions and Escrow Holder was unaware of any restrictions on the trustee's powers. [*Vournas v. Fidelity Nat'l Title Ins. Co.* (1999) 73 CA4th 668, 674-675, 86 CR2d 490, 495]
- [4:646.2] Escrow Holder was instructed by parties to the escrow to pay off a promissory note secured by the subject property. Plaintiff, a *nonparty* to the escrow, sued Escrow Holder for breach of fiduciary duty and negligence, contending that Escrow Holder, knowing that the note had been assigned to plaintiff by another nonparty to the escrow, should have paid the note to it. Escrow Holder was *not* liable because it did not owe a duty of care to plaintiff, a *nonparty*, based on an assignment from *another nonparty*. [*Summit Fin'l Holdings, Ltd. v. Continental Lawyers Title Co.* (2002) 27 C4th 705, 707-708, 117 CR2d 541, 543 (disapproving *Kirby v. Palos Verdes Escrow Co., Inc.* (1986) 183 CA3d 57, 227 CR 785); compare *Builders' Control Service of Northern Calif., Inc. v. North American Title Guar. Co.* (1962) 205 CA2d 68, 73-75, 22 CR 712, 715-717—escrow holder may be liable for disbursing funds in violation of assignment made by *party* to escrow]
- [4:646.3] Escrow holder did not owe a duty of care to the guarantor of a commercial gas station lease when, in the first of a series of missteps, its escrow officer negligently miscommunicated the business' name to its insurer. The insurer sent out a notice of cancellation and the business' lessor, fearing the gas station was operating without insurance, filed an unlawful detainer action. Although the guarantor had provided the purchase funds and a note secured by his own residence to assist his nephew in acquiring the gas station business, the guarantee was given after the close of escrow and only for the purpose of settling the unlawful detainer action. Thus, because the guarantor was not a party to the escrow, nor mentioned in the escrow instructions as a third party beneficiary, the escrow holder was not liable for any losses the guarantor sustained after the gas station business declined. [*Alereza v. Chicago Title Co.* (2016) 6 CA5th 551, 553, 211 CR3d 469, 470]

[4:646.4 - 4:646.6] ***Reserved.***

(2) [4:646.7] **Liability on third party beneficiary theory:** Liability might lie on a third party beneficiary theory where the escrow was intended to directly benefit a nonparty. [See *Feinberg v. Intrastate Escrow Corp.* (1963) 216 CA2d 80, 83-85, 30 CR 781, 783-784—third party beneficiary of escrow that was secretly canceled could recover against escrow holder under estoppel principles; compare *Markowitz v. Fidelity Nat'l Title Co.* (2006) 142 CA4th 508, 527-528, 48 CR3d 217, 230-231—evidence established no more than plaintiff (third party) was incidental, not intended, beneficiary of escrow instructions]

c. [4:647] **Interpleader remedy to avoid liability:** When conflicting demands are made by the parties to the escrow, escrow holders often move to interplead the disputed funds in an effort to shield themselves from potential liability.

The escrow's “general conditions” usually give the escrow holder the right of interpleader; and also typically provide that the buyer and seller will pay the escrow holder's attorney fees and costs incurred in connection therewith (but see *Francis v. Eisenmayer* (1959) 171 CA2d 221, 229, 340 P2d 54, 58—escrow instructions requiring buyer and seller to pay escrow holder's attorney fees incurred in connection with escrow (including interpleader) did not give escrow holder right to recover fees in buyer's action for escrow's independent fraud). However, under CCP § 386 et seq., interpleader is a viable remedy even if the instructions are silent on the point (see CCP § 396(b)).

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Indeed, when there are conflicting demands to the escrowed property, if the escrow holder closes escrow (i.e., delivers the property to one of the parties) *without* interpleading the property, the escrow holder breaches their duties as an escrow holder; it is not enough for the escrow holder to close the escrow and expect the aggrieved party to immediately file suit to halt the property transfer. [*Virtanen v. O'Connell* (2006) 140 CA4th 688, 697-699, 44 CR3d 702, 708-710—closing escrow not "functional equivalent" of filing interpleader action; *see also* ¶ *4:571*]

d. [4:648] **Mobile home sale escrows:** Health & Saf.C. § 18035(f) requires the escrow agent for the sale of a mobile home to hold funds in escrow upon receiving written notice of a dispute between the parties to the escrow, notwithstanding any written escrow instructions to the contrary (Health & Saf.C. § 18035(k)). An agent who fails to comply with this Code provision may be liable to the injured party. [See *Castillo v. Express Escrow Co.* (2007) 146 CA4th 1301, 1306-1308, 53 CR3d 485, 489-490]

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Chapter 4. Purchase and Sale Agreement

Forms

[Form 4:A] Sample Grant Deed

Image 1 within document in PDF format.

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Chapter 4. Purchase and Sale Agreement

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[Form 4:B] Sample Quitclaim Deed

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Chapter 4. Purchase and Sale Agreement

Forms

[Form 4:C] Bill of Sale

BILL OF SALE

FOR VALUABLE CONSIDERATION, the receipt and sufficiency of which are hereby acknowledged, ________________ ("Transferor"), hereby transfers, conveys and assigns to ________________ ("Transferee"), its successors and assigns, all of Transferor's right, title and interest in and to those certain items of personal property described in **"Exhibit "A,"** attached hereto and incorporated herein ("Transferred Property").

1. Transferor warrants and represents that Transferor is the sole owner of the Transferred Property and that the Transferred Property is free and clear of all liens, encumbrances, security interest and any claims to title.
2. This Bill of Sale may be relied upon as conclusive proof that each and all of the Transferred Property has been transferred to Transferee.
3. This Bill of Sale has been prepared, negotiated and executed, and shall be construed in accordance with, the laws of the State of California.
4. In the event any action or proceeding is brought by either party hereto against the other party hereto by reason of the breach or enforcement of this Bill of Sale, the prevailing party shall be entitled to have and recover from the other party all costs and expenses of the action or proceeding, including reasonable attorneys' fees. Any action or proceeding relating to or arising out of this Bill of Sale shall be filed, if a state action, in the Superior Court of the State of California for the County of ___________, or if a federal action, in the United States District Court for the ___________ District of California.

[ALTERNATIVE: DISCLAIMER OF WARRANTIES]

EXCEPT AS MAY BE OTHERWISE PROVIDED IN THIS BILL OF SALE, TRANSFEROR AND TRANSFEREE ACKNOWLEDGE AND AGREE THAT THIS IS A NON-WARRANTY BILL OF SALE AND THAT BUYER IS PURCHASING THE TRANSFERRED PROPERTY WITHOUT ANY WARRANTIES, WHETHER EXPRESS OR IMPLIED, AND WHETHER PURSUANT TO THE CALIFORNIA UNIFORM COMMERCIAL CODE, OR OTHERWISE. TO THE EXTENT ANY WARRANTIES WOULD APPLY TO THE TRANSFERRED PROPERTY OR THIS TRANSACTION, TRANSFEROR UNCONDITIONALLY WAIVES, AND SELLER DISCLAIMS, ANY SUCH WARRANTIES.

TRANSFEREE FURTHER EXPRESSLY ACKNOWLEDGES THAT TRANSFEREE IS PURCHASING THE TRANSFERRED PROPERTY IN AN "AS IS," "WHERE IS" CONDITION, WITH ALL ITS FAULTS. TRANSFEREE HAS INSPECTED THE TRANSFERRED PROPERTY AND IS SATISFIED THAT THE TRANSFERRED PROPERTY IS COMPLETELY AS DESCRIBED IN EXHIBIT "A" AND IS IN GOOD CONDITION. TRANSFEROR

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HAS NOT INSPECTED THE TRANSFERRED PROPERTY, DOES NOT KNOW IF THE TRANSFERRED PROPERTY IS COMPLETELY AS DESCRIBED IN EXHIBIT "A," NOR DOES TRANSFEROR KNOW THE PURPOSE TO WHICH TRANSFEREE WILL PUT THE PROPERTY. TRANSFEROR MAKES NO REPRESENTATION CONCERNING THE VALUE OF THE TRANSFERRED PROPERTY.

TRANSFEROR DOES NOT WARRANT THE MERCHANTABILITY OF THE TRANSFERRED PROPERTY OR WHETHER IT IS FIT FOR ANY PARTICULAR PURPOSE, OR EVEN IF THE TRANSFERRED PROPERTY IS FIT FOR THE ORDINARY PURPOSE FOR WHICH IT IS NORMALLY USED, AND TRANSFEREE SPECIFICALLY WAIVES ANY IMPLIED WARRANTY OF MERCHANTABILITY OF THE TRANSFERRED PROPERTY OR WARRANTY THAT THE TRANSFERRED PROPERTY IS FIT FOR ANY PARTICULAR PURPOSE OR THE PURPOSE FOR WHICH IT IS NORMALLY USED.

IF TRANSFEROR BREACHES ITS WARRANTY OF TITLE, TRANSFEREE'S SOLE AND EXCLUSIVE REMEDY SHALL BE LIMITED TO THE RECOVERY OF AN AMOUNT EQUAL TO THE FAIR MARKET VALUE OF THE TRANSFERRED PROPERTY AS OF THE DATE HEREOF AND, IN NO EVENT, SHALL TRANSFEREE BE ENTITLED TO CONSEQUENTIAL, EXEMPLARY OR PUNITIVE DAMAGES OF ANY KIND OR NATURE WHATSOEVER.

IN WITNESS WHEREOF, Transferor and Transferee have executed this Bill of Sale as of ___________, _.

TRANSFEROR

____

TRANSFEREE

____

EXHIBIT "A" TO BILL OF SALE

[All personal property to be transferred to the buyer should be itemized. However, do not forget that, in addition to the rather obvious items of personal property, there may be some items of intangible property which you may wish to include (such as contract rights, etc.). Some lawyers use a separate Assignment for the transfer of intangible property (see Form 4:D for the transfer of intangible property), but there is nothing necessarily wrong with modifying the Bill of Sale to include the transfer of intangible property.]

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Chapter 4. Purchase and Sale Agreement

Forms

[Form 4:D] Assignment of Intangible (and Other) Property

The following is a very broad form of Assignment and may require substantial modification depending on the type of property as well as the terms of the purchase transaction.

RECORDING REQUESTED BY
AND WHEN RECORDED MAIL TO
Name
Address
City
State
Zip

____

ASSIGNMENT

This Assignment is made this ___ day of ________________, _, by ________________, a ___________ ("Assignor") and ________________, a ________________ ("Assignee"), with reference to the following facts:

A. WHEREAS, Assignor is the owner of that certain real property, commonly known as ___________ Street, ___________, California and more particularly described in Exhibit "A," attached hereto and incorporated herein (the "Property").

B. WHEREAS, on or about the date hereof, Assignor sold all of its right, title and interest in and to the Property to Assignee, including but not limited to all of Assignor's right, title and interest in and to the property described in Paragraph 1, below.

C. Assignor and Assignee desire to enter into this Assignment to confirm the assignment by Assignor to Assignee of all of Assignee's right, title and interest in and to the Intangible Property.

NOW, THEREFORE, in consideration of the mutual covenants of the parties herein, and for good and valuable consideration, the receipt of sufficiency of which is hereby acknowledged, the parties agree as follows:

1. **Assignment by Assignor.** Assignor hereby sells, transfers and assigns to Assignee all of Assignor's right, title and interest in and to each and all of the following: (i) all warranties and guaranties pertaining to any property of any kind used in or about the Property including but not limited to all warranties from contractors, architects, engineers and material and labor suppliers (whether written or implied) ("Warranties"); and (ii) any and all other contracts ("Other Contracts") (each of which is more particularly described in Exhibit "B" attached hereto; (iii) all records, books of account, catalogs, advertising material,

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manuals and correspondence maintained by Assignor in connection with the Property (with the exception of Assignor's standard operational manuals), including any reports (but excluding management reports) prepared by Assignor relating to the past, present or future development of the Property, in whatever mode maintained, including information contained on computer discs, provided, however, that none of the foregoing shall include any correspondence or other communication between Assignor and its attorneys; (iv) all licenses, franchises, certifications, authorizations, approvals, rights, privileges, entitlements and permits issued or approved by any governmental or quasi-governmental authority or other person or entity having authority over the Property ("Permits"), and all applications, filings and submittals therefor, in each case relating to the operation ownership, subdivision, development, use or maintenance of the Property or any part thereof, including without limitation, construction permits, grading permits, elevator permits, machinery permits, business licenses, ingress and egress permits, development agreements, subdivision, parcel and tract maps and approvals thereof, utility agreements and commitments, improvement agreements, certificates of occupancy and the like, but excluding therefrom for all purposes of this Assignment any licenses issued to or solely on behalf of any tenant; and (v) all other intangible property right relating to the use, occupancy or operation of the Property, including but not limited to the right to use the name "___________").

2. **Governing Law.** This Assignment is made and entered into in the State of California and shall be interpreted, construed and enforced in accordance with the laws of the State of California.

3. **Binding Effect.** This Assignment shall apply to, bind, and inure to benefit of Assignor and Assignee, and their respective heirs, legal representatives, successors and assigns.

4. **Counterparts.** This Assignment may be executed in one or more counterparts, each of which shall be an original, but all of which shall together constitute one instrument.

IN WITNESS WHEREOF, this Assignment has been executed as of the date first above written.

"**ASSIGNOR**"

____

a ________________

By: ________________

Its: ___________

"ASSIGNEE"

____

a, ________________

By: ________________

Its: ________________

Add Notary Acknowledgements.

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Chapter 4. Purchase and Sale Agreement

Forms

[Form 4:E] (Landlord's) Assignment of Leases

If the Leases are recorded, the Assignment should be recorded and, therefore, put in recordable form.

ASSIGNMENT OF LEASES

This **ASSIGNMENT OF LEASES** (this "Assignment") is made as of the ___ day of ________________, _, by and between ________________, a ___________, ("Assignor") and ________________, a ________________, ("Assignee") with reference to the following facts:

RECITALS

A. WHEREAS, Assignor is the owner of that certain real property, commonly known as ___________ Street, ________________, California, and more particularly described in Exhibit "A," attached hereto and incorporated herein (the "Property").

B. WHEREAS, on or about the date hereof, Assignor has sold all of its right, title and interest in and to the Property to Assignee, including but not limited to all of Assignor's right, title and interest in and to each and all of those leases of portions of the Property, more particularly described on Exhibit "B," attached and incorporated herein (the "Leases").

C. Assignor and Assignee desire to enter into this Assignment to confirm the assignment by Assignor to Assignee of all of Assignor's right, title and interest in and to the Leases and to confirm Assignee's assumption of Assignor's obligations under the Leases as of _____, ___ (the "Effective Date").

NOW, THEREFORE, in consideration of the mutual covenants of the parties herein, and for good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties agree as follows:

1. **Assignment by Assignor.** Assignor hereby sells, transfers and assigns to Assignee all of Assignor's right, title and interest in and to each and all of the Leases, effective the Effective Date.

2. **Acceptance and Assumption by Assignee.** Assignee hereby accepts the foregoing assignment and transfer and specifically assumes and agrees to perform and observe each and every covenant, agreement and condition to be performed or observed by the "Landlord" under each and all of the Leases.

3. **Governing Law.** This Assignment is made and entered into in the State of California and shall be interpreted, construed and enforced in accordance with the laws of the State of California.

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4. **Binding Effect.** This Assignment shall apply to, bind, and inure to benefit of Assignor and Assignee, and their respective heirs, legal representatives, successors and assigns.

5. **Counterparts.** This Assignment may be executed in one or more counterparts, each of which shall be an original, but all of which shall together constitute one instrument.

IN WITNESS WHEREOF, Assignor and Assignee have executed this Assignment as of the date first above written.

"ASSIGNOR"
________________,
a ________________
By: ________________
Its: ___________
"ASSIGNEE"
________________,
a ________________
By: ________________
Its: ___________

Add Notary Acknowledgement if this document is to be recorded.

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Chapter 4. Purchase and Sale Agreement

Forms

[Form 4:F] Power of Attorney (Limited) for Real Property Purchase and Sale Transaction

RECORDING REQUESTED BY
AND WHEN RECORDED MAIL TO:
Name
Street
Address
City &
State
Zip

____

LIMITED POWER OF ATTORNEY

The undersigned hereby makes, constitutes and appoints ________ my true and lawful Attorney for me and in my name, place and stead and for my use and benefit:..

(a) To ask, demand, sue for, recover, collect and receive each and every sum of money, debt, account, legacy, bequest, interest, dividend, annuity and demand (which now is or hereafter shall become due, owing or payable) belonging to or claimed by me, and to use and take any lawful means for the recovery thereof by legal process or otherwise, and to execute and deliver a satisfaction or release therefor, together with the right and power to compromise or compound any claim or demand;

(b) To exercise any or all of the following powers as to real property, any interest therein and/or any building thereon: To contract for, purchase, receive and take possession thereof and of evidence of title thereto; to lease the same for any term or purpose, including leases for business, residence, and oil and/or mineral development; to sell, exchange, grant or convey the same with or without warranty; and to mortgage, transfer in trust, or otherwise encumber or hypothecate the same to secure payment of a negotiable or non-negotiable note or performance of any obligation or agreement;

(c) To exercise any or all of the following powers as to all kinds of personal property and goods, wares and merchandise, choses in action and other property in possession or in action: To contract for, buy, sell, exchange, transfer and in any legal manner deal in and with the same; and to mortgage, transfer in trust, or otherwise encumber or hypothecate the same to secure payment of a negotiable or non-negotiable note or performance of any obligation or agreement;

(d) To borrow money and to execute and deliver negotiable or non-negotiable notes therefor with or without security; and to loan money and receive negotiable or non-negotiable notes therefor with such security as he/she shall deem proper;

(e) To transact business of any kind or class and as my act and deed to sign, execute, acknowledge and deliver any deed, lease, assignment of lease, covenant, indenture, indemnity, agreement, mortgage, deed of trust, assignment of mortgage or of the

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beneficial interest under deed of trust, extension or renewal of any obligation, subordination or waiver of priority, hypothecation, bottomry, charter-party, bill of lading, bill of sale, bill, bond, note, whether negotiable or non-negotiable, receipt, evidence of debt, full or partial release or satisfaction of mortgage, judgment and other debt, request for partial or full reconveyance of deed of trust and such other instruments in writing or any kind or class as may be necessary or proper in the premises.

GIVING AND GRANTING unto my said Attorney full power and authority to do and perform all and every act and thing whatsoever requisite, necessary or appropriate to be done in and about the premises as fully to all intents and purposes as I might or could do if personally present, hereby ratifying all that my said Attorney shall lawfully do or cause to be done by virtue of these presents.

Notwithstanding anything in this Limited Power of Attorney, the powers and appointment contained herein shall only apply to matters pertaining to the purchase and sale and financing of that certain real and personal property located at ________________ (the “Property”), including any and all instruments and transactions which may be reasonably necessary to consummate said purchase and sale and financing. Accordingly, the grant herein unto my Attorney specifically includes the right to execute any and all real estate broker's listing agreements; offers to purchase or sell; counter-offers to purchase or sell; acceptance of offers to purchase or sell; escrow instructions; amendments to purchase and sale agreements and/or escrow instructions; instructions to the lenders; instructions to real estate brokers; grant deeds and other conveyancing instruments; and to execute all other documents and take all other actions as may be necessary or desirable to consummate the purchase and sale and financing of the Property.

This Limited Power of Attorney shall automatically expire on midnight ___________, _, and shall thereafter be of no force or effect.

My said Attorney is empowered hereby to determine in his/her sole discretion the time when, purpose for and manner in which any power herein conferred upon him shall be exercised, and the conditions, provisions and covenants of any instrument or document which may be executed by him/her pursuant hereto; and in the acquisition or disposition of real or personal property, my said Attorney shall have exclusive power to fix the terms thereof for cash, credit and/or property, and if on credit with or without security.

Executed this ___________ day of ________________, ___

____

[ADD NOTARY ACKNOWLEDGEMENT]

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Chapter 4. Purchase and Sale Agreement

Forms

[Form 4:G] (Nonbinding) Letter of Intent

___________, _

____
____
____

Re: ___________

Dear ___________:

The purpose of this letter is to set forth a nonbinding letter of intent between ___________, a ___________ ("Seller") and ________________, a ________________ ("Buyer") for the purchase of the real property and improvements described below, on the following terms:

1. Property. The Property to be purchased ("Property") consists of the land and that certain ___ story building located thereon, commonly known as ________________ Street, City of ___________, California. The Property shall include all personal property used in the ownership or operation of the Property which is located at the Property (which personal property shall be described on an inventory list approved by Seller and Buyer).

2. Purchase Price. The total purchase price for the Property shall be ________________ Thousand Dollars ($________), which shall be paid all in cash. ________________ Dollars ($________) shall be deposited in escrow by Buyer upon opening of escrow, and an additional ___________ Dollars ($________) shall be deposited in escrow by Buyer upon satisfaction (or waiver) of the contingencies described below.

3. Escrow. An escrow for the purchase and sale of the Property shall be opened at a mutually acceptable title company in ________________ County, California, within three (3) business days after the execution of a binding purchase agreement between Buyer and Seller.

4. Closing Date. The escrow for the sale of the Property shall close on ___________, _.

5. Title. Title to the Property shall be conveyed to Buyer by grant deed, subject only to such covenants, conditions and other matters of record as are approved by the Buyer.

6. Buyer. The Buyer shall be ________________, or any assignee of Buyer.

7. Contingencies. Buyer's obligation to purchase the Property shall be contingent upon the following:

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(a) Condition of Title. Buyer's review of a preliminary title report, together with copies of all exceptions, within fifteen (15) days after delivery of same to Buyer.

(b) Inspections and Soils Test. Buyer's review and approval of the physical condition of the Property, including but not limited to soils test conducted by Buyer, all within ___ (_) days after the opening of escrow. Seller shall provide Buyer with reasonable access to the Property and Buyer shall indemnify Seller for any loss, damage or injury resulting from Buyer's access to the Property.

(c) Financing. Buyer's ability to obtain financing on terms and conditions acceptable to Buyer within ___ (_) days after the opening of escrow.

8. Conduct of Business Before Closing. Prior to the closing, the Property will be operated in the ordinary course consistent with previous practice.

This agreement is a nonbinding letter of intent and no party is bound to anything. Notwithstanding either party's execution hereof, nothing in this letter shall create a legally enforceable contract and no party shall be bound to anything unless and until a definitive purchase agreement has been fully negotiated, drafted and executed by both parties. This letter is therefor for discussion purposes only and no party shall have any obligation to continue negotiations.

Very truly yours,
By: _________________
Its: _________________
Agreed:_________________
Date: ____________, _.
_________________,
a _________________
By: _________________
Its: _________________

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Chapter 4. Purchase and Sale Agreement

Forms

[Form 4:H] (Attorney-Drafted) Purchase and Sale Agreement and Joint Escrow Instructions

[Note: What follows is a form containing various provisions to be considered when drafting a purchase and sale agreement. However, any given provision may or may not be appropriate under the circumstances of any particular transaction and, of course, depending on whether your representation is of the buyer or seller. Reference to the text of Chapter 4 is necessary to determine the advisability of including any particular provision and whether additional provisions may be necessary or desirable.]

AGREEMENT OF PURCHASE AND SALE
AND JOINT ESCROW INSTRUCTIONS

This **AGREEMENT OF PURCHASE AND SALE AND JOINT ESCROW INSTRUCTIONS** (this "Agreement") is made as of the ___ day of ________________, 20__, by and between ________________, a ___________ ("Seller"), and ________________, a ___________ ("Buyer").

RECITALS

A. **WHEREAS,** Seller as the owner of certain land located in the City of ___________, County of ________________, State of California, commonly known as ________________ and legally described on **Exhibit "A,"** attached hereto (the "Land"), together with all improvements thereon and appurtenances thereto ("Improvements"). (The Land and Improvements are hereinafter collectively referred to as the "Real Property.").

B. **WHEREAS,** Seller is the owner of certain personal property located in, on and about the Real Property, as more specifically described on **Exhibit "B,"** attached hereto ("Personal Property"). Seller is also the owner of certain intangible property relating to the Real Property and more particularly described in the Assignment attached hereto as **Exhibit "C"** ("Intangible Property"). (The Real Property, Personal Property and Intangible Property are hereinafter collectively referred to as the "Property").

C. **WHEREAS,** Seller desires to sell the Property to Buyer, and Buyer desires to purchase the Property from Seller, all on the terms and conditions of this Agreement.

NOW, THEREFORE, in consideration of the covenants and agreements contained herein, the parties hereto agree as follows:

1. PURCHASE AND SALE.

Seller agrees to sell the Property to Buyer, and Buyer agrees to purchase the Property from Seller, on the terms and conditions hereinafter set forth in this Agreement.

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2. PURCHASE PRICE.

The total purchase price (“Purchase Price”) for the Property shall be ________________ Dollars ($________), payable by Buyer to Seller as follows:

(a) The cash sum of ________________ Dollars ($________) shall be deposited in Escrow upon the opening thereof, to be held in an interest-bearing passbook account at a lending institution which is FDIC insured (with interest accruing to the credit of Buyer).

(b) The additional cash sum of ________________ Dollars ($________) shall be deposited in Escrow by Buyer upon satisfaction (or waiver) of all of the Contingencies described in Paragraph 4.1, below, and such deposit shall be held in the passbook account described in Paragraph 2(a), above, (with interest accruing to the benefit of Buyer).

(c) The balance of the Purchase Price, to wit, ________________ Dollars ($________), shall be deposited in Escrow by Buyer prior to Close of Escrow for delivery to Seller upon Close of Escrow.

[If a portion of the Purchase Price is to be paid by (i) buyer's assumption of, or taking subject to, an existing loan; and/or (ii) the creation of new purchase-money financing from seller, then (a) the methodology for assuming (or taking subject to) the existing encumbrance should be stated; and the terms and conditions of the purchase money, seller financed Note and Deed of Trust should be identified and the form of Note and Deed of Trust (and any other seller financing loan documents; e.g. Security Agreement, UCC-1 Financing Statement, etc.) should be attached as exhibits.]

3. CONDITION OF TITLE TO PROPERTY.

3.1. Title to the Property shall be conveyed to Buyer upon the Close of Escrow.

3.2. Title to the Property shall be conveyed to Buyer by Grant Deed (on the Title Company's standard form Grant Deed), free and clear of all liens except for (i) liens securing real property taxes and assessments (which constitute liens not yet due and payable); and (ii) such other exceptions and reservations shown on a Preliminary Title Report (“Preliminary Report”) issued by ________________ Title Company (“Title Company”) which are approved by Buyer. (All exceptions to title permitted pursuant to this Paragraph ___ are referred to in this Agreement as “Permitted Exceptions.”) Seller agrees to furnish Buyer with a copy of the Preliminary Report, together with a copy of all recorded exceptions to title, by ___________, ___. Buyer shall have _____ (___) days after receipt of the Preliminary Report and the recorded exceptions to title within which to notify Seller in writing of Buyer's disapproval of any exceptions set forth in the Preliminary Report. In the event of Buyer's disapproval of the Preliminary Report, Seller, at its sole election (to be exercised by written notice to Buyer within ___ (_) days after receipt of Buyer's said notice of disapproval), shall have ___ (_) days after Buyer's said disapproval within which to remove or otherwise remedy the disapproved exceptions. If Seller cannot eliminate or otherwise remedy the disapproved exceptions within said ___ (_) day time period, this Agreement shall thereupon terminate and all sums and documents deposited in Escrow shall be returned to the parties who respectively deposited the same, and Buyer and Seller shall each pay one-half (1/2) of the Escrow costs. Failure of Buyer to provide written disapproval of the Preliminary Report within the above time period shall be deemed approval.

3.3. Title to the Real Property shall be evidenced by the commitment of the Title Company to issue a standard California Land Title Association **[or, if applicable, an American Land Title Association]** policy of title insurance with liability in the amount of the Purchase Price showing title to the Real Property vested in (or as designated by) Buyer **[and, if applicable, insuring Seller's purchase-money lien as evidenced by the purchase-money Deed of Trust]** subject only to the Permitted Exceptions.

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3.4. Title to the Personal Property shall be evidenced by the Bill of Sale, attached hereto as **Exhibit "D."** Title to the Intangible Property shall be evidenced by the Assignment attached hereto as **Exhibit "C."** Title to the Personal Property and Intangible Property shall be conveyed free and clear from all liens, encumbrances and claims of any third parties.

4. **CONTINGENCIES.**

4.1. Buyer's obligation to purchase the Property is subject to the following contingencies described in subparagraphs (a) through (j), below in this Paragraph 4.1 ("Contingencies"). Each and all of the following Contingencies are for the sole benefit of Buyer and may be waived or deemed satisfied by Buyer in Buyer's sole and absolute discretion.

(a) Buyer's obtaining a loan, by _____, 20__ (secured by a first Deed of Trust encumbering the Property) of not less than ________________ Dollars ($________), for a term of not less than ___________ (___) years, at an interest rate not to exceed _____ percent (____%) per annum, with customary loan fees and costs.

(b) Buyer's review and approval of the Preliminary Report and all recorded exceptions to title within _____ (___) days after receipt thereof. **[If buyer is obtaining ALTA title insurance coverage, or if the Buyer otherwise requires a survey, approval of a survey by Buyer should also be a Contingency. Additionally, if ALTA coverage is contemplated, a provision should be added designating which party will procure the survey and which party will pay for the survey.]**

(c) Buyer's inspection and examination of the physical condition of the Property. Buyer shall have access to the property at reasonable times and shall have the right to conduct, at Buyer's expense, soil tests, engineering feasibility studies, environmental investigations and such other studies with respect to the physical condition of the Property as Buyer may desire. Buyer shall have until ___________, 20__, to conduct such tests and studies, and to give written notice to Seller of any conditions unacceptable to Buyer. Buyer shall hold and save Seller harmless from and against any and all loss, cost, damage, liability, injury or expense, arising out of or in any way related to damage to property, injury to or death of persons, or the assertion of lien claims caused by such entry, inspection and implementation of soil tests, environmental investigations and other studies with respect to the physical condition of the Property. If Buyer elects to terminate this Agreement by reason of failure of the Contingency set forth in this subparagraph (c), Buyer shall promptly upon such election deliver to Seller all written reports, studies and information prepared by third parties for Buyer which pertain to the physical condition of the Property.

(d) Buyer's determination that zoning and other governmental regulations affecting the use of the Property are satisfactory for Buyer's intended use. Buyer shall have until ___________, 20__ to make such determination and to give written notice to Seller of any zoning or governmental regulations which are unacceptable to Buyer.

(e) Buyer's satisfaction, by ___________, 20__, that it can secure the right, under applicable zoning and land use laws, regulations, and ordinances to change the present zoning of the Real Property from ___________ to ___________.

(f) Buyer's ability to obtain, by ___________, 20__ the following licenses or permits: ________________.

(g) Buyer's approval of the Leases and Other Contracts within ___ (_) days after Seller's delivery thereof to Buyer.

(h) Buyer's approval of the Updated Rent Roll within _____ (___) days after Seller's delivery thereof to Buyer.

(i) Buyer's approval of the architectural drawings, plans and specifications (including final as-built drawings) for the Improvements, within ___________ (___) days after Seller's delivery thereof to Buyer.

(j) Buyer's review and approval of the Income and Expense Records for the Property by ___________, 20__.

If Buyer disapproves of the satisfaction of any Contingency within the applicable time period provided above, Buyer's sole remedy shall be to terminate this Agreement and Seller shall have no obligation to remedy any Contingency which Buyer disapproves. If this Agreement terminates as a result of the failure of the satisfaction of any of the Contingencies, all sums and

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documents deposited in Escrow shall be returned to the parties who respectively deposited the same, and Buyer and Seller shall each pay one-half (1/2) of the Escrow costs.

4.2. If Buyer fails to give written notice to Seller of its disapproval of any Contingency within the respective applicable time limit set forth above in Paragraph 4.1, it shall conclusively be deemed that Buyer has waived such Contingency and such Contingency shall conclusively be deemed satisfied.

5. EXCHANGE.

5.1. Buyer and Seller acknowledge that Seller shall have the right to cause this Agreement to be modified so that Seller may effectuate an exchange under the Internal Revenue Code of 1954, and the California Revenue and Taxation Code. Seller shall exercise its right to modify this Agreement by giving Buyer written notice by no later than **_____** (_) calendar days prior to the date scheduled for the Close of Escrow. Buyer shall bear no additional cost, expense or liability (whether actual or contingent) as a result of the exchange transaction and shall not be required to take title to any other property as part of such exchange transaction. If the parties to this Agreement are unable to agree as to the terms of the modification of this Agreement to allow Seller to exchange the Property by **_____**, 20**__**, the Close of Escrow shall take place as if the Seller had not exercised its right to exchange the property for Other Property. **[Note: Due to potential liability arising from the environmental condition of real property, it is unwise for a Buyer to take title to a second piece of property merely to accommodate the Seller's desire to effectuate a tax-deferred exchange. See Chapter 5.]**

6. REPRESENTATIONS AND WARRANTIES BY SELLER.

6.1. Seller makes the representations and warranties in this Paragraph 6, each and all of which shall survive any and all inquiries and investigations made by Buyer and shall survive the Close of Escrow and recordation of the Grant Deed.

6.1.1. **_____** is a **[corporation, partnership, etc.]** duly organized, validly existing and in good standing under the laws of the State of California which has the power and authority to enter into this Agreement and to consummate the transactions contemplated hereby. The Seller and the specific, individual parties signing this Agreement on behalf of Seller represent and warrant that the parties signing this Agreement on behalf of the Seller have the full legal power, authority and right to execute and deliver this Agreement.

6.1.2. Neither the entering into this Agreement nor the performance of any of Seller's obligations under this Agreement will violate the terms of any contract, agreement or instrument to which Seller is a party.

6.1.3. To the best of Seller's knowledge, the Real Property is zoned to permit the operation of a **[describe type of project; e.g. office building, shopping center, apartment project, etc.].** Seller has not actually received any formal, written notice of any pending change in zoning from any governmental or quasi-governmental authority, which change would materially affect the present zoning of the Land or the present use of the Real Property. The term “formal written notice” as used in this Agreement shall mean that kind and method of notice which must legally be given to the owner of the Real Property, but shall not mean notice by publication.

6.1.4. Seller has not actually received any formal written notice of any pending widening, modification or realignment of any street or highway contiguous to the Real Property or any existing or proposed eminent domain proceeding which would result in a taking of all or any part of the Real Property.

6.1.5. Seller has not actually received any formal written notice that any of the easements, covenants, conditions, restrictions or agreements to which the Real Property is subject interferes with or is breached by the use or operation of the Real Property as presently used and operated as a **[describe type of project].**

6.1.6. Seller has not been served (by means of formal, legal service of process as required by law) with any litigation, and no arbitration proceedings have been commenced, which do or will affect any aspect of the Property or Seller's ability to perform

its obligations under this Agreement. In addition, within the last ____________ (___) **[years or months],** Seller has not been threatened in writing with any litigation (or arbitration) by a third party which would affect any aspect of the Property or Seller's ability to perform its obligations under this Agreement.

6.1.7. Seller has not actually received any formal written notice of any presently uncured violation of any law, ordinance, rule or regulation (including, but not limited to, those relating to zoning, building, fire, health and safety) of any governmental, quasi-governmental authority bearing on the construction, operation, ownership or use of the Property.

6.1.8. There are not any written commitments to, or written agreements with, any governmental or quasi-governmental authority or agency materially affecting the Property which have not been heretofore disclosed by Seller to Buyer in writing.

6.1.9. Seller has not been served (by means of formal, legal service of process as required by law) or formally notified in writing by any governmental or quasi-governmental authority (i) that the Real Property or any adjoining property, contains or may contain any "Hazardous Materials" in violation of any "Environmental Regulations" (as those terms are defined in Paragraph 6.1.10, below); or (ii) that the Seller has stored, used or maintained Hazardous Materials or suffered, permitted, allowed or acquiesced in any storage, use or maintenance of Hazardous Materials on, in or under the Real Property in violation of any Environmental Regulations. In addition, to the best of Seller's knowledge, but without any specific investigation therefore, there are no Hazardous Materials in any way relating to all or any portion of the Real Property or the area surrounding the Real Property.

6.1.10. As used in this Agreement, the terms "Environmental Regulations" and "Hazardous Materials" shall have the following meanings:

(a) "Environmental Regulations" shall mean all applicable statutes, regulations, rules, ordinances, codes, licenses, permits, orders, approvals, plans, authorizations, and similar items, of all governmental agencies, departments, commissions, boards, bureaus or instrumentalities of the United States, states and political subdivisions thereof and all applicable judicial and administrative and regulatory decrees, judgments and orders relating to the protection of human health or the environment, including, without limitation: (i) all requirements, including but not limited to those pertaining to reporting, licensing, permitting, investigation and remediation of emissions, discharges, releases or threatened releases of Hazardous Materials, whether solid, liquid or gaseous in nature, into the air, surface water, groundwater or land, or relating to the manufacture, processing, distribution, use, treatment, storage, disposal, transport or handling of Hazardous Materials, whether solid, liquid or gaseous in nature; and (ii) all requirements pertaining to the protection of the health and safety of employees or the public.

(b) "Hazardous Materials" shall mean (i) any flammables, explosive or radioactive materials, hazardous wastes, toxic substances or related materials including, without limitation, substances defined as "hazardous substances," "hazardous materials," "toxic substances" or "solid waste" in the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended, 42 U.S.C. Sec. 9601, et seq.; the hazardous Materials Transportation Act, 49 U.S.C. Section 1801, et seq.; the Toxic Substances Control Act, 15 U.S.C., Section 2601 et seq.; the Resource Conservation and Recovery Act of 1976, 42 U.S.C. Section 6901 et seq.; and in the regulations adopted and publications promulgated pursuant to said laws; (ii) those substances listed in the United States Department of Transportation Table (49 C.F.R. 172.101 and amendments thereto) or by the Environmental Protection Agency (or any successor agency) as hazardous substances (40 C.F.R. Part 302 and amendments thereto); (iii) those substances defined as "hazardous wastes," "hazardous substances" or "toxic substances" in any similar federal, state or local laws or in the regulations adopted and publications promulgated pursuant to any of the foregoing laws or which otherwise are regulated by any governmental authority, agency, department, commission, board or instrumentality of the United States of America, the State of California or any political subdivision thereof; (iv) any pollutant or contaminant or hazardous, dangerous or toxic chemicals, materials, or substances within the meaning of any other applicable federal, state, or local law, regulation, ordinance, or requirement (including consent decrees and administrative orders) relating to or imposing liability or standards of conduct concerning any hazardous, toxic or dangerous waste, substance or material, all as amended; (v) petroleum or any by-products thereof; (vi) any radioactive material, including any source, special nuclear or by-product material as defined at 42 U.S.C. Sections 2011 et seq., as amended, and in the regulations adopted and publications promulgated pursuant to said law; (vii) asbestos in any form or condition; and (viii) polychlorinated biphenyls.

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6.1.11. The term “Leases” means all written agreements between Seller and all parties having rights to occupy or possess the Property. By ___________ (___), Seller shall deliver to Buyer true and complete copies of all the Leases. A schedule of all Leases as of ___________, 20__, is attached hereto as **Exhibit “E,”** listing all Leases, the duration of each, the then current rental payable under each, and certain other information respecting each such Lease (“Rent Roll”). Except as set forth in the Rent Roll, there are no other Leases in force as of the date of this Agreement, and no person, other than (i) the tenants named in the Leases; and (ii) those parties who have rights under any Permitted Exception, have any right to use, occupy or possess the Property or any portion thereof. Except as set forth in the Rent Roll, no rent concessions are due any tenant; no rent has been paid more than one (1) month in advance by any tenant; no security or other deposit or advance payments of any kind have been made by any tenant; no tenant has any claim against Seller for any security deposit or other deposits (except for the return of the unused portion of their security deposit at the termination of the tenant's lease); no breach exists on the part of any tenant, whether in the payment of rent (or other sum), or the performance of any obligations or covenant under their respective Lease; and no tenant has any defense or off-set to rent or any other obligation accruing after the Close of Escrow. Each of the Leases described in the Rent Roll is in full force and effect. Seller has not received any written notice of any breach on the part of Seller under any Lease. After the execution of this Agreement, no Lease will be modified or amended and there will be no new Leases except those employing the form of Lease attached hereto as **Exhibit “F,”** (and only then for a rental of ___________). **[identify here the parameters for rent rates and other terms and conditions for any Leases to be signed after the date of the Agreement, but before the Close of Escrow].** There are no oral agreements for the use, occupancy or possession of the Property or any portion thereof. There are no oral agreements with any tenant, which materially change the terms of any of the Leases or which would make the information on the Rent Roll materially inaccurate. If, by ___________, 20__, any of the information in the Rent Roll and/or any of the representations and warranties of Seller in this Paragraph 6.1.11 have become untrue, Seller shall provide Buyer with an updated rent roll (“Updated Rent Roll”) and the representations and warranties made by Seller in this Paragraph 6.1.11 shall be deemed to be made with respect to the Updated Rent Roll.

6.1.12. As used herein, the term “Other Contracts” means all agreements, written and oral, to which Seller is a party and which directly affect the ownership or operation of the Property (other than the Leases). As of the date of this Agreement, there are no Other Contracts except those listed in **Exhibit “G,”** attached hereto. By _____, 20__, Seller shall deliver to Buyer true and complete copies of all Other Contracts. All of the Other Contracts may be terminated without penalty upon the giving of not more than thirty (30) days' notice by Seller (or Seller's successor-in-interest to the Property). There is no material default or breach by Seller, or any other party, to any Other Contract. Prior to the Close of Escrow, no Other Contract will be modified or amended without the written consent of Buyer, and there will be no additional Other Contracts without the prior written consent of Buyer.

6.1.13. Until the Close of Escrow, the Property will continue to be operated in substantially the same manner as operated as of the date of this Agreement. Seller will not do or cause anything to be done that would change, alter or modify the operation of the Property as a [describe type of project] in the manner in which it is operated as of the date of this Agreement, without the prior written consent of Buyer.

6.1.14. Seller has neither engaged nor dealt with any broker or finder in connection with the sale contemplated by this Agreement except for ___________ (“___”). Seller shall pay, and shall hold Buyer harmless from and against, any commission or finder's fee payable to ___________ or any other party who represents or claims to represent Seller.

6.1.15. Seller will not alter the physical condition of the Property from and after the date of this Agreement, reasonable wear and tear excepted. If, through no fault of Seller, the physical condition of the Property is different on the date scheduled for the Close of Escrow as of the date of this Agreement, the terms and conditions of Paragraph 6.2, below shall apply. **[The Buyer may wish to require the Seller to deliver the subject property with all plumbing, heating, ventilation and air conditioning, and other systems in “good working order.”]**

6.2. If, prior to the Close of Escrow, new events have occurred which were beyond the control of Seller and which render any previously true representation or warranty untrue, Seller shall, within three (3) days thereafter, disclose those matters by written notice to Buyer. Buyer shall have ten (10) days after the earlier of (i) such disclosure; or (ii) Buyer's independent discovery that

such representation or warranty has become untrue, to elect, in its sole and absolute discretion, and as its sole remedy, by written notice to Seller within said ten (10) day period, whether (1) to purchase the Property; or (2) terminate this Agreement. If Buyer elects to terminate this Agreement pursuant to this Paragraph 6.2, Escrow shall immediately terminate upon Seller's receipt of Buyer's notice of election to terminate this Agreement and all sums and documents deposited in Escrow shall be returned to the parties who deposited the same and Seller and Buyer shall each pay one-half (1/2) of Escrow costs. If Buyer fails to notify Seller and Escrow Holder of its election to terminate this Agreement within said ten (10) day time period provided above, Buyer shall be deemed to have accepted the modified representations and warranties and elected to purchase the Property.

6.3. The books and records pertaining to operating income and expenses of the Property for the three (3) most recent years of operation ("Income and Expense Records") thereto shall be open to inspection by Buyer or Buyer's agents during regular business hours upon reasonable notice after the date hereof, and Seller shall cooperate with Buyer or Buyer's agents during regular business hours upon reasonable notice after the date hereof.

6.4. Other than those express representations and warranties contained in this Agreement, Seller makes no warranty or representation, express or implied, including but not limited to, implied warranties of merchantability and fitness for a particular purpose.

6.5. Except to the extent Seller has made a specific representation and warranty with respect thereto, no document or information provided by Seller to Buyer shall constitute a representation as to the completeness or accuracy of such documents or information. **[The Buyer may want the Seller to deliver various documents in the Seller's files (such as reports, studies, geological investigations, etc.). Although the Seller may be willing to accommodate the Buyer as a courtesy only, the Seller does not want to be liable in the event such information is inaccurate or incomplete. Therefore, care should be taken to specifically indicate those documents and information as to which the Seller makes a representation and warranty as to their contents, and which documents and information are being provided only as a courtesy to the Buyer.]**

6.6. **[Consider whether, on behalf of the Seller, you want to define "Seller's knowledge" as being limited to the knowledge of specific individuals. For example, limit the representations to the knowledge of the Property Manager or a specific principal of the Seller who would likely be in a position to know the facts pertaining to the representation.]**

7. **REPRESENTATIONS AND WARRANTIES BY BUYER.**

7.1. Buyer makes the following representations and warranties in this Paragraph 7, each and all of which shall survive any and all inquiries and investigations made by Seller and shall survive the Close of Escrow and recordation of the Grant Deed.

7.1.1. Each and all of the information and any financial statement delivered by Buyer to Seller is true and correct. **[Typically, this representation is only made if the transaction is seller financed. However, even in a non-seller financed transaction, the Seller may want to review the Buyer's financial statement before executing the contract. By including this representation and warranty, the Seller may also be able to sue for fraud (punitive) damages if the representation or warranty is untrue. Nevertheless, the Buyer may want to include a provision similar to that in Paragraph 6.2, above, which states that, if the financial condition of the Buyer changes prior to the Close of Escrow, Buyer will notify Seller and Seller will have the right to terminate the Agreement.]**

7.1.2. Buyer has neither engaged nor dealt with any broker or finder in connection with the sale contemplated by this Agreement except for **_________________** ("**____________**"). Buyer shall pay, and hold Seller harmless from and against, any commission or finder's fee payable to **_____**, **_____**, or any other party who represents or claims to represent Buyer. **[This representation and warranty will need to be modified if the Buyer has no obligation to pay a broker's commission.]**

7.1.3. **_____** is a **[corporation, partnership, etc.]** duly organized, validly existing and in good standing under the laws of the State of California which has the power and authority to enter into this Agreement and to consummate the transactions contemplated hereby. The Buyer, and the specific, individual parties signing this Agreement on behalf of Buyer represent and warrant that

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the parties signing this Agreement on behalf of the Buyer have the full legal power, authority and right to execute and deliver this Agreement.

7.1.4. Buyer has or will make its own investigation concerning the physical condition of the Property, condition of title or any other matter pertaining to the Property, and, other than the specific representations and warranties made by Seller pursuant to this Agreement, Buyer is not relying on any representations, warranties or inducements of Seller or Seller's broker with respect to the physical condition of the Property, condition of title to the Property, or any other matter pertaining to the Property. Accordingly, except for those specific representations and warranties of Seller set forth in this Agreement, Buyer is purchasing the Property and each and every aspect thereof in an "as-is" condition.

8. INDEMNIFICATION.

8.1. Subject to any other provisions of this Agreement to the contrary, each party ("Indemnitor") agrees to indemnify and hold the other party ("Indemnitee") harmless from and against any claim, loss, damage or expense, including any reasonable attorneys' fees (including attorneys' fees on appeal), asserted against or suffered by the Indemnitee resulting from:

(a) Any breach by the Indemnitor of this Agreement;

(b) Any liability of the Indemnitor with respect to the Property, under the Leases or Other Contracts, or otherwise, as provided in Paragraph 9, below; or

(c) The inaccuracy or breach of any of the representations, warranties or covenants made by the Indemnitor.

8.2. The Indemnitee shall submit any claim for indemnification under this Agreement to the Indemnitor in writing within a reasonable time after Indemnitee determines that an event has occurred which has given rise to a right of indemnification under this Paragraph 8 and shall give Indemnitor a reasonable opportunity to investigate and cure any default of Indemnitor under this Agreement and eliminate or remove any claim by a third party. Notwithstanding the foregoing, if the nature of Indemnitor's default or the third party claim is such that it would be impractical or unreasonable to give Indemnitor an opportunity to investigate and cure such default and remove such claim, Indemnitee need not give Indemnitor such opportunity.

8.3. If such claim for indemnification relates to a claim or demand presented in writing by a third party against Indemnitee, Indemnitor shall have the right to employ counsel reasonably acceptable to Indemnitee to defend any such claim or demand, and Indemnitee shall make available to Indemnitor, or its representatives, all records and other materials in its possession or under its control reasonably required by Indemnitor for its use in contesting such liability. If Indemnitor does not elect to defend any such claim or demand, Indemnitee may do so at its option, but shall not have any obligation to do so.

9. ASSUMPTION OF LIABILITIES.

9.1. Effective as of the Close of Escrow, Buyer shall be deemed to have assumed all obligations and liabilities of Seller pertaining to the Property or under the Other Contracts, except all obligations and liabilities with respect thereto which arise prior to the Close of Escrow or which arise as a result of events which occur prior to the Close of Escrow. Except for the foregoing assumption of obligations and liabilities by Buyer, Buyer does not assume and shall not be liable for any of the obligations or liabilities of Seller of any kind or nature affecting or otherwise relating to Seller, the Property, the Leases, the Other Contracts, or otherwise.

9.2. Seller shall, prior to the Close of Escrow, timely perform and discharge all obligations and liabilities of every kind whatsoever to be discharged prior to the Close of Escrow and arising from or relating to (i) the Property, including, but not limited to, the use and ownership of the Property; (ii) the operation of the Property; (iii) the Leases; and (iv) the Other Contracts.

10. LIQUIDATED DAMAGES.

IF BUYER FAILS TO COMPLETE THE PURCHASE OF THE PROPERTY AS HEREIN PROVIDED BY REASON OF ANY DEFAULT OF BUYER, IT IS AGREED THAT THE DEPOSITS ACTUALLY MADE PURSUANT TO PARAGRAPHS 2(a) AND 2(b) OF THIS AGREEMENT SHALL BE NON-REFUNDABLE AND SELLER SHALL BE

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ENTITLED TO SUCH DEPOSITS, WHICH AMOUNTS SHALL BE ACCEPTED BY SELLER AS LIQUIDATED DAMAGES AND NOT AS A PENALTY AND (TOGETHER WITH THE RIGHT TO RECOVER ATTORNEY'S FEES AS PROVIDED IN THIS AGREEMENT) SHALL BE SELLER'S SOLE AND EXCLUSIVE REMEDY. IT IS AGREED THAT SAID AMOUNT CONSTITUTES A REASONABLE ESTIMATE OF THE DAMAGES TO SELLER PURSUANT TO CALIFORNIA CIVIL CODE SECTION 1671 ET SEQ. BUYER AND SELLER AGREE THAT IT WOULD BE IMPRACTICAL OR IMPOSSIBLE TO PRESENTLY PREDICT WHAT MONETARY DAMAGES SELLER WOULD SUFFER UPON BUYER'S FAILURE TO COMPLETE ITS PURCHASE OF THE PROPERTY. BUYER DESIRES TO LIMIT THE MONETARY DAMAGES FOR WHICH IT MIGHT BE LIABLE HEREUNDER AND BUYER AND SELLER DESIRE TO AVOID THE COSTS AND DELAYS THEY WOULD INCUR IF A LAWSUIT WERE COMMENCED TO RECOVER DAMAGES OR OTHERWISE ENFORCE SELLER'S RIGHTS. IF FURTHER INSTRUCTIONS ARE REQUIRED BY ESCROW HOLDER TO EFFECTUATE THE TERMS OF THIS PARAGRAPH 10, BUYER AND SELLER AGREE TO EXECUTE THE SAME. THE PARTIES ACKNOWLEDGE THIS PROVISION BY PLACING THEIR INITIALS BELOW:

BUYER: ___________ SELLER: ___________

11. ARBITRATION OF DISPUTES.

IF ANY CLAIM OR DISPUTE ARISES UNDER THIS AGREEMENT, THEN SUCH DISPUTE SHALL BE RESOLVED BY A GENERAL REFERENCE PURSUANT TO CALIFORNIA CODE OF CIVIL PROCEDURE SECTION 638 AND IN ACCORDANCE WITH THE FOLLOWING PROVISIONS OF THIS PARAGRAPH 11. IT IS THE INTENT OF THE PARTIES TO THIS AGREEMENT THAT THIS REFERENCE AGREEMENT PROVISION BE SPECIFICALLY ENFORCEABLE, AS FOLLOWS:

(a) A CONTROVERSY, DISPUTE OR CLAIM ARISING OUT OF OR PERTAINING TO THIS AGREEMENT SHALL BE TRIED BY A REFEREE UNDER AN ORDER OF GENERAL REFERENCE TO TRY ALL ISSUES OF FACT AND LAW, WHETHER LEGAL OR EQUITABLE, TO BE CHOSEN BY COUNSEL FOR THE PARTIES FROM A LIST OF RETIRED SUPERIOR COURT JUDGES FURNISHED BY THE ___________ SUPERIOR COURT, WITH ALL PARTIES HEREBY WAIVING ANY RIGHT TO A TRIAL BY JURY. IF COUNSEL ARE UNABLE TO AGREE, THEN THE REFEREE SHALL BE APPOINTED BY THE COURT IN ACCORDANCE WITH CODE OF CIVIL PROCEDURE SECTION 640, WITH EACH PARTY ENTITLED TO ONLY ONE DISQUALIFICATION PURSUANT TO CODE OF CIVIL PROCEDURE SECTION 170.6. THE TRIAL SHALL BE CONDUCTED AND THE ISSUES DETERMINED IN COMPLIANCE WITH ALL JUDICIAL RULES AND ALL STATUTORY AND DECISIONAL LAW OF THE STATE OF CALIFORNIA, AS IF THE MATTER WERE FORMALLY LITIGATED IN SUPERIOR COURT AND NOT BY WAY OF A REFERENCE. THE PREVAILING PARTY IN THE REFERENCE SHALL BE ENTITLED TO RECEIVE AS PART OF THE JUDGMENT IN ITS FAVOR AN AWARD OF ALL ACTUAL ATTORNEYS' FEES AND COSTS INCURRED WITH RESPECT TO THE REFERENCE, PLUS INTEREST AT THE HIGHEST RATE PERMITTED BY LAW AS NOT BEING USURIOUS FROM AND AS OF THE DATE OF THE ALLEGED BREACH.

(b) THE REFEREE SHALL CONDUCT AND DECIDE ALL PRE-TRIAL AND POST-TRIAL PROCEDURES WHICH MAY ARISE AS IF THE MATTER WERE FORMALLY LITIGATED IN THE SUPERIOR COURT. THE JUDGMENT ENTERED UPON THE DECISION OF THE REFEREE SHALL BE SUBJECT TO ALL POST-TRIAL PROCEDURES AND TO APPEAL IN THE SAME MANNER AS AN APPEAL FROM ANY ORDER OF JUDGMENT IN A CIVIL ACTION. ALL RULES OF EVIDENCE AS SET FORTH IN THE CALIFORNIA EVIDENCE CODE, OTHER STATUTORY AND DECISIONAL LAW OF CALIFORNIA AND ALL ___________ COUNTY SUPERIOR COURT RULES AND CALIFORNIA RULES OF COURT SHALL BE APPLICABLE TO ANY PROCEEDING BEFORE THE REFEREE. THE TRIAL SHALL BE CONDUCTED ON CONSECUTIVE DATES, AS OPPOSED TO BEING CONDUCTED PIECEMEAL ON VARIOUS DATES SEPARATED BY POSTPONEMENTS

OR ADJOURNMENTS, AND IS TO BE CONDUCTED IN A COURTROOM IF AT ALL POSSIBLE AND, IF NOT, IN SURROUNDINGS WITH FORMALITY AS CLOSE TO A COURTROOM AS POSSIBLE.

(c) THIS REFERENCE AGREEMENT MAY BE SPECIFICALLY ENFORCED BY THE FILING OF A COMPLAINT OR PETITION OR MOTION SEEKING SPECIFIC ENFORCEMENT OR BY MOTION DIRECTED TO THE LAW AND MOTION DEPARTMENT OF THE ___________ SUPERIOR COURT RULES.

(d) NOTICE: BY INITIALING IN THE SPACE BELOW, YOU ARE AGREEING TO HAVE ANY DISPUTE ARISING OUT OF THE MATTERS INCLUDED IN THE "ARBITRATION OF DISPUTES" PROVISION DECIDED BY NEUTRAL ARBITRATION AS PROVIDED BY CALIFORNIA LAW AND YOU ARE GIVING UP ANY RIGHTS YOU MIGHT POSSESS TO HAVE THE DISPUTE LITIGATED IN A COURT OR JURY TRIAL. BY INITIALING IN THE SPACE BELOW YOU ARE GIVING UP YOUR JUDICIAL RIGHTS TO DISCOVERY AND APPEAL, UNLESS THOSE RIGHTS ARE SPECIFICALLY INCLUDED IN THE "ARBITRATION OF DISPUTES" PROVISION, ABOVE. IF YOU REFUSE TO SUBMIT TO ARBITRATION AFTER AGREEING TO THIS PROVISION, YOU MAY BE COMPELLED TO ARBITRATE UNDER THE AUTHORITY OF THE CALIFORNIA CODE OF CIVIL PROCEDURE. YOUR AGREEMENT TO THIS PROVISION IS VOLUNTARY.

WE HAVE READ AND UNDERSTAND THE FOREGOING AND AGREE TO SUBMIT DISPUTES ARISING OUT OF THE MATTERS INCLUDED IN THE "ARBITRATION OF DISPUTES" PROVISION, ABOVE, TO NEUTRAL ARBITRATION.

BUYER: ___________ SELLER: ___________

[Note: Borrower and Seller may want to modify the foregoing arbitration provision to provide that the arbitration will be held in accordance with the rules of a specific arbitration association, such as the American Arbitration Association or Judicial Arbitration and Mediation Services, Inc. ("JAMS"). In addition, the arbitration provision can be modified to limit discovery and control other issues. See text of Chapter 4.]

[Note: Consider whether you want to include a mediation requirement. Mediation is a non-binding alternative dispute resolution method. The advantage to mediation is that it may result in a quick, inexpensive settlement. The disadvantage is that, if no settlement is reached, it will have involved an unnecessary expenditure of time and legal fees.]

In any event, the Seller will want the right to be able to file a lawsuit and record a lis pendens irrespective of whether arbitration or mediation is required under the Agreement.

12. **BUYER'S WAIVER OF RIGHT TO COMPEL SPECIFIC PERFORMANCE.**

As an inducement to Seller to enter into this Agreement, Buyer specifically agrees that it shall not have, and hereby forever relinquishes and waives, any right to compel Seller to specifically perform this agreement or otherwise compel Seller to sell the Property to Buyer. Buyer further acknowledges and agrees that the Property is not unique; that the Property is being purchased for speculative, investment purposes; that Buyer will not suffer irreparable harm if Seller fails to convey title; and that money damages will be an adequate remedy to compensate Buyer for Seller's failure to sell the Property to Buyer. Buyer hereby agrees that it will not, and waives any right to, file any lis pendens against the Property (or any portion thereof) and Buyer further waives any right to seek specific performance under California Civil Code Sections 3384, et seq. Note: Obviously, the Buyer will not want to agree to this provision because it will preclude the Buyer from compelling the Seller to sell Buyer the property.

13. **ESCROW AND CLOSING.**

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13.1. As soon as possible after the full execution of this Agreement, Buyer and Seller shall open an escrow for the purpose of consummating the purchase and sale contemplated by this Agreement (“Escrow”) by depositing an executed copy of this Agreement with ________________ Company, at ________________, ________________, California (“Escrow Holder”). This Agreement shall constitute escrow instructions to Escrow Holder. Seller and Buyer shall, promptly upon request by Escrow Holder, execute such additional escrow instructions as may be reasonably required by Escrow Holder, including Escrow Holder's standard printed conditions and stipulations with respect to escrows concerning the purchase and sale of real property; provided, however, that if there is any conflict between the provisions of this Agreement and the provisions of any such additional instructions, the provisions of this Agreement shall prevail. Upon delivery to Escrow of a fully executed copy of this Agreement by both parties, Escrow shall be deemed opened on the terms and conditions set forth in this Agreement.

13.2. Escrow shall close, and the Grant Deed shall be recorded in the Office of the County Recorder of ________________ County, California on ___________, 20__ (“Close of Escrow”).

13.3. Within the time set forth below, or if none is specified, prior to the Close of Escrow, Seller shall deliver to Escrow Holder, or if so indicated, to Buyer, the following documents and items:

(a) At least one (1) day prior to the Close of Escrow, the duly executed and acknowledged Grant Deed.

(b) At least one (1) day prior to the Close of Escrow, a duly executed Bill of Sale in the form of **Exhibit “D,”** evidencing the transfer to Buyer of all of Seller's right, title and interest in and to the Personal Property.

(c) At least one (1) day prior to the Close of Escrow, an executed and acknowledged Assignment of Leases in the form of **Exhibit “H,”** evidencing the assignment to Buyer of all of Seller's right, title and interest in and to the Leases.

(d) At least one (1) day prior to the Close of Escrow, an executed and notarially acknowledged Assignment in the form of **Exhibit “C,”** evidencing the assignment to Buyer of all of Seller's right, title and interest in and to the Intangible Property.

(e) At least one (1) day prior to Close of Escrow, Seller shall deliver such certifications, declarations or other documents as may be required under Internal Revenue Code § 1445 and California Revenue and Tax Code § 18662, together with any and all other documents required by law pertaining to foreign or out-of-state sellers.

(f) To Buyer at the location of the Property, at Close of Escrow, all original executed counterparts of each Lease, Other Contract, Permit (as that term is defined in the Agreement) and Warranty (as that term is defined in the Assignment). To Buyer and Escrow Holder, by no later than ___________, 20__, the Updated Rent Roll.

(g) To Buyer, upon Close of Escrow, one (1) executed letter addressed to all the tenants of the Property advising them of the consummation of the purchase and sale of the Property and directing the tenants to pay the rent and other charges due under the Leases to Buyer.

(h) To Buyer, at the location of the Property, at Close of Escrow, all keys to the Property, adequately and properly labeled.

(i) To Buyer, at the location of the Property at Close of Escrow, all books, records, booklets, catalogs, advertising material and manuals regularly maintained by Seller at the Property relating to the use or operation of the Property, but excepting from the foregoing Seller's standard operational manuals.

(j) To Buyer, at least ___ (_) days prior to the Close of Escrow, a termite and pest control report prepared by a California licensed pest exterminator and paid for by Seller at its sole cost and expense, showing accessible areas of the Improvements to be free of visible infestation caused by wood destroying insects, fungi and dry rot.

(k) To Buyer at the Property, such executed and completed applications as may be required to effectuate a transfer to Buyer of the Permits (as that term is defined in the Assignment).

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13.4. Buyer shall deliver to Escrow Holder prior to the Close of Escrow the balance of the cash portion of the Purchase Price set forth in Paragraph 2, as adjusted pursuant to this Agreement, together with an additional sum sufficient to cover Buyer's closing costs as set forth in Paragraph 13.7.2, below.

13.5. On the Close of Escrow, the Escrow Holder shall record the Grant Deed and shall deliver the monies and instruments to which each party is entitled pursuant to this Agreement, only when the Title Company is in a position to issue its CLTA **[or, if applicable, ALTA]** policy of title insurance subject only (i) to the Permitted Exceptions; and (ii) Title Company's standard pre-printed exceptions, with liability in the amount of the purchase price, showing title to the Real Property vested in Buyer (or as designated by Buyer) ("Title Policy").

13.6. Upon Close of Escrow, possession of the Property shall be delivered to Buyer subject to the Permitted Exceptions and all rights of tenants under the Leases, and the following items, documents and monies shall be delivered to the parties by Escrow Holder as set forth below:

(a) To Seller: the cash portion of the Purchase Price as set forth in Paragraph 2 as adjusted pursuant to this Agreement and reduced by the amount of Seller's closing costs as set forth in Paragraph 13.7.1, below.

(b) To Buyer: the Title Policy.

13.7. Upon Close of Escrow, Escrow and title charges shall be paid in the manner provided below.

13.7.1. Seller shall pay: **[Allocation of the following costs varies depending on local customary practice.]**

(a) The cost of the Title Policy.

(b) The cost of any and all documentary transfer tax or stamps or other sales tax.

(c) One-half (1/2) of the Escrow fees.

13.7.2. Buyer shall pay:

(a) One-half (1/2) of the cost of the Title Policy.

(b) All recording fees.

(c) One-half (1/2) of the Escrow fees.

13.8. If Escrow fails to close as a result of the default of this Agreement by a party, the defaulting party shall pay all title and escrow charges; provided, however, that nothing in this Paragraph 13 shall be deemed to limit, and the provisions of this Paragraph 13 shall be in addition to, all other rights and remedies of the non-defaulting party.

13.9. Escrow Holder is authorized and instructed to debit Seller for Seller's closing costs as set forth in Paragraph 13.7.1, above.

14. **PRORATIONS.**

14.1. Prorations shall be made as of the Close of Escrow. All prorations shall be made on the basis of a thirty (30) day month and shall be paid in cash to Seller if it is entitled thereto, or shall be credited against the cash portion of the Purchase Price if Buyer is entitled thereto. Such prorations shall be made by Escrow Holder on the basis of a statement(s) approved by Buyer and Seller and deposited into the Escrow prior to the Close of Escrow. The date used for prorations is hereinafter referred to as the "Proration Date."

(a) All real estate taxes and all personal property taxes due and owing as of the Proration Date, and all penalties and interest thereon, shall be paid by Seller. Current real estate taxes, special assessments and personal property taxes which are not yet due and owing shall be prorated based upon the most recent tax bill, so that the portion of current taxes allocable to the period

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from the beginning of such tax year through the Proration Date shall be charged to and paid by Seller and the portion of the current taxes allocable to the portion of such tax year from the Proration Date to the end of such tax year shall be charged to and paid by Buyer. Proration of taxes and assessments shall be final as of the Proration Date, regardless of the amount of taxes or assessments that actually are, or subsequently become, due.

(b) Expenses of operating the Property (other than insurance premiums, taxes and utility charges) which were prepaid by Seller for a period beyond the Proration Date.

(c) Unpaid rent under the Leases for the period in which the Proration Date occurs shall be prorated as if the same had been collected by Seller. Buyer shall receive a credit against the cash portion of the Purchase Price payable by Buyer in an amount equal to all prepaid rent under the Leases which is applicable to the period after the Proration Date, and all unused security or other deposits under the Leases. To the extent rent applicable to the period prior to the Proration Date is collected by Buyer subsequent to the Proration Date, Buyer shall remit to Seller that portion of such rent applicable to the period prior to the Proration Date, less Buyer's cost of collection of same which Buyer has paid to third parties. Any rent recovered by Buyer subsequent to the Proration Date pertaining to a particular tenant shall first be applied to any delinquency of said tenant after the Proration Date. Nothing contained herein shall require buyer to endeavor to collect any rent which was delinquent as of the Proration Date.

14.2. Buyer shall be responsible for obtaining and paying for utility services from and after Close of Escrow.

15. DAMAGE OR DESTRUCTION PRIOR TO CLOSE OF ESCROW.

If the Property, or any portion thereof, is damaged or destroyed prior to the Close of Escrow from any cause whatsoever, whether an insured risk or not, including but not limited to, fire, flood, accident or other casualty which, according to the Buyer's and Seller's best estimate, would cost more than _________________ Dollars ($________) to repair, Buyer shall have the option, upon written notice to Seller, to either (i) terminate this Agreement; or (ii) purchase the Property. If Buyer elects to terminate this Agreement, Escrow shall immediately terminate upon Seller's receipt of Buyer's notice of election to terminate and Escrow Holder shall thereupon promptly return all documents, items and monies in its possession to the party who shall have deposited same with Escrow Holder. In the event of such termination, each party shall pay one-half (1/2) of the Escrow fees. If Buyer elects to purchase the Property, Buyer shall be entitled to, and Seller shall assign to Buyer, all insurance proceeds covering such damage or destruction and, in addition, Seller shall pay Buyer the amount of any deductible (which can be paid by Seller by means of a credit against the Purchase Price). In the event that Buyer's and Seller's best estimate of the cost of repair is _________________ Dollars ($________) or less, Buyer shall purchase the Property and be entitled to, and Seller shall assign to Buyer, all insurance proceeds covering such damage or destruction. In addition, the difference between the amount of insurance proceeds available and the cost of repair shall be deducted from the cash portion of the Purchase Price. Should any damage or destruction occur prior to the Close of Escrow, the date scheduled for the Close of Escrow shall be extended for a period of time not to exceed thirty (30) days, for the purpose of allowing Buyer and Seller sufficient time to estimate the cost of repair. If Buyer fails to notify Seller of its election under this Paragraph 15, Buyer shall be deemed to have elected to purchase the Property.

16. EMINENT DOMAIN.

16.1. The words “condemnation” or “condemned” as used in this Paragraph 16 shall mean the exercise of, or intent to exercise, the power of eminent domain expressed in writing, as well as the filing of any action or proceeding for such purpose, by any person, entity, body, agency or authority having the right or power of eminent domain (the “condemning authority”).

16.2. If Seller receives written notice from a condemning authority advising of a condemnation of all or any portion of the Property (“Condemnation Notice”), Seller shall immediately advise Buyer of same in writing and deliver therewith a copy of the Condemnation Notice. Within ten (10) days after Buyer's receipt of the Condemnation Notice, Buyer shall notify Seller of its election to either (i) terminate this Agreement and the Escrow; or (ii) purchase the Property. If Buyer elects to terminate this Agreement, Escrow shall immediately terminate upon Seller's receipt of Buyer's notice of election to terminate this Agreement and Escrow Holder shall thereupon promptly return all documents, items and monies in its possession to the party who shall have

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deposited same with Escrow Holder. In the event of such termination, each party shall pay one-half (1/2) of the Escrow fees. If Buyer elects to purchase the Property, Seller shall transfer to Buyer at the Close of Escrow all proceeds from condemnation or Seller's right to receive all such proceeds. If Buyer fails to notify Seller of its election under this Paragraph 16, Buyer shall be deemed to have elected to purchase the Property.

17. SURVIVAL OF CLOSE OF ESCROW.

All representations, warranties, covenants, conditions, agreements and obligations contained in or relating to this Agreement shall survive the Close of Escrow and the recordation of the Grant Deed and shall not merge therein unless specifically stated otherwise in this Agreement.

18. NOTICES.

All notices to be given pursuant to this Agreement shall be either (i) personally delivered; (ii) sent via certified or registered mail, postage prepaid; (iii) overnight courier (such as Federal Express, DHL, etc.); or (iv) by telecopy transmittal. If sent via certified or registered mail, receipt shall be deemed effective forty-eight (48) hours after being deposited in the United States mail. If sent via telecopy transmission, a confirming copy shall be sent to the sender, and receipt of the telecopy transmittal shall be deemed made twenty-four (24) hours after the sending thereof. If sent via overnight courier, receipt shall be deemed effective twenty-four (24) hours after the sending thereof. All notices to be given pursuant to this Agreement shall be given to the parties at the following respective address.

to Buyer:

....
....
....
Telecopier No.: _____

with a copy to:

....
....
....
Telecopier No.: _____

to Seller:

....
....
....
Telecopier No.: _____

with a copy to:

....
....
....
Telecopier No.: _____

to Escrow Holder:

....
....
....
Telecopier No.: _____

19. ENTIRE AGREEMENT.

This Agreement, and the Exhibits attached hereto, represent the entire Agreement between the parties in connection with the transactions contemplated hereby and the subject matter hereof and this Agreement supersedes and replaces any and all prior and contemporaneous agreements, understandings and communications between the parties, whether oral or written, with regard to

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the subject matter hereof. There are no oral or written agreements, representations or inducements of any kind existing between the parties relating to this transaction which are not expressly set forth herein. This Agreement may not be modified except by a written agreement signed by both Buyer and Seller. Without limiting the foregoing, Buyer and Seller expressly acknowledge and agree that they have not relied on any written or oral statements made by the other party's real estate broker in entering into this Agreement.

20. BINDING EFFECT.

This Agreement shall be binding upon and inure to the benefit of the parties hereto, their respective heirs, legal representatives, administrators, successors in interest and assigns. **[The parties may want to restrict assignment by the Buyer. Alternatively, the seller might permit assignment by the Buyer, but expressly provide that the assignment by the Buyer will not exonerate Buyer from its obligations under the Agreement.]**

21. WAIVER.

No waiver by any party at any time of any breach of any provision of this Agreement shall be deemed a waiver or a breach of any other provision herein or a consent to any subsequent breach of the same or another provision. If any action by any party shall require the consent or approval of another party, such consent or approval of such action on any one occasion shall not be deemed a consent to or approval of such action on any subsequent occasion or a consent to or approval of any other action.

22. CAPTIONS AND HEADINGS.

The captions and paragraphs numbers appearing in this Agreement are inserted only as a matter of convenience and do not define, limit, construe, or describe the scope or intent of this Agreement.

23. COUNTERPARTS.

This Agreement may be executed in counterparts, each of which shall be considered an original and all of which taken together shall constitute one and the same instrument.

24. GOVERNING LAW.

This Agreement has been prepared, negotiated and executed in, and shall be construed in accordance with, the laws of the State of California. Any action or proceeding relating to or arising out of this Agreement shall be filed, if a State action, in the Superior Court of the State of California for the County of ___________, or if a Federal action, in the United States District Court for the _____ District of California.

25. ATTORNEYS' FEES.

If either party named herein brings an action or proceeding to enforce the terms hereof or declare rights hereunder, the prevailing party in any such action (or proceeding), on trial or appeal, shall be entitled to its reasonable attorneys' fees to be paid by the losing party as fixed by the Court.

26. TIME OF ESSENCE.

Time is of the essence with respect to all matters contained in this Agreement.

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27. DATE OF AGREEMENT.

All references in this Agreement to "the date of this Agreement" or "the date hereof" shall be deemed to refer to the date set forth in the first paragraph of this Agreement.

28. INVALIDITY OF ANY PROVISION.

If any provision (or any portion of any provision) of this Agreement is held to be illegal, invalid, or unenforceable by a court of competent jurisdiction under present or future laws effective during the term of this Agreement, the legality, validity, and enforceability of the remaining provisions (or the balance of such provision) shall not be affected thereby.

29. NO RECORDATION.

Buyer shall not record this Agreement, any memorandum of this Agreement, any assignment of this Agreement, or any other document which would cause a cloud on the title to the Property.

30. DRAFTING OF AGREEMENT.

Buyer and Seller acknowledge that this Agreement has been negotiated at arm's length, that each party has been represented by independent counsel and that this Agreement has been drafted by both parties and no one party shall be construed as the draftsperson.

31. NO THIRD PARTY BENEFICIARY RIGHTS.

This Agreement is entered into for the sole benefit of Buyer and Seller and no other parties are intended to be direct or incidental beneficiaries of this Agreement and no third party shall have any right in, under or to this Agreement.

32. INCORPORATION OF EXHIBITS.

Each and all of the exhibits attached to this Agreement are incorporated herein as if set forth in full in this Agreement.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement as of the date set forth in the first paragraph of this Agreement.

"SELLER"
_________________,
a _________________
By: _________________
Its: _________________
"BUYER"
_________________,
a _________________
By: _________________
Its: _________________

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SCHEDULE OF EXHIBITS

Exhibit “A”	Legal Description of Land
Exhibit “B”	Personal Property
Exhibit “C”	Assignment of Intangible Property
Exhibit “D”	Bill of Sale
Exhibit “E”	Rent Roll
Exhibit “F”	Form of Lease
Exhibit “G”	Other Contracts
Exhibit “H”	Assignment of Leases

Exhibit “A”
Legal Description of Land

Exhibit “B”
Personal Property

Exhibit “C”
Assignment of Intangible Property

Exhibit “D”
Bill of Sale

Exhibit “E”
Rent Roll

Exhibit “F”
Form of Lease

Exhibit “G”
Other Contracts

Exhibit “H”
Assignment of Leases

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Cal. Prac. Guide Real Prop. Trans. Form 4:J

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 4. Purchase and Sale Agreement

Forms

[Form 4:J] Tenant Estoppel Certificate

TO WHOM IT MAY CONCERN:

Reference is made to that certain Lease, consisting of _ pages, dated _____, _, by and between ___________ as Lessor and ___________ as Lessee ("Lease") for lease of the space known as ________________ ("Premises").

The undersigned Lessee under the Lease acknowledges that Lessor is about to sell its interest in the property which is the subject of the Lease and the undersigned hereby certifies as follows:

1. The undersigned is now in possession of the Premises. The Lease term commenced on ___, _ and expires on ___________, _. The Lease is presently in full force and effect.

2. These are ___ options to extend the lease for periods of _ years each, of which (none have)/(_ has or have) been exercised. Lessee does not have any right of first refusal or option to lease any space in the building of which the Premises are a part.

3. Monthly rent is currently $________ and Lessee has not prepaid any rent or other charge other than ___________.

4. The security deposit now held by Lessor is the sum of $________.

5. The undersigned has accepted the Premises and has no claim, defense, set-off or counterclaim against the Lessor under the Lease.

6. All construction requirements respecting the Premises to be performed by the Lessor have been performed.

7. The Lease has not been amended or modified in any way, whether orally or in writing, except as noted below.

   Amendment dated ___________, consisting of _____ pages.

8. All tenant allowances agreed to be paid by the Lessor respecting the Premises have been paid.

9. There are presently no defaults by Lessor under the Lease, nor does anything exist which, with the giving of notice or passage of time, would constitute a default by Lessor under the Lease.

10. Lessee does not have any right of first refusal or option to purchase all or any portion of the building of which the Premises are a part.

Executed this _ day of ___________, _.

LESSEE

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Cal. Prac. Guide Real Prop. Trans. Form 4:K

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 4. Purchase and Sale Agreement

Forms

[Form 4:K] Sample General Conditions of Escrow Holder

[Author's Note: What follows is an example of standard, general conditions typically required by an escrow holder. However, remember that these terms are negotiable.]

1. Your duty to act as escrow holder shall not commence until these instructions, signed by all parties, are received by you. Until such time either party may unilaterally cancel and, upon written request delivered to you, a party may withdraw funds and documents such party previously handed to you.

2. All funds received in this escrow shall be deposited with a State or National bank with other escrow funds. Make disbursements by your check; checks not presented for payment within six months after date are subject to service charges in accordance with your schedule in effect from time to time. Make all adjustments and proratings on the basis of a 30 day month. “Close of Escrow” as used in this escrow means the date on which documents are recorded, unless otherwise specified. All documents and funds due the respective parties herein are to be mailed to the addresses set out below their respective signatures, unless otherwise instructed. Our signatures on any document and instructions pertaining to this escrow indicate our unconditional approval of same. Whenever provision is made herein for the payment of any sum, the delivery of any instrument or the performance of any act “outside of escrow”, you as escrow holder shall have no responsibility therefor, shall not be concerned therewith and are specifically relieved of any obligation relative thereto.

3. You shall not be responsible or liable in any manner whatsoever for the sufficiency or correctness as to form, manner of execution or validity of any documents deposited in escrow, nor as to the identity, authority or rights of any person executing the same, either as to documents of record or those handled in this escrow. Your duties hereunder shall be limited to the safekeeping of such money and documents received by you as escrow holder and for the disposition of the same in accordance with the written instructions accepted by you in this escrow. You shall not be required to take any action in connection with the collection or maturity of any obligations deposited in this escrow, unless otherwise instructed.

4. Seller represents and warrants, and you shall be fully protected, in assuming that as to any insurance policy handed you, such policy is in force, has not been hypothecated, and that all necessary premiums therefor have been paid. You will transmit for assignment any insurance policy handed you for use in this escrow, but you shall not be responsible for verifying the acceptance of the assignment and policy by the insurance company. ESCROW HOLDER WILL MAKE NO ATTEMPT TO VERIFY THE RECEIPT OF THE REQUEST FOR ASSIGNMENT BY THE ISSUING COMPANY. You are hereby placed on notice that if the insurance company should fail to receive said assignment, the issuing company may deny coverage for any loss suffered by Buyer. IT IS THE OBLIGATION OF THE BUYER OR HIS/HER REPRESENTATIVE TO VERIFY THE ACCEPTANCE OF THE ASSIGNMENT OF THE POLICY BY THE ISSUING COMPANY.

5. Deliver assurances of title, and insurance policies, if any, to holder of senior encumbrance or his/her order, or if there are no encumbrances, then to the buyer or his order.

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6. In the event that the conditions of this escrow have not been complied with at the expiration of the time provided for herein, or any extension thereof, you are instructed to complete the same at the earliest possible date thereafter, unless we or either of us has made written demand upon you for the return of the money and/or instruments deposited by either of us, in which case you may withhold and stop all further proceedings in this escrow without liability upon your part for interest on funds held or for damages until written mutual cancellation instructions signed by all parties shall have been deposited in this escrow, whereupon you are then instructed to disburse the escrow funds and instruments accordingly, less your proper charges, to the respective parties hereto whereupon this escrow will without further notice be considered terminated.

7. NO NOTICE, DEMAND OR CHANGE OF INSTRUCTIONS SHALL BE OF ANY EFFECT IN THIS ESCROW UNLESS GIVEN IN WRITING BY ALL PARTIES AFFECTED THEREBY. In the event conflicting demands or notices are made or served upon you or any controversy arises between the parties hereto, or with third persons, growing out of or relating to this escrow, you shall have the absolute right to withhold and stop all further proceedings in and performance of this escrow until you receive written notification satisfactory to you of the settlement of the controversy by agreement of the parties thereto, or by final judgment of a court of competent jurisdiction. All of the parties to this escrow hereby jointly and severally promise and agree to pay promptly on demand as well as to indemnify you and to hold you harmless from and against all litigation and interpleader costs, damages, judgments, attorney's fees, expenses, obligations and liabilities of every kind which, in good faith, you may incur or suffer in connection with or arise out of this escrow, whether said litigation, interpleader, obligations, liabilities or expenses arising during the performance of this escrow or subsequent thereto, directly or indirectly.

8. You are hereby authorized to deposit any funds or documents handed you under these escrow instructions, or cause the same to be deposited, with any duly authorized sub-escrow agent, subject to your order at or prior to close of escrow, in the event such deposit shall be necessary or convenient for the consummation of this escrow.

9. All parties agree that as far as your rights and liabilities are involved, this transaction is an escrow and not any other legal relation and you are an escrow holder only on the within expressed terms, and you shall have no responsibility of notifying any of the parties to this escrow of any sale, resale, loan, exchange, or other transaction involving any property herein described or of any profit realized by any person, firm or corporation (broker, agent and parties to this and/or any other escrow included) in connection therewith, regardless of the fact that such transaction(s) may be handled by you in this escrow or in another escrow. NO ACTION SHALL LIE AGAINST ESCROW HOLDER FOR ANY CLAIM, LOSS, LIABILITY OR ALLEGED CAUSE OF ACTION OF ANY KIND OR NATURE WHATSOEVER, HOWEVER CAUSED OR INCURRED, UNDER THIS ESCROW OR IN CONNECTION WITH THE HANDLING OR PROCESSING OF THIS ESCROW UNLESS BROUGHT WITHIN TWELVE (12) MONTHS AFTER THE CLOSE OF ESCROW.

10. You are not to be concerned with the giving of any disclosures except as expressly required by Federal or State law to be given by an escrow agent. Neither are you to be concerned with the effect of zoning ordinances, land division regulations, or building restrictions which may pertain to or affect the land or improvements that are the subject of this escrow.

11. The parties to this escrow have satisfied themselves outside of escrow that the transaction covered by this escrow is not in violation of the Subdivision Map Act or any other law regulating land division, and you as escrow holder are relieved of all responsibility and/or liability in connection therewith, and are not to be concerned with the enforcement of said laws.

12. In the event any Offer to Purchase, Deposit Receipt or any other form of Purchase Agreement is deposited in this escrow, it is understood that such document shall be effective only as between the parties signing said document. You as escrow holder are not to be concerned with the terms of such document and are relieved of all responsibility in connection therewith. You are to be concerned only with the directives specifically set forth in the escrow instructions and amendments thereto, and are not to be concerned with or liable for items designated as “memoranda” in the within escrow instructions nor with any other agreement or contract between the parties. You are authorized to furnish copies of escrow instructions, supplements, amendments, or notices of cancellation and closing statements in this escrow to real estate broker(s) and lender(s) referred to in this escrow. You are not required to submit any title report issued in connection with this escrow to any party or agent unless directed to do so by

written mutual instructions. You may, however, do so without incurring liability to any party for such submission. You are hereby authorized to submit such report to any proposed lender.

13. Time is of the essence of these escrow instructions. In the event of failure to pay fees or expenses due you hereunder, on demand, the parties agree to pay a reasonable fee for any attorney's services which may be required to collect such fees or expenses.

14. If a party to this escrow unilaterally assigns or orders the proceeds of this escrow to be paid to other than the original parties to this escrow, such assignment or order shall be subordinated to the expenses of this escrow, liens of record on the subject property, and payments directed to be made by original parties together. If the result of such assignment or order would be to leave the escrow without sufficient funds to close, then you are directed to close nevertheless, and to pay such assignment or orders only out of the net proceeds and to pay them in the order in which such assignments or orders are received by you. You are to furnish a copy of these instructions, amendments thereto, closing statements and/or any other documents deposited in this escrow to the lender or lenders and/or the real estate broker or brokers involved in this transaction upon request of such lenders or brokers. In the event of an assignment or transfer of interest by operation of law, with or without the approval or consent of any or all of the parties hereto, you shall retain the right to deduct any and all escrow costs, fees and expenses provided for herein from said assigned or transferred funds, properties or rights, said assignment or transfer notwithstanding.

15. If there is no written activity by any principal delivered to this escrow within any six-month period after the time limit date as set forth in the escrow instructions or written extension thereof, your agency obligation shall terminate at your option and all documents, monies or other items held by you shall be returned to the respective parties entitled thereto, less fees and charges herein provided.

16. If any check submitted to escrow is dishonored upon presentment for payment, you are authorized to notify all principals and/or their respective agents of such nonpayment.

17. These instructions may be executed in counterparts, each of which shall be deemed an original regardless of the date of its execution and delivery. All such counterparts together shall constitute one and the same document.

18. The parties to these escrow instructions authorize you to destroy these instructions and all other instructions and records in this escrow at any time after five (5) years from date of close of escrow.

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Cal. Prac. Guide Real Prop. Trans. Ch. 5-A

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 5. Environmental Hazards Liability

A. Introduction

[5:1] Environmental hazards liability is among the most complex and dynamic areas of real property practice. An intricate body of statutory requirements and restrictions, common law interpretations, enforcement practices, and assessment and remediation techniques are in a continual state of evolution and flux. All of this has combined to create new and increased risks for both buyers and sellers of real property, requiring all parties to a real estate transaction to focus energy, attention and funds on assessing the environmental condition of the subject property. For this reason, it is crucial that all parties to a real property acquisition understand the scope of the applicable law.

[5:2] *Scope Note:* This Chapter provides a basic introduction to the principal federal and California statutes and cases governing environmental hazards liability of *buyers and sellers of real property*, together with some considerations for structuring a purchase and sale transaction to accommodate environmental concerns. However, practitioners should also be aware that statutory and common law in the area has significant implications far beyond the concerns of buyers and sellers of real property: Lenders, trustees, brokers, tenants, adjoining landowners and others are all affected by environmental laws in various ways. A comprehensive treatment of the subject could itself consume volumes and, thus, is beyond the scope of this Practice Guide. Moreover, practitioners are cautioned to monitor developments in the field, as the relevant laws, and the interpretation of those laws, continue to change rapidly and in dramatic ways.

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Cal. Prac. Guide Real Prop. Trans. Ch. 5-B

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Chapter 5. Environmental Hazards Liability

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1. [5:3] **Federal Laws:** The basic federal statutory scheme in the area of environmental hazards liability includes the *Comprehensive Environmental Response, Compensation and Liability Act of 1980* (CERCLA, 42 USC § 9601 et seq.); and the *Resource Conservation and Recovery Act* (RCRA, 42 USC § 6901 et seq.), which includes the EPA Technical Standards and Corrective Action Requirements for Owners and Operators of Underground Storage Tanks (42 USC § 6991 et seq.).

a. [5:4] **CERCLA:** CERCLA (42 USC § 9601 et seq.) (also known as the federal “Superfund” law) is the chief Federal Act imposing liability on owners and operators of real property for hazardous waste disposal. It is the primary source of environmental hazards liability for buyers and sellers. [*Burlington Northern & Santa Fe Ry. Co. v. United States* (2009) 556 US 599, 602, 129 S.Ct. 1870, 1874—CERCLA is designed to promote “timely cleanup of hazardous waste sites” and ensure associated costs are borne by those responsible for contamination; see also *California Dept. of Toxic Substances Control v. Hearthside Residential Corp.* (9th Cir. 2010) 613 F3d 910, 915—CERCLA encourages responsible parties to

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remediate hazardous facilities without delay and also encourages early settlement between potentially responsible parties and environmental regulators]

CERCLA has survived constitutional challenge under the Commerce Clause: The legislative history reflects Congress' recognition that even if the hazardous substance disposal has not caused off-site damage and is confined within an individual state, the unregulated management of hazardous substances significantly threatens interstate commerce. [See *Voggenthaler v. Maryland Square LLC* (9th Cir. 2013) 724 F3d 1050, 1059—applying CERCLA to soil and groundwater contamination is proper under Commerce Clause as a means of regulating "articles in commerce and activities affecting commerce"; *United States v. Olin Corp.* (11th Cir. 1997) 107 F3d 1506, 1509-1511 (relying on U.S. Supreme Court's approach for testing constitutionality of federal statutes under Commerce Clause as set forth in *United States v. Lopez* (1995) 514 US 549, 559-562, 115 S.Ct. 1624, 1630-1631)]

(1) [5:5] **Basis for CERCLA liability—operative terms:** CERCLA liability is triggered by a "potentially responsible party's" (PRP's, *¶ 5:7*) "release" (or threatened release) of a "hazardous substance" from a "facility" into the "environment." [42 USC §§ 9604, 9606(a), 9607(a); *United States v. Chapman* (9th Cir. 1998) 146 F3d 1166, 1170]

(a) [5:5.1] **"Hazardous substance":** CERCLA defines "hazardous substance" as "any substance designated pursuant to" several other statutes or EPA regulations promulgated under CERCLA. [42 USC § 9601(14); *Cose v. Getty Oil Co.* (9th Cir. 1993) 4 F3d 700, 704; *Castaic Lake Water Agency v. Whittaker Corp.* (CD CA 2003) 272 F.Supp.2d 1053, 1059]

There is *no minimum level* threshold. "*Any* substance" as used by CERCLA means just that—i.e., any quantity of a hazardous substance. [*A & W Smelter & Refiners, Inc. v. Clinton* (9th Cir. 1998) 146 F3d 1107, 1110; *Johnson v. James Langley Operating Co., Inc.* (8th Cir. 2000) 226 F3d 957, 962; but see *Amoco Oil Co. v. Borden, Inc.* (5th Cir. 1989) 889 F2d 664, 669 (interpreting CERCLA causation requirement to impose minimum level requirement "through the back door")]

1) [5:5.2] **Not petroleum:** There is a significant exception: A "hazardous substance" for CERCLA (and State Superfund) purposes does *not include petroleum*, natural gas or synthetic *gas* usable for fuel (42 USC § 9601(14)). *See ¶ 5:90 ff.*

(b) [5:5.3] **"Release":** The term "release" as used by CERCLA includes "any spilling, leaking, pumping, pouring, emitting, emptying, discharging, injecting, escaping, leaching, dumping, or disposing into the environment" of a hazardous substance (including the abandonment or discarding of barrels or other closed receptacles containing such substances). [42 USC § 9601(22); *Pakootas v. Teck Cominco Metals, Ltd.* (9th Cir. 2006) 452 F3d 1066, 1074-1075; see also *Sycamore Industrial Park Assocs. v. Ericsson, Inc.* (7th Cir. 2008) 546 F3d 847, 852-853—there is substantial overlap in terms used by CERCLA to define "release" and "disposal" (*¶ 5:63.1a*)]

1) [5:5.3a] **Includes "passive migration":** CERCLA's inclusion of the term "leaching" indicates that "passive migration" of hazardous substances constitutes a "release." [*Pakootas v. Teck Cominco Metals, Ltd.* (9th Cir. 2006) 452 F3d 1066, 1075; compare *ABB Indus. Systems, Inc. v. Prime Technology, Inc.* (2nd Cir. 1997) 120 F3d 351, 358; and *McCoy v. Gustafson* (2009) 180 CA4th 56, 103 CR3d 37, fn. 29—it is an "open question" under CERCLA whether passive underground migration of contaminants amounts to "release"]

Compare: On the other hand, passive migration does not necessarily constitute a "disposal" under CERCLA (*see* ¶ 5:63.2 ff.).

[5:5.3b - 5:5.3e] ***Reserved.***

2) [5:5.3f] **Exclusions:** A CERCLA "release" expressly *excludes:*

- any release that results in toxic exposure to *employees solely within the workplace* with respect to *claims they may make against their employer* (42 USC § 9601(22)(A));
- engine exhaust emissions from motor vehicles, rolling stock, aircraft, vessels, or a pipeline pumping station engine (42 USC § 9601(22)(B));
- certain nuclear incident releases (see 42 USC § 9601(22)(C)); and
- the normal application of fertilizer (42 USC § 9601(22)(D)).

(c) [5:5.4] **“Facility”:** A “facility” within the meaning of CERCLA means (i) any building, structure, installation, equipment, pipe, pipeline, well, pit, pond, lagoon, impoundment, ditch, landfill, storage container, motor vehicle, rolling stock or aircraft, or (ii) any site or area where a hazardous substance has been deposited, stored, disposed of, placed, or otherwise “come to be located.” [42 USC § 9601(9); see *Pakootas v. Teck Cominco Metals, Ltd.* (9th Cir. 2006) 452 F3d 1066, 1074—Upper Columbia River in Washington State deemed “facility” because hazardous waste from British Columbia upstream smelter had “come to be located” there]

A “facility” under CERCLA does *not* include any consumer product in consumer use or any vessel. [42 USC § 9601(9)]

1) [5:5.5] **Encompasses multiple locations:** Hazardous substances may be located in several discrete locations, each of which is a CERCLA “facility.” Thus, several “facilities” may be related to a *single* hazardous waste discharge or disposal. [*United States v. Meyer* (WD MI 1999) 120 F.Supp.2d 635, 639—private sewer line around perimeter of property and municipal sewer line into which waste released both qualified as “facilities”; see also *Lincoln Properties, Ltd. v. Higgins* (1992) 823 F.Supp. 1528, 1536-1538—CERCLA “facility” may include buildings adjacent to original source from which contaminated vapors are migrating]

2) [5:5.6] **Exclusions:** A CERCLA “facility” does *not* include:

- groundwater (*Castaic Lake Water Agency v. Whittaker Corp.* (CD CA 2003) 272 F.Supp.2d 1053, 1076—including groundwater in CERCLA's broad definition of “facility” “stretches the definition beyond reason and defies common sense”); or

- a consumer product in consumer use or vessel (42 USC § 9601(9); see *Otay Land Co., LLC v. U.E. Ltd., L.P.* (2017) 15 CA5th 806, 829-830, 225 CR3d 119, 138-139—commercial shooting range not “consumer product in consumer use”; *Castaic Lake Water Agency v. Whittaker Corp.*, supra, 272 F.Supp.2d at 1073-1076—water wells, as opposed to water *within* wells supplied to consumers, are a CERCLA “facility”; *Rivas v. Safety-Kleen Corp.* (2002) 98 CA4th 218, 238, 119 CR2d 503, 519—structures containing asbestos building materials, as opposed to containers of such materials for consumer use, are a CERCLA “facility”).

(d) [5:5.7] **“Environment”:** The “environment” as defined by CERCLA is (i) the navigable waters, waters of the contiguous zone, and the ocean waters of which the natural resources are under exclusive U.S. management authority under the Magnuson-Stevens Fishery Conservation and Management Act (16 USC § 1801 et seq.), and (ii) any other surface water, ground water, drinking water supply, land surface or subsurface strata, or ambient air within the U.S. or under U.S. jurisdiction. [42 USC § 9601(8)]

[5:5.8 - 5:5.9] ***Reserved.***

(e) [5:5.10] **Compare—minimal toxic exposure within confined area:** By making a “release” of hazardous materials from a “facility” into the “environment” the operative triggers of liability, Congress necessarily limited CERCLA's reach. It does not cover (and is inapplicable to) toxic exposure of only a few persons inside an enclosed space. [*Rivas v. Safety-Kleen Corp.* (2002) 98 CA4th 218, 234, 119 CR2d 503, 515, 517—workers' on-the-job toxic chemical exposure from using cleaning solvents to wash auto parts not a “release into the environment” covered by CERCLA]

(2) Clean-up cost recoupment and remediation actions

(a) [5:6] **Federal government right of action:** Under CERCLA, the federal government has a right of action against, among others, *current and former owners and operators* of a contaminated real property to recover amounts spent by the government in cleaning up the site. The federal government may also order other parties who are “potentially responsible” for the contaminated condition of the property to clean up the site. [42 USC §§ 9604, 9606, 9607; *see ¶ 5:121 ff.*]

(b) [5:6.1] **Private right of action:** Additionally, parties who undertake the clean-up of a contaminated site have a private right of action under CERCLA to recoup all or a portion of those “response costs” from other “potentially responsible parties.” [42 USC §§ 9607(a)(4)(B) & 9613(f); *United States v. Atlantic Research Corp.* (2007) 551 US 128, 131, 127 S.Ct. 2331, 2333-2334; *see ¶ 5:125 ff.*]

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(This is a significant remedy, setting CERCLA apart from many other environmental laws—including the RCRA; *see ¶ 5:125.10 ff.*)

(3) [5:7] **"Potentially responsible parties":** CERCLA identifies the "potentially responsible parties" (PRPs) who can be ordered by the government to remediate a hazardous waste site or, alternatively, sued for reimbursement of the government's or a private party's clean-up costs with respect to the site.

As discussed in more detail below (¶ 5:60 ff.), there are four classes of PRPs under CERCLA: owners, operators, arrangers and transporters. [42 USC § 9607(a); *Burlington Northern & Santa Fe Ry. Co. v. United States* (2009) 556 US 599, 608-609, 129 S.Ct. 1870, 1878; *Cooper Indus., Inc. v. Aviall Services, Inc.* (2004) 543 US 157, 161, 125 S.Ct. 577, 580-581]

The "owner" and "operator" classes encompass a wide range of property owners and occupants. The classes include both current and former owners and operators, and the owners and operators of any site or area where a hazardous substance has "come to be located." [See 42 USC §§ 9601(9) (defining "facility"), 9607(a)(1), (2); *Atlantic Richfield Co. v. Christian* (2020) 590 US _, _, 140 S.Ct. 1335, 1347, 1352—98 landowners within 300-square mile area were PRPs because pollutants from former copper smelter facility had "come to be located on the landowners' properties"; *see* ¶ 5:5.4, 5:62 ff.]

(4) Nature and scope of liability

(a) [5:8] **Retroactive, joint and several liability:** CERCLA liability is *retroactive* and subject to a potentially *open-ended statute of limitations*. Therefore, if a hazardous waste condition existed on the property at the time a PRP had an interest in the property, liability can be imposed on the PRP at any time—even many years after the PRP transferred its interest in the contaminated site and without regard to whether the contamination occurred before CERCLA was enacted (*see* ¶ *5:63 ff., 5:70*).

Moreover, though there may be several PRPs, CERCLA liability generally is *joint and several*. The defendant PRP bears the burden of proving its liability for the hazardous waste can be apportioned with reasonable certainty among the various (sometimes many) PRPs. If that burden is not met, each PRP may be held jointly and severally liable for the entire clean-up cost. [42 USC § 9607(a) et seq.; *see ¶ 5:72 ff.*]

(PRPs sued for *contribution* under CERCLA can also be held jointly liable; *see ¶ 5:135.10*.)

(b) [5:9] **Tantamount to strict liability; limited defenses:** Technically, CERCLA does not impose strict liability on PRPs. However, because there are so few defenses to liability, and the recognized defenses are extremely narrow, CERCLA has, for all practical purposes, created a strict liability scheme. [See *AIU Ins. Co. v. Sup.Ct. (FMC Corp.)* (1990) 51 C3d 807, 836, 274 CR 820, 852—CERCLA "is a strict liability statute that serves essentially remedial goals, irrespective of fault"; *Carson Harbor Village, Ltd. v. Unocal Corp.* (9th Cir. 2001) 270 F3d 863, 870 (en banc); *and* ¶ *5:64 ff., 5:100 ff.*]

1) [5:10] **Lack of knowledge immaterial:** A PRP is subject to CERCLA liability whether or not it actually knew of the hazardous condition at the time the PRP had an interest in the property. [*United States v. Monsanto Co.* (4th Cir. 1988) 858 F2d 160, 168; *see ¶ 5:64 ff.*]

2) [5:11] **Irrespective of fault:** Similarly, CERCLA liability may be assessed regardless of whether the PRP participated in causing the contamination of the property. [*United States v. Monsanto Co.* (4th Cir. 1988) 858 F2d 160, 167; *see ¶ 5:64*]

[5:11.1 - 5:11.4] ***Reserved.***

(5) [5:11.5] **Federally-mandated accrual date for state law causes of action:** CERCLA controls the commencement of the statute of limitations both on CERCLA *and state law* causes of action for personal injury or property damage caused or contributed to by the release of hazardous substances from a facility into the environment. [42 USC § 9658(a)(1); *see discussion at ¶ 5:143.1 ff.*]

(6) [5:12] **Exclusive federal jurisdiction; effect on state law claims:** U.S. district courts have exclusive original jurisdiction over claims arising under CERCLA. [42 USC § 9613(b)]

While state courts lack jurisdiction over CERCLA claims, they retain jurisdiction over claims brought under other sources of law, including state common law claims. [*Atlantic Richfield Co. v. Christian* (2020) 590 US _, _, 140 S.Ct.

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1335, 1349—Montana state courts retained jurisdiction over property owners' state law trespass, nuisance and strict liability claims for contamination within Superfund site (¶ 5:123.1, 5:169.3); *see* ¶ 5:140 ff.]

[5:13 - 5:14] ***Reserved.***

b. RCRA

(1) [5:15] **Permits; reporting/notification requirements:** The Resource Conservation and Recovery Act of 1976 (RCRA, 42 USC § 6901 et seq.) was enacted to provide a mechanism for preventing the creation of new hazardous waste sites by, among other things, establishing a system for tracking hazardous wastes from the time they are created through the time of their disposal. RCRA accomplishes this by way of a permitting scheme and reporting/notification requirements imposed upon those who generate or transport hazardous wastes, and upon the owners and operators of facilities for the treatment, disposal or storage of hazardous wastes. [*Pakootas v. Teck Cominco Metals, Ltd.* (9th Cir. 2006) 452 F3d 1066, 1078; see also *Hinds Investments, L.P. v. Angioli* (9th Cir. 2011) 654 F3d 846, 850—RCRA's primary purpose is to "minimize the present and future threat to human health and the environment" by reducing hazardous waste generation and ensuring its proper treatment, storage and disposal]

These permitting and reporting/notification requirements are accompanied by stiff criminal and civil penalties for noncompliance. [See generally, 42 USC § 6928] (Specific penalty provisions are codified throughout RCRA depending upon the specific kind of violation involved.)

(2) [5:16] **Reporting re underground storage tanks:** RCRA also contains the EPA Technical Standards and Corrective Action Requirements for Owners and Operators of Underground Storage Tanks. [42 USC § 6991 et seq.; 40 CFR Part 280] Several reporting requirements are imposed:

- [5:17] Any owner of an underground storage tank (UST) that contains petroleum or any other substance designated as "hazardous" must report to the designated state or local authority information concerning the "age, size, type, location and uses" of each such UST. [42 USC § 6991a(a)(1)]
- [5:18] An owner of a UST must also report to the designated authority any actual or threatened discharge of a substance from a UST and the nature and scope of the corrective action being taken by the UST owner in response. [42 USC § 6991b(c)(3)]
- [5:19] Additionally, if a UST is ever taken out of service, the owner must report that fact to the designated authority, along with other information relevant to the nonoperational UST. [42 USC § 6991a(a)(2)]

(3) [5:20] **Distinguished from CERCLA:** Unlike CERCLA, RCRA is not principally designed to effectuate the clean-up of hazardous waste sites or to compensate those who remediate environmental hazards. RCRA's primary purpose is to reduce the generation of hazardous waste and ensure the proper treatment, storage and disposal of hazardous waste that is nonetheless generated "so as to minimize the present and future threat to human health and the environment." [42 USC § 6902(b); *Meghrig v. KFC Western, Inc.* (1996) 516 US 479, 483, 116 S.Ct. 1251, 1254; *Pakootas v. Teck Cominco Metals, Ltd.* (9th Cir. 2006) 452 F3d 1066, 1078]

Unlike CERCLA, the RCRA does *not* provide private parties with a *damages* remedy for past or ongoing clean-ups (*see ¶ 5:125.10 ff.*).

c. [5:21] **Other Federal Acts:** Some of the other Federal Acts relating to environmental hazards liability include:

- The Federal Water Pollution Prevention and Control Act, more commonly known as the Clean Water Act (33 USC § 1251 et seq.). [See *Communities for a Better Environment v. State Water Resources Control Bd.* (2003) 109 CA4th 1089, 1092, 1 CR3d 76, 78—Act's goal is "to restore and maintain the chemical, physical, and biological integrity of the Nation's waters"; *Idaho Conservation League v. Poe* (9th Cir. 2023) 86 F4th 1243, 1244 (upholding environmental organization's "citizen suit" against miner who committed ongoing Clean Water Act (CWA) violations by operating suction dredge in river without proper CWA permit); *Natural Resources Defense Council v. California Dept. of Transp.* (9th Cir. 1996) 96 F3d 420, 424—private party's suit against state officials for prospective injunctive relief under Act's "citizen suit" provision (33 USC § 1365) not barred by 11th Amendment immunity]

- The Clean Air Act (42 USC § 7401 et seq.).

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• The Toxic Substances Control Act (15 USC § 2601 et seq.).

• The National Environmental Policy Act (42 USC § 4321 et seq.).

• The Residential Lead-Based Paint Hazard Reduction Act (42 USC § 4851 et seq.).

Cross-refer: The Residential Lead-Based Paint Hazard Reduction Act (above) and regulations promulgated thereunder impose significant disclosure obligations on sellers (and potentially their brokers) of "target housing" (most residential structures built before 1978) with regard to lead-based paint and related hazards. *See detailed discussion at ¶ 4:366.2 ff.*

d. [5:22] **EPA regulations:** The Environmental Protection Agency has chief responsibility for implementing and enforcing federal environmental hazards laws, and promulgates regulations that expand upon the vast body of applicable federal law.

[5:23 - 5:24] ***Reserved.***

2. [5:25] **California State Laws:** The State of California has enacted several hazardous substance liability statutes. The Carpenter-Presley-Tanner Hazardous Substance Account Act (so-called California "Superfund," Health & Saf.C. § 78000 et seq. (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24)) is a companion to the Federal CERCLA. Likewise, California's Hazardous Waste Control Law (Health & Saf.C. § 25100 et seq.) is the analogue to the Federal RCRA.

California has also adopted several statutes requiring reporting and notification with respect to certain hazardous substances under specified circumstances. These include: the Porter-Cologne Water Quality Control Act (Water C. § 13000 et seq.); the Safe Drinking Water and Toxic Enforcement Act of 1986 ("Proposition 65," Health & Saf.C. § 25249.5 et seq.); the Asbestos Notification Law (Health & Saf.C. § 25915 et seq.); and the Hazardous Substances Underground Storage Tank Act (Health & Saf.C § 25280 et seq.).

And another state statutory scheme, the Environmental Responsibility Acceptance Act (Civ.C. § 850 et seq.), creates a unique procedure to expedite identification of potentially responsible parties and the assumption of response action by PRPs to remediate contaminated sites.

Each of these Acts is briefly described at ¶ 5:26 ff.

a. [5:26] **California "Superfund" (remediation and clean-up liability):** The so-called California "Superfund" (Health & Saf.C. § 78000 et seq. (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24)) governs liability to the state for hazardous waste remediation and clean-up costs. It is patterned after the Federal CERCLA (¶ 5:4 ff.) and contains provisions substantially similar to CERCLA in most areas—including provisions governing who can be held liable and the defenses to liability. [See *Castaic Lake Water Agency v. Whittaker Corp.* (CD CA 2003) 272 F.Supp.2d 1053, 1084, fn. 40; *Orange County Water Dist. v. Alcoa Global Fasteners, Inc.* (2017) 12 CA5th 252, 297, 219 CR3d 474, 513—State Superfund implements California's CERCLA responsibilities and establishes Hazardous Substance Account to fund environmental remediation actions and related efforts; *Van Horn v. Department of Toxic Substances Control* (2014) 231 CA4th 1287, 1298, 180 CR3d 416, 424—state's principal interest under Superfund is timely and efficient clean-up of hazardous substance releases that threaten public health and environment]

As under CERCLA, liability for hazardous waste remediation is strict. However, the California Superfund is different from CERCLA in certain respects. For example:

(1) [5:27] **Apportionment of liability:** Unlike CERCLA, the California Superfund requires apportionment of clean-up costs among potentially responsible parties (PRPs) to the extent possible. [Health & Saf.C. § 79760 (recodified & added Stats. 2022, Ch.257, oper. 1/1/24); see *Orange County Water Dist. v. Alcoa Global Fasteners, Inc.* (2017) 12 CA5th 252, 340, 219 CR3d 474, 549 (decided under predecessor statute) (finding county water district's reliance on federal authorities regarding apportionment unpersuasive); *Fireman's Fund Ins. Co. v. City of Lodi, Calif.* (9th Cir. 2002) 302 F3d 928, 946—liability under California Superfund not joint and several but apportioned according to fault]

Moreover, the oversight agency (Department of Toxic Substances Control) must propose an expedited settlement with PRPs whose hazardous substance contribution to a contaminated site is minimal. [Health & Saf.C. § 79920 (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24)]

(a) [5:27.1] **"Orphan fund" for reimbursement of insolvent or defunct PRP's share:** A PRP who, under federal law (which imposes joint and several liability, *¶ 5:72 ff.*), has had to pay clean-up costs for the share of an insolvent or

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defunct PRP may apply for reimbursement through California's Orphan Share Reimbursement Trust Fund. [See Health & Saf.C. § 80000 et seq. (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24)]

(2) [5:28] **Liability not retroactive:** The California Superfund expressly does *not* create any new liability for acts that occurred prior to January 1, 1982 (if such acts were not otherwise in violation of law at the time committed) and, therefore, unlike CERCLA, does not impose unlimited retroactive liability. [Health & Saf.C. § 78185(a) (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24); see *OrangeCounty Water Dist. v. Sabic Innovative Plastics US, LLC* (2017) 14 CA5th 343, 388-389, 222 CR3d 83, 122-123 (decided under predecessor statute) (noting statute establishes affirmative defense)—summary adjudication improper where defendant's acts did not violate law at time committed and evidence consisted solely of water district's admission it was unaware of any environmental violation charges against defendant prior to property's 1972 sale]

(3) [5:29] **Disclosure requirements:** The California Superfund requires that nonresidential real property owners disclose to any prospective buyer, lessee or renter the presence of any hazardous substance that the owner knows or has reason to believe has been released on or under the property. Failure to do so subjects the owner to actual damages and any other remedies provided by law. In addition, sanctions may be imposed for failure to make such disclosures. [See Health & Saf.C. § 78700 (recodified & added Stats. 2022, oper. 1/1/24); *Epochal Enterprises, Inc. v. LF Encinitas Properties, LLC* (2024) 99 CA5th 44, 49-50, 57, 317 CR3d 573, 577, 583-584 (decided under predecessor statute)—lease provision limiting commercial landlord/owner's liability was invalid and therefore did not preclude tenant/lessee's damages award because said provision necessarily violated landlord/owner's statutory duty to disclose presence of asbestos on leased property]

b. [5:30] **Hazardous Waste Control Law:** The RCRA (*¶ 5:15 ff.*) authorizes states to establish their own programs for tracking hazardous wastes, provided the state requirements are not less stringent than the RCRA's. [*People v. Union Pac. R.R. Co.* (2006) 141 CA4th 1228, 1240, 47 CR3d 92, 98] The Hazardous Waste Control Law (HWCL, Health & Saf.C. § 25100 et seq.) is the California counterpart to the RCRA; it regulates state facilities that generate, process, treat or store hazardous wastes by, among other things, authorizing the California Department of Toxic Substances Control (DTSC) to take a variety of actions concerning the facilities.

(1) [5:31] **DTSC inspections, testing and financial responsibility determinations:** Among other things, the HWCL authorizes the DTSC to:

- Make inspections of (a) sites on which hazardous waste is treated, stored, handled or disposed of, (b) real property on which there has been a disposal of hazardous waste, or (c) real property that is within 2,000 feet of a property on which there has been a disposal of hazardous waste;
- Conduct various tests and monitoring activities on those sites; and
- Require specified parties who have a reasonable basis to believe there has been or may be a release or threatened release of a hazardous substance, hazardous wastes or hazardous material, and any person having information regarding the activities of any of those parties, to furnish and transmit to the DTSC information relating to those parties' ability to pay for or perform a response, or corrective action (but only for the purpose of determining how to finance a response or corrective action or otherwise enforce the HWCL). [See Health & Saf.C. §§ 25185, 25185.5 & 25185.6]

(2) [5:32] **DTSC remediation orders; permit action:** The HWCL also authorizes the DTSC to issue orders requiring the owner or operator of such properties to take actions and make reports concerning hazardous waste thereon. [Health & Saf.C. § 25187.1(a)]

Further, the DTSC has the right to deny, suspend and revoke permits applied for or issued pursuant to the HWCL. [Health & Saf.C. §§ 25186, 25186.1, 25186.2 & 25186.5]

(3) [5:33] **California Superfund remedies upon voluntary written request:** If the person responsible for a hazardous release voluntarily requests in writing that the DTSC issue an order for corrective action pursuant to the remedies set forth in California's Superfund law (as opposed to those provided in the HWCL), the DTSC must do so. [See Health & Saf.C. § 25187(b)(1)(A); *Soco West, Inc. v. California Environmental Protection Agency* (2013) 213 CA4th 1511, 1515, 1519, 153 CR3d 440, 442-443, 446—Legislature intended responsible party, *not* DTSC, to "dictate the appropriate cleanup program"]

[5:34 - 5:35] ***Reserved.***

c. [5:36] **Porter-Cologne Water Quality Control Act of 1970:** This Act (Water C. § 13000 et seq.) is the California analogue to the Federal Clean Water Act. Implemented by the Water Resources Control Board and its many Regional Water Quality Control Boards (RWQCBs), the Act regulates the proposed or actual dispersal and/or disposal (¶ 5:36.2) of a broad range of substances (¶ 5:36.1) that will or might have an effect on the quality of California waters (¶ 5:36.3 ff.). [See *Coastal Environmental Rights Foundation v. California Regional Water Quality Control Bd.* (2017) 12 CA5th 178, 181-183, 218 CR3d 596, 600-602 (summarizing statutory framework for regulating water quality)]

(1) Definitions

(a) [5:36.1] **"Waste":** The Act's definition of "waste" includes "sewage and any and all other waste substances, liquid, solid, gaseous, or radioactive, associated with human habitation, or of human or animal origin, or from any producing, manufacturing, or processing operation, including waste placed within containers of whatever nature prior to, and for purposes of, disposal." [Water C. § 13050(d)]

The Act's definition can encompass innocuous substances that are not harmful on their own, but can become harmful as a result of human activity. [See *Lake Madrone Water Dist. v. State Water Resources Control Bd.* (1989) 209 CA3d 163, 169-170, 256 CR 894, 897-898—silt and sediment that accumulated in creek bed and then released when dam's gate valve opened deemed "waste" (dam created "man-made artificial location for its concentration," rendering otherwise "innocuous substance" one "deadly to aquatic life"); *Sweeney v. Calif. Regional Water Quality Control Bd.* (2021) 61 CA5th 1093, 1116-1119, 275 CR3d 442, 461-463—uncontaminated dirt deemed "waste" because "it was harmful as used in reconstructing the levee in tidal wetlands"]

(b) [5:36.2] **"Discharge":** The Act does not define "discharge." Accordingly, courts apply the term's ordinary meaning—i.e., (i) "to allow (a liquid, gas, or other substance) to flow out from where it has been confined," (ii) "to give outlet or vent to," and (iii) "to emit." [See *Sweeney v. Calif. Regional Water Quality Control Bd.* (2021) 61 CA5th 1093, 1120-1121, 275 CR3d 442, 464-465—placement of fill materials into waters to build and repair levees was a "discharge"]

(c) [5:36.3] **"Waters of the state":** "Waters of the state" are "any surface water or groundwater, including saline waters, within the boundaries of the state." [Water C. § 13050(e); see *Sweeney v. Calif. Regional Water Quality Control Bd.* (2021) 61 CA5th 1093, 1121-1122, 275 CR3d 442, 465-466—waste discharged into "channels and ditches" satisfied "waters of the state" element, even though most activities occurred on dry land]

1) [5:36.3a] **Compare—Federal Clean Water Act definition:** The federal Clean Water Act applies to "the waters of the United States," which refers to "relatively permanent, standing or continuously flowing bodies of water forming geographical features," such as "streams, oceans, rivers, and lakes." The Act also extends to adjacent wetlands that are indistinguishable from "waters of the United States," i.e., wetlands that have "a continuous surface connection with that water, making it difficult to determine where the 'water' ends and the 'wetland' begins." [33 USC § 1362(7); *Sackett v. EPA* (2023) 598 US 651, 671, 676-679, 684, 143 S.Ct. 1322, 1336, 1339-1341, 1344 (internal quotations omitted)—wetlands on residential property were not "waters of the United States" because they were distinguishable from nearby lake]

(d) [5:36.4] **"Pollution":** "Pollution" means "an alteration of the quality of the waters of the state by waste to a degree which unreasonably affects" either (i) "the waters for beneficial uses" or (ii) "facilities which serve these beneficial uses." [Water C. § 13050(*l*)(1)]

Pollution may include "contamination," which means "an impairment of the quality of the waters of the state by waste to a degree which creates a hazard to the public health through poisoning or through the spread of disease." Contamination includes "any equivalent effect resulting from the disposal of waste, whether or not waters of the state are affected." [Water C. § 103050(*l*)(2), (k)]

(2) [5:37] **Notice requirements:** The Act imposes strict notification requirements on persons who have discharged hazardous substances in or on state waters, irrespective of fault. Failure to comply with the Act's notification requirements may result in substantial monetary fines and, in some cases, imprisonment. [See Water C. §§ 13271 & 13272]

(3) [5:38] **Remedial enforcement:** The RWQCBs are empowered to enforce the Act through cease and desist, clean-up and abatement orders against responsible parties, or to remediate affected sites themselves and recover the clean-up costs from responsible parties. [See Water C. §§ 13301, 13304(a), (b), (c)]

RWQCBs are also authorized to impose requirements on proposed waste discharges. [See Water C. § 13263(a); *Santa Clara Valley Water Dist. v. San Francisco Bay Regional Water Quality Control Bd.* (2020) 59 CA5th 199, 209-211, 273 CR3d 333, 339-341—RWQCB had jurisdiction to impose mitigation requirements for water district's flood control project because it would require periodic removal of unnecessary sediment from creek, which is "discharge of waste"]

(4) [5:39] **Persons liable:** Enforcement actions are authorized against persons who have "caused or permitted" waste to be discharged into the state's waters, creating or threatening to create "a condition of pollution or nuisance." [Water C. § 13304(a); see *Sweeney v. Calif. Regional Water Quality Control Bd.* (2021) 61 CA5th 1093, 1122-1123, 275 CR3d 442, 466—evidence of "likely, potential, or threatened harm" to aquatic habitat and species supported cleanup and abatement order]

Section 13304(a) imposes liability on two independent classes of persons: (i) persons who "caused" a discharge, and (ii) persons who "permitted" a discharge. [See *United Artists Theatre Circuit, Inc. v. Regional Water Quality Control Bd.* (2019) 42 CA5th 851, 876-877, 255 CR3d 796, 816-817 (distinguishing Water C. § 13304(a)'s "independent" terms "caused" and "permitted"); *and* ¶ 5:39.1 ff.]

The Act does not impose liability on persons "whose involvement with a spill was remote and passive." [*Redevelopment Agency of City of Stockton v. BNSF Ry. Co.* (9th Cir. 2011) 643 F3d 668, 671, 677-678 (internal quotes omitted)—railroads not liable under § 13304(a) for water pollution caused by nearby industrial site, even though contaminants flowed through "french drain" installed by railroads to remove water from roadbed (railroads "did not cause or permit" contamination and their involvement was "entirely passive and unknowing"); *discussed further at* ¶ 5:153.1]

(a) [5:39.1] **Persons who "caused" discharge:** Consistent with the common law of nuisance (*see* ¶ 5:150 ff.), liability under Water C. § 13304(a) for causing a discharge extends not only to a person who maintains the nuisance, but also the person who creates or assists in creating it. [*City of Modesto Redevelop. Agency v. Sup.Ct. (Dow Chem. Co.)* (2004) 119 CA4th 28, 37-38, 43, 13 CR3d 865, 871-872, 875-876 (*"Modesto I"*)—dry cleaning solvent and equipment manufacturers/distributors could be liable under § 13304(a) if they took affirmative steps toward improper waste discharge, but not by merely placing solvents into commerce stream without adequate warnings re improper disposal dangers; see also *City of Modesto v. Dow Chem. Co.* (2018) 19 CA5th 130, 159, 227 CR3d 764, 786 (*"Modesto II"*)—proper causation analysis is whether it is more likely than not defendant's conduct was "substantial factor" in causing pollution]

(b) [5:39.2] **Persons who "permitted" discharge:** Even if a person did not "cause" a spill, they may be liable under Water C. § 13304(a) if they "permitted" a discharge. [See *San Diego Gas & Elec. Co. v. San Diego Regional Water Quality Control Bd.* (2019) 36 CA5th 427, 439-440, 248 CR3d 496, 505 (stressing "persons may be subject to a cleanup or abatement order if they have caused *or permitted* a discharge of waste," even if they are "not found to be a substantial factor or but for cause" of the discharge) (emphasis in original; internal quotes omitted)]

1) [5:39.3] **Owner's liability for lessee's discharge; knowledge requirement:** A property owner is liable under Water C. § 13304(a) if they "permit" a discharge by a lessee. The property owner, however, must have actual or constructive knowledge of the lessee's activities. This means the property owner can only be ordered to clean up a discharge caused by a lessee if the owner knew or should have known that the lessee's activity created a reasonable possibility of a discharge and the owner allowed the lessee's activity to take place. [*United Artists Theatre Circuit, Inc. v. Regional Water Quality Control Bd.* (2019) 42 CA5th 851, 864-865, 880-881, 887-888, 255 CR3d 796, 806-807, 820, 825-826—shopping center owner could be ordered to clean up PCE discharged by tenant who operated dry cleaning business because owner knew about tenant's activities]

(c) [5:39.4] **Corporate parent's liability for subsidiary's discharge:** A parent corporation may be liable for a subsidiary's toxic discharge if the corporate parent had control over the subsidiary's operations that resulted in pollution. [*Atlantic Richfield Co. v. Central Valley Regional Water Quality Control Bd.* (2019) 41 CA5th 91, 97, 100, 253 CR3d 888, 892, 895 (applying Supreme Court's standard for imposing liability on corporate parent set forth in *United States v. Bestfoods* (1998) 524 US 51, 118 S.Ct. 1876 (¶ 5:77 ff.))—"proper standard" for determining corporate parent's liability for waste discharged from subsidiary's abandoned mine is "eccentric control over *any* category of mining activity resulting in toxic discharge"]

(d) [5:39.5] **Federal government's compliance:** Under the Clean Water Act (¶ 5:21), federal agencies managing federal lands generally must comply with state water pollution laws and regulations, including state laws and regulations

governing discharges from nonpoint sources (i.e., pollution sources that are *not* "point sources" under the Clean Water Act), such as the Porter-Cologne Act (¶ 5:36). [33 USC § 1323(a); *Central Sierra Environmental Resource Ctr. v. Stanislaus Nat'l Forest* (9th Cir. 2022) 30 F4th 929, 932, 938-940—Forest Service did not violate Porter-Cologne Act where state previously agreed to waive compliance with reporting and permitting requirements; see also 33 USC § 1362(14) (defining "point source" as "any discernable, confined and discrete conveyance … from which pollutants are or may be discharged")]

(e) [5:39.6] **Discharges compliant with permits, waivers and prohibitions; relevance of RWQCBs' water quality objectives:** Water quality objectives in a RWQCB's plan do not directly apply to individual dischargers, "but instead reflect standards that regulators must take into account in fashioning requirements that *do* apply to dischargers." RWQCBs have available three methods for imposing specific obligations on dischargers: (i) imposing "water discharge requirements" (or WDRs), which are functionally permits that authorize specific discharges under enumerated conditions; (ii) granting waivers, which must include conditions that restrict the discharges covered by the waivers; and (iii) setting particular prohibitions that specify conditions or areas where waste discharges are not permitted. [*Central Sierra Environmental Resource Ctr. v. Stanislaus Nat'l Forest* (9th Cir. 2022) 30 F4th 929, 940-942 (citing Water C. §§ 13243, 13263(a) and 13269) (emphasis in original)]

Dischargers that comply with applicable WDRs, waivers and prohibitions are not liable under the Porter-Cologne Act, even if their discharges cause pollution levels in local waterways to exceed an RWQCB's water quality objectives. [*Central Sierra Environmental Resource Ctr. v. Stanislaus Nat'l Forest*, supra, 30 F4th at 942-943—Forest Service did not violate Porter-Cologne Act by allowing livestock grazing in national forest, even though runoff from grazing allegedly caused bacteria levels in local streams to exceed relevant water quality objectives]

d. [5:40] **Hazardous Substances Underground Storage Tank Act:** This Act (Health & Saf.C. § 25280 et seq.) regulates underground storage tanks (USTs) and imposes requirements on owners and operators of the property on which they are located.

(1) [5:41] **Reporting UST leaks:** Unauthorized leaks from a UST must be reported—in most cases, within 24 hours of the leak. [Health & Saf.C. § 25295]

(2) [5:42] **Other regulations:** Property owners and operators are also subject to regulations regarding permitting of USTs, closure of USTs, soil clean-up, tank removal and repair, and maintenance of USTs, among other things. [See Health & Saf.C. § 25296 et seq.]

e. [5:43] **Safe Drinking Water and Toxic Enforcement Act of 1986 (Proposition 65):** Proposition 65 (Health & Saf.C. § 25249.5 et seq.) provides that persons in the course of business shall not knowingly "discharge or release" a chemical known to the state to cause cancer or reproductive toxicity "into water or onto or into land where such chemical passes or probably will pass into any source of drinking water …" [Health & Saf.C. § 25249.5]

Proposition 65 also prohibits persons in the course of business from knowingly or intentionally exposing any individual to any such carcinogenic chemical or reproductive toxin without giving the individual "clear and reasonable warning" in accordance with the Act. [Health & Saf.C. § 25249.6]

The chemicals requiring compliance under Proposition 65 are set forth in a list published by the Governor, which is periodically updated to include additional chemicals. [Health & Saf.C. § 25249.8]

(1) [5:43.1] **"Discharge or release" defined:** A prohibited "discharge or release" within the meaning of Health & Saf.C. § 25249.5 (¶ 5:43) refers to "a movement of chemicals from a confined space into the land or the water." It does *not* include the "passive migration" or "continued presence" of a toxic chemical in the land. [*Consumer Advocacy Group, Inc. v. Exxon Mobil Corp.* (2002) 104 CA4th 438, 441, 450, 128 CR2d 454, 456, 463]

(2) [5:43.2] **Civil action for violation:** A violation of Health & Saf.C. § 25249.5 is remediable by statutory civil penalties (up to $2,500 per day per violation). A civil action may be filed by any person in the "public interest," so long as state and local prosecuting agencies have been notified of the alleged violation and declined to pursue an enforcement action. [Health & Saf.C. § 25249.7(b)(1) & (d); *Shamsian v. Atlantic Richfield Co.* (2003) 107 CA4th 967, 976, 132 CR2d 635, 642—CCP § 340(a) one-year statute of limitations applies, subject to federally-mandated CERCLA "discovery rule" (¶ *5:143.2*)]

(3) [5:43.3] **Constructive knowledge sufficient:** A person may be liable for violating Proposition 65 (¶ 5:43 ff.) if they had constructive knowledge that a product contained a carcinogenic chemical or reproductive toxin. [*Lee v. Amazon.com, Inc.*

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(2022) 76 CA5th 200, 240, 291 CR3d 332, 363—consumer not required to prove internet retailer had actual knowledge that products purchased from third-party seller on retailer's website contained mercury]

f. [5:44] **Asbestos Notification Law:** The Asbestos Notification Law (Health & Saf.C. § 25915 et seq.) sets forth a scheme for notifying employees, contractors and other persons providing services on a property of the presence of asbestos on that property.

(1) [5:45] **Properties affected:** The notification requirement applies to owners, lessees, sublessees and owners' agents with respect to all or any portion of a "public or commercial building" constructed prior to 1979. Residences, schools and apartment buildings with less than 10 units are excluded. [Health & Saf.C. §§ 25915, 25915.2]

(2) [5:46] **Content of notice:** The requisite notice must include, among other things, the location of asbestos in the building, procedures for minimizing release of and exposure to asbestos in the building, results of any asbestos survey of the building, and a description of potential health risks. [Health & Saf.C. § 25915(a) & (b)]

In addition, warning signs must be posted in any area of a building where construction, remodeling or maintenance may cause the release of or exposure to asbestos. [Health & Saf.C. § 25916]

[5:46.1 - 5:46.4] ***Reserved.***

g. [5:46.5] **Environmental Responsibility Acceptance Act:** The Environmental Responsibility Acceptance Act (ERAA, Civ.C. § 850 et seq.) establishes an elaborate procedural scheme for the expeditious identification of PRPs and remediation of contaminated sites. The burden is on property owners aware of a hazardous materials release at their property to take steps to identify and notify likely PRPs. The notified PRPs then bear the burden of providing the site owner and oversight agency with a release report and "commitment statement" to take remedial action. Disputed matters are supposed to proceed to mediation before litigation may be commenced. [Civ.C. § 850 et seq.]

The ERAA is discussed in detail at ¶ *5:138 ff.*

h. [5:46.6] **Polanco Redevelopment Act:** The Polanco Redevelopment Act (Health & Saf.C. § 33459 et seq.) authorizes a redevelopment agency to bring an action against "responsible parties" for the costs of cleaning up contamination on property within the agency's redevelopment project area. The elements of a Polanco cost-recovery action differ from those for a government CERCLA cost-recovery action (¶ *5:121.1*); but the Polanco Act incorporates the liability standards applied in CERCLA cases (¶ *5:64 ff.*). The Polanco Act does not limit a redevelopment agency's rights to those available under CERCLA. [Health & Saf.C. § 33459 et seq.; see also *Redevelopment Agency of City of Stockton v. BNSF Ry. Co.* (9th Cir. 2011) 643 F3d 668, 678—railroads not liable under Polanco Act's CERCLA provision for contaminants running through their drainage system because they were not "owners" or "operators" within meaning of CERCLA; *City of Modesto Redevelop. Agency v. Sup.Ct. (Dow Chem. Co.)* (2004) 119 CA4th 28, 36-43, 13 CR3d 865, 870-876 ("*Modesto I*") (interpreting and applying Act's provision for agency cost-recoupment from "responsible parties"); *City of Modesto v. Dow Chem. Co.* (2018) 19 CA5th 130, 151-160, 227 CR3d 764, 780-786 (clarifying Act's causation requirements in light of *Modesto I*); *Redevelopment Agency of City of San Diego v. San Diego Gas & Elec. Co.* (2003) 111 CA4th 912, 914, 4 CR3d 317, 319—agency also had standing under Act to bring action for order *compelling* responsible parties to remove or remedy contamination within project area]

i. [5:46.7] **Gatto Act:** The Gatto Act (Health & Saf.C. § 25403 et seq.) is the "policy successor" to the Polanco Act (¶ 5:46.6). It enables cities, counties and housing authorities to investigate and clean up hazardous materials in blighted areas within their boundaries. It is to be interpreted and implemented consistent with the Polanco Act and the case law construing it. [Health & Saf.C. § 25403.8]

(Although the Polanco Act technically is still in effect, redevelopment agencies were dissolved in 2012 (Health & Saf.C. § 34172; see also *City of Modesto v. Dow Chem. Co.* (2018) 19 CA5th 130, 142, 227 CR3d 764, 772).)

j. [5:47] **Other State Acts:** The statutes discussed at ¶ 5:25 ff. comprise the heart of California's complex regulatory scheme governing hazardous substances. However, there are several other California hazardous materials statutes, which should be reviewed for applicability to each particular transaction. These include:

• California's Business Plan Requirements (Health & Saf.C. § 25500 et seq.);

• The Elder California Pipeline Safety Act of 1981 (Gov.C. § 51010 et seq.);

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• California Hazardous Substances Act (Health & Saf.C. § 108100 et seq.);

• California Methamphetamine Contamination Property Cleanup Act of 2005 (Health & Saf.C. § 25400.10 et seq.);

• Air Toxic “Hot Spots” Information and Assessment Act of 1987 (Health & Saf.C. § 44300 et seq.).

[5:48 - 5:55] ***Reserved.***

3. [5:56] **Local Laws:** The release and remediation of hazardous substances is also regulated at the local (city/county) level.

a. [5:56.1] **Preemption issues:** Generally, CERCLA and the California Superfund permit local governments to enact hazardous waste ordinances and pursue remedies in addition to those provided by CERCLA and the California Superfund, so long as those remedies do not conflict or interfere with the purposes and objectives of CERCLA or the California Superfund. [*Fireman's Fund Ins. Co. v. City of Lodi, Calif.* (9th Cir. 2002) 302 F3d 928, 943]

Any local ordinance provisions that prohibit conduct expressly authorized by, or that stand as “an obstacle to the accomplishment and execution” of the full purposes of, CERCLA or the California Superfund are *preempted*. [*Fireman's Fund Ins. Co. v. City of Lodi, Calif.*, supra, 302 F3d at 956-957—portions of municipal ordinance authorizing City to investigate and remediate existing or threatened hazardous waste within its borders preempted by CERCLA and California Superfund]

(1) [5:57] **Preemption where contaminated property listed as California Superfund remediation site:** When the California Department of Toxic Substances Control (DTSC) has listed contaminated property as a site subject to remedial clean-up under the California Superfund, the *sole* authority for administering actual remediation of the property is vested with the DTSC. Thus, remediation of a designated California Superfund site may *not* be subject to local regulation *without the DTSC's approval and supervision*. [*City of Lodi v. Randtron* (2004) 118 CA4th 337, 349-350, 13 CR3d 107, 114—where City was designated as California Superfund site, remediation order issued by City pursuant to ordinance authorizing City's investigation and remediation of its contaminated soil and groundwater was preempted by California Superfund]

[5:58 - 5:59] ***Reserved.***

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Chapter 5. Environmental Hazards Liability

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(c) [5:138.116] Three-year statute of limitations
(3) [5:138.125] Superseding owner/PRP agreements

1. Persons and Entities Subject to Liability

a. [5:60] **Categories of "PRPs":** CERCLA and the California Superfund designate four categories of individuals and entities as "potentially responsible parties" (PRPs). PRPs include:

- *current owners and operators* of the contaminated property (see *California Dept. of Toxic Substances Control v. Hearthside Residential Corp.* (9th Cir. 2010) 613 F3d 910, 911 (interpreting "owner and operator" to mean "current" owner/operator at time clean-up costs are incurred for purposes of CERCLA liability; *and*¶ *5:82.16*));

- property owners and operators *at the time the hazardous materials were disposed of* on the property;

- individuals and entities who *arranged with a third party for the disposal, treatment or transportation* of their hazardous materials at or to a facility owned by a third party, and which facility contains those hazardous materials (see *California Dept. of Toxic Substances Control v. Alco Pac., Inc.* (9th Cir. 2007) 508 F3d 930, 934—so-called "arranger liability"; *and*¶ *5:83*); and

- individuals and entities who *accepted hazardous materials for transport* to disposal or treatment facilities, incineration plants or other sites of their choosing from which there is a release or threatened release of hazardous materials. [42 USC § 9607(a)(1)-(4); Health & Saf.C. § 78145 (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24); *Burlington Northern & Santa Fe Ry. Co. v. United States* (2009) 556 US 599, 608-609, 129 S.Ct. 1870, 1878; *Carson Harbor Village, Ltd. v. Unocal Corp.* (9th Cir. 2001) 270 F3d 863, 874-875 (en banc)]

  In effect, CERCLA's broad reach "extends liability all the way down the causal chain," from those who generate waste through those who maintain it and those who dispose of it. [*OHM Remediation Services v. Evans Cooperage Co., Inc.*

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(5th Cir. 1997) 116 F3d 1574, 1578; see also *Pneumo Abex Corp. v. High Point, Thomasville & Denton R.R. Co.* (4th Cir. 1998) 142 F3d 769, 774]

(1) [5:60a] **Actual liability not the touchstone:** Actual liability under CERCLA is not the touchstone for PRP status. Even before any determination of actual liability, a party who ostensibly fits into one of the categories referenced at ¶ 5:60 may be “potentially liable” simply by being sued under the Act. [See *Carson Harbor Village, Ltd. v. Unocal Corp.* (9th Cir. 2001) 270 F3d 863, 874; *United States v. Hercules, Inc.* (8th Cir. 2001) 247 F3d 706, 716 (same)]

“The courts may eventually clear a CERCLA defendant or third-party defendant from liability; but until it does, such a defendant is at least potentially liable.” [*OHM Remediation Services v. Evans Cooperage Co., Inc.* (5th Cir. 1997) 116 F3d 1574, 1582; see also *Pneumo Abex Corp. v. High Point, Thomasville & Denton R.R. Co.* (4th Cir. 1998) 142 F3d 769, 773, fn. 2—courts have understood “potentially responsible party” to “refer to a party who may be covered by the statute at the time that said party is sued under the statute”]

(2) [5:60b] **Contractual PRP status:** Nothing in CERCLA precludes an otherwise “innocent” party from becoming a PRP by contract. [See *Karras v. Teledyne Indus., Inc.* (SD CA 2002) 191 F.Supp.2d 1162, 1169—where PRPs ordered to reimburse government for response costs set up trusts to perform work pursuant to order by written agreement, trusts contractually agreed to be liable for clean-up and thereby became PRPs eligible to pursue CERCLA contribution action]

(3) [5:60.1] **Federal government not immune:** CERCLA expressly waives federal government sovereign immunity, making each “department, agency, and instrumentality of the United States” subject to CERCLA liability “in the same manner and to the same extent … as any nongovernmental entity …” [42 USC § 9620(a)(1); see also *United States v. Shell Oil Co.* (9th Cir. 2002) 294 F3d 1045, 1053—CERCLA's sovereign immunity waiver is coextensive with scope of liability imposed by CERCLA (i.e., if CERCLA “provides for liability, then § 9620(a)(1) waives sovereign immunity to that liability”); *Nu-West Mining, Inc. v. United States* (D ID 2011) 768 F.Supp.2d 1082, 1087 (same)]

Consequently, the federal government and its agencies are subject to PRP liability as an “owner” or “operator” of a facility where hazardous substances are disposed of or released; the federal government is afforded no immunity or defense that is not shared by private parties. [See *Pennsylvania v. Union Gas Co.* (1989) 491 US 1, 10, 109 S.Ct. 2273, 2279 (overruled on other grounds by *Seminole Tribe of Florida v. Florida* (1996) 517 US 44, 66, 116 S.Ct. 1114, 1128); *United States v. Shell Oil Co.* (9th Cir. 2002) 294 F3d 1045, 1053—CERCLA's waiver of sovereign immunity coextensive with scope of liability imposed by 42 USC § 9607; *East Bay Mun. Util. Dist. v. United States Dept. of Commerce* (DC Cir. 1998) 142 F3d 479, 482-484—CERCLA's waiver of sovereign immunity extends to any instance in which government owned or operated a facility, regardless of whether it acted in a regulatory or proprietary capacity]

(4) [5:60.2] **State and local governments not immune:** CERCLA also abrogates state and local government immunity in terms virtually identical to its waiver of federal government immunity. [See 42 USC § 9601(20)(D)—state/local government exclusion from CERCLA “owner”/“operator” liability “shall not apply to any State or local government which has caused or contributed to the release or threatened release of a hazardous substance from the facility, and such a State or local government shall be subject to the provisions of this chapter in the same manner and to the same extent … as any nongovernmental entity”; *East Bay Mun. Util. Dist. v. United States Dept. of Commerce* (DC Cir. 1998) 142 F3d 479, 480—municipal utility district responsible as “owner” for costs of cleaning up hazardous waste from abandoned mine site it acquired in developing reservoir system]

(a) [5:60.3] **Compare—emergency responder defense:** State and local governments are shielded from CERCLA liability when hazardous substances are released during fire-fighting and other emergency undertakings (unless damages are the result of gross negligence or intentional misconduct). [42 USC § 9607(d)(2); see *AMW Materials Testing, Inc. v. Babylon, N.Y.* (2nd Cir. 2009) 584 F3d 436, 442-448 (rejecting contention that defense applies only in contribution context)—town and fire department did not have sufficient “control” over facility containing stored hazardous materials at time of fire to be deemed “operators” for liability purposes]

b. [5:61] **Liability of property owners and operators:** The discussion at ¶ 5:62 ff. focuses primarily on the liability of current and former *owners and operators* of a contaminated property. A detailed treatment of the laws affecting the other two categories of PRPs (*¶ 5:60*) is beyond the scope of this Practice Guide.

The California Superfund adopts by reference the provisions of CERCLA regarding “responsible parties” and liable persons. [Health & Saf.C. § 78145(a)(1) (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24); see also *Orange County Water Dist. v. Alcoa Global Fasteners, Inc.* (2017) 12 CA5th 252, 297, 219 CR3d 474, 514 (decided under predecessor

statute)] Therefore, the discussion of CERCLA liability at ¶ 5:62 ff. applies equally to liability under the California Superfund.

Although the first two categories of PRPs refer to the "owner and operator" (¶ 5:60) of a "facility" (¶ 5:5.4 ff.), those terms are not redundant. In some circumstances, the operator may not be the owner, or a "facility" may have more than one operator. [See *Geraghty & Miller, Inc. v. Conoco, Inc.* (5th Cir. 2000) 234 F3d 917, 928 (abrogated on other grounds as recognized by *Vine Street LLC v. Borg Warner Corp.* (5th Cir. 2015) 776 F3d 312, 317)]

(1) General parameters

(a) [5:62] **"Owner" liability; permit/easement/license holders distinguished:** Any person who owns (or owned at the time of disposal) a "facility" (42 USC § 9601(9); ¶ 5:5.4) is an "owner" under CERCLA, unless the person can meet each of the contiguous property owner exemption requirements (42 USC § 9607(q); ¶ 5:85 ff.). [42 USC § 9607(a)(1), (2)]

Though CERCLA does not define "owner" for PRP purposes, the term clearly includes those who own (or owned) a *fee* interest in the contaminated site (¶ 5:62a). On the other hand, looking to the common law, courts have concluded that mere holders of possessory interests in the contaminated land, such as permittees, easement holders or licensees, are not "owners" subject to CERCLA liability. [See *City of Los Angeles v. San Pedro Boat Works* (9th Cir. 2011) 635 F3d 440, 444 (revocable permit holder); *Long Beach Unified School Dist. v. Dorothy B. Godwin Calif. Living Trust* (9th Cir. 1994) 32 F3d 1364, 1368-1369 (easement holder); see also *Redevelopment Agency of City of Stockton v. BNSF Ry. Co.* (9th Cir. 2011) 643 F3d 668, 679—having an easement or license does not make one an "owner" for purposes of CERCLA liability]

1) [5:62a] **Regardless of fault:** A person can be an "owner" for PRP purposes even if they are not responsible for the underlying release of a hazardous substance and cannot be compelled to pay for any part of the cleanup—e.g., they are protected by the "innocent landowner" defense (42 USC § 9607(b)(3); ¶ 5:110 ff.), the statute of limitations has expired (¶ 5:121.13 ff.), or the person is entitled to some other affirmative defense (¶ 5:100 ff.) or exemption from liability (¶ 5:84 ff.). Indeed, a person is a PRP if they own (or owned at the time of disposal) a site or area where hazardous substances have "come to be located" and the site or area is not a "contiguous property" (42 USC § 9607(q); ¶ 5:85 ff.). [*Atlantic Richfield Co. v. Christian* (2020) 590 US _, _, 140 S.Ct. 1335, 1347, 1352-1353, 1356—landowners deemed PRPs and not contiguous property owners where pollutants from former smelter facility came "to be located" on their properties and they "had reason to know their property could be contaminated" (¶ 5:7, 5:85.1); see also *United States v. Atlantic Research Corp.* (2007) 551 US 128, 136, 127 S.Ct. 2331, 2336—"[E]ven parties not responsible for contamination may fall within the broad definitions of PRPs in [42 USC § 9607(a)]"]

2) [5:62.1] **Lessee as "owner":** Persons who have only a *leasehold* (possessory) interest in property are, of course, not regarded as owners under general property law. Nonetheless, in certain circumstances, courts have extended CERCLA "owner" liability to lessees. [*Commander Oil Corp. v. Barlo Equip. Corp.* (2nd Cir. 2000) 215 F3d 321, 326, 329]

a) [5:62.2] ***De facto ownership determinative; relevant factors:*** The lessee's right of control over the site is not itself the equivalent of "ownership" for CERCLA purposes. Rather, a lessee can be subject to CERCLA liability as an "owner" only if its rights under the lease bear sufficient *indicia of ownership* as to be tantamount to the rights of an owner; i.e., the inquiry is whether the lessee is, in effect, a *de facto* owner. [*Commander Oil Corp. v. Barlo Equip. Corp.* (2nd Cir. 2000) 215 F3d 321, 331]

Factors that may be sufficient to transform a lessee into an "owner" under CERCLA include:

• an extensive lease term, with no reservation of rights in the owner (lessor) to determine how the property is used;

• the owner's inability to terminate the lease before it expires by its terms;

• the lessee's right to sublet all or part of the property without notice to the owner and without the owner's consent;

• the lessee's obligation to pay all taxes, assessments, insurance and operating and maintenance costs; and

• the lessee's responsibility for making all repairs to the property. [*Commander Oil Corp. v. Barlo Equip. Corp.*, supra, 215 F3d at 330-331—lessee did not bear sufficient "indicia of ownership" (e.g., lessee required to obtain written consent from record owner to sublet or alter property)]

b) [5:62.3] **Compare—"operator" liability:** A lessee's right of control over the contaminated site can give rise to CERCLA *operator* liability (¶ 5:62.5 ff.). [See *Commander Oil Corp. v. Barlo Equip. Corp.* (2nd Cir. 2000) 215 F3d 321, 328 (distinguishing "operator" from "owner" liability)]

[5:62.4] ***Reserved.***

(b) [5:62.5] **"Operator" liability:** A nonowner party may still be a PRP under either of the first two CERCLA categories if it is or was an "operator" of the hazardous waste facility. [See 42 USC § 9607(a)(1), (2); *Long Beach Unified School Dist. v. Dorothy B. Godwin Calif. Living Trust* (9th Cir. 1994) 32 F3d 1364, 1367—easement holder may be "operator" subject to CERCLA liability if it uses its easement to operate a facility that releases hazardous materials]

"Under the plain language of the statute, any person who operates a polluting facility is directly liable for the costs of cleaning up the pollution … This is so regardless of whether that person is the facility's owner, the owner's parent corporation or business partner, or even a saboteur who sneaks into the facility at night to discharge its poisons out of malice." [*United States v. Bestfoods* (1998) 524 US 51, 65, 118 S.Ct. 1876, 1886 (addressing parent corporation's direct "operator" liability for subsidiary's pollution; *¶ 5:77 ff.*)]

1) [5:62.6] **Actual control over contaminated facility required:** An "operator" for CERCLA purposes is one who "directs the workings of, manages, or conducts the affairs of a [contaminating] facility." It is *not* enough that the alleged PRP have the *authority* to control the facility. An "operator" under CERCLA "must manage, direct, or conduct operations *specifically related to* pollution, that is, operations having to do with the leakage or disposal of hazardous waste, or decisions about compliance with environmental regulations." [*United States v. Bestfoods* (1998) 524 US 51, 66-67, 118 S.Ct. 1876, 1887 (emphasis added)—PRP "operator" must participate in *contaminated facility's* polluting activities; *Geraghty & Miller, Inc. v. Conoco, Inc.* (5th Cir. 2000) 234 F3d 917, 928 (abrogated on other grounds as recognized by *Vine Street LLC v. Borg Warner Corp.* (5th Cir. 2015) 776 F3d 312, 317)—material issue of fact whether contractor employed to investigate and assist in *constructing remediation facility* was "operator"; see also *Nu-West Mining, Inc. v. United States* (D ID 2011) 768 F.Supp.2d 1082, 1089-1091—federal government was subject to "operator" liability as "a matter of law" due to its active involvement in design and location of contaminated mining site waste dumps and its direct responsibility for ensuring same complied with mining plans and environmental rules]

Pursuant to this standard, a CERCLA "operator" must, in effect, be actively involved in running the facility where the pollution occurs, typically on a *day-to-day managerial basis*—for example, negotiating contracts for dumping waste at the facility, or directing where the wastes are to be dumped. [See *American Cyanamid Co. v. Capuano* (1st Cir. 2004) 381 F3d 6, 22-23; *Browning-Ferris Indus. of Ill., Inc. v. Ter Maat* (7th Cir. 1999) 195 F3d 953, 957; *Long Beach Unified School Dist. v. Dorothy B. Godwin Calif. Living Trust* (9th Cir. 1994) 32 F3d 1364, 1367]

Merely standing by and failing to prevent contamination is *not* enough to confer CERCLA "operator" status. [See *Long Beach Unified School Dist. v. Dorothy B. Godwin Calif. Living Trust*, supra, 32 F3d at 1368; *Carson Harbor Village, Ltd. v. Unocal Corp.* (CD CA 2003) 287 F.Supp.2d 1118, 1194, aff'd (9th Cir. 2006) 433 F3d 1260]

2) [5:62.7] **Federal government's operator liability:** In many cases, the federal government's legal and regulatory authority can directly affect an entire industry or a specific facility's operations. [See, e.g., *United States v. Central Eureka Mining Co.* (1958) 357 US 155, 157-161, 78 S.Ct. 1097, 1098-1101 & fn. 4—federal government ordered gold mines closed during World War II for purpose of reallocating resources to boost copper mining production]

The federal government's general control over an industry or facility, however, is not enough to make the federal government an "operator" under CERCLA. Under the *Bestfoods* standard (¶ 5:62.5 ff.), the federal government must "manage, direct, or conduct operations" specifically related to pollution at the facility to be subject to CERCLA liability as an "operator." [*United States v. Sterling Centrecorp Inc.* (9th Cir. 2020) 977 F3d 750, 758-759—United States not liable as prior "operator" for exercising "general regulatory authority over the mining industry during World War II" and ordering gold mine that became Superfund Site to shut down its mining operations]

(2) [5:63] **Intervening owners/operators as PRPs:** CERCLA originally designated as PRPs those who are current owners and operators of a contaminated property, as well as those who owned and/or operated the property at the time the contamination occurred. [42 USC § 9607(a)] This, of course, left immune from liability former owners and operators of a contaminated property who did not own or operate the property at the time of the hazardous substance release (i.e., those who either transferred their interest in the property or ceased to operate the property before any action was taken or liability imposed with respect to the contamination).

Amendments in 1986 closed this gap by adding *intervening landowners* to the categories of PRPs: An intervening landowner is a PRP if it (a) took title to the property after the release of hazardous materials thereon; (b) has not contributed to the contaminated condition of the property; (c) has actual knowledge of the presence of hazardous materials on the property; and (d) fails to disclose the environmental condition of the property to the subsequent buyer of the property. [42 USC § 9601(35)(C)]

(a) [5:63.1] **"Disposal" requirement:** Intervening landowners or operators can be liable as PRPs only if there was a *"disposal"* of hazardous waste on the property during the period when they held or operated the property. [42 USC § 9607(a)(2); see *Carson Harbor Village, Ltd. v. Unocal Corp.* (9th Cir. 2001) 270 F3d 863, 875 (en banc); *and*¶ *5:60*]

Therefore, what constitutes a "disposal" is crucial to establishing liability of intervening owners or operators.

1) [5:63.1a] **Statutory definition:** For purposes of 42 USC § 9607(a), CERCLA defines "disposal" as the "discharge, deposit, injection, dumping, spilling, leaking, or placing" of hazardous material into or on land or water so that the hazardous material may *enter the environment* or be emitted into the air or discharged into any waters. [42 USC § 9601(29) (incorporating RCRA definition of "disposal," 42 USC § 6903(3)); see *Otay Land Co., LLC v. U.E. Ltd., L.P.* (2017) 15 CA5th 806, 834-836, 225 CR3d 119, 142-143—spent lead and target debris at shooting range constituted solid waste disposal when left to accumulate; *Orange County Water Dist. v. Sabic Innovative Plastics US, LLC* (2017) 14 CA5th 343, 373, 381, 386-387, 222 CR3d 83, 110, 117, 121-122 (finding evidence of "release" not required)—hazardous substance need not actually reach environment for "disposal" to occur; *Voggenthaler v. Maryland Square LLC* (9th Cir. 2013) 724 F3d 1050, 1064 (finding disposal need not be *directly* into groundwater or on land)—dry cleaning facility liable for spilling toxic chemical onto its floor that subsequently entered environment over several decades; compare *Sycamore Industrial Park Assocs. v. Ericsson, Inc.* (7th Cir. 2008) 546 F3d 847, 850-853—cleanup of hazardous substance (asbestos) contained *entirely inside building* does not support CERCLA cost-recovery action; *3550 Stevens Creek Assocs. v. Barclays Bank of Calif.* (9th Cir. 1990) 915 F2d 1355, 1361—asbestos built into structure cannot enter environment or be emitted into air and therefore is not actionable under CERCLA]

2) [5:63.2] **Passive migration of hazardous waste?** The circuits have taken a variety of approaches to the question whether a "disposal" (as defined in ¶ 5:63.1a) includes *passive migration* of hazardous materials, depending in large part on the factual circumstances of the case. [See *Carson Harbor Village, Ltd. v. Unocal Corp.* (9th Cir. 2001) 270 F3d 863, 875-877 (collecting cases)]

The Ninth Circuit decides the issue by examining the statutory terms (discharge, deposit, injection, dumping, etc.) in relation to the facts of the case and then determining "whether the *movement of contaminants* is, under the plain meaning of the terms, a 'disposal.'" [*Carson Harbor Village, Ltd. v. Unocal Corp.*, supra, 270 F3d at 879 (emphasis added)—under facts of case, gradual passive migration of contamination through soil *not a* "disposal"; see also *Pakootas v. Teck Cominco Metals, Ltd.* (9th Cir. 2016) 830 F3d 975, 977, 983-985 (finding *Carson Harbor*'s en banc decision controlling)—"aerial deposition" of hazardous substances through smelter's smokestacks *not* a "disposal"]

a) [5:63.3] **Affirmative human conduct not essential:** Most of the statutory terms (discharge, deposit, dumping, etc.) connote active conduct. But *Carson*, supra, observes that, in some circumstances, there may be a "disposal" without affirmative human conduct (e.g., leaking abandoned storage tanks). [See *Carson Harbor Village, Ltd. v. Unocal Corp.* (9th Cir. 2001) 270 F3d 863, 880-881—"'leaking' and 'spilling' may not require affirmative human conduct" (citation omitted)]

b) [5:63.4] **Compare—passive migration as "release":** Whether or not it constitutes a "disposal," passive migration of hazardous substances can amount to a CERCLA "release"; *see*¶ *5:5.3a*.

(3) [5:64] **No-fault liability:** Courts construe CERCLA as imposing *strict liability* (¶ *5:9*), subject only to very limited defenses (¶ *5:100 ff.*). Thus, PRPs who are *either* current owners *or* operators, *or* intervening or former owners or operators, can potentially be held liable for the presence of hazardous materials on the property *even though they had no involvement*

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in creating the contaminated condition. [*Carson Harbor Village, Ltd. v. Unocal Corp.* (9th Cir. 2001) 270 F3d 863, 870 (en banc); *Long Beach Unified School Dist. v. Dorothy B. Godwin Calif. Living Trust* (9th Cir. 1994) 32 F3d 1364, 1366—"CERCLA liability has been described as 'a black hole that indiscriminately devours all who come near it'"; *Orange County Water Dist. v. Sabic Innovative Plastics US, LLC* (2017) 14 CA5th 343, 376-377, 222 CR3d 83, 113-114—current operator strictly liable for response costs even if hazardous substance release predated commencement of operator's lease]

(a) [5:65] **Buyers' exposure:** Once in the chain of title, buyers of real property can be held liable even if they did not have any interest in the property at the time it became contaminated and, except in extremely rare cases (*see¶ 5:110 ff.*), even if they did not know of the presence of hazardous materials on the property at the time they took title. [*United States v. Monsanto Co.* (4th Cir. 1988) 858 F2d 160, 168]

Indeed, in a subsequent contribution action to recover cleanup costs (¶ 5:125.3 ff.), a "no-fault" current owner may be allocated a share of liability. This will prevent the owner from receiving a "windfall" if they purchased contaminated property at below-market value and then restored its value by compelling the former owner or operator to pay the full cleanup cost. [See *Valbruna Slater Steel Corp. v. Joslyn Mfg. Co.* (7th Cir. 2019) 934 F3d 553, 567—current owner who "clearly understood" site's serious pollution problems before purchasing steel mill property, and who "paid far less than the asking price," was liable for 25% of cleanup costs in contribution action against former steel mill's owner/operator]

(b) Sellers' exposure

1) [5:66] **Sellers who generated contamination or owned property at time of hazardous substance occurrence:** Sellers of contaminated property who owned the property at the time the hazardous substance disposal occurred (whether or not they caused the disposal), *or* who were generators of the hazardous materials, remain PRPs under CERCLA and the California Superfund notwithstanding a completed sale and regardless of how much time has passed since they owned the property. [42 USC § 9607(a)(2), (3) & (4)]

2) [5:67] **Intervening sellers:** Sellers of contaminated property who *neither* owned the property at the time the contamination occurred *nor* generated any of the hazardous substances affecting the property will escape liability under CERCLA *only* if they:

• Did *not have actual knowledge* of the presence of hazardous substances on the property at the time they sold the property; *or*

• Had actual knowledge of the presence of hazardous substances on the property at the time of the sale *and disclosed same to the buyer* pursuant to CERCLA requirements. [42 USC § 9601(35)(C)]

Sellers who have actual knowledge of the contaminated state of their property and fail to disclose same to the buyer before conveying title *remain PRPs* under CERCLA *and lose the right to assert any defenses* they may have to CERCLA liability. [42 USC § 9601(35)(C)]

3) [5:68] **Nondisclosure State Superfund liability:** In addition, the California Superfund imposes an affirmative obligation on owners of *nonresidential* real property to disclose to prospective buyers, lessees or renters the presence of any hazardous substance that the owner knows or has reason to believe has been released on or under the property. Failure to make such a disclosure subjects owners to liability for the buyer's, lessee's or renter's actual damages arising therefrom. [Health & Saf.C. § 78700 (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24)]

Further, if the owner has *knowingly and intentionally* failed to disclose to the buyer, lessee or renter a material environmental hazard of which the owner had actual knowledge, the owner may also be subject to civil penalties of up to $5,000 for each occurrence. [Health & Saf.C. § 78700 (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24)]

(4) [5:69] **Liability retroactive and open-ended:** CERCLA liability is *retroactive and open-ended:*

(a) [5:70] **Pre-CERCLA contamination:** A PRP is subject to CERCLA liability even if the contamination occurred before CERCLA was enacted, and even if the contamination was lawful at the time it occurred. [*United States v. Olin Corp.* (11th Cir. 1997) 107 F3d 1506, 1513-1515; *United States v. Dickerson* (D MD 1986) 640 F.Supp. 448, 451]

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A PRP also can be held liable under CERCLA even if its entire relationship to the property (purchase, ownership and sale) occurred before CERCLA was enacted. [*United States v. Northeastern Pharmaceutical & Chem. Co., Inc.* (8th Cir. 1986) 810 F2d 726, 732-734]

This principle would seem also to apply to intervening landowners. The intervening landowner will be a PRP if it knew of the contamination on its property and failed to disclose that fact to the buyer, even if the sale took place before CERCLA became law. [See *United States v. Northeastern Pharmaceutical & Chem. Co., Inc.*, supra, 810 F2d at 732-734 (concerning preenactment conduct generally); 42 USC § 9601(35)(C)]

(b) [5:71] **Future contamination:** Similarly, liability under CERCLA can be open-ended. PRPs with respect to a property *remain* PRPs as to any *future discovery* of hazardous substances on that property, *whenever occurring*. [42 USC § 9601(35)(C)]

(5) [5:72] **Joint and several vs. several liability:** Although CERCLA imposes a strict liability standard on PRPs, it does *not* mandate joint and several liability in every case. Rather, Congress intended the scope of liability to be determined on the basis of "traditional and evolving principles" of common law. As such, § 433A of the Restatement (Second) of Torts is the "universal starting point" in determining joint and several liability issues under CERCLA. [*Burlington Northern & Santa Fe Ry. Co. v. United States* (2009) 556 US 599, 613-614, 129 S.Ct. 1870, 1880-1881]

(a) [5:72.1] **Joint and several liability for indivisible harm:** Thus, where the *harm is indivisible*, CERCLA liability is joint and several, and any single PRP can be held liable for the entire amount of the response costs regardless of the degree to which that PRP participated in contaminating the property. [See *Burlington Northern & Santa Fe Ry. Co. v. United States* (2009) 556 US 599, 614, 129 S.Ct. 1870, 1881 (citing Rest.2d Torts § 433A, comm. i)—courts refuse to make arbitrary apportionment when two or more causes produce single, indivisible harm; *United States v. Monsanto Co.* (4th Cir. 1988) 858 F2d 160, 171-172; *Pakootas v. Teck Cominco Metals, Ltd.* (9th Cir. 2018) 905 F3d 565, 588—CERCLA liability ordinarily joint and several except in rare cases where environmental harm to site "is shown to be divisible"]

(b) [5:73] **Several liability (apportionment of liability) for distinct harms:** On the other hand, in accordance with § 433A of the Restatement, *apportionment of liability* is appropriate under CERCLA where there are "distinct harms" (¶ 5:73.1) for which there is a reasonable basis to determine the harm caused by each PRP (¶ *5:74*). [*Burlington Northern & Santa Fe Ry. Co. v. United States*, supra; see also *PCS Nitrogen Inc. v. Ashley II of Charleston LLC* (4th Cir. 2013) 714 F3d 161, 181]

1) [5:73.1] **"Distinct harms" defined:** "Distinct harms" are *separate* injuries. Defendants may be able to demonstrate that harms are "distinct" based on geographical factors, such as where a site consists of noncontiguous areas of contamination, or separate and distinct subterranean "plumes" of groundwater contamination. [See *United States v. Hercules, Inc.* (8th Cir. 2001) 247 F3d 706, 717-718]

2) [5:74] **Reasonable basis for determining divisibility of "single harm":** Apportionment of CERCLA liability is also appropriate when there is a reasonable basis for determining that each defendant caused a separate amount of harm, limited in time, and no single defendant has any responsibility for the harm caused by the other(s); e.g., two defendants, independently operating the same plant, pollute a stream over successive periods of time, or discharge waste into the stream in readily identifiable quantities. [*Matter of Bell Petroleum Services, Inc.* (5th Cir. 1993) 3 F3d 889, 895, 903; see *United States v. P.H. Glatfelter Co.* (7th Cir. 2014) 768 F3d 662, 678—remand required where contamination theoretically capable of apportionment; *United States v. Hercules, Inc.* (8th Cir. 2001) 247 F3d 706, 718—divisibility even possible where wastes have become cross-contaminated or commingled]

a) [5:74.1] **Burden and standard of proof:** A defendant PRP seeking to avoid joint and several liability bears the burden of proving that a reasonable basis for apportionment exists. [*Burlington Northern & Santa Fe Ry. Co. v. United States* (2009) 556 US 599, 614, 129 S.Ct. 1870, 1881; see *Matter of Bell Petroleum Services, Inc.* (5th Cir. 1993) 3 F3d 889, 895, 901-902—court erred in ordering joint and several liability where PRP met burden of proving reasonable basis for apportionment; compare *PCS Nitrogen Inc. v. Ashley II of Charleston LLC* (4th Cir. 2013) 714 F3d 161, 182-183—although harm at site was "theoretically divisible," PRP's methodologies failed to provide evidence necessary to establish reasonable basis for apportionment]

The normal *preponderance of the evidence* standard of proof applies. [See *Pakootas v. Teck Cominco Metals, Ltd.* (9th Cir. 2018) 905 F3d 565, 589 (noting "[t]his burden is substantial because the divisibility analysis is

intensely factual" (internal quotations omitted)); *Fireman's Fund Ins. Co. v. City of Lodi, Calif.* (9th Cir. 2002) 302 F3d 928, 947—municipality cannot enact ordinance imposing higher clear and convincing evidence burden of proof on defendant PRP seeking to apportion liability]

b) [5:74.2] **Evidence required?** There is a split of authority on the nature of proof required to support a finding that a reasonable basis for apportionment exists:

Some courts require *concrete and specific evidence* in support of any proposed apportionment. [See *United States v. Hercules, Inc.* (8th Cir. 2001) 247 F3d 706, 718; *Chem-Nuclear Systems, Inc. v. Bush* (2002) 292 F3d 254, 260—relying on chain of possible inferences insufficient]

Other courts have permitted *informal* estimates or data to support apportionment. [See *Matter of Bell Petroleum Services, Inc.* (5th Cir. 1993) 3 F3d 889, 903-904; *United States v. Hercules, Inc.,* supra, 247 F3d at 719]

c) [5:74.3] **No zero-share apportionment:** Current operators subject to CERCLA cost-recovery claims are by definition jointly and severally liable regardless of fault. Thus, even when current operators do not contribute any environmental contamination to a site and take steps to remediate the pollution, they are liable to some degree and cannot avoid joint and several liability through a zero-share apportionment: "The structure and purposes of CERCLA simply do not permit current owner or operator PRPs to use individual share apportionment to apportion themselves a zero-share harm … Such a rule would frustrate the several narrow statutory defenses and exemptions Congress created to address truly 'innocent' landowners." [*PCS Nitrogen Inc. v. Ashley II of Charleston LLC* (4th Cir. 2013) 714 F3d 161, 184-185; *but see* ¶ *5:125.3 ff.* regarding PRP's ability to sue other responsible parties for contribution]

d) [5:74.4] **Equitable factors *not considered:*** In keeping with the strict liability nature of CERCLA (¶ *5:9*), equitable considerations (e.g., relative fault) "play no role" in the apportionment analysis. [*Burlington Northern & Santa Fe Ry. Co. v. United States* (2009) 556 US 599, 615, 129 S.Ct. 1870, 1882, fn. 9—apportionment is proper only when evidence supports divisibility of damages jointly caused by PRPs; see also *PCS Nitrogen Inc. v. Ashley II of Charleston LLC* (4th Cir. 2013) 714 F3d 161, 182—equitable considerations play no role in apportionment analysis because availability of 42 USC § 9613(f) contribution action mitigates any resulting inequality (¶ *5:74.7*); *United States v. Hercules, Inc.* (8th Cir. 2001) 247 F3d 706, 718—where causation unclear, courts should not "split the difference" in attempt to achieve equity]

1/ [5:74.5] **Applicable in "exceptional cases"?** Courts appear to be split on whether equity can enter into the CERCLA liability apportionment process in "exceptional cases" (as where a PRP is insolvent). [See *United States v. Hercules, Inc.* (8th Cir. 2001) 247 F3d 706, 718, fn. 10—rejecting suggestion that financial condition should "play a role" in divisibility analysis; compare *Matter of Bell Petroleum Services, Inc.* (5th Cir. 1993) 3 F3d 889, 896, 902, fn. 13—suggesting insolvency should be considered to avoid "unjust" result]

2/ [5:74.6] **Compare—equity applicable at contribution phase:** On the other hand, equitable factors are relevant at the *contribution* phase (¶ *5:134*). [*United States v. Hercules, Inc.* (8th Cir. 2001) 247 F3d 706, 718]

e) [5:74.7] **Effect of failure to prove basis for apportionment:** A defendant PRP who is unable to demonstrate a reasonable basis for apportionment may be held liable to the government for the entire harm (¶ *5:72.1*). However, this does not mean the PRP must ultimately shoulder a disproportionate amount of the response costs: The PRP may sue other responsible parties for *contribution* (¶ *5:125 ff.*) and, in that action, may assert both legal and equitable (¶ *5:134*) theories of cost allocation. [*United States v. Monsanto Co.* (4th Cir. 1988) 858 F2d 160, 173]

Joint and several liability may even be imposed in contribution cases (*see* ¶ *5:135.10*).

(c) [5:75] **Settlement with EPA:** Under certain circumstances, a PRP may be able to achieve apportionment of liability by entering into a settlement with the Environmental Protection Agency. However, this settlement option is available only to PRPs whose participation in creating the hazardous condition was relatively minimal and who meet other CERCLA criteria. [See 42 USC § 9622(g); *see also* ¶ *5:198* re "prospective purchaser agreements"]

[5:76] *Reserved.*

(6) [5:77] **Liability of corporate parents, officers, directors and shareholders:** A corporate parent may be reached under CERCLA for its subsidiary's pollution on either a derivative liability theory *or* a direct operator liability theory. As discussed at ¶ 5:77.1 ff., however, a corporate parent is *not* exposed to CERCLA liability simply because the parent has

authority over the subsidiary or shares a common board of directors or common officers. [*United States v. Bestfoods* (1998) 524 US 51, 68-70, 118 S.Ct. 1876, 1887-1889]

(a) [5:77.1] **Derivative liability on veil-piercing theory:** CERCLA did not displace the general principle of corporate law that a parent corporation is not liable for the acts of its subsidiaries; nor, however, did CERCLA rewrite the well-settled rule that the corporate veil may be pierced, rendering shareholders liable for the corporation's conduct when the corporate form would otherwise be misused to accomplish certain wrongful purposes (such as fraud) on the shareholders' behalf. [*United States v. Bestfoods* (1998) 524 US 51, 61-63, 118 S.Ct. 1876, 1884-1885]

It follows, therefore, that a subsidiary's owner or operator liability under CERCLA may be *imputed* to the parent corporation under traditional *veil-piercing standards;* i.e., if it is appropriate to pierce the corporate veil because of misuse of the corporate form, a parent corporation may incur *derivative liability* for its subsidiary's pollution under CERCLA. [*United States v. Bestfoods*, supra, 524 US at 62-64, 118 S.Ct. at 1885-1886]

1) [5:77.2] **Whether subsidiary liable as CERCLA owner or operator:** The indirect veil-piercing approach can subject a parent corporation to CERCLA liability either as an owner *or* operator. “If a subsidiary that operates, but does not own, a facility is so pervasively controlled by its parent for a sufficiently improper purpose to warrant veil piercing, the parent may be held derivatively liable for the subsidiary's acts as an operator.” [*United States v. Bestfoods* (1998) 524 US 51, 64, 118 S.Ct. 1876, 1886, fn. 10]

2) [5:77.3] **Veil-piercing standard?** There is disagreement whether, in considering the propriety of imposing CERCLA derivative liability, courts should borrow state veil-piercing (“alter ego”) law or apply a federal common law.

One line of authority maintains that, given the federal interest in uniform application of CERCLA, federal common law—not state formulations of the “alter ego” doctrine—must govern the circumstances under which corporate veil-piercing is warranted under CERCLA. [*Lansford-Coaldale Joint Water Auth. v. Tonolli Corp.* (3rd Cir. 1993) 4 F3d 1209, 1225; see also *Joslyn Mfg. Co. v. T.L. James & Co., Inc.* (5th Cir. 1990) 893 F2d 80, 83—“Veil piercing should be limited to situations in which the corporate entity is used as a sham to perpetrate a fraud or avoid personal liability” (emphasis omitted)]

The U.S. Supreme Court in *Bestfoods*, supra, noted but did not resolve the split of authority because the question was not presented in that case. [See *United States v. Bestfoods* (1998) 524 US 51, 63, 118 S.Ct. 1876, 1885, fn. 9]

Other courts, observing that CERCLA is silent on the issue, apply state veil-piercing law. [See *Carter-Jones Lumber Co. v. Dixie Distributing Co.* (6th Cir. 1999) 166 F3d 840, 847]

a) [5:77.4] **Comment:** For all practical purposes, the problem may not be worth debating. As one court noted, since “federal common law draws upon state law for guidance, … the choice between state and federal [veil-piercing] law may in many cases present questions of academic interest, but little practical significance.” [*In re Acushnet River & New Bedford Harbor Proceedings Re Alleged PCB Pollution* (D MA 1987) 675 F.Supp. 22, 33]

Cross-refer: For a comprehensive treatment of veil-piercing under the “alter ego doctrine,” see Friedman, Soza & Jann, *Cal. Prac. Guide: Corporations* (TRG), Ch. 2.

(b) [5:78] **Direct “operator” liability based on active control of polluting facility:** Although the contamination site is owned by the subsidiary, a parent corporation may incur *direct* CERCLA liability as an “*operator*” if it actively controlled and managed the polluting facility. “Nothing in [CERCLA] bars a parent corporation from direct liability for its own actions in operating a facility owned by its subsidiary.” [*United States v. Bestfoods* (1998) 524 US 51, 64, 118 S.Ct. 1876, 1886; see *Schiavone v. Pearce* (2nd Cir. 1996) 79 F3d 248, 254—subsidiary's direct “owner” liability is “entirely distinct from parent *operator* liability, proof of which looks to the independent actions of the parent corporation, evidenced through its control over the polluting site” (emphasis in original)]

1) [5:78.1] **Corporate shield no bar:** If any act of operating a subsidiary's facility is done *on behalf of* a parent corporation, the existence of the parent-subsidiary relationship under state corporate law is *irrelevant.* The parent is subject to *direct* CERCLA liability for its *own acts* regardless of the corporate shield or the legal structure of ownership. [*United States v. Bestfoods* (1998) 524 US 51, 65, 118 S.Ct. 1876, 1886; see *Browning-Ferris Indus. of Ill., Inc. v. Ter Maat* (7th Cir. 1999) 195 F3d 953, 955; *Riverside Market Develop. Corp. v. International Bldg. Products, Inc.* (5th Cir. 1991) 931 F2d 327, 330—persons cannot escape CERCLA liability by hiding behind corporate shield when, as operators, they actually participate in prohibited conduct]

2) [5:78.2] **Focus on parent's direct interactions with subsidiary's *facility:*** The nature of the relationship between parent and subsidiary—i.e., whether the parent operates the subsidiary's general business, whether the two share common directors or officers, etc.—goes to the question of derivative liability (*¶ 5:77.1*); it is *not* dispositive of the parent's *direct liability* as a CERCLA "operator." [*United States v. Bestfoods* (1998) 524 US 51, 70-71, 118 S.Ct. 1876, 1889]

A parent faces *direct "operator"* liability only if it operates the *polluting facility*, evidenced by *participation* in the *facility's activities*. Mere *authority* to control the PRP subsidiary is not enough. [*United States v. Bestfoods*, supra, 524 US at 65-72, 118 S.Ct. at 1887-1889]

a) [5:78.3] **Degree of participation:** A parent's activities that involve the facility but which are simply consistent with its investor status (e.g., monitoring subsidiary's performance, supervising its finance and budget decisions, and articulating general policies and procedures) should not themselves give rise to direct liability. "The critical question is whether, in degree and detail, actions directed to the facility by an agent of the parent alone are eccentric under accepted norms of parental oversight of a subsidiary's facility." [*United States v. Bestfoods* (1998) 524 US 51, 71-72, 118 S.Ct. 1876, 1889]

The parent must "manage, direct, or conduct operations *specifically related* to *pollution*, that is, operations having to do with the leakage or disposal of hazardous waste, or decisions about compliance with environmental regulations." [*United States v. Bestfoods*, supra, 524 US at 66-67, 118 S.Ct. at 1887 (emphasis added); see *United States v. Sterling Centrecorp Inc.* (9th Cir. 2020) 977 F3d 750, 757-758—parent corporation's "pervasive control" over facility's environmental response operations was established by parent corporation's official directing compliance with cleanup and abatement order and subsidiary lacking "financial wherewithal to do so"]

A fortiori, the mere fact that the parent is the *sole owner* of the subsidiary is insufficient to confer direct "operator" status on the parent. [See *Castaic Lake Water Agency v. Whittaker Corp.* (CD CA 2003) 272 F.Supp.2d 1053, 1079]

b) [5:78.4] **Derivative liability standard distinguished:** By the same token, the parent's involvement in the subsidiary's polluting activities need not rise to the level of behavior that would warrant piercing the corporate veil. The parent might not have overstepped the bounds of corporate separateness sufficiently to warrant imputing CERCLA liability on an alter ego theory, yet may be involved enough in the facility's management that it should be held liable as an operator. [*United States v. Bestfoods* (1998) 524 US 51, 66, 118 S.Ct. 1876, 1886, fn. 12]

[5:78.5 - 5:78.9] *Reserved.*

3) [5:78.10] **Interaction through common directors/officers; government's burden:** A corporation, of course, can only act through an agent (its directors, officers or other duly-authorized employees). And typically, parents and subsidiaries share common directors and/or officers. But on the question of the parent's direct operator liability, it cannot be assumed a common director or officer acted on the *parent's* behalf in managing the polluting facility. "[D]irectors and officers holding positions with a parent and its subsidiary can and do 'change hats' to represent the two corporations separately, despite their common ownership." [*United States v. Bestfoods* (1998) 524 US 51, 69-70, 118 S.Ct. 1876, 1888 (internal quotes and citation omitted)]

The burden is on the party (usually the government) asserting the parent's liability as an "operator" to show the common officers/directors were acting in their capacities as officers/directors *of the parent*, and not as officers/directors of the subsidiary, when they participated in polluting activities or decision-making at the subsidiary's facility. [See *United States v. Bestfoods*, supra, 524 US at 70, 118 S.Ct. at 1888 & fn. 13; *United States v. Sterling Centrecorp Inc.* (9th Cir. 2020) 977 F3d 750, 757-758—official tasked with directing environmental response operations wore parent corporation's "hat" (official used parent corporation's letterhead, received communications in his capacity as parent's official, rarely mentioned subsidiary, and sent compliance reports directly to parent; in short, official's actions benefitted parent corporation to subsidiary's detriment); *and see* *¶ 5:79*]

[5:78.11 - 5:78.14] *Reserved.*

(c) [5:78.15] **Direct "operator" liability based on joint venture:** *Bestfoods*, supra, expressly left room for a parent corporation to be liable directly as a CERCLA "operator" by way of its participation in the facility with its subsidiary

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as a *joint venturer.* However, liability will be imposed on that theory only where the existence of the parent-subsidiary joint venture is *properly documented.* [*BP Amoco Chem. Co. v. Sun Oil Co.* (D DE 2001) 166 F.Supp.2d 984, 994—no factual basis to conclude relationship between alleged joint venturers was anything other than that of shareholders to corporate subsidiary]

(d) [5:79] **Application to officer, director and shareholder liability for corporate pollution:** The U.S. Supreme Court in *Bestfoods*, supra, dealt exclusively with the liability of a corporate parent for its subsidiary's polluting activities. All indications, however, are that the *Bestfoods* analysis and principles apply as well to attempts to reach corporate directors, officers and shareholders for environmental contamination caused by the corporate entity. [See *United States v. Bestfoods* (1998) 524 US 51, 62, 118 S.Ct. 1876, 1885—"nothing in CERCLA purports to reject [the] bedrock principle" that the corporate form erects a shield against personal liability absent a basis for piercing the corporate veil]

Thus, as with parent and subsidiary, a director, officer or shareholder can be held responsible under CERCLA for the corporate entity's hazardous substance release or disposal only (i) on an *indirect* (derivative) liability theory where abuse of the corporate form (or fraud) warrants *piercing the corporate veil* (*¶ 5:77.1 ff.*); *or* (ii) a *direct* liability theory as an "operator" where the particular director, officer or shareholder *actively participated in day-to-day management of the polluting facility* (*¶ 5:78 ff.*). [See *Browning-Ferris Indus. of Ill., Inc. v. Ter Maat* (7th Cir. 1999) 195 F3d 953, 955-956; *United States v. Meyer* (WD MI 1999) 120 F.Supp.2d 635, 640—defendant owner was operator by directing construction, alteration and repair of sewer lines releasing waste]

Similarly, as with parent and subsidiary, on the question of direct operator liability, it cannot be assumed that an officer/director common to a shareholder and the corporation acted on the *shareholder's* behalf in managing the polluting facility. Rather, it must be shown that the common officer/director was acting as an officer/director of the *shareholder*, and not as an officer/director of the corporation, when the common officer/director participated in decisions regarding the facility's operations (*¶ 5:78.10*). [See *Raytheon Constructors, Inc. v. Asarco Inc.* (10th Cir. 2003) 368 F3d 1214, 1217-1219—successor of minority shareholder of mining corporation not liable as direct operator for environmental clean-up costs at mine site based on actions of shareholder's president who also served as president of corporation]

On the other hand, as with parent and subsidiary, a director, officer or shareholder cannot hide behind the corporate shield to escape *direct* liability as an *operator* of the polluting facility. [*Browning-Ferris Indus. of Ill., Inc. v. Ter Maat*, supra, 195 F3d at 955—corporate officer/principal shareholder directly liable as CERCLA "operator" of landfill site if he *operated landfill personally on day-to-day basis*, rather than merely directing corporation's business]

1) [5:79.1] **Example:** In an analogous state law case, a corporate president was held personally liable for civil fines arising from the corporation's violations of the California Hazardous Waste Control law (*¶ 5:30*). The result apparently turned on a direct liability theory, based on the fact the president was responsible for all of the corporation's operating decisions. [*Liquid Chem. Corp. v. Department of Health Services* (1991) 227 CA3d 1682, 1705-1706, 279 CR 103, 114-116—"we have little doubt that the state Legislature by enacting HWCA intended to impose liability on those individuals personally responsible for decisions relative to the management of hazardous waste"]

2) [5:79.2] **Indemnity rights:** Notwithstanding personal liability, the responsible individual (director, officer, shareholder or employee) may have indemnity rights against the PRP corporation under a properly-worded *indemnification* agreement (which may be rooted in the corporation's bylaws).

That CERCLA imposes personal liability on corporate personnel is not enough to void an otherwise enforceable indemnification agreement. A right of indemnification does not affect the director's/officer's/employee's liability with respect to the government but simply shifts the source of payment for the resulting damages. [*United States v. Lowe* (5th Cir. 1994) 29 F3d 1005, 1010; *see also*¶ 5:230 ff. re buyer-seller environmental indemnities]

[5:80] ***Reserved.***

(e) [5:81] **Compare—cost-shifting liability of successor corporations:** Private parties who incur response costs are entitled to bring a cost recovery suit against PRPs for full indemnification (42 USC § 9607(a)); and PRPs who incur response costs are entitled (after having been sued or having settled with the government) to bring a private contribution action against other PRPs to recoup a portion of the liability (42 USC § 9613(f)(1)); *see*¶ *5:125 ff.* Whether a *successor corporation* to a now-defunct PRP corporation can be reached in cost-recovery/contribution suits turns on the law of successor liability. *See detailed discussion at*¶ *5:126.5 ff.*

Under the California Superfund, a PRP may apply for reimbursement from the state's "orphan fund" if part of the clean-up cost has been apportioned to a now-defunct corporation; *see*¶ *5:27.1*.

(7) [5:82] **Liability of limited partners:** PRP issues similar to those in the corporate liability context also arise with regard to contaminated facilities owned and operated by a *limited partnership*. Like a corporation with regard to its shareholders, a limited partnership ordinarily erects a personal liability shield around its limited (as opposed to its general) partners *except* to the extent limited partners actively participate in control of the business. [See Corps.C. § 15903.03; and Friedman, Soza & Jann, *Cal. Prac. Guide: Corporations* (TRG), Ch. 2]

(a) [5:82.1] **"Owner" liability:** The scant authority regarding CERCLA's interaction with state partnership law comes down on both sides of the CERCLA "owner" liability issue:

• [5:82.2] One district court rejects state law as the benchmark for liability. Reasoning that both individuals and partnerships are statutorily defined "persons" under CERCLA, this court upholds a plaintiff's claim for imposing joint and several liability against the offending partnership's general *and limited* partners. [*Soo Line R.R. Co. v. B.J. Carney & Co.* (D MN 1992) 797 F.Supp. 1472, 1485-1486]

• [5:82.3] But an Eleventh Circuit decision disagrees with any notion in *Soo Line*, supra, that CERCLA imposes liability directly on a limited partner merely because the partnership is liable as an "owner." Observing that neither CERCLA nor its legislative history addresses limited partner liability, this court concludes that *state law* governs limited partners' CERCLA liability based on the partnership's ownership of the contaminated site. [*Redwing Carriers, Inc. v. Saraland Apartments* (11th Cir. 1996) 94 F3d 1489, 1499-1502 & fn. 12]

Therefore, limited partners cannot be reached for the partnership's CERCLA liability as an "owner" where they took no active part in control of the partnership's business. [*Redwing Carriers, Inc. v. Saraland Apartments*, supra, 94 F3d at 1503]

[5:82.4] **Comment:** The Eleventh Circuit *Redwing* position (¶ *5:82.3*) is probably the most consistent with principles announced by the U.S. Supreme Court in the corporate parent-subsidiary context (¶ *5:77 ff.*). Most probably, a limited partner (who is not a direct owner of the polluting facility) can incur indirect (derivative) liability as an "owner" under CERCLA only if there is a basis for piercing the limited liability shield of the limited partnership form (¶ *5:77.1 ff.*).

(b) [5:82.5] **Compare—direct operator liability:** Even under the view that limited partners cannot be held *indirectly* liable under CERCLA based on the *partnership's ownership* of the contaminated site, they can be held *directly* liable as *operators* of the site if they *in fact personally operated* the facility. [*Redwing Carriers, Inc. v. Saraland Apartments* (11th Cir. 1996) 94 F3d 1489, 1503-1504—mere *authority* to control facility not enough to impose "operator" liability]

• [5:82.6] **Comment:** To this extent, *Redwing*, supra, clearly appears consistent with the U.S. Supreme Court's *Bestfoods* analysis. By analogy to the corporate parent-subsidiary context, limited partners who actively participate in management of the partnership's polluting facility are *themselves* "operators" under CERCLA and *directly liable* as such (*see*¶ *5:78 ff.*).

[5:82.7 - 5:82.14] ***Reserved.***

(8) [5:82.15] **Liability of general partners in limited liability partnership:** Corporate law principles have also been used to determine the CERCLA "owner" liability of a *general partner* in a *limited liability partnership*. One district court, applying state law, ruled that general partners in a limited liability partnership can be held individually liable for the partnership's CERCLA liability if the partnership assets are insufficient to satisfy the liability. [See *United States v. 175 Inwood Assocs. LLP* (ED NY 2004) 330 F.Supp.2d 213, 223-224]

(9) [5:82.16] **Determining when "owner and operator" status occurs for purposes of CERCLA liability:** Ownership status is measured at the time clean-up costs are *incurred* (not when a recovery lawsuit seeking reimbursement is filed): "Congress's decision to activate the statute of limitations [for cost-recovery actions; 42 USC § 9613(g)(2)] at the time of cleanup is strong contextual evidence that Congress intended the owner at the time of cleanup to be the 'current owner' in a subsequent recovery suit." [*California Dept. of Toxic Substances Control v. Hearthside Residential Corp.* (9th Cir. 2010) 613 F3d 910, 915—"owner" of contamination source at time of cleanup responsible for remediation costs associated with adjacent property even though owner sold its property before State filed cost-recovery suit; but see *Pennsylvania Dept. of Environmental Protection v. Trainer Custom Chemical, LLC* (3rd Cir. 2018) 906 F3d 85, 87 (distinguishing *Hearthside*) —current property owner liable for cleanup costs it incurred before purchasing property]

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c. "Arranger" liability

(1) [5:83] **Product manufacturers/distributors:** CERCLA is not a vehicle for toxic tort (personal injury/product liability) actions against third party product manufacturers and distributors. Nor can *third party* product manufacturers be reached for response (cleanup) costs as CERCLA owners/operators. [*Rivas v. Safety-Kleen Corp.* (2002) 98 CA4th 218, 233-234, 119 CR2d 503, 515]

Nonetheless, under the plain language of the statute a product manufacturer or distributor may qualify as a 42 USC § 9607(a) PRP "arranger" and thus be subject to a CERCLA recovery action if it takes "intentional steps" to dispose of a hazardous substance. [*Burlington Northern & Santa Fe Ry. Co. v. United States* (2009) 556 US 599, 611-613, 129 S.Ct. 1870, 1879-1880—although aware of incidental spills, pesticide manufacturer did *not* qualify as "arranger" because it did not sell pesticide with *intention* of any being disposed during transfer process; see also *Rivas v. Safety-Kleen Corp.*, supra, 98 CA4th at 233-234, 119 CR2d at 515, fn. 8 (collecting cases)—manufacturers and distributors "occasionally" may find themselves subject to CERCLA recovery actions if they *intend to arrange for disposal* of pollutants under guise of product sales]

(a) [5:83.1] **"Useful product" defense:** In light of the "intentional steps" requirement (¶ 5:83), courts have long recognized the so-called "useful product" defense that prevents a seller of a "useful product" from being subject to "arranger" liability, even when the product itself is a hazardous substance. In other words, a person may be subject to "arranger" liability only if the material in question constitutes "waste" rather than a useful product. Thus, "a company selling a product that uses and/or generates a hazardous substance as part of its operation may not be held liable as an arranger under CERCLA unless … [it] entered into the relevant transaction with *the specific purpose* of disposing of a hazardous substance." [See *Team Enterprises, LLC v. Western Investment Real Estate Trust* (9th Cir. 2011) 647 F3d 901, 909 (emphasis in original)—manufacturer of machine used in dry cleaning process not liable as an "arranger" for contribution to environmental cleanup costs]

On the other hand, even when a sale includes a useful product component, the seller still may be held liable as an arranger if the evidence establishes the seller intended to dispose of a hazardous substance through the sale. [See *United States v. Dico, Inc.* (8th Cir. 2019) 920 F3d 1174, 1178-1180—despite evidence that contaminated buildings' structural steel beams would be reusable if decontaminated, substantial evidence supported finding seller intended to arrange for hazardous substance disposal]

[5:83.2 - 5:83.4] ***Reserved.***

(2) [5:83.5] **Federal government:** The federal government is not immune from liability under CERCLA (¶ *5:60.1*). Thus, it may qualify as a 42 USC § 9607(a) PRP "arranger" and be subject to a CERCLA cost-recovery action if it has "direct involvement in arrangements for the disposal of waste." [See *Nu-West Mining, Inc. v. United States* (D ID 2011) 768 F.Supp.2d 1082, 1088—federal government was subject to "arranger" liability for contamination caused at four mining sites it leased to private companies (government not only had requisite "intent" to dispose of hazardous substance, it "owned" substance and had "authority to control" and "exercised some actual control" over disposal of same)]

d. Exemptions and immunities

(1) [5:84] **Limited liability of lenders and fiduciaries:** Lenders and various fiduciaries (trustees and executors) are subject to potential Superfund liability as "owners" or "operators" of a contaminated property. However, federal and state laws create significant exemptions for certain lenders and fiduciaries:

(a) Exemptions under CERCLA

1) [5:84.1] **Secured lenders not participants in management:** Banks and other lenders are "owners" or "operators" exposed to CERCLA liability for property they hold as collateral only if they are "actually participating in the management or operational affairs" of the borrower (merely having the capacity to influence a PRP's management decisions does not bring the lender within the scope of CERCLA liability). [See 42 USC § 9601(20)(A), (F)(i), (G)]

Also, lenders will not incur CERCLA "owner" or "operator" liability by foreclosing on a contaminated property so long as they (i) do not take over the property's business operations, and (ii) sell or lease the property at the "earliest practicable, commercially reasonable time, on commercially reasonable terms." [See 42 USC § 9601(20)(F)(ii)]

a) [5:84.2] **EPA "policy guidance" reviving EPA Regs:** An EPA "policy guidance" instructs EPA investigators to look to EPA 1992 regulations in determining when banks and secured lenders may incur CERCLA liability. Although they had been struck down as exceeding the EPA's rulemaking authority, these regulations are now revived as consistent with the legislation cited at ¶ 5:84.1. [See 57 Fed. Reg. 18344]

b) [5:84.2a] **Public or quasi-public companies:** Although not "typical" lenders, public or quasi-public companies that merely hold legal title to property in order to secure recoupment of developments costs are exempt from "owner" liability under 42 USC § 9601(20)(A)'s security interest exception. [*In re Bergsoe Metal Corp.* (9th Cir. 1990) 910 F2d 668, 671—fact that port authority held paper title to lead recycling plant it helped finance did not make it an "owner" under CERCLA; *Monarch Tile, Inc. v. City of Florence* (11th Cir. 2000) 212 F3d 1219, 1222—city that retained "indicia of ownership" in property for purpose of securing repayment of development bonds qualified for secured creditor exception; see also *United States v. Capital Tax Corp.* (7th Cir. 2008) 545 F3d 525, 531-532 & fn. 5—firm that buys distressed real estate properties and resells them for profit, retaining only legal title to secure remaining purchase price, may be exempt from owner liability under CERCLA'S "security interest" exception and common law equitable conversion principles]

2) [5:84.3] **Fiduciaries:** Trustees, executors/administrators of a decedent's estate, guardians, receivers, conservators and other such fiduciaries generally are immune from personal liability under CERCLA unless (i) the trust (or other estate) was specifically established to limit the property owner's liability; (ii) the fiduciary's negligence caused or contributed to the hazardous substance release; or (iii) the fiduciary is actively managing the business for profit. [See 42 USC § 9607(n)]

(b) [5:84.4] **State law exemptions:** The California Superfund also exempts certain lenders and fiduciaries from state liability. [Health & Saf.C. § 25548 et seq.]

The state exemptions are similar (but not completely identical) to those under CERCLA. [See Health & Saf.C. §§ 25548.1, 25548.2, 25548.3, 25548.4 & 25548.5]

[5:84.5 - 5:84.9] ***Reserved.***

(2) [5:84.10] **Small-quantity waste generator ("de micromis") exemption:** Individuals and small businesses that generate specified small amounts of hazardous waste or household-type garbage are exempt from CERCLA response cost liability ("de micromis exemption"). However, this exemption applies only to EPA-designated "National Priority List" (NPL) sites, and only if "all or part" of the disposal, treatment or transport of waste occurred before April 1, 2001. [42 USC § 9607(o)(1)]

(a) [5:84.11] **Burden of proof and payment of defense costs:** The burden is on a private party bringing a contribution action against a de micromis generator to show the de micromis exemption does not apply. [42 USC § 9607(o)(4)]

Moreover, if the de micromis generator prevails in the suit on the basis of the 42 USC § 9607(o) exemption, the private party plaintiff must pay the de micromis party's "reasonable" defense costs, including attorney fees and expert witness fees. [42 USC § 9607(p)(7)]

(b) [5:84.12] **Exceptions:** There are three situations in which an otherwise eligible de micromis generator will *not* escape CERCLA liability:

• The EPA determines that the wastes involved "have contributed significantly or could contribute significantly, either individually or in the aggregate," to the cost of remediation or natural resource restoration with respect to the site;

• The EPA determines that the de micromis party did not cooperate in the clean-up or natural resource restoration with respect to the site; or

• The de micromis generator has been convicted of a criminal violation for the same conduct to which the exemption would apply. [42 USC § 9607(o)(2)]

(3) [5:84.13] **Municipal solid waste generator exemption:** Residential properties, small businesses and nonprofit organizations that generate "municipal solid waste"—the term of art for household-type garbage—at NPL sites (*see¶ 5:84.10*) are also exempt from CERCLA response cost liability. [42 USC § 9607(p)(1)]

(a) [5:84.14] **"Municipal solid waste":** "Municipal solid waste" is statutorily defined. Examples include "food and yard waste, paper, clothing, appliances, consumer product packaging, disposable diapers, office supplies, cosmetics, glass and metal food containers, elementary or secondary school science laboratory waste, and household hazardous waste." [42 USC § 9607(p)(4)]

The statute also defines what does *not* constitute "municipal solid waste." [See 42 USC § 9607(p)(4)]

(b) [5:84.15] **Exempt entities:** This exemption applies to:

- Owners, operators, or lessees of residential property;

- Business entities that employed on average no more than 100 full-time employees, or the equivalent, for three years prior to notification of liability, and that are small-business concerns under the Small Business Act (15 USC § 631 et seq.); and

- Nonprofit organizations that employed no more than 100 paid individuals during the year prior to notification of liability. [42 USC § 9607(p)(1)]

(c) [5:84.16] **Private party contribution actions only:** Only *private party contribution actions* against owners, operators or lessees of residential property that generate "municipal solid waste" are within the exemption (42 USC § 9607(p)(6)). The exemption statute does *not* apply to government actions or private party *cost-recovery* actions against homeowners or renters for contamination caused by their garbage.

However, a private party bringing a cost-recovery suit against a municipal solid waste generator is subject to the same burden of proof and defense cost rules applicable to private parties suing a "de micromis generator" for contribution (¶ *5:84.11*). [See 42 USC § 9607(p)(5)(B) & (7)]

(d) [5:84.17] **Exceptions:** The three exceptions to the "de micromis exemption" (¶ *5:84.12*) also apply to the "municipal solid waste generator" exemption. [See 42 USC § 9607(p)(2)]

(4) [5:85] **Contiguous property owner exemption:** A person who owns real property that is or may be contaminated by a hazardous substance release or threatened release from *contiguous or "otherwise similarly situated"* real property that is not owned by that person is not considered a CERCLA owner or operator solely by reason of the contamination, so long as certain conditions (¶ 5:85.1) are satisfied. [42 USC § 9607(q)(1)(A) (emphasis added)]

(a) [5:85.1] **Qualifying conditions:** A property owner invoking this exemption must satisfy the following conditions by a preponderance of the evidence (42 USC § 9607(q)(1)(A), (B); *Atlantic Richfield Co. v. Christian* (2020) 590 US _, _, 140 S.Ct. 1335, 1356):

- The property owner did not cause, contribute or consent to the hazardous substance release on the adjacent property (42 USC § 9607(q)(1)(A)(i));

- The property owner is not potentially liable, or affiliated with any person who is potentially liable, through (i) any direct or indirect familial relationship, or any contractual, corporate or financial relationship (other than that created by the instruments by which title to the property is conveyed or financed, or by a contract for the sale of goods or services), or (ii) the result of a reorganization of a business entity that was potentially liable (42 USC § 9607(q)(1)(A)(ii));

- The property owner has taken reasonable steps to stop any continuing or threatened future release, and to prevent or limit human, environmental or natural resource exposure to any hazardous substances released from its property (42 USC § 9607(q)(1)(A)(iii));

- The property owner has provided full cooperation, assistance and access to persons authorized to conduct response actions or natural resource restoration at the contiguous property from which there has been an actual or threatened release of hazardous substances (42 USC § 9607(q)(1)(A)(iv); see *Atlantic Richfield Co. v. Christian*, supra, _ US at

_, 140 S.Ct. at 1356—landowners did not qualify as contiguous property owners because, among other things, their proposed restoration plan would interfere with EPA's cleanup (¶ 5:62a));

• The property owner has complied with any land use restrictions imposed with respect to any response action at the property, and does not impede the effectiveness or integrity of any "institutional control" employed in connection with a response action (42 USC § 9607(q)(1)(A)(v));

• The property owner has complied with any EPA information requests or administrative subpoenas (42 USC § 9607(q)(1)(A)(vi));

• The property owner has provided all legally required notices regarding the discovery or release of any hazardous substances at its property (42 USC § 9607(q)(1)(A)(vii)); *and*

• The property owner has made "all appropriate inquiry" within the meaning of 42 USC § 9601(35)(B) regarding the property, and did not know or have reason to know that its property was or could be contaminated by a hazardous substance release or threatened release from the contiguous property (42 USC § 9607(q)(1)(A)(viii); *see* *Atlantic Richfield Co. v. Christian*, supra, _ US at _, 140 S.Ct. at 1356—landowners did not qualify as contiguous property owners because, among other things, they purchased property after mining company built "Washington Monument sized smelter" near town and "evidence of public knowledge of contamination was almost overwhelming" (internal quotes omitted) (¶ 5:62a); *and* *¶ 5:85.6 ff.*).

1) [5:85.2] **Comment:** A memorandum posted on the EPA website, intended to assist the EPA staff in making enforcement decisions, offers some general guidance concerning the conditions set forth at *¶ 5:85.1* (see "Enforcement Discretion Guidance Regarding Statutory Criteria for Those Who May Qualify as CERCLA Bona Fide Prospective Purchasers, Contiguous Property Owners, or Innocent Landowners (`Common Elements')," available at *www.epa.gov*).

➪ [5:85.3] ***PRACTICE POINTER:*** The most significant reason for a buyer of contaminated or potentially contaminated property to preserve the contiguous property owner exemption is to minimize the buyer's proportionate share of liability and maximize the recovery of clean-up costs from other PRPs in the event a CERCLA contribution claim (*¶ 5:125.4*) is later asserted against the buyer.

Also, lenders and insurers may be more willing to finance and insure, and tenants to lease, the property notwithstanding the apparent contamination.

(b) [5:85.4] **Available only in CERCLA actions:** The contiguous owner exemption is available only in CERCLA actions. It will not exempt a property owner from liability under the Resource Conservation and Recovery Act (*¶ 5:125.10 ff.*) or any other non-CERCLA cause of action.

Nor is there any comparable exemption under the California Superfund. Therefore, when a state agency orders the clean-up of property contaminated by a hazardous substance release from contiguous property, an owner exempt under CERCLA may still end up responsible for a share of the cleanup costs under state law. (*But see* *¶ 5:87 ff.* re state law limited immunity for "bona fide purchasers" from statutory nonagency clean-up cost claims.)

(c) [5:85.5] **"Otherwise similarly situated" property defined:** The contiguous property owner exemption applies to a person who owns real property contiguous "*or otherwise similarly situated*" to the property that is the source of the contamination (*¶ 5:85*). Presumably, the "otherwise similarly situated" language is intended to cover the owner of property down gradient from the contaminating property, even if the down gradient property is not right next to the contaminating property. However, it is unclear how many miles apart the two properties can be for a property owner to be covered by the exemption.

(d) [5:85.6] **Standard for "appropriate inquiry":** The contiguous property owner exemption requires potential purchasers to conduct an "appropriate inquiry" before purchasing the property (42 USC § 9607(q)(1)(A)(viii)). An "appropriate inquiry" generally requires a duly-qualified "environmental professional" (*¶ 5:85.7*) to:

— Interview past and present owners, operators and occupants of the site (40 CFR § 312.23);

— Review various government and historical documents pertaining to the site going back to 1960 (40 CFR §§ 312.24, 312.26);

— Visually inspect the site and adjoining properties (unless "unusual circumstances" make the inspection unperformable) (40 CFR § 312.27);

— Document and comment on significant data gaps or other uncertainties regarding possible contamination of the site (such as conditions limiting the site inspection) (40 CFR §§ 312.21(c)(2), 312.27(c)(2));

— Account for commonly known or reasonably ascertainable information about the site (40 CFR § 312.30); and

— Address the likely presence of contamination of the site and the ability to detect any such contamination (40 CFR § 312.31). [See 40 CFR § 312.1 et seq.]

If the site is *abandoned* (40 CFR § 312.10(b)) *and no current owner is available* to be interviewed, the professional must conduct *at least one* interview with the owner or occupant of a *neighboring property* in order to obtain information about past owners or uses of the site. [40 CFR § 312.23(d)]

1) [5:85.7] **"Environmental professional" qualifications:** The "appropriate inquiry" must be conducted by or under the supervision of an "environmental professional," defined as an individual who "possesses sufficient specific education, training, and experience necessary to exercise professional judgment to develop opinions and conclusions" about real or threatened hazardous substance releases at the site. [See 40 CFR § 312.10(b)(1) (also detailing specific qualifications and minimum period of "relevant experience") & (5)]

2) [5:85.8] **Time-frame:** An "appropriate inquiry" must be conducted within *one year prior to acquisition* of the property; and if conducted more than *six months* before the acquisition date, certain aspects of the inquiry (e.g., interviews and visual inspection) must be updated. [40 CFR § 312.20(a), (b)]

3) [5:85.9] **Procedures used to comply with standard:** "Environmental professionals" may employ the procedures set forth in the American Society for Testing and Materials (ASTM) International Standard E1527-05 to comply with the "appropriate inquiry" standard. [40 CFR § 312.11]

4) [5:85.10] **Written report requirement:** The results of the inquiry must be documented in a *written report* that contains, at a minimum, certain information, including a prescribed statement signed by the environmental professional. [See 40 CFR § 312.21(c), (d)]

[5:85.11 - 5:85.14] ***Reserved.***

(e) [5:85.15] **Effect of finding contamination during preacquisition inquiry—disqualifying event:** Contiguous property owners who find contamination before purchasing property *cannot* qualify for the contiguous property owner exemption once they take title. However, those property owners may nonetheless qualify for the "bona fide prospective purchaser" exemption so long as certain conditions are satisfied (*¶ 5:86.1*). [42 USC § 9607(q)(1)(C)]

1) [5:85.16] **Comment:** As a practical matter, the contiguous property owner exemption is extremely difficult to establish with respect to industrial and most commercial properties, since they typically have some level of contamination. Nonetheless, as with the "innocent landowner defense" (*¶ 5:116*), availability of the exemption may have the positive effect of encouraging real estate buyers to conduct vigorous environmental investigations before taking title. Such investigations heighten the awareness of all parties regarding the environmental condition of the property and frequently result in achieving a more balanced allocation of risks (*see¶ 5:220 ff.*).

(5) [5:86] **Bona fide prospective purchaser exemption:** Persons who otherwise would be liable as CERCLA owners or operators may be protected under the "bona fide prospective purchaser" exemption even if they detected contamination during a preacquisition due diligence (and thus would not be eligible for the CERCLA "innocent landowner defense," *¶ 5:114*). [42 USC § 9607(r)]

"[A] bona fide prospective purchaser whose potential liability for a release or threatened release is based solely on the purchaser's being considered to be an owner or operator of a facility shall not be liable as long as the bona fide purchaser does not impede the performance of a response action or natural resource restoration." [42 USC § 9607(r)

(1); see also *Voggenthaler v. Maryland Square LLC* (9th Cir. 2013) 724 F3d 1050, 1061-1062—shopping center owner not entitled to bona fide prospective purchaser exemption because, among other things, it failed to prevent further harm by not limiting human and environmental exposure to contamination already present; *PCS Nitrogen Inc. v. Ashley II of Charleston LLC* (4th Cir. 2013) 714 F3d 161, 179-181—even though it did not introduce hazardous substances, current owner of contaminated parcel not entitled to bona fide prospective purchaser exemption because it did not "exercise appropriate care" at site]

(The Brownfields Utilization, Investment, and Local Development Act (BUILD Act), effective 3/23/18 (PL 115-141, Div. N, 132 Stat. 1052) expanded the bona fide prospective purchaser definition to include tenants and lessees of facilities where certain requirements are met, *see ¶ 5:86.3*.)

(a) [5:86.1] **"Bona fide prospective purchaser" criteria:** A facility's owner or lessee can be a "bona fide prospective purchaser" within the meaning of the 42 USC § 9607(r) exemption only under the following circumstances:

1) [5:86.2] **Owners:** If the person is the facility's owner, the person must have acquired the property after January 11, 2002, and must establish all of the following criteria by a preponderance of the evidence (42 USC § 9601(40)(A)(i)(II); *Voggenthaler v. Maryland Square LLC* (9th Cir. 2013) 724 F3d 1050, 1061-1062):

• All "disposal" of hazardous substances at the facility must have occurred *before* the person acquired the facility (42 USC § 9601(40)(B)(i));

• The person made "all appropriate inquiries," according to generally accepted good commercial and customary standards and practices as described in the statute, into the previous ownership and uses of the facility (42 USC § 9601(40)(B)(ii); *see¶ 5:86.6*);

• The person provided all legally required notices regarding the discovery or release of any hazardous substances at the facility (42 USC § 9601(40)(B)(iii));

• The person has taken reasonable steps to stop any continuing release, prevent any threatened future release, and prevent or limit human, environmental or natural resource exposure to any previously released hazardous substances (42 USC § 9601(40)(B)(iv));

• The person has provided full cooperation, assistance and access to persons authorized to conduct response actions or natural resource restoration at the facility (42 USC § 9601(40)(B)(v));

• The person is in compliance with any land use restrictions established or relied on in connection with response action at the facility, and does not impede the effectiveness or integrity of any "institutional control" employed at the facility in connection with a response action (42 USC § 9601(40)(B)(vi));

• The person has complied with any EPA information requests or administrative subpoenas (42 USC § 9601(40)(B)(vii)); *and*

• The person is not potentially liable, or affiliated with any potentially liable person, for response costs through (i) any direct or indirect familial relationship, or (ii) any contractual, corporate or financial relationship (other than that created by the instruments by which title to the facility is conveyed or financed, by a tenancy, by the instruments creating a leasehold interest in the facility, or by a contract for the sale of goods or services), or (iii) the result of reorganization of a business that was potentially liable (42 USC § 9601(40)(B)(viii)).

2) [5:86.3] **Lessees:** If the person is the facility's lessee, the following requirements apply:

• The lessee must have acquired the leasehold interest after January 11, 2002 (42 USC § 9601(40)(A)(ii)(I));

• The lessee must establish, by a preponderance of the evidence, that the leasehold interest is not designed to avoid liability under CERCLA (42 USC § 9601(40)(A)(ii)(II));

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• Either (i) the facility owner is able to establish all of the criteria set forth in *¶ 5:86.2* *or* (ii) the lessee is able to establish those criteria, *or* (iii) the owner was able to establish those criteria when the leasehold took effect, but can no longer do so due to circumstances unrelated to the lessee's actions, *and* the lessee is able to establish all of the criteria (except for the requirement of making appropriate inquiries into the previous ownership and uses of the facility). [42 USC § 9601(40)(A)(ii)(III)]

➪ [5:86.4] ***PRACTICE POINTER:*** The reasons for preserving the bona fide prospective purchaser exemption are the same as those for preserving the contiguous property owner exemption. *See¶ 5:85.3*.

(b) [5:86.5] **Available only in CERCLA actions:** As with the contiguous property owner exemption, the bona fide prospective purchaser exemption is available only in CERCLA actions; *see¶ 5:85.4*. (But California law gives “bona fide purchasers” limited liability protection from statutory nonagency cleanup cost claims; *see¶ 5:87 ff.*)

(c) [5:86.6] **Standard for “appropriate inquiry”:** Like the contiguous property owner exemption, the bona fide prospective purchaser exemption requires the potential purchaser to conduct an “appropriate inquiry” before purchasing the property (*¶ 5:86.1*). The same basic “appropriate inquiry” standard applies (40 CFR § 312.1(b)(1)(ii); *see¶ 5:85.6 ff.*). Additionally, the site assessment must include a search of environmental clean-up liens recorded against the property (40 CFR § 312.25), take into account any specialized knowledge or experience of the prospective purchaser relevant to the property (40 CFR § 312.28), and evaluate whether the purchase price reasonably reflects the property's fair market value if it were not contaminated (40 CFR § 312.29).

(d) [5:86.7] **“Contiguous property owner” may qualify:** A would-be contiguous property owner who purchases property knowing or having reason to know that the property was or could be contaminated does not qualify for the contiguous property owner exemption, but may qualify for the bona fide prospective purchaser exemption (*¶ 5:85.15*).

1) [5:86.8] **Groundwater investigation required?** In addition to the other conditions that would-be contiguous property owners must satisfy to qualify for the bona fide prospective purchaser exemption, they must show that “reasonable steps” were taken to stop any continuing or threatened future release of hazardous substances at the property (*¶ 5:86.1*). Those “reasonable steps” could include the investigation and remediation of any groundwater contamination, even though under the “reasonable steps” condition of the contiguous property owner exemption, the owner is not required to investigate and remediate groundwater contamination (42 USC § 9607(q)(1)(D)).

➪ [5:86.9] ***PRACTICE POINTER:*** Until this issue is clarified by the EPA or the courts, such an owner might consider erring on the side of caution and voluntarily eliminate any groundwater contamination in order to avoid being brought into a postpurchase third-party CERCLA action.

(6) [5:87] **State law exemption for bona fide purchasers of “urban infill area”:** Under California's Land Reuse and Revitalization Act (LRRA, Health & Saf.C. § 25395.60 et seq.), certain qualifying buyers (“bona fide purchasers”) of contaminated property in an “urban infill area” who enter into a preacquisition “consultative services agreement” with certain state agencies and agree to clean up the property and pay the agency's costs to oversee the clean-up, may receive limited liability protection and a right of contribution against PRPs.

The exemption also is available to “innocent landowners,” “contiguous property owners” and “prospective purchasers,” as defined, under roughly the same conditions (¶ 5:87.1 ff.). [See Health & Saf.C. §§ 25395.70, 25395.75 & 25395.91] The California LRRA (Health & Saf.C. § 25395.60 et seq.) is due to be repealed by its own terms effective 1/1/27. [Health & Saf.C. § 25395.109]

(a) Qualifying criteria

1) [5:87.1] **Property:** The property must have been acquired on or after January 1, 2005, cannot be listed as a federal or state Superfund site or a Hazardous Substances Underground Storage Tank Act site, *and* must be located in an “urban infill area.” [Health & Saf.C. § 25395.79.2]

(An “urban infill area” within the meaning of the Act is essentially *contaminated redevelopment property*—i.e., vacant or “underutilized” land in an urban area that has been previously developed or is surrounded by previously-developed parcels. See Health & Saf.C. § 25395.79.2(c).)

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2) [5:87.2] **Purchaser:** The buyer of the qualifying property (¶ 5:87.1) must meet the Act's standards for a "bona fide purchaser" … which are essentially the same criteria required for a CERCLA "bona fide prospective purchaser" (¶ *5:86.1*). [Health & Saf.C. §§ 25395.69, 25395.80]

(b) [5:87.3] **Agency "consultative services agreement" required:** A purchaser who meets the qualification set forth at ¶ 5:87.2 must enter into an agreement with one of three state agencies (see Health & Saf.C. §§ 25395.64, 25395.68, 25395.71) to:

• Perform a site assessment and, if the agency determines it is necessary, prepare and implement a response plan (Health & Saf.C. § 25395.92(a));

• Reimburse the agency for all costs incurred to review and/or oversee implementation of the site assessment plan (Health & Saf.C. § 25395.93(b)); *and*

• Provide notice to the public of the response plan and an opportunity for public participation in any response activities (Health & Saf.C. § 25395.96(a)).

(c) [5:87.4] **Scope of liability immunity:** Qualifying purchasers (¶ 5:87.2) are immune from *nonagency* claims brought "under any applicable statute" for response costs "or other damages" associated with a release or threatened release of hazardous substances on the property. [Health & Saf.C. § 25395.81(a)(1)]

Exceptions: However, there are several exceptions, which further narrow the already-narrow immunity protection. Significantly, the Act provides no immunity for claims:

— under federal statutes (including CERCLA);

— for bodily injury or wrongful death;

— under the state Hazardous Waste Control Law (¶ *5:30*) or Polanco Act (¶ *5:46.6*);

— by the state board, regional board or Department of Toxic Substances Control to protect public health and safety or the environment pursuant to an applicable statute. [See Health & Saf.C. § 25395.86]

1) [5:87.5] **Common law claims?** Although the Act itself defines "applicable law" to include common law claims (Health & Saf.C. § 25395.66), that language is not used in the immunity statute. Quite the contrary, Health & Saf.C. § 25395.81 expressly limits the purchaser's immunity to liability "under an applicable *statute*." Commentators have suggested this inconsistency might be the result of a drafting error—i.e., that there was no legislative intent to exclude common law claims from the immunity protection. But absent further legislative or judicial clarification, purchasers probably should assume the statute will be literally interpreted to provide no immunity shield from common law liability.

[5:87.6 - 5:87.9] ***Reserved.***

(d) [5:87.10] **Right of contribution:** Bona fide purchasers (as well as innocent landowners and contiguous landowners) have a right of contribution from responsible persons for response costs incurred. They are also entitled to prevailing party attorney and expert fees in successful litigation under an applicable contribution or cost recovery statute, subject to certain conditions (among other things, a written demand for clean-up costs must have been served on the defendant). [See Health & Saf.C. §§ 25395.84(a), 25395.85]

1) [5:87.11] **Limited by National Contingency Plan?** The right of contribution under the Act *might* be narrowed by a CERCLA provision, which limits a private party's cost recovery to necessary costs of response consistent with the National Contingency Plan (¶ *5:126.1*). According to the Seventh Circuit, this federal restriction cannot be trumped by state law and, therefore, clean-up costs inconsistent with the National Contingency Plan cannot be recovered under a state contribution statute. [*PMC, Inc. v. Sherwin-Williams Co.* (7th Cir. 1998) 151 F3d 610, 617-618]

The Ninth Circuit has not ruled on the issue.

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[5:87.12 - 5:87.14] ***Reserved.***

(7) [5:87.15] **State law exemption for "bona fide ground tenant":** The state Land Reuse and Revitalization Act (*¶ 5:87*) also provides a "bona fide ground tenant" leasing contaminated property with limited liability protection and a contribution right against PRPs.

Note: For purposes of this exemption *only*, a "release" does not include passive migration. [Health & Saf.C. § 25395.102(c)]

This state law exemption is part of the California LRRA, due to expire 1/1/27. [Health & Saf.C. § 25395.109]

(a) Qualifying criteria

1) [5:87.16] **Property:** The property must meet all of the conditions of Health & Saf.C. § 25395.79.2 (*¶ 5:87.1*), except that the Hazardous Substances Underground Storage Tank Act "petroleum site" exclusion (Health & Saf.C. § 25395.79.2(b)(3)) does *not* apply. [Health & Saf.C. § 25395.102(d)]

2) [5:87.17] **"Bona fide ground tenant":** The ground tenant must show by a *preponderance of the evidence* all of the following:

• It acquired a nonfee interest in, and control of, the property *on or after January 1, 2007*, pursuant to either:

— a ground lease with a term of 25 years or more;

— an easement with a term of 25 years or more; *or*

— any other legal means for access and use of the property that provides a term of 25 years or more *and* is acceptable to the state agency entering into an agreement with the tenant to assess the property's contamination and implement a clean-up response plan if necessary (*¶ 5:87.18*);

• It meets the Act's standards for a "bona fide purchaser" (*¶ 5:87.2*);

• All hazardous waste releases occurred *before* the tenant acquired legal access to and control of the property;

• The tenant did not cause or contribute to any hazardous waste release on the property;

• It has contractually agreed with one or more specified persons or entities (*¶ 5:87.18*) that payments to the property owner, or any alternate revenue streams or assets acceptable to the agency, be pledged to secure a loan the proceeds of which are dedicated to implementing a clean-up plan; *and*

• The tenant is not, or affiliated with any person who is, potentially liable for the subject release through either:

— a direct or indirect familial relationship;

— a contractual, corporate or financial relationship, unless that relationship arises from the written document(s) by which the tenant obtains control and implements development of the property, or a contract for the sale of goods or services; *or*

— the result of a reorganization of a business that was potentially liable for the release. [Health & Saf.C. § 25395.102(b)]

(b) [5:87.18] **"Appropriate inquiries" and site assessment/response implementation agreement required:** To qualify for the immunity described at ¶ 5:87.19 ff., the tenant who meets the qualifications set forth at ¶ 5:87.16 ff. must (i) make all "appropriate inquiries" *and* (ii) enter into an agreement (the "Agreement") with the agency and one or more specified persons or entities (the property owner, a redevelopment agency, or a city or county) to:

• Perform an assessment of the risk of the property's intended use to the health and safety of the property's intended occupants (Health & Saf.C. § 25395.103(b)), and, if the agency determines it is necessary, implement a response plan;

• Reimburse the agency for all costs incurred to review and/or oversee the site assessment/response plan implementation; *and*

• Submit sufficient information to the agency to show that the property and ground tenant satisfy the required criteria (¶ 5:87.16 ff.). [Health & Saf.C. § 25395.103]

(c) [5:87.19] **Scope of liability immunity:** A qualifying ground tenant (¶ 5:87.17 ff.) enjoys the same immunity from *nonagency* claims afforded to a qualifying "bona fide purchaser" (¶ 5:87.4) once it obtains a "certification" of immunity from the agency that meets the criteria of Health & Saf.C. § 25395.104(b) & (c). [Health & Saf.C. § 25395.104(a)(1)]

In addition, once the Agreement is made (*¶ 5:87.18*), the agency cannot require the ground tenant to take any clean-up action other than that specified in the Agreement. [Health & Saf.C. § 25395.104(a)(2)]

1) [5:87.20] **Persons/entities subject to immunity:** The immunities described at ¶ 5:87.19 apply not only to the qualifying ground tenant, but also to (i) any successor who similarly qualifies and assumes the tenant's obligations under the Agreement (*¶ 5:87.18*), *and* (ii) a person who provides financing to the qualifying successor. [Health & Saf.C. § 25395.104(e)]

Moreover, a qualifying ground tenant who purchases the property subsequent to leasing or acquiring an easement thereon may convert its status to that of a "bona fide purchaser" so long as it meets the criteria therefor (*¶ 5:87.2*), and thereby qualify for the "bona fide purchaser" immunities (*¶ 5:87.4*). [Health & Saf.C. § 25395.104(*l*)]

2) [5:87.21] **May apply to "de minimis" release during response action:** A tenant who acquires immunity status retains that status if a release occurs during a response action that is "de minimis" *and* the agency determines that all necessary clean-up actions to address the release have been taken. [Health & Saf.C. § 25395.105(a)]

3) [5:87.22] **Exceptions:** "Bona fide ground tenant" immunity does not apply to claims for bodily injury or wrongful death or under the Hazardous Waste Control Law (*¶ 5:30*), criminal acts, permit violations, contractual indemnity agreements between purchasers and sellers of real property, or response actions ordered by an agency to protect public health and safety or the environment under an "applicable statute." [Health & Saf.C. § 25395.106(a), (b)]

a) [5:87.23] **Common law claims?** It is unclear whether the "bona fide ground tenant" immunity statute applies to common law claims; prudence suggests, however, that ground tenants should assume that it does not. *See discussion at¶ 5:87.5.*

(d) [5:87.24] **Right of contribution:** The right of contribution available to bona fide purchasers, innocent landowners and contiguous landowners (*¶ 5:87.10*) also applies to bona fide ground tenants. [See Health & Saf.C. § 25395.85]

1) [5:87.25] **Limited by NCP?***See discussion at¶ 5:87.11.*

2. Scope of Liability

a. [5:88] **"Response costs," plus incidental costs of enforcement:** PRPs are liable under CERCLA and the California Superfund for "response costs"—i.e., the cost of cleaning up the contaminated property. [See 42 USC § 9601(23) & (25), defining "removal" and "response" under CERCLA; and Health & Saf.C. §§ 79650 & 78140 (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24)]

Under both CERCLA and the California Superfund, PRPs can also be held liable for costs incidental to enforcement (e.g., litigation and oversight expenses), as well as interest on the amount of the response costs. [See 42 USC § 9607(a)(4); Health & Saf.C. §§ 79650 & 78140, oper. 1/1/24); *and further discussion at*¶ *5:121.10, 5:122 & 5:126.10*]

(1) [5:88.1] **Manner of assessment:** The statutory liability may be assessed against a PRP in a variety of ways:

• The PRP may be ordered by the state or federal government to clean up the contaminated property. [42 USC §§ 9604, 9606; *see*¶ *5:122*]

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- The state or federal government may partially or totally remediate the hazardous condition itself and then sue one or more PRPs to recover its response costs. [42 USC § 9607; see also 42 USC § 9613(b) & (c) re jurisdiction/venue and nationwide service of process; *and discussion at*¶ *5:121.1 ff.*]

- A private party may undertake the remediation, either voluntarily or by compulsion under government order, and then sue one or more other PRPs for cost recovery or contribution. [42 USC §§ 9607(a)(4)(B) & 9613(f); *see*¶ *5:125 ff.*]

(2) [5:89] **Punitive damages for noncompliance with abatement order:** Under CERCLA, a PRP who fails to remedy the contamination in compliance with a state or federal government clean-up order may be assessed punitive damages in an amount up to three times the government's cost of remediating the site. [42 USC § 9607(c)(3)]

(3) [5:89.1] **Other civil penalties:** In addition, PRPs can be subject to civil penalties of $25,000 per day for certain CERCLA violations, including failure to comply with governmental clean-up orders. [See 42 USC §§ 9606 & 9609]

➪ [5:89.2] ***PRACTICE POINTER:*** Because of the enormous breadth of liability under CERCLA and the potentially disastrous costs of remediating a contaminated property, real property buyers and sellers must take care to insulate themselves from liability in every way possible. Buyers in particular must be able to evaluate when the environmental risks involved in the intended transaction are too great to justify consummating the purchase. (*See*¶ *5:110 ff.* re "innocent landowner defense"; ¶ *5:220 ff.* re contractual protections; ¶ *5:238 ff.* re environmental site assessments; *and*¶ *5:250 ff.* re insurance.)

b. [5:90] **Petroleum exclusion:** Both CERCLA and the California Superfund *exclude* refined and unrefined petroleum, natural gas and synthetic gas usable for fuel from the definition of "hazardous substance." [42 USC § 9601(14); Health & Saf.C. § 78075(b) (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24); see also *McCoy v. Gustafson* (2009) 180 CA4th 56, 113-114, 103 CR3d 37, 82-83—petroleum exclusion includes fuel oil, leaded gasoline, indigenous components in refined or unrefined gasoline and any such components added during refining process]

Accordingly, these substances are not regulated by CERCLA and the California Superfund; and owners and operators have no liability under those statutes for the cleanup costs. [*Cose v. Getty Oil Co.* (9th Cir. 1993) 4 F3d 700, 704; *Wilshire Westwood Assoc. v. Atlantic Richfield Corp.* (9th Cir. 1989) 881 F2d 801, 803, 810; *KFC Western, Inc. v. Meghrig* (1994) 23 CA4th 1167, 1177-1178, 28 CR2d 676, 683]

(1) [5:90.1] **Defendant's burden:** The burden of proving that the petroleum exclusion applies rests with the party seeking to assert it. Therefore, in a cost-recovery action (¶ *5:126 ff.*), once plaintiff presents evidence sufficient to show a release or threatened release of hazardous substances (¶ *5:126c ff.*), defendant bears the burden of proving the petroleum exclusion applies. [*Johnson v. James Langley Operating Co., Inc.* (8th Cir. 2000) 226 F3d 957, 963, fn. 4; see also *Otay Land Co, LLC v. U.E. Ltd., L.P.* (2017) 15 CA5th 806, 836-837, 225 CR3d 119, 144]

(2) [5:91] **Compare—CERCLA liability for "adulterated" petroleum and natural gas contamination:** The petroleum and gas exclusions do not apply where the petroleum or gas on the property has become adulterated with *other* hazardous substances that are regulated by CERCLA and that are *not normally found in* petroleum or natural gas. In that event, a PRP's liability may be assessed as usual under CERCLA (¶ *5:85 ff.*). [See 50 Fed.Reg. 13,460; *Mid Valley Bank v. North Valley Bank* (ED CA 1991) 764 F.Supp. 1377, 1384—petroleum exclusion inapplicable to waste oil containing nonindigenous CERCLA hazardous substance]

But the petroleum exclusion is fully applicable if the petroleum product contains a specifically-listed CERCLA hazardous substance that is *indigenous* to petroleum (unless the CERCLA hazardous substance is present in the petroleum at a concentration level exceeding levels that naturally occur in the petroleum product). [*Cose v. Getty Oil Co.* (9th Cir. 1993) 4 F3d 700, 704; see *State of Washington v. Time Oil Co.* (WD WA 1988) 687 F.Supp. 529, 532]

(3) [5:92] **Compare—RCRA liability:** Although the petroleum exclusion brings petroleum and natural gas outside the scope of CERCLA, these hazardous waste products *are* regulated by other statutes—including the Federal Resource Conservation and Recovery Act of 1976 (RCRA, 42 USC § 6901 et seq.) and California's Hazardous Waste Control Law (Health & Saf.C. § 25100 et seq.).

(However, RCRA private party remedies are not as expansive as those under CERCLA; significantly, a private party cannot sue under RCRA to recover the costs of clean-up efforts. *See*¶ *5:125.10 ff.*)

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[5:93 - 5:99] ***Reserved.***

3. [5:100] **Defenses:** As earlier discussed, CERCLA and the California Superfund generally impose *strict liability*, without regard to fault (*¶ 5:64*). The statutes recognize only very limited PRP defenses; and those defenses are narrowly construed.

a. [5:101] **Statutory defenses:** The statutory defenses to PRP liability are the same under CERCLA and the California Superfund: (1) the act of war/act of God defense; (2) the third party defense; and (3) the "innocent landowner defense." [42 USC §§ 9601(35) & 9607(b); Health & Saf.C. § 78145(b) (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24) (incorporating CERCLA defenses by reference)]

➪ [5:102] ***PRACTICE POINTER:*** As discussed at ¶ 5:103 ff., these defenses are narrowly construed. Among the relatively few reported decisions to date considering the defenses, only a small fraction have found in favor of the PRP. Therefore, the statutory defenses should not be relied upon as effective insulation from environmental hazards liability. And, in any event, these defenses should not be relied upon in lieu of careful *environmental assessment and investigation* of a property prior to closing a purchase and sale transaction (*¶ 5:235 ff.*).

(1) [5:103] **Act of war/act of God defense:** Proof by a preponderance of the evidence that the release or threatened release of a hazardous substance and the resulting damages were caused *solely by* an "*act of God*" or "*act of war*" is a complete defense to PRP liability. [42 USC § 9607(b)(1) & (2)]

(a) [5:104] **"Act of God" narrowly defined:** CERCLA codifies a very narrow definition of "act of God":

> "… an unanticipated grave natural disaster or other natural phenomenon of an exceptional, inevitable, and irresistible character, the effects of which could not have been prevented or avoided by the exercise of due care or foresight." [42 USC § 9601(1)]

The definition is literally applied to require a truly *exceptional* natural phenomena. Consequently, most cases considering the "act of God" defense have rejected it. [See *United States v. Stringfellow* (CD CA 1987) 661 F.Supp. 1053, 1061—heavy rainfall not "act of God" within meaning of CERCLA defense where rains foreseeable based on normal climatic conditions and where harm caused by rain on toxic waste disposal facility could have been prevented through design of proper drainable channels; *United States v. W.R. Grace & Co.-Conn.* (D MT 2002) 280 F.Supp.2d 1135, 1148—fact that vermiculite and asbestos were naturally-occurring on properties was not natural phenomena of exceptional nature within ambit of "act of God" defense]

(b) [5:104.1] **"Act of war" narrowly construed:** CERCLA does not define "act of war." The few authorities discussing the defense, however, suggest the term has a *narrow* meaning in line with the general legislative intent that CERCLA operate as a strict liability statute with narrowly-construed exceptions. [*United States v. Shell Oil Co.* (9th Cir. 2002) 294 F3d 1045, 1061]

Consequently, the Ninth Circuit has held that an "act of war" triggering the CERCLA § 9607(b)(2) defense does not include all types of governmental action taken under authority of the War Powers Clause of the U.S. Constitution; there must minimally be *acts of combat*. "To take but one example, we have been unable to discover any case in which wartime price controls have been held to be 'acts of war.'" [*United States v. Shell Oil Co.*, supra, 294 F3d at 1061-1062 (rejecting 42 USC § 9607(b)(2) defense based on government activities in regulating wartime petroleum production)]

(c) [5:105] **"Sole" cause limitation:** Neither defense is available unless the PRP can show the "act of God" or "act of war" was the *sole* cause of the hazardous substance release. [*United States v. Stringfellow* (CD CA 1987) 661 F.Supp. 1053, 1061 ("act of God" defense); *United States v. Shell Oil Co.* (9th Cir. 2002) 294 F3d 1045, 1062 ("act of war" defense)]

(2) [5:106] **Third party defense:** Alternatively, a PRP may establish a complete defense by proving by a preponderance of the evidence that the release or threatened release of a hazardous substance and the damages resulting therefrom were caused *solely by* "an act or omission of a third party other than an employee or agent of the defendant, or than one whose act or omission occurs in connection with a contractual relationship, existing directly or indirectly, with the defendant …" [42 USC § 9607(b)(3)]

Thus, the third party defense is available only to PRPs who have *no direct or indirect employee, agency or contractual relationship* with the party responsible for the hazardous substance contamination. [*United States v. Monsanto Co.* (4th Cir. 1988) 858 F2d 160, 169—PRP's lease relationship with disposing party negated defense; *United States v. 175 Inwood Assocs. LLP* (ED NY 2004) 330 F.Supp.2d 213, 227-229 (same even where lease assigned to party asserting defense); *O'Neil v. Picillo* (D RI 1988) 682 F.Supp. 706, 728—PRP failed to meet burden of proving a "*totally unrelated third party* is the sole cause of the release" (emphasis in original)]

(a) [5:106.1] **Narrowly construed:** Like the other CERCLA defenses, the third party defense is construed *narrowly* to further CERCLA's remedial purpose. [*Castaic Lake Water Agency v. Whittaker Corp.* (CD CA 2003) 272 F.Supp.2d 1053, 1080]

(b) [5:107] **Contractual relationship limitation—application to real property sale transactions:** The circumstances under which buyers of contaminated properties might successfully assert the 42 USC § 9607(b)(3) defense appear very limited:

• With respect to the immediate seller, a buyer's third party defense would undoubtedly fail because buyer and seller are in a direct contractual relationship.

• Moreover, buyers will undoubtedly face difficulty in successfully asserting the third party defense with respect to any other person or entity who ever owned the property because the buyers arguably have an "indirect" contractual relationship with *all* persons and entities in the chain of title. [See *California Dept. of Toxic Substances Control v. Westside Delivery, LLC* (9th Cir. 2018) 888 F3d 1085, 1094-1099—defendant who purchased contaminated property at county tax auction had indirect contractual relationship with previous owner and thus could not claim third party defense]

(c) [5:108] **"Due care" and "precautions" limitations:** Even if a PRP can overcome the contractual relationship limitation, a successful third party defense also requires proof that:

• The PRP "exercised due care with respect to the hazardous substance concerned, taking into consideration the characteristics of such hazardous substance, in light of all relevant facts and circumstances"; *and*

• The PRP "took precautions against foreseeable acts or omissions of any such third party and the consequences that could foreseeably result from such acts or omissions." [42 USC § 9607(b)(3); see *State of New York v. Shore Realty Corp.* (2nd Cir. 1985) 759 F2d 1032, 1049—defense not available because precautions against foreseeable act or omissions condition not satisfied; *Castaic Lake Water Agency v. Whittaker Corp.* (CD CA 2003) 272 F.Supp.2d 1053, 1082-1084—defendants raised genuine issue of fact re third party defense by proffering evidence that they took steps to protect their drinking water customers from contaminated water]

1) [5:108.1] **Defense defeated by willful ignorance:** Under the provisions set forth at ¶ 5:106 ff., "[w]illful ignorance of how a third party disposes of a hazardous substance would preclude use of the defense." [*United States v. Bliss* (ED MO 1987) 667 F.Supp. 1298, 1304, fn. 3]

[5:108.2 - 5:108.4] ***Reserved.***

2) [5:108.5] **"Due care" condition construed:**42 USC § 9607(b)(3) does not define "due care" in the context of the third party defense. But the legislative history indicates that a PRP raising the defense must show that it took all precautions with respect to the particular waste that a "similarly situated reasonable and prudent person" would have taken under the circumstances "to protect the public from a health or environmental threat." [See *Castaic Lake Water Agency v. Whittaker Corp.* (CD CA 2003) 272 F.Supp.2d 1053, 1082]

"Due care" does *not*, however, impose a duty on a purchaser to investigate prior to purchase "whether there is pollution on the land caused by someone with whom the purchaser is not in contractual privity." [*United States v. 175 Inwood Assocs. LLP* (ED NY 2004) 330 F.Supp.2d 213, 230 (internal quotes omitted) (but "no duty to investigate" rule inapplicable because defendant was in contractual privity with disposing party); *Bob's Beverage, Inc. v. Acme, Inc.* (ND OH 1999) 169 F.Supp.2d 695, 715]

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• [5:108.6] Defendants who had notice of the presence of hazardous substances on their property when they purchased it, but took almost five years to complete clean-up activities, failed to show they used "due care" under the circumstances. [*United States v. 175 Inwood Assocs. LLP*, supra, 330 F.Supp.2d at 230]

• [5:108.7] Defendant first detected hazardous substances in on-site groundwater samples in 1988. It did not, however, report the detection to the EPA or the equivalent state agency until 1992, even though by its own account many 55-gallon drums containing the substances had been left outside, unattended on the property adjoining its own, for years. A reasonable jury could not conclude that defendant took all precautions with respect to the hazardous waste that a similarly situated reasonable person would have taken under the circumstances. [*Bob's Beverage, Inc. v. Acme, Inc.* (ND OH 1999) 169 F.Supp.2d 695, 716]

(d) [5:109] **"Sole" cause limitation:** Like the "act of war"/"act of God" defense, the third party defense applies only where a totally unrelated third party is the *sole cause* of the contamination.

The "sole" cause limitation incorporates the concept of proximate or legal cause in negligence jurisprudence. As such, a third party is *not* the sole cause of contamination if the hazardous substance release was *unforeseeable* and the party's conduct was an *indirect and insubstantial link* in the chain of events leading to the release. [*Castaic Lake Water Agency v. Whittaker Corp.* (CD CA 2003) 272 F.Supp.2d 1053, 1081-1082 (collecting cases)]

A fortiori, the third party defense is not available where there are *multiple* causes of the release or threatened release at the contaminated site. [*United States v. Stringfellow* (CD CA 1987) 661 F.Supp. 1053, 1061—multiple causes precluded third party defense based on alleged "negligence and reckless conduct" of State of California; see also *State of New York v. Shore Realty Corp.* (2nd Cir. 1985) 759 F2d 1032, 1049]

(3) [5:110] **"Innocent landowner defense":** PRPs not eligible for the third party defense because they are in a direct contractual relationship with the polluting party (¶ 5:106 ff.) may nonetheless escape liability under CERCLA's "innocent landowner defense." [42 USC § 9601(35)(A)] A buyer may successfully assert the innocent landowner defense against the immediate seller, despite their direct contractual relationship, so long as the buyer can satisfy all of the statutory conditions (¶ 5:111 ff.).

The innocent landowner defense applies in different ways to different types of situations (e.g., PRPs who acquired their properties by gift, bequest or operation of law are treated differently from governmental entity PRPs; see 42 USC § 9601(35)(A)). The discussion at ¶ 5:111 ff. focuses on the defense as applied between buyers and sellers of real property.

(a) [5:111] **Qualifying conditions:** In the context of real property buyers and sellers, a property owner asserting the innocent landowner defense must satisfy the following conditions by a preponderance of the evidence:

• The property owner acquired the property *after* the disposal or placement of the hazardous substance on, in or at the property;

• At the time the property owner acquired an interest in the property, the property owner *did not know and had no reason to know* that any hazardous substance that is the subject of the release or threatened release was disposed of on, in or at the property (*see¶ 5:113*);

• The property owner *exercised due care* with respect to the subject hazardous substance, taking into consideration the characteristics of that substance, under the circumstances (*see* ¶ *5:108, 5:108.5 ff.*);

• The property owner took precautions against foreseeable acts or omissions of third parties and the consequences that could foreseeably result from such acts or omissions (*see¶ 5:108*);

• The property owner has provided *full cooperation, assistance and access* to the property to persons authorized to conduct response actions at the property (including the cooperation and access necessary for the installation, integrity, operation and maintenance of any complete or partial response action);

• The property owner has complied with any land use restrictions established or relied on in connection with the response action at the property; *and*

• The property owner has not impeded the effectiveness or integrity of any "institutional control" employed at the property in connection with a response action. [42 USC § 9601(35)(A); see *Kaufman & Broad-South Bay v. Unisys Corp.* (ND CA 1994) 868 F.Supp. 1212, 1216]

1) [5:112] **Comment:** Most of the relatively few reported decisions to have considered the innocent landowner defense have rejected it (see *United States v. Monsanto Co.* (4th Cir. 1988) 858 F2d 160, 168, fn. 14); and the cases upholding the defense have involved special circumstances (see, e.g., *United States v. Pacific Hide & Fur Depot, Inc.* (D ID 1989) 716 F.Supp. 1341, 1347-1349—successful PRPs inherited property and were not involved in business causing contamination; *United States v. Serafini* (MD PA 1988) 706 F.Supp. 346, 353-354—court conceded plausibility of innocent landowner defense, but only in context of denying government's summary judgment motion).

The EPA website offers some general guidance regarding the threshold conditions (see "Enforcement Discretion Guidance Regarding Statutory Criteria for Those Who May Qualify as CERCLA Bona Fide Prospective Purchasers, Contiguous Property Owners, or Innocent Landowners (`Common Elements')," available at *www.epa.gov*).

(b) [5:113] **"Appropriate inquiry" required:** To establish that the property owner had no reason to know of the presence of hazardous materials on the property (*¶ 5:111*), the owner must prove that:

• On or before the date the property was acquired, the property owner made "all appropriate inquiries" into the previous ownership and uses of the property consistent with good commercial or customary practice; *and*

• The property owner took "reasonable steps" to stop any continued release, prevent any threatened future release, and prevent or limit any human, environmental or natural resource exposure to any previously released hazardous substance. [42 USC § 9601(35)(B)(i); see *United States v. W.R. Grace & Co.-Conn.* (D MT 2002) 280 F.Supp.2d 1135, 1147-1148—"appropriate inquiry" requirement not met where owner merely stated that when property purchased there was no active mining and it was not aware of presence of asbestos]

1) [5:114] **Applicable standard:** The "appropriate inquiry" standard for the innocent landowner defense is the same as for the bona fide prospective purchaser exemption. [40 CFR § 312.1(b)(1)(i); *¶ 5:86.6*]

2) [5:115] **Effect of finding contamination during preacquisition inquiry—defense not available:** A property owner who finds contamination before purchasing the property *cannot* assert the innocent landowner defense but may qualify for the "bona fide prospective purchaser" exemption so long as certain conditions are satisfied (*¶ 5:86 ff.*).

a) [5:116] **Comment:** Like the "contiguous property owner" exemption (*¶ 5:85*), the innocent landowner defense is extremely difficult to establish with regard to industrial and most commercial properties since they usually have some level of contamination. Nonetheless, a vigorous preacquisition environmental investigation conducted in an effort to preserve the innocent landowner defense has certain benefits.

[5:117 - 5:118.4] ***Reserved.***

(c) [5:118.5] **Same analysis re eligibility for cost recovery action:** Although cast as an affirmative defense, CERCLA's "innocent landowner" provisions also set forth the appropriate analysis for determining whether a current landowner, presumed to be a PRP, is free from liability and thus eligible to bring a cost recovery action (as opposed to a contribution action) against other PRPs (*¶ 5:125.1 ff.*). [*Boyce v. Bumb* (ND CA 1996) 944 F.Supp. 807, 812, fn. 10]

(d) [5:118.6] **Defense available to prior owners?** It is an open question whether the innocent landowner defense is available only to current owners, or both current *and* past owners. [See *Carson Harbor Village, Ltd. v. Unocal Corp.* (9th Cir. 2001) 270 F3d 863, 883, fn. 10 (en banc)]

(4) [5:119] **No third party or innocent landowner defense for intervening landowners who fail to disclose hazardous materials:** *Intervening landowners* are *not eligible* to assert either the third party defense or the innocent landowner defense (*see also* *¶ 5:63* re intervening landowner status under CERCLA):

Notwithstanding availability of the innocent landowner defense generally, "if the defendant obtained actual knowledge of the release or threatened release of a hazardous substance at [the property] when the defendant owned the real property and then subsequently transferred ownership of the property to another person without disclosing such knowledge, such defendant shall be treated as liable … and no [third party or innocent landowner] defense … shall be available to such defendant." [42 USC § 9601(35)(C)]

Accordingly, a seller who takes a head-in-the-sand approach to a known (or potential) hazardous substance condition by failing or refusing to disclose the problem to a prospective buyer, is disqualified from taking advantage of the third party defense or innocent landowner defense in subsequent litigation.

b. [5:120] **No nonstatutory defenses:** CERCLA liability is subject *only* to those defenses *specifically* set forth in the statutory scheme and no others.

(1) [5:120.1] **Equitable defenses:** Nonstatutory equitable defenses such as laches are *not recognized defenses* to CERCLA liability. [*Town of Munster, Ind. v. Sherwin-Williams Co., Inc.* (7th Cir. 1994) 27 F3d 1268, 1271]

Thus, e.g., the notion of *caveat emptor* will not itself operate as a seller's defense to a buyer's claim for contribution toward the cost of cleaning up an environmentally troubled property. [*Smith Land & Improvement Corp. v. Celotex Corp.* (3rd Cir. 1988) 851 F2d 86, 89-90 (but "caveat emptor" may be considered in mitigation of amount due by contribution); see also *Mardan Corp. v. C.G.C. Music, Ltd*. (9th Cir. 1986) 804 F2d 1454, 1457, fn. 3 (but upholding bar to buyer's indemnification action against seller based on express settlement and release agreement)]

(a) [5:120.2] **Compare—response cost allocation:** Equitable defenses may be considered, however, in *allocating* response cost liability between PRPs. *See*¶ *5:135*.

[5:120.3 - 5:120.4] ***Reserved.***

(2) [5:120.5] **Negligence-based defenses:** Similarly, negligence-type defenses based on duty, causation or contribution are not recognized defenses to CERCLA liability. [*State of Calif. Dept. of Toxic Substances Control v. Alco Pac., Inc.* (CD CA 2002) 217 F.Supp.2d 1028, 1037]

However, causation *may* be considered in apportioning liability between PRPs (¶ *5:73 ff.*) or in connection with the statutory third party defense (¶ *5:106 ff.*).

4. [5:121] **Government Rights of Action:** The government has two options when there is a release (or threatened release) subject to CERCLA:

• The government may order a responsible party to conduct the clean-up pursuant to 42 USC § 9606 (¶ *5:122*); or

• The government may conduct the clean-up itself and file a cost-recovery action under 42 USC § 9607(a)(4) (¶ 5:121.1 ff.). [42 USC § 9604; *Cooper Indus., Inc. v. Aviall Services, Inc.* (2004) 543 US 157, 161, 125 S.Ct. 577, 580; *City of Rialto v. West Coast Loading Corp.* (9th Cir. 2009) 581 F3d 865, 869; see also *Matter of Bell Petroleum Services, Inc.* (5th Cir. 1993) 3 F3d 889, 897—one purpose of statute is shifting cost of cleaning up environmental harm from taxpayers to parties who benefited from disposal of wastes that caused harm]

a. Government-conducted clean-up

(1) [5:121.1] **Government's prima facie cost-recovery case:** The government (having remediated the contaminated site) establishes a prima facie CERCLA case for recovery of its response costs by proving:

• the site is a "facility" (¶ *5:5.4*);

• a "release" or "threatened release" (¶ *5:5.3*) of a "hazardous substance" occurred at the facility (¶ *5:5.1*);

• it incurred costs in responding to the release or threatened release; and

• the defendant is the liable party (¶ *5:7*). [*Redevelopment Agency of City of San Diego v. Salvation Army* (2002) 103 CA4th 755, 764-765, 127 CR2d 30, 39; *United States v. Chapman* (9th Cir. 1998) 146 F3d 1166, 1169]

(a) [5:121.1a] **"Necessary nexus" between costs incurred and defendant not required:** With regard to the "incurred costs" element of its prima facie cost-recovery case, the government need only show that it *in fact incurred* response costs; it need not prove that the costs were necessary or that defendant caused the government to incur the costs. [*United States v. W.R. Grace & Co.-Conn.* (D MT 2002) 280 F.Supp.2d 1135, 1146-1147]

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(b) [5:121.2] **Defendant's burden:** Once the government establishes its prima facie case, the burden shifts to defendant to prove the government's response action was inconsistent with the National Contingency Plan (NCP, *see*¶ 5:121.3 ff.). [*United States v. Chapman* (9th Cir. 1998) 146 F3d 1166, 1169]

1) [5:121.3] **Nature of NCP:** The "National Contingency Plan," promulgated by the EPA as regulations pursuant to CERCLA (42 USC § 9605(a); 40 CFR Part 300), sets forth governmental standards for environmental assessment, investigation, evaluation and clean-up, and establishes national priorities with respect to the use of Superfund moneys. [See *Cooper Indus., Inc. v. Aviall Services, Inc.* (2004) 543 US 157, 161, 125 S.Ct. 577, 580, fn. 2; *Fireman's Fund Ins. Co. v. City of Lodi, Calif.* (9th Cir. 2002) 302 F3d 928, 949]

2) [5:121.3a] **Effect of failure to comply with NCP:** The NCP is designed to make the party seeking response costs choose a cost-effective course of action. Accordingly, only response costs incurred *in accordance with the NCP* are recoverable under CERCLA. [*Fireman's Fund Ins. Co. v. City of Lodi, Calif.* (9th Cir. 2002) 302 F3d 928, 949; *United States v. Chapman* (9th Cir. 1998) 146 F3d 1166, 1170; see also *Orange County Water Dist. v. Alcoa Global Fasteners, Inc.* (2017) 12 CA5th 252, 325, 219 CR3d 474, 537 (noting State Superfund places NCP compliance at "heart" of environmental remediation actions)—failure to comply with national environmental remediation program standards precluded water district's State Superfund claim]

a) [5:121.3b] **Compare—partial compliance:** However, where *some* (but not all) response action did not comply with the NCP, clean-up costs remain recoverable *to the extent* the action taken was *consistent* with the NCP. [*State of Minn. v. Kalman W. Abrams Metals, Inc.* (8th Cir. 1998) 155 F3d 1019, 1024—although state agency could not recover costs for failed "high-risk, high-cost" action, it could recover costs for subsequent remedial action *consistent* with NCP]

3) [5:121.4] **Government response action presumed consistent with NCP:** When the United States is seeking recovery of response costs, consistency with the NCP is *presumed*. The burden is on the defendant to rebut the presumption of consistency by establishing that the government's response action was *arbitrary and capricious*. [*State of Calif. ex rel. Calif. Dept. of Toxic Substances Control v. Neville Chem. Co.* (9th Cir. 2004) 358 F3d 661, 673; *Fireman's Fund Ins. Co. v. City of Lodi, Calif.* (9th Cir. 2002) 302 F3d 928, 949]

A *state* agency is similarly entitled to the presumption of consistency with the NCP. [See *Fireman's Fund Ins. Co. v. City of Lodi, Calif.*, supra, 302 F3d at 950 & fn. 20]

a) [5:121.5] **Local municipalities?** A *city acting under the oversight of a state agency* also is entitled to the presumption of consistency with the NCP. But whether a city seeking recovery of response costs *on its own* has the benefit of the presumption is undecided. [See *Fireman's Fund Ins. Co. v. City of Lodi, Calif.* (9th Cir. 2002) 302 F3d 928, 950 & fn. 20 (agreement between City and state agency re clean-up of toxic sites designated City as "lead enforcement entity" but in essence gave *state agency* responsibility of conducting clean-up); see also *Orange County Water Dist. v. Alcoa Global Fasteners, Inc.* (2017) 12 CA5th 252, 327, 219 CR3d 474, 538—policies underlying CERCLA's cost recovery provisions militated against extending NCP presumption to county water district's State Superfund claim]

[5:121.6 - 5:121.9] ***Reserved.***

(2) [5:121.10] **Recoverable costs:** CERCLA permits the recovery of "all costs" arising from a removal or remedial action. [42 USC § 9607(a)(4)(A); see also *United States v. Iron Mountain Mines* (ED CA 2010) 724 F.Supp.2d 1086, 1092—if United States obtains less than complete relief from settling parties, it may bring action against any nonsettling PRPs for remainder (*discussed further at*¶ *5:136*)]

(a) [5:121.11] **Attorney fees:** The U.S. Government or a State or Indian Tribe is entitled to recover its litigation expenses —*including attorney fees*—as part of its response costs. [*United States v. Chapman* (9th Cir. 1998) 146 F3d 1166, 1174-1176—"all costs" under 42 USC § 9607(a)(4)(A) includes attorney fees; see also *Pakootas v. Teck Cominco Metals, Ltd.* (9th Cir. 2018) 905 F3d 565, 583-584 (declining to limit *Chapman* to response cost actions premised on defendant's refusal to obey EPA cleanup order or fund response costs)]

But any other litigant is limited to recovery of "*necessary costs of response*" (¶ *5:125*) which does *not* include litigation-related attorney fees (¶ *5:128*). [*Fireman's Fund Ins. Co. v. City of Lodi, Calif.* (9th Cir. 2002) 302 F3d

928, 953—42 USC § 9607(a)(4)(A) "all costs" recovery (including attorney fees) not available to *cities* and other local municipalities]

1) [5:121.12] **Limited to "reasonable fees":** Although the statute does not expressly so provide, the Ninth Circuit interprets it to authorize an award of only such fees as the court deems *reasonable*. [*United States v. Chapman* (9th Cir. 1998) 146 F3d 1166, 1174—where government initially claimed $34,000 in response costs, $400,000 attorney fee award vacated and case remanded for redetermination of *reasonable* fees]

Not all courts agree, however. [See *United States v. Domenic Lombardi Realty, Inc.* (D RI 2004) 334 F.Supp.2d 105, 108—declining to follow *Chapman* because "CERCLA contains no statutory language limiting recovery to 'reasonable' fees or costs" in government enforcement actions (but court also noted it was sympathetic to defendant's concern that government overstaffed case and used it as training vehicle for junior attorneys)]

(b) [5:121.12a] **Investigation costs:** The U.S. Government or a State or Indian Tribe also is entitled to recover costs associated with investigating contamination and identifying potentially responsible parties. [*Pakootas v. Teck Cominco Metals, Ltd.* (9th Cir. 2018) 905 F3d 565, 580-582—Tribe entitled to recover costs of investigating presence and movement of toxic waste, determining whether contaminants leached into environment, and tracing contamination to defendant's activities]

(3) [5:121.13] **Statute of limitations:** A government cost-recovery action must be commenced within the following time periods:

• *Removal action*—within three years after completion of the removal action (or within six years after a "determination to grant a waiver under section 9604(c)(1)(C) … for continued response action");

• *Remedial action*—within six years after initiation of physical on-site construction of the remedial action, except that if remedial action is initiated within three years after completion of the removal action (above), costs incurred in the *removal action* may be recovered in the remedial action cost-recovery suit. [42 USC § 9613(g)(2); *United States v. Drum Service Co. of Florida* (MD FL 1999) 109 F.Supp.2d 1348, 1355-1356]

To determine which statute of limitations applies, the clean-up must be identified as either a "removal" or "remedial" action. [*United States v. Drum Service Co. of Florida*, supra, 109 F.Supp.2d at 1356] The terms are defined by statute (42 USC § 9601(23), (24)) and interpreted by case law. *See¶ 5:133.17*.

(a) [5:121.13a] **Accrual of removal action—end of *entire removal phase:*** For purposes of triggering the statute of limitations, the general rule is that *all* removal actions performed at a *single site* constitute a *single indivisible* removal action. As such, the statute of limitations begins to run only at the *conclusion of the entire removal phase*. [*State of Calif. Dept. of Toxic Substances Control v. Alco Pac., Inc.* (CD CA 2004) 308 F.Supp.2d 1124, 1133—"This finding conforms with the vast majority of case law discussing the issue of CERCLA statute of limitations"]

"On a practical level, this appears to be the correct approach because it is apparent that the clean-up of toxic waste can often only be accomplished in phases. [I]t would defeat the purposes of [CERCLA] to require the government to sue responsible parties at the conclusion of each phase." [*State of Calif. Dept. of Toxic Substances Control v. Alco Pac., Inc.*, supra, 308 F.Supp.2d at 1133 (internal citation omitted)]

1) [5:121.13b] **"Unusual circumstances" exception?** One court has applied a narrow exception to the general rule set forth at ¶ 5:121.13a, treating *each* removal action at a single site as a *separate* removal action under "unusual circumstances." [*United States v. Ambroid Co., Inc.* (D MA 1999) 34 F.Supp.2d 86, 88-89—"unusual circumstances" included EPA's completion of clean-up and closing of site, EPA's transfer of site responsibility to state authorities, and EPA's treatment of removal actions as separate]

However, *Ambroid* has been criticized as "a dubious precedent because no [other] court appears willing to follow it." [*State of Calif. Dept. of Toxic Substances Control v. Alco Pac., Inc.* (CD CA 2004) 308 F.Supp.2d 1124, 1133]

(b) [5:121.14] **Accrual of remedial action—adoption of final remedial plan:** The limitations period for a government cost-recovery *remediation* suit does not commence to run until *adoption of a final remedial action plan*. [*State of Calif. ex rel. Calif. Dept. of Toxic Substances Control v. Neville Chem. Co.* (9th Cir. 2004) 358 F3d 661, 663, 666-667—"initiation of physical onsite construction of remedial action" can only occur after final remedial action plan adopted (also noting this rule is consistent with all other circuits deciding issue)]

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1) [5:121.14a] **Effect of incurring costs before plan adopted:** Costs incurred before a final remedial plan is approved are not recoverable in a remedial action. But those costs may be recovered as "removal" costs, subject to the three-year statute of limitations for removal actions. [*State of Calif. ex rel. Calif. Dept. of Toxic Substances Control v. Neville Chem. Co.* (9th Cir. 2004) 358 F3d 661, 663, 670, fn. 6]

2) [5:121.14b] **Comment—private cost-recovery remedial suits?** *Neville*, supra, did not address whether the rule at ¶ 5:121.14 ff. applies to private cost-recovery "remedial" suits (*see*¶ *5:133.15*). [*State of Calif. ex rel. Calif. Dept. of Toxic Substances Control v. Neville Chem. Co.* (9th Cir. 2004) 358 F3d 661, 663, 667, fn. 3] However, there does not appear to be any logical reason why such suits should be treated differently.

(4) [5:121.15] **Lien to secure costs recovery:** CERCLA authorizes the government to file a lien on the contaminated property in order to secure recovery of its cleanup costs and damages. [42 USC § 9607(*l*)]

(a) [5:121.16] **Automatic:** The government's lien is created automatically—i.e., a lien on the contaminated property may be recorded *without notice or a hearing*. [See 42 USC § 9607(*l*)]

Moreover, because filing of the lien is an "enforcement activity," any preenforcement challenges to the merits of the lien (e.g., challenges pertaining to property owner's liability) are *barred* by 42 USC § 9613(h) (limiting federal court jurisdiction in connection with preenforcement review of government response action and administrative orders). [*Reardon v. United States* (1st Cir. 1991) 947 F2d 1509, 1512-1513; see also *Pakootas v. Teck Cominco Metals, Ltd.* (9th Cir. 2011) 646 F3d 1214, 1220—§ 9613(h) operates as a "jurisdiction-stripping" statute by withholding federal jurisdiction to review claims that constitute "challenges" to *ongoing* CERCLA clean-up actions, including those made in citizen suits and under non-CERCLA statutes]

(b) [5:121.17] **Constitutionality?** At least one circuit has held that 42 USC § 9607(*l*) violates the Fifth Amendment Due Process Clause because it deprives a property owner of a significant property interest without notice and a predeprivation hearing. [*Reardon v. United States* (1st Cir. 1991) 947 F2d 1509, 1523-1524; compare *United States v. Glidden Co*. (ND OH 1997) 3 F.Supp.2d 823, 837—no due process violation where owners received notice of EPA's intent to perfect lien and were provided with informal hearing before neutral EPA official (aff'd on this point in *United States v. 150 Acres of Land* (6th Cir. 2000) 204 F3d 698, 710-711)]

(c) [5:121.18] **"Windfall lien" on "bona fide prospective purchaser" property:** The government may also impose a so-called "windfall lien" on property owned by a "bona fide prospective purchaser" (¶ *5:86 ff.*) to secure recovery of its otherwise unrecovered response (clean-up) costs so long as its response action increased the fair market value of the property above the fair market value of the property that existed before the response action was initiated. By agreement with the property owner, the lien may alternatively be imposed on other property of the owner. [See 42 USC § 9607(r)(2), (3) & (4)]

b. [5:122] **Government ordered clean-up:** Instead of undertaking the clean-up itself, the government may require a PRP to undertake the response action. [42 USC § 9606(a); *Pakootas v. Teck Cominco Metals, Ltd.* (9th Cir. 2006) 452 F3d 1066, 1072-1073; see also *City of Rialto v. West Coast Loading Corp.* (9th Cir. 2009) 581 F3d 865, 869—Congress gave government option of ordering PRPs to conduct clean-up because Superfund money is limited]

In such cases, the EPA either will issue an administrative order requiring remedial action or seek a court injunction compelling the responsible party to initiate the clean-up. [42 USC § 9606(a); *City of Rialto v. West Coast Loading Corp.*, supra, 581 F3d at 870; *Pakootas v. Teck Cominco Metals, Ltd.,* supra, 452 F3d at 1073]

It is unclear whether, in issuing a clean-up order under § 9606(a), the EPA must allege the same elements that are required for a private 42 USC § 9607(a) cost-recovery action. [*Pakootas v. Teck Cominco Metals, Ltd.*, supra, 452 F3d at 1074, fn. 13]

(1) [5:122.1] **Private cost-recovery/contribution actions:** Private parties who are ordered to undertake a response action may file suit against other PRPs to recover all or a part of the clean-up costs incurred. [See 42 USC §§ 9607(a) (joint and several cost-recovery actions), 9613(f)(1) (contribution actions)] *See detailed discussion at*¶ *5:125 ff.*

(2) [5:122.2] **Costs recoverable by government:** The government may incur recoverable enforcement costs even when private parties are ordered to conduct the clean-up. [*Atlantic Richfield Co. v. American Airlines, Inc.* (10th Cir. 1996) 98 F3d 564, 569]

(a) [5:122.3] **Oversight costs:** The government's recoverable enforcement costs include costs incurred in monitoring or overseeing a responsible party's clean-up. [*United States v. E.I. DuPont de Nemours & Co. Inc.* (3rd Cir. 2005) 432 F3d 161, 162 (en banc); *United States v. Chromalloy American Corp.* (5th Cir. 1998) 158 F3d 345, 349]

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The California Superfund expressly includes enforcement and oversight activities within the meaning of "response." [See Health & Saf.C. § 78140 (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24)]

(b) [5:122.4] **Indirect costs of managing Superfund program in general:** The government may also recover the proportion of the overall costs incurred to manage the Superfund program in general that are attributable to the particular clean-up project involved. [*United States v. W.R. Grace & Co.* (9th Cir. 2005) 429 F3d 1224, 1250]

(3) [5:123] **Judicial review of clean-up orders:** CERCLA permits judicial review of challenges to government clean-up orders, but limits the timing of such reviews. In short, a PRP can obtain judicial review of an administrative order requiring remedial action either *before* or *after* it has complied with the order; and, as soon as it spends dollar one, it can *always* seek cost recovery from other PRPs and obtain judicial review of those claims. [See 42 USC § 9613(h); *City of Rialto v. West Coast Loading Corp.* (9th Cir. 2009) 581 F3d 865, 871-872—once PRP begins complying with order it cannot seek judicial review until it completes required work]

"It is true that there are some limitations and disincentives attendant to each avenue of judicial review. But Congress intentionally chose *not* to authorize judicial review whenever a PRP desired. Instead, by specifying the '[t]iming of review' in § 9613(h), Congress chose to prioritize 'the timely cleanup of hazardous waste sites.'" [*City of Rialto v. West Coast Loading Corp.*, supra, 581 F3d at 872 (emphasis in original); *Pakootas v. Teck Cominco Metals, Ltd.* (9th Cir. 2011) 646 F3d 1214, 1220—by enacting § 9613(h), Congress "made a choice" to protect execution of CERCLA plans *during their pendency* from lawsuits that might interfere with expeditious clean-up efforts; compare *General Elec. Co. v. E.P.A.* (DC Cir. 2004) 360 F3d 188, 190-191—judicial review timing limits do *not* apply to challenges to CERCLA's constitutionality]

(a) [5:123.1] **Section 9613(h) does not bar state court actions:** Unlike 42 USC § 9613(b) (¶ 5:12), § 9613(h) does not apply to state courts and, therefore, does not affect their jurisdiction. 42 USC 9613(h) only applies to federal courts and does not implicitly prohibit state court actions arising under state law. Thus, a property owner may bring an action in state court under state common law to recover restoration damages to rehabilitate property that is subject to an ongoing CERCLA cleanup. [*Atlantic Richfield Co. v. Christian* (2020) 590 US _, _, 140 S.Ct. 1335, 1349-1352—Montana state court had jurisdiction over property owners' lawsuit seeking restoration damages under state common law to rehabilitate property within Superfund site (property owners, however, were required to obtain EPA approval for their proposed plan; ¶ 5:169.3)]

[5:124] ***Reserved.***

5. Private Rights of Action

a. [5:125] **Authority, generally—"necessary costs of response":** CERCLA expressly gives private parties the right to sue PRPs to recover all or a portion of the *"necessary costs of response"* incurred in remediating the contaminated property. [42 USC §§ 9607(a)(4)(B) & 9613(f); see *United States v. Atlantic Research Corp.* (2007) 551 US 128, 131, 127 S.Ct. 2331, 2333; *Cooper Indus., Inc. v. Aviall Services, Inc.* (2004) 543 US 157, 160, 125 S.Ct. 577, 580; *Carson Harbor Village, Ltd. v. Unocal Corp.* (9th Cir. 2001) 270 F3d 863, 870 (en banc)]

Courts have also indicated private contribution actions may be brought under federal common law, although that is "debatable." [*Cooper Indus., Inc. v. Aviall Services, Inc.*, supra, 543 US at 162, 125 S.Ct. at 581]

Similarly, the California Superfund provides for private actions between PRPs seeking contribution or indemnity. [Health & Saf.C. § 79670 (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24); see also *Otay Land Co., LLC v. U.E. Ltd., L.P.* (2017) 15 CA5th 806, 825-826, 225 CR3d 119, 135-136 (decided under predecessor statute) (finding State Superfund's private right of action to be a grant of statutory indemnity that permits recovery of *voluntarily incurred* clean-up costs); *Orange County Water Dist. v. Alcoa Global Fasteners, Inc.* (2017) 12 CA5th 252, 301, 219 CR3d 474, 517 (decided under predecessor statute) (finding State Superfund's private right of action to be "an instance of statutory indemnity," entitling *nonliable* county water district to sue industrial site owners and operators for costs associated with project intended to address groundwater contamination (¶ 5:126.3)); *Fullerton Redevelop. Agency v. Southern Calif. Gas Co.* (2010) 183 CA4th 428, 432-433, 107 CR3d 396, 399 (decided under predecessor statute)—PRPs ordered to clean up contaminated property pursuant to state law may seek contribution and indemnity from those liable for associated costs]

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(1) [5:125.1] **Contribution vs. cost-recovery action:** CERCLA recognizes two distinct types of private party actions:

- A *cost-recovery* suit (42 USC § 9607(a)) brought by a private party, whether a party subject to any of the CERCLA defenses (*¶ 5:101 ff.*) *or* a PRP, to recoup *all* of its *own* clean-up expenditures from a responsible party (i.e., a suit for complete indemnity in the nature of joint and several liability); or

- A *contribution* suit (42 USC § 9613(f)(1)) brought by a private PRP against other PRPs to recoup that portion of the plaintiff PRP's clean-up liability it paid, or has become liable to pay, under a settlement or judgment that exceeds the plaintiff PRP's *pro rata (equitable) share* of the overall liability. [*United States v. Atlantic Research Corp.* (2007) 551 US 128, 138-139, 127 S.Ct. 2331, 2338; see also *Whittaker Corp. v. United States* (9th Cir. 2016) 825 F3d 1002, 1006-1007 (¶ 5:125.2b, 5:125.3); *Ameripride Services Inc. v. Texas Eastern Overseas Inc.* (9th Cir. 2015) 782 F3d 474, 490 (¶ 5:126.10)]

  The remedies under 42 USC § 9607(a) and § 9613(f) are not coextensive or interchangeable. Quite the contrary, the two remedies "*complement* each other by providing causes of action to persons in *different procedural circumstances*." [*United States v. Atlantic Research Corp.*, supra, 551 US at 139, 127 S.Ct. at 2338 (emphasis added; internal quotes omitted); see also *Cooper Indus., Inc. v. Aviall Services, Inc.* (2004) 543 US 157, 163, 125 S.Ct. 577, 582, fn. 3—cost-recovery and contribution remedies "are similar at a general level in that they both allow private parties to recoup costs from other private parties. But the two remedies are clearly distinct"]

  (a) [5:125.2] **Cost-recovery action:** A private party may bring a 42 USC § 9607(a) action against PRPs for full recovery of the costs *it incurred* in cleaning up the contaminated site. [*United States v. Atlantic Research Corp.* (2007) 551 US 128, 139, 127 S.Ct. 2331, 2338; see also *Kotrous v. Goss-Jewett Co. of Northern Calif.* (9th Cir. 2008) 523 F3d 924, 934—private parties may bring cost recovery actions even if they themselves are PRPs (*discussed further at¶ 5:125.7*); *AMCAL Multi-Housing, Inc. v. Pacific Clays Products, Inc.* (CD CA 2007) 518 F.Supp.2d 1194, 1196—private PRPs may bring cost recovery suits regardless of whether any statutory defense to PRP status applies (*¶ 5:101 ff.*)]

  Compare: A PRP who pays money to satisfy a clean-up settlement or judgment against it does not "incur" its own response costs but, instead, *reimburses other parties for costs* they incurred. Therefore, in this scenario, the plaintiff's claim against other PRPs is for *contribution* (*¶ 5:125.3*)—*not*§ 9607(a) "cost recovery." [*United States v. Atlantic Research Corp.*, supra, 551 US at 138, 127 S.Ct. at 2338 & fn. 5; *Agere Systems, Inc. v. Advanced Environmental Technology Corp.* (3rd Cir. 2010) 602 F3d 204, 225]

  1) [5:125.2a] **Recovery of voluntary clean-up costs:** A 42 USC § 9607(a) cost-recovery action lies *without any prior establishment of plaintiff's liability to a third party*. Therefore, *voluntarily-incurred* clean-up costs are recoverable in (indeed, *only in*) a § 9607(a) cost-recovery action. [*United States v. Atlantic Research Corp.* (2007) 551 US 128, 139, 127 S.Ct. 2331, 2338, fn. 6; see also *W.R. Grace & Co.-Conn. v. Zotos Int'l, Inc.* (2nd Cir. 2009) 559 F3d 85, 96—PRPs not previously subjected to 42 USC §§ 9606/9607 actions who remediate contaminated sites under consent orders with state agencies *voluntarily incur* costs for purposes of filing cost-recovery actions; *Consolidated Edison Co. of New York, Inc. v. UGI Utilities, Inc.* (2005) 423 F3d 90, 97—PRP who entered into voluntary clean-up agreement with state agency to avoid liability for state law claims entitled to bring § 9607(a) cost-recovery action]

  Compare—42 USC § 9613(f) contribution claims for clean-up expenditures incurred during or following a civil action or under administrative or judicially approved settlement: *See discussion at¶ 5:125.4 ff.*

  2) [5:125.2b] **Cost-recovery after PRP settlement with third party:** A PRP's right to contribution for some expenses following settlement with a third party does not necessarily preclude the PRP from bringing a cost-recovery action for other expenses. [See *Whittaker Corp. v. United States* (9th Cir. 2016) 825 F3d 1002, 1011-1013—cost-recovery action against government improperly dismissed where expenses company sought to recover for investigating and cleaning up site were separate and distinct from those for which it was found liable to third party]

  3) [5:125.2c] **Action against settling § 9316(f)(2) PRP:** A PRP who has resolved its liability to the government in an administrative or judicially-approved settlement is insulated from *contribution* claims under CERCLA regarding matters addressed in the settlement (¶ 5:136); however, it may still be subject to a 42 USC § 9607(a) cost-recovery suit. [*United States v. Atlantic Research Corp.* (2007) 551 US 128, 140, 127 S.Ct. 2331, 2339; *see further discussion at*¶ 5:136 ff.]

4) [5:125.2d] **Joint and several liability:** Whereas reimbursement costs are equitably apportioned in a 42 USC § 9613(f) contribution action, PRP liability in a 42 USC § 9607(a) cost-recovery action apparently is *joint and several.* [*United States v. Atlantic Research Corp.* (2007) 551 US 128, 140, 127 S.Ct. 2331, 2338-2339 & fn. 7—"We assume without deciding" that § 9607(a) provides for joint and several liability]

(b) [5:125.3] **Contribution action:** 42 USC § 9613(f) explicitly grants PRPs a right of "contribution," construed in its traditional sense as referring to a "tortfeasor's right to collect from others responsible for the same tort after the tortfeasor has paid more than his or her proportionate share, the shares being determined as a percentage of fault." [*United States v. Atlantic Research Corp.* (2007) 551 US 128, 138, 127 S.Ct. 2331, 2337-2338 (quoting Black's Law Dictionary); see also *Whittaker Corp. v. United States* (9th Cir. 2016) 825 F3d 1002, 1007—parties use contribution to get reimbursed for being made to pay more than their fair share to someone else]

42 USC § 9613(f)(1) contribution actions are authorized before or after *common liability* under CERCLA has been established *and* there has been an inequitable distribution of the common liability. "[A] PRP's right to contribution under [§ 9613(f)(1)] is contingent upon an inequitable distribution of common liability among liable parties." [*United States v. Atlantic Research Corp.*, supra, 551 US at 139, 127 S.Ct. at 2338; *Agere Systems, Inc. v. Advanced Environmental Technology Corp.* (3rd Cir. 2010) 602 F3d 204, 219—42 USC § 9613(f) contribution claims require "common liability" among PRPs at time underlying claim is resolved]

In 42 USC § 9613(f)(1) contribution actions, as distinguished from 42 USC § 9607(a) cost-recovery actions, plaintiffs may *only* recover costs they did *not* "incur." A PRP who pays money to satisfy a settlement agreement or a court judgment *reimburses* other parties for costs *they incurred*, and is thereby limited to a § 9613(f)(1) contribution claim. [*United States v. Atlantic Research Corp.*, supra, 551 US at 139, 127 S.Ct. at 2338; see also *Hobart Corp. v. Waste Mgmt. of Ohio, Inc.* (6th Cir. 2014) 758 F3d 757, 767-768 & fn. 8 (finding no "logical distinction" between § 9613(f)(1) and (f)(3)(B) for purposes of cost reimbursement)—plaintiff's sole remedy against other PRPs under administrative settlement is contribution action; compare *Agere Systems, Inc. v. Advanced Environmental Technology Corp.* (3rd Cir. 2010) 602 F3d 204, 225 (distinguishing *Atlantic Research*)—PRPs who were never sued themselves and therefore did not have § 9613(f) contribution claims for costs they previously paid pursuant to private settlement agreements with other PRPs could pursue § 9607(a) cost-recovery action to recoup said costs]

1) [5:125.4] **Section 9606/9607(a) action or settlement of liability as prerequisite to § 9613(f) contribution suit:** CERCLA expressly authorizes PRP contribution claims only "during or following any civil action" under 42 USC § 9606 or § 9607(a), or by a PRP who has resolved its response-costs liability to the United States or a state in an administrative or judicially-approved settlement. [42 USC § 9613(f)(1) & (3)(B); see *United States v. Atlantic Research Corp.* (2007) 551 US 128, 132, 127 S.Ct. 2331, 2334 & fn. 1; *Agere Systems, Inc. v. Advanced Environmental Technology Corp.* (3rd Cir. 2010) 602 F3d 204, 217; see also *Bernstein v. Bankert* (7th Cir. 2012) 733 F3d 190, 201-202—PRP is limited to contribution once its *CERCLA* liability to government is "resolved"; *and* *¶ 5:125.5 ff.*]

A PRP who has neither been sued by the government under 42 USC § 9606 to compel a clean-up or under § 9607(a) to recover response costs, nor been adjudged liable for response costs in an administrative or judicially approved settlement, may *not* obtain contribution under § 9613(f) from other liable parties for voluntarily-incurred clean-up costs. [See *Cooper Indus., Inc. v. Aviall Services, Inc.* (2004) 543 US 157, 160-161, 125 S.Ct. 577, 580] A PRP who has voluntarily incurred clean-up costs may, however, pursue cost recovery under § 9607(a). [See *United States v. Atlantic Research Corp.* (2007) 551 US 128, 138-139, 127 S.Ct. 2331, 2337-2338 (¶ 5:125.2a)]

a) [5:125.5] **Administrative order sufficient?** It is unsettled whether an *administrative* clean-up order itself qualifies as a "civil action" under 42 USC § 9606 or § 9607(a), permitting the PRP to bring a 42 USC § 9613(f)(1) contribution claim. [*Cooper Indus., Inc. v. Aviall Services, Inc.* (2004) 543 US 157, 168, 125 S.Ct. 577, 584, fn. 5 (raising but not deciding issue); see also *Beazer East, Inc. v. Mead* (3rd Cir. 2008) 525 F3d 255, 262 (noting Supreme Court "apparently left open" issue, but finding such claims "not wholly insubstantial and frivolous")]

b) [5:125.5a] **Settlement of non-CERCLA liability:** A settlement must resolve a *CERCLA-specific* liability to trigger 42 USC § 9613(f)(3)(B)'s right to contribution. [*Territory of Guam v. United States* (2021) 593 US 310, 313-316, 141 S.Ct. 1608, 1611-1612—consent decree resolving Clean Water Act claims did not trigger 3-year statute of limitations period for CERCLA contribution action]

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The Supreme Court expressly rejected arguments previously credited by some federal circuit courts of appeal in concluding that a settlement resolving a party's environmental liability under a non-CERCLA statute can trigger § 9613(f)(3)(B)'s right to contribution. [*Territory of Guam v. United States*, supra, _ US at _, 141 S.Ct. at 1614-1615; see also *Consolidated Edison Co. of New York, Inc. v. UGI Utilities, Inc.* (2nd Cir. 2005) 423 F3d 90, 95—"We read section 113(f)(3)(B) to create a contribution right only when liability for CERCLA claims, rather than some broader category of legal claims, is resolved"]

Comment: Territory of Guam, supra, apparently abrogates existing precedent in the Third, Seventh and Ninth Circuits holding § 9613(f)(3)(B)'s right to contribution is triggered when the party resolves some portion of their cleanup liability, regardless of whether the liability arises under CERCLA or some other statute. [See *Refined Metals Corp. v. NL Indus. Inc.* (7th Cir. 2019) 937 F3d 928, 931-932—statute of limitations on current owner's contribution action began running when owner entered settlement resolving liability for cleanup, even if settlement did not specifically address owner's CERCLA liability (¶ 5:133.5a); *Asarco LLC v. Atlantic Richfield Co.* (9th Cir. 2017) 866 F3d 1108, 1120-1121—corrective measures taken under RCRA consent decree qualified as § 9613(f)(3)(B) "response action"; *Trinity Indus., Inc. v. Chicago Bridge & Iron Co.* (3rd Cir. 2013) 735 F3d 131, 136-137—industrial site owner could seek contribution pursuant to consent order issued under Pennsylvania's environmental cleanup acts even though order was not made pursuant to CERCLA]

c) [5:125.5b] **Civil action requirement jurisdictional?** According to one court, the "civil action" prerequisite to a 42 USC § 9613(f) contribution suit (*¶ 5:125.4*) is *not a jurisdictional threshold*. Rather, it constitutes an *element of the claim* that can be waived by failure to timely object. [See *Beazer East, Inc. v. Mead* (3rd Cir. 2008) 525 F3d 255, 261, 265]

d) [5:125.5c] **Future response costs:** A responsible party may agree to pay estimated future response costs as part of a settlement to discharge its CERCLA liability. The responsible party, however, cannot immediately recover any portion of the amount paid to cover future response costs from other responsible parties in a 42 USC § 9613(f)(1) contribution action. This is because "speculative, potential future response costs are not recoverable in a CERCLA contribution action," even if the party seeking contribution already paid those costs as part of a settlement and the payment is irrevocable. [*ASARCO LLC v. Atlantic Richfield Co., LLC* (9th Cir. 2020) 975 F3d 859, 865-866—plaintiff could not pursue § 9613(f)(1) contribution for estimated future response costs it paid to federal and state governments under consent decree (total cleanup costs were about $50 million less than amount plaintiff paid under consent decree); *see*¶ 5:126.10 ff.]

In such cases, the party seeking CERCLA contribution is limited to (i) contribution for necessary response costs that were already incurred, and (ii) a declaratory judgment to establish liability and a contribution allocation for costs that have not been incurred, but may be incurred in the future. [*ASARCO LLC v. Atlantic Richfield Co.*, supra, 975 F3d at 867-868; *see*¶ 5:132.2]

2) [5:125.6] **No expanded right to contribution under § 9613(f)(1) "saving clause":**42 USC § 9613(f)(1) has a "saving clause," stating that nothing "shall diminish the right of any person to bring an action for contribution in the absence of a civil action under section[s] 9606 … or 9607." [42 USC § 9613(f)(1); *City of Emeryville v. Robinson* (9th Cir. 2010) 621 F3d 1251, 1262]

The sole effect of this sentence is to preserve any cause of action for contribution that might exist *independently* of § 9613(f)(1). But the saving clause does not create an alternative contribution right of action or expand § 9613(f)(1) to authorize contribution actions not brought "during or following" a 42 USC § 9606 or § 9607(a) civil action; nor does it specify what other independent contribution causes of action (if any) might exist outside § 9613(f)(1). [*Cooper Indus., Inc. v. Aviall Services, Inc.* (2004) 543 US 157, 166-167, 125 S.Ct. 577, 583-584; and see *City of Emeryville v. Robinson* (9th Cir. 2010) 621 F3d 1251, 1262 (interpreting § 9613(f)(1) saving clause as precluding any finding of preemption as to *state law* contribution claims)]

3) [5:125.7] **Implied right to contribution under § 9607(a)?** The U.S. Supreme Court has not yet decided whether a PRP who does not satisfy the CERCLA prerequisites to a 42 USC § 9613(f) contribution claim might have an *implied* right of contribution under 42 USC § 9607(a) (i.e., a cost-recovery action claiming some form of liability against other PRPs other than joint and several, *see*¶ *5:125.9*). [*Cooper Indus., Inc. v. Aviall Services, Inc.* (2004) 543 US

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157, 170-171, 125 S.Ct. 577, 586—"we need not and do not decide today whether any judicially implied right of contribution survived the passage of SARA"]

However, given the Court's holding in *Atlantic Research Corp.*, supra (¶ *5:125.2 ff.*), the issue arguably now is moot. Indeed, because 42 USC § 9607(a) expressly permits PRPs to seek cost recovery, the Court determined it "need not address the alternative" argument that § 9607(a) contains an additional implied right of contribution for PRPs who are not eligible for 42 USC § 9613(f) relief. [*United States v. Atlantic Research Corp.* (2007) 551 US 128, 141, 127 S.Ct. 2331, 2339, fn. 8; see also *Kotrous v. Goss-Jewett Co. of Northern Calif.* (9th Cir. 2008) 523 F3d 924, 934—PRPs must seek cost recovery, not contribution, if they themselves are not subject to cost recovery action (effectively overruling prior Ninth Circuit authority holding any action between PRPs is necessarily for contribution); *E.I. DuPont de Nemours & Co. v. United States* (3rd Cir. 2007) 508 F3d 126, 135—PRPs who voluntarily incur clean-up costs may assert § 9607(a) cost recovery actions, thereby eliminating need to rely on § 9613(f) as their exclusive remedy]

4) [5:125.8] **Apportionment on several liability basis:** A 42 USC § 9613(f)(1) contribution claim necessarily is one to apportion the parties' common liability on a *several* basis; the action cannot be brought to impose joint and several liability (*see*¶ *5:72 ff.*). [*United States v. Atlantic Research Corp.* (2007) 551 US 128, 140, 127 S.Ct. 2331, 2338-2339; see also *United States v. Aerojet General Corp.* (9th Cir. 2010) 606 F3d 1142, 1145—CERCLA allows PRPs to apportion response costs equitably]

a) [5:125.8a] **Equitable factors:** In resolving contribution claims and allocating response costs among liable parties, the court may use whatever *equitable* factors it deems appropriate. [*United States v. Atlantic Research Corp.* (2007) 551 US 128, 140, 127 S.Ct. 2331, 2339; compare *Otay Land Co., LLC v. U.E. Ltd., L.P.* (2017) 15 CA5th 806, 864-865, 225 CR3d 119, 166-167 (California Superfund contribution/indemnity actions)—court's analysis must include consideration of party responsibility for contributing to contamination; *see discussion at* ¶ *5:134 ff.*]

Consequently, after balancing the equities, a court may find in an appropriate case that a particular PRP's equitable share of the total liability should be *zero*—in effect permitting full cost recovery against other PRPs (or letting the "zero liability" PRP off the hook in another PRP's contribution action). But again, the claim by such a PRP is one for *contribution*, not 42 USC § 9607(a) full cost recovery. [*Fireman's Fund Ins. Co. v. City of Lodi, Calif.* (9th Cir. 2002) 302 F3d 928, 945]

5) [5:125.9] **Collateral source rule inapplicable to CERCLA contribution actions:** Under the common law "collateral source rule," payments made to an injured party from sources other than the tortfeasor may not be credited against the tortfeasor's liability even if the payments cover all or part of the harm for which the tortfeasor is liable. [*Friedland v. TIC-The Indus. Co.* (10th Cir. 2009) 566 F3d 1203, 1205-1206; see detailed discussion in Haning, Flahavan, Cheng & Wright, *Cal. Prac. Guide: Personal Injury* (TRG), Ch. 3]

Plaintiff in a 42 USC § 9613(f) contribution action, however, may *not* invoke the common law collateral source rule. Reason: A § 9613(f) suit is a claim between two or more *culpable* tortfeasors; thus, the policy underlying the collateral source rule—to provide the "innocent party" with the benefit of any windfall—is not advanced in such cases. [See *Friedland v. TIC-The Indus. Co.*, supra, 566 F3d at 1206-1207—PRP who received full compensation from two insurers before settling cost-recovery action with government could not maintain contribution action against another PRP]

(c) [5:125.10] **Compare—narrower private party remedies under RCRA:** The Resource Conservation and Recovery Act (RCRA, ¶ *5:15*) contains a "citizen suit" provision permitting private parties to bring suit against certain responsible persons (including former owners) who have contributed or are contributing to the handling, storage, treatment, transportation or disposal of hazardous waste. [42 USC § 6972]

Even so, "contributing to" for purposes of imposing RCRA "generator" liability means a person must have a "measure of control" over the waste at the time of disposal or be otherwise "actively involved" in the waste disposal process. [See *Hinds Investments, L.P. v. Angioli* (9th Cir. 2011) 654 F3d 846, 852, *discussed further at*¶ 5:25.10d]

1) Application

• [5:125.10a] An environmental group's suit against the U.S. Forest Service for allegedly *contributing* to the contamination of a national forest through the disposal of hazardous lead ammunition by hunters was denied.

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Reason: The Forest Service played only a passive role in said disposal. [*Center for Biological Diversity v. United States Forest Service* (9th Cir. 2023) 80 F4th 943, 946, 953-955]

• [5:125.10b] An environmental organization's suit against a city for allegedly contributing to solid waste "transportation" by pumping contaminated water through its water-supply system was denied. Reason: "Transportation" of solid waste must be "directly connected" to the waste disposal process, e.g., by "shipping waste to hazardous waste treatment, storage, or disposal facilities." [*California River Watch v. City of Vacaville* (9th Cir. 2022) 39 F4th 624, 630-633]

• [5:125.10c] An environmental organization's suit against an electric utility for, among other things, allegedly discarding toxic wood treatment chemicals into storm waters via "tire-tracking" was denied. Reason: A plaintiff must show the defendant was "actively involved in" or had "some degree of control over" the waste disposal process. The evidence, however, showed that "tire-tracking" by the utility's trucks was a *potential,* as opposed to an *actual,* mechanism by which the utility might contribute to waste disposal and therefore insufficient to establish RCRA liability. [*Ecological Rights Foundation v. Pacific Gas & Elec. Co.* (9th Cir. 2017) 874 F3d 1083, 1101]

• [5:125.10d] The owners of shopping centers that housed dry cleaning stores sued the manufacturers of the dry cleaning equipment used by those stores, claiming the equipment's design contributed to the disposal of hazardous waste. The alleged contributions, however, were deemed "passive" and thus insufficient to impose RCRA liability as "a matter of law." [*Hinds Investments, L.P. v. Angioli* (9th Cir. 2011) 654 F3d 846, 848, 852]

2) [5:125.10e] **Standing to sue:** A plaintiff who brings a "private citizen" RCRA suit acts as a private attorney general. However, a RCRA plaintiff is not required to be "innocent," and may even be a successor landowner bearing some responsibility for the subject contamination. [See *Nashua Corp. v. Norton Co.* (ND NY 2000) 116 F.Supp.2d 330, 356]

3) [5:125.11] **Timing—imminent and substantial danger required:** A private party may sue under RCRA only upon a showing that the hazardous waste at issue "may present an *imminent and substantial endangerment* to health or the environment." [42 USC § 6972(a)(1)(B) (emphasis added); *Meghrig v. KFC Western, Inc.* (1996) 516 US 479, 485, 116 S.Ct. 1251, 1255; *Nashua Corp. v. Norton Co.* (ND NY 2000) 116 F.Supp.2d 330, 356]

Thus, a private party RCRA suit is not authorized if the endangerment is not threatened to occur immediately (not "imminent") or the hazardous waste at issue no longer presents such a danger. The language in § 6972(a)(1)(B) "implies that there must be a threat which is present *now*, although the impact of the threat may not be felt until later." [*Meghrig v. KFC Western, Inc.*, supra, 516 US at 486, 116 S.Ct. at 1255 (emphasis in original; internal quotes and citation omitted); *Ecological Rights Foundation v. Pacific Gas & Elec. Co.* (9th Cir. 2017) 874 F3d 1083, 1101—"risk-based showing" sufficient, i.e., that activities *may* present imminent and substantial endangerment; *Nashua Corp. v. Norton Co.*, supra, 116 F.Supp.2d at 356—no requirement that actual harm will occur immediately]

4) [5:125.12] **Remedies limited to injunctive relief:** A private party's remedies under RCRA are limited to *injunctive relief*—either (i) a prohibitory injunction restraining a responsible party from further violating the RCRA and/or (ii) a mandatory injunction ordering a responsible party to "take such other action as may be necessary …" [42 USC § 6972(a); *Meghrig v. KFC Western, Inc.* (1996) 516 US 479, 484, 116 S.Ct. 1251, 1254; see *Nashua Corp. v. Norton Co.* (ND NY 2000) 116 F.Supp.2d 330, 355-356; *Express Car Wash Corp. v. Irinaga Bros., Inc.* (D OR 1997) 967 F.Supp. 1188, 1192-1194]

5) [5:125.13] **Impact—no RCRA damages remedy for past or ongoing clean-up:** Taken together, the limitations at ¶ 5:125.12 make clear that RCRA's citizen suit provision does *not* give private parties a remedy to recover compensation for *past clean-up efforts*, whether denominated as "damages" or "equitable restitution." [*Meghrig v. KFC Western, Inc.* (1996) 516 US 479, 484, 487, 116 S.Ct. 1251, 1254, 1256; *Nashua Corp. v. Norton Co.* (ND NY 2000) 116 F.Supp.2d 330, 357-358—claims for past response costs, whether characterized as investigative or clean-up costs, dismissed; see also *South Carolina Dept. of Health & Environmental Control v. Commerce & Industry Ins. Co.* (4th Cir. 2004) 372 F3d 245, 255-256—RCRA is "preventative" as opposed to CERCLA which is "curative"]

a) [5:125.13a] **No right to contribution or indemnity:** It follows, therefore, that private parties have *no* right to *contribution or indemnity* under the RCRA. [*United States v. Domestic Indus., Inc.* (ED VA 1999) 32 F.Supp.2d 855, 870—no right to contribution or indemnity from third party for civil penalty assessed against RCRA defendant; see also *Davenport v. Neely* (MD AL 1998) 7 F.Supp.2d 1219, 1229—no right to contribution or indemnity from third parties for future clean-up costs incurred by RCRA defendant]

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b) [5:125.14] **Preremediation RCRA compensation for future clean-up?** The U.S. Supreme Court in *Meghrig*, supra, expressly did not consider whether, provided the hazardous waste *presently* poses a risk of *imminent and substantial endangerment* to health or the environment (*¶ 5:125.11*), a private party might succeed under RCRA in obtaining an injunction requiring a responsible party to pay clean-up costs arising *after* commencement of a RCRA suit or ordering remuneration for clean-up costs paid *after* “the invocation of RCRA's statutory process.” [*Meghrig v. KFC Western, Inc.* (1996) 516 US 479, 488, 116 S.Ct. 1251, 1256 (dictum)]

However, post-*Meghrig* cases have rejected any such right of recovery.

1/ [5:125.14a] **No recovery for ongoing clean-up:** Plaintiffs may not recover clean-up costs incurred after a RCRA suit has been filed when the remediation system was in place or substantially in place at the time the suit was filed. [*Express Car Wash Corp. v. Irinaga Bros., Inc.* (D OR 1997) 967 F.Supp. 1188, 1194]

2/ [5:125.14b] **No recovery for unilateral clean-up:** Nor may plaintiffs recover clean-up costs for remediation *initiated voluntarily* (without a court order) *after commencement of a RCRA suit*. [*Avondale Fed. Sav. Bank v. Amoco Oil Co.* (7th Cir. 1999) 170 F3d 692, 694—no reimbursement for “antsy” plaintiff who, in order to finalize land deal, unilaterally decided to clean up property after filing RCRA suit]

6) [5:125.15] **Other procedural hurdles:** Moreover, even to the extent a private party RCRA suit is authorized, there are preliminary procedural hurdles: Notably, a “citizen suit” generally may not be commenced without first giving 90 days' notice to the Administrator of the EPA, to the “State in which the alleged endangerment may occur,” and to potential defendants. [42 USC § 6972(b)(2)(A); *Meghrig v. KFC Western, Inc.* (1996) 516 US 479, 486, 116 S.Ct. 1251, 1255]

Further, no private party RCRA suit can proceed if either the EPA or the State has commenced, and is diligently prosecuting, a separate enforcement action. [42 USC § 6972(b)(2)(B) & (C); *Meghrig v. KFC Western, Inc.*, supra, 516 US at 486, 116 S.Ct. at 1255]

And RCRA contains an “anti-duplication” provision stating that it does not apply (except to the extent not inconsistent) to activities subject to the Federal Water Pollution Control Act (which includes the Clean Water Act), the Safe Drinking Water Act, the Marine Protection Research and Sanctuaries Act of 1972, or the Atomic Energy Act of 1954. [See 42 USC § 6905(a); see also 42 USC § 6905(b)(1)—EPA Administrator shall “avoid duplication, to the maximum extent practicable,” with other specified acts; compare *Ecological Rights Foundation v. Pacific Gas & Elec. Co.* (9th Cir. 2017) 874 F3d 1083, 1089, 1094—anti-duplication provision did not bar RCRA citizen suit arising from stormwater discharge of pollutants (although Clean Water Act permitted EPA to require permits for such discharges, EPA declined to do so)]

[5:125.16 - 5:125.19] ***Reserved.***

7) [5:125.20] **Compare—remedies under other laws:** The RCRA preserves clean-up costs recoupment remedies under other federal and state laws (42 USC § 6972(f)). Thus, private parties may have a damages remedy when the hazardous substance is covered by CERCLA or another environmental statute. [See 42 USC § 6972(f); *Meghrig v. KFC Western, Inc.* (1996) 516 US 479, 487, 116 S.Ct. 1251, 1256—RCRA does not preempt remedies under other federal and state laws]

(2) [5:126] **Conditions for CERCLA private cost-recovery or contribution:** There are four basic conditions to a private party's cost-recovery or contribution action under CERCLA (the conditions are the same under both 42 USC § 9607(a) and § 9613(f)(1)). [*City of Colton v. American Promotional Events, Inc.-West* (9th Cir. 2010) 614 F3d 998, 1002-1003; *Carson Harbor Village, Ltd. v. Unocal Corp.* (9th Cir. 2001) 270 F3d 863, 870-871 (en banc); *Rivas v. Safety-Kleen Corp.* (2002) 98 CA4th 218, 233, 119 CR2d 503, 515]

Specifically, a plaintiff seeking cost recovery or contribution must establish the following four conditions:

• Defendant must be a PRP (¶ 5:126a ff.);

• A hazardous substance release or threat of a release (¶ 5:126c ff.);

• Consequential response costs (¶ 5:126h ff.); and

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• NCP-consistent remediation (¶ 5:126.1 ff.).

(a) [5:126a] **Defendant's PRP status:** Defendant must be a PRP—i.e., defendant must fall within one of the four categories of persons covered by CERCLA (*see¶ 5:60*). [42 USC § 9607; *City of Colton v. American Promotional Events, Inc.-West,* supra; see also *Chubb Custom Ins. Co. v. Space Systems/Loral, Inc.* (9th Cir. 2013) 710 F3d 946, 961-962—PRPs are individuals or entities who through their own actions, including ownership of property, become statutorily liable under CERCLA for response costs]

1) [5:126b] **Compare—defendant's insurance company as subrogee:** A defendant's insurance company, in its capacity as subrogee, does not acquire PRP-like status by reimbursing its insured for response costs. This is so because "a subrogee—simply by stepping into the shoes of the insured via a reimbursement—cannot be liable for response costs under CERCLA, and thus cannot itself incur response costs." [See *Chubb Custom Ins. Co. v. Space Systems/ Loral, Inc.* (9th Cir. 2013) 710 F3d 946, 962, 971-972—insurer had no standing under 42 USC § 9607(a) to bring subrogation suit against third parties to recover payments made to its insured for response costs]

Indeed, insurance companies that reimburse businesses for their clean-up costs must follow strict statutory guidelines before they can recover money from third parties believed responsible for the underlying pollution. [See 42 USC § 9612(c)(2)—subrogation action is maintainable only if subrogee pays compensation to a "claimant" as defined; *Chubb Custom Ins. Co. v. Space Systems/Loral, Inc.*, supra, 710 F3d at 971—insured must first make claim to Superfund or PRP before insurer can bring subrogation action under 42 USC § 9612(c)]

(b) [5:126c] **Hazardous substance release:** There must have been a "release or threatened release" of a "hazardous substance" from defendant's "facility" within the meaning of CERCLA (*see¶ 5:5.1 ff.*). [42 USC § 9607(a)(4); *City of Colton v. American Promotional Events, Inc.-West*, supra]

1) [5:126d] **"Threatened release" events:** A "threatened release" may include a defendant's ownership of corroding or deteriorating tanks, a defendant's lack of expertise in handling hazardous wastes, or a defendant's failure to license a "facility" (*¶ 5:5.4*). [See *Johnson v. James Langley Operating Co., Inc.* (8th Cir. 2000) 226 F3d 957, 963, fn. 3; *State of New York v. Shore Realty Corp.* (2nd Cir. 1985) 759 F2d 1032, 1045]

2) [5:126e] **No liability for release of excluded materials:** Plaintiff cannot recover if the release or threatened release involves only "excluded" materials. [*Johnson v. James Langley Operating Co., Inc.* (8th Cir. 2000) 226 F3d 957, 963 & fn. 4]

Thus, plaintiffs who seek response costs in connection with *federally-permitted* releases must assert their claims (if at all) under some *other* federal or common law. [*Carson Harbor Village, Ltd. v. Unocal Corp.* (CD CA 2003) 287 F.Supp.2d 1118, 1183, aff'd (9th Cir. 2006) 433 F3d 1260]

a) [5:126f] **Burden of proof:** A plaintiff is only required to present evidence of a release or threatened release of hazardous substances, and not evidence regarding the nature of those substances. The burden then shifts to defendant to prove that *excluded* materials were released, such as under the "petroleum exclusion" (*¶ 5:90*). [*Johnson v. James Langley Operating Co., Inc.* (8th Cir. 2000) 226 F3d 957, 963 & fn. 4]

[5:126g] ***Reserved.***

(c) [5:126h] **Consequential response costs:** The hazardous substance release or threatened release must have caused plaintiff response costs. [42 USC § 9607(a)(4); see *City of Colton v. American Promotional Events, Inc.-West* (9th Cir. 2010) 614 F3d 998, 1002-1003; *Carson Harbor Village, Ltd. v. Unocal Corp.* (9th Cir. 2001) 270 F3d 863, 870-871 (en banc); *Browning-Ferris Indus. of Ill., Inc. v. Ter Maat* (7th Cir. 1999) 195 F3d 953, 958]

1) [5:126i] **"Relaxed"/"loose" nexus standard:** Courts evaluating the causation element of a private party CERCLA claim do not apply "traditional tort notions of causation" but, instead, utilize a "relaxed" standard. [*Carson Harbor Village, Ltd. v. Unocal Corp.* (CD CA 2003) 287 F.Supp.2d 1118, 1185-1186, aff'd (9th Cir. 2006) 433 F3d 1260; see also *Orange County Water Dist. v. Alcoa Global Fasteners, Inc.* (2017) 12 CA5th 252, 306, 219 CR3d 474, 521—"[V]irtually every court" holds CERCLA plaintiff need not establish direct causal connection between defendant's hazardous substances and their release or plaintiff's response costs]

Specifically, plaintiff need only prove that defendant's hazardous materials were deposited on plaintiff's property from which there was a "release" (¶ 5:5.3), and that the *release* caused plaintiff response costs. [*Kalamazoo River*

Study Group v. Menasha Corp. (6th Cir. 2000) 228 F3d 648, 655; *ITT Indus., Inc. v. BorgWarner, Inc.* (WD MI 2009) 615 F.Supp.2d 640, 644—cost recovery claim not dependent on proving particular defendant responsible for "release causing response costs"; *Carson Harbor Village, Ltd. v. Unocal Corp.,* supra, 287 F.Supp.2d at 1186-1187—nexus between release for which defendant is responsible and costs incurred by plaintiff is "a loose one"; and see *Orange County Water Dist. v. Alcoa Global Fasteners*, supra, 12 CA5th at 306, 219 CR3d at 521 (noting "causation" requirement under both CERCLA and State Superfund is "independent of a given defendant")]

a) [5:126j] **Compare—"de minimis" polluter defense to contribution liability:** The CERCLA causation standard is not equated with a minimum or "threshold" release (or threatened release) of a hazardous substance; i.e., it is not part of plaintiff's prima facie burden to demonstrate a defendant was responsible for a minimum quantity of hazardous waste.

However, because contribution liability is apportioned equitably (¶ *5:125.9, 5:134*), a defendant may avoid joint and several liability for response costs in a 42 USC § 9613(f) contribution action by demonstrating that its share of hazardous waste at the site "constitutes no more than background amounts of such substances in the environment and cannot concentrate with other wastes to produce higher amounts." [*Acushnet Co. v. Mohasco Corp.* (1st Cir. 1999) 191 F3d 69, 77; see also *PMC, Inc. v. Sherwin-Williams Co.* (7th Cir. 1998) 151 F3d 610, 616]

"This rule is not based on CERCLA's causation requirement, but is logically derived from § 9613(f)'s express authorization that a court take equity into account when fixing each defendant's fair share of response costs." [*Acushnet Co. v. Mohasco Corp.*, supra, 191 F3d at 77-78 (but noting that not every "de minimis" polluter will avoid contribution liability under such a defense)]

2) [5:126k] **"Incur costs" requirement broadly interpreted:** Whether plaintiff "incurred" costs is broadly interpreted. The court is *not* required to trace the source of funds used to pay response costs, or to deny recovery to a PRP plaintiff who borrowed the funds. [See *Karras v. Teledyne Indus., Inc.* (SD CA 2002) 191 F.Supp.2d 1162, 1169—where PRPs ordered to reimburse government for response costs set up plaintiff Trusts to perform work pursuant to government order, Trusts "incurred costs" for services of environmental consultants even though they were not parties to order and received funds from PRPs]

3) [5:126*l*] **"Two-site" cases:** In "two-site" cases, where contamination at one location migrates to reach a different location, plaintiff meets its burden regarding causation if it (i) "identifies contaminant at its site," (ii) "identifies the same (or perhaps a chemically similar) contaminant at the defendant's site," and (iii) "provides evidence of a plausible migration pathway by which the contaminant could have traveled from the defendant's facility to the plaintiff's site." [*Castaic Lake Water Agency v. Whittaker Corp.* (CD CA 2003) 272 F.Supp.2d 1053, 1066 (summary judgment motion)]

This "burden-shifting approach is in keeping with CERCLA's broad remedial purpose, and is consistent with the 'minimum causal nexus' most courts require under CERCLA." [*Castaic Lake Water Agency v. Whittaker Corp.*, supra, 272 F.Supp.2d at 1066 (internal citations omitted)]

a) [5:126m] **Scope of settlement resolving CERCLA liability for only one site:** PRPs who settle their CERCLA liability for contamination that migrated onto an adjacent site must include the original contamination site within the settlement in order to preclude a subsequent purchaser from bringing a contribution action to recover response costs to remediate the original contamination site. [See *GP Vincent II v. Estate of Beard* (9th Cir. 2023) 68 F4th 508, 516-518—subsequent purchaser of contaminated site may bring CERCLA contribution action against prior owners who previously settled their respective CERCLA liabilities for contamination that migrated onto adjacent property]

4) [5:126n] **Multiple generator cases:** A plaintiff asserting a CERCLA claim against multiple PRPs need not establish a "but for" causal link between each PRP's contamination and the response costs incurred. Rather, "where either [PRP's] conduct would have caused the same response cost to be incurred in the same amount, and the conduct was of substantially equal blameworthiness, the proper construction of the causation requirement … is that both [PRPs] should be treated as having caused the response cost." [*Boeing Co. v. Cascade Corp.* (9th Cir. 2000) 207 F3d 1177, 1185; *Carson Harbor Village, Ltd. v. Unocal Corp.* (CD CA 2003) 287 F.Supp.2d 1118, 1186, aff'd (9th Cir. 2006) 433 F3d 1260 (discussing cases)—"other courts have reached similar conclusions"]

The issue of the "quantum" of contamination that a particular defendant contributed to the property is then addressed in *allocating* liability among the PRPs (*see*¶ *5:134*). [*Carson Harbor Village, Ltd. v. Unocal Corp.*, supra, 287 F.Supp.2d at 1187, fn. 270]

(d) [5:126.1] **Consistent with NCP:** The final condition is that the remediation undertaken by plaintiff must have been "necessary costs of response … consistent with the national contingency plan" (NCP, ¶ *5:121.3 ff.*). [42 USC § 9607(a)(4)(B); see *City of Colton v. American Promotional Events, Inc.-West* (9th Cir. 2010) 614 F3d 998, 1003—response costs are considered "necessary" when actual and real threat to human health or environment exists; *Carson Harbor Village, Ltd. v. Unocal Corp.* (9th Cir. 2001) 270 F3d 863, 870-871 (en banc); and *Carson Harbor Village, Ltd. v. Unocal Corp.* (CD CA 2003) 287 F.Supp.2d 1118, 1153-1154 (discussing cases)—Ninth Circuit has uniformly stated that consistency with NCP is essential element of private CERCLA actions]

In general, private response action is "consistent with the NCP" if, evaluated as a whole, it complies with certain EPA procedural requirements *and* results in a "CERCLA-quality cleanup." [40 CFR § 300.700(c)(3)(i); *City of Colton v. American Promotional Events, Inc.-West*, supra; *Carson Harbor Village, Ltd. v. County of Los Angeles* (9th Cir. 2006) 433 F3d 1260, 1265; *Young v. United States* (10th Cir. 2005) 394 F3d 858, 864]

Compare: A *government* entity's response costs are *presumed* to be consistent with the NCP (¶ *5:121.4*), while private parties must *plead and prove* consistency with the NCP. [*Carson Harbor Village, Ltd. v. Unocal Corp.* (CD CA 2003) 287 F.Supp.2d 1118, 1152, fn. 215, aff'd (9th Cir. 2006) 433 F3d 1260]

1) [5:126.1a] **"Remedial" vs. "removal" actions; different NCP requirements:** A private party's cost-recovery action may be "remedial" or "removal" (¶ *5:133.16a*). The statutory requirements for NCP compliance relative to such actions are different, with the requirements for remedial actions being "much more detailed and onerous." [*United States v. W.R. Grace & Co.* (9th Cir. 2005) 429 F3d 1224, 1228 (internal quotes omitted)]

The NCP requires a party undertaking removal to conduct a site evaluation (40 CFR § 300.420). A party initiating a remedial action must conduct a site evaluation *and* complete a "feasibility study before selecting the appropriate remedy," which includes satisfying certain community relations requirements, such as providing a notice and public comment period (40 CFR § 300.430). [*Carson Harbor Village, Ltd. v. County of Los Angeles* (9th Cir. 2006) 433 F3d 1260, 1266, 1269—party seeking to recover remedial response costs failed to comply with NCP public comment and feasibility study requirements]

2) [5:126.2] **Per se compliance where action taken pursuant to EPA order:** Response action taken in compliance with the terms of an EPA order issued pursuant to CERCLA § 106 (42 USC § 9606) is *deemed consistent* with the NCP. [40 CFR § 300.700(c)(3)(ii); see *Bancamerica Commercial Corp. v. Mosher Steel of Kansas, Inc.* (10th Cir. 1996) 100 F3d 792, 796-797]

3) [5:126.2a] **Substantial compliance sufficient:** Consistency with the NCP does not require *strict* compliance; *substantial compliance* suffices. [*Carson Harbor Village, Ltd. v. Unocal Corp.* (CD CA 2003) 287 F.Supp.2d 1118, 1159-1160]

This case-by-case standard has been adopted "to avoid discouraging private parties from cleaning up hazardous wastes for fear that recovery of their costs would later be precluded by less than perfect compliance with the NCP." [*Waste Management of Alameda County, Inc. v. East Bay Regional Park Dist.* (ND CA 2001) 135 F.Supp.2d 1071, 1100; *Carson Harbor Village, Ltd. v. Unocal Corp.*, supra, 287 F.Supp.2d at 1159]

a) [5:126.2b] **Evaluated by examining clean-up in entirety:** Substantial compliance is evaluated by focusing on the *entirety* of the clean-up, "rather than on a checklist of required actions." [*Carson Harbor Village, Ltd. v. Unocal Corp.* (CD CA 2003) 287 F.Supp.2d 1118, 1160—requiring compliance with checklist might defeat cost recovery for meritorious clean-up based merely on party's technical failure]

b) [5:126.2c] **Agency involvement as substitute for NCP public participation requirement:** There is out-of-circuit authority that a government agency's *significant* oversight involvement in remedial action may demonstrate substantial compliance with the NCP public participation requirement. [See *Carson Harbor Village, Ltd. v. County of Los Angeles* (9th Cir. 2006) 433 F3d 1260, 1266-1267 (collecting cases)]

The Ninth Circuit has not yet decided this issue; but it has held that agency action amounting to no more than "*minor and ministerial*" involvement cannot be an effective substitute for public participation. [*Carson Harbor Village, Ltd. v. County of Los Angeles*, supra, 433 F3d at 1267]

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[5:126.2d - 5:126.2f] ***Reserved.***

4) [5:126.2g] **“CERCLA-quality clean-up” required:** In addition to showing that it substantially complied with the NCP (¶ 5:126.1 ff.), the private party must demonstrate that its actions resulted in a “CERCLA-quality clean-up.” [*Young v. United States* (10th Cir. 2005) 394 F3d 858, 864; *Carson Harbor Village, Ltd. v. Unocal Corp.* (CD CA 2003) 287 F.Supp.2d 1118, 1160, aff'd (9th Cir. 2006) 433 F3d 1260]

A “CERCLA-quality clean-up” is one in which (i) the remedy is protective of human health and the environment; (ii) permanent solutions and alternative treatment or resource recovery technologies are implemented; (iii) it is cost-effective; and (iv) it is selected after “meaningful public participation.” [55 Fed.Reg. 8793; *Carson Harbor Village, Ltd. v. Unocal Corp.* (CD CA 2003) 287 F.Supp.2d 1118, 1160; see also *Young v. United States*, supra, 394 F3d at 864-865—plaintiffs' response action “inconsistent with the NCP because it did not result in *any*—let alone CERCLA-quality—cleanup” (emphasis in original)]

5) [5:126.2h] **Preremediation governmental approval not required:** Whether a plaintiff's response costs are consistent with the NCP is a fact question to be determined at the *damages stage* of the case *rather* than by the “mechanism” of obtaining governmental agency approval *before* commencing remediation. [*Cadillac Fairview/ California, Inc. v. Dow Chem. Co.* (9th Cir. 1988) 840 F2d 691, 695—“[Defendants] will have ample opportunity at trial to express their concern that the costs incurred by [plaintiff] were unnecessary or inconsistent with the [NCP]”; *Carson Harbor Village, Ltd. v. Unocal Corp.* (CD CA 2003) 287 F.Supp.2d 1118, 1154]

(e) [5:126.3] **Similar conditions under State Superfund:** The same prerequisites apply to private actions under the California Superfund, except that the last condition (remediation necessary and in compliance with the national contingency plan) is omitted. [See Health & Saf.C. § 79670(a) (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24) —statute's liability provisions apply to “response or corrective” actions rather than removal and remedial actions; see also *Orange County Water Dist. v. Alcoa Global Fasteners, Inc.* (2017) 12 CA5th 252, 298, 219 CR3d 474, 515 (decided under predecessor statute) (deciding issue of apparent first impression)—county water district could bring private indemnity action against industrial site owners and operators to recover costs associated with project intended to address groundwater contamination even though district not liable under State Superfund]

[5:126.4] ***Reserved.***

(3) [5:126.5] **Successor liability—state vs. federal common law:** Under certain circumstances, a *successor corporation* to a now-defunct PRP corporation can be held liable in a CERCLA cost-recovery or contribution action. Although CERCLA does not address the issue, courts uniformly agree that the equitable doctrine of successor liability applies to CERCLA. [*United States v. General Battery Corp., Inc.* (3rd Cir. 2005) 423 F3d 294, 298]

But the circuits are split on whether the successor liability standard is a question of state corporation law or federal common law:

(a) [5:126.6] **View that federal common law controls:** Some courts have attempted to fashion a “uniform” federal common law for CERCLA successor liability. [See *United States v. General Battery Corp., Inc.* (3rd Cir. 2005) 423 F3d 294, 298; *United States v. Carolina Transformer Co.* (4th Cir. 1992) 978 F2d 832, 837-838; *John S. Boyd Co., Inc. v. Boston Gas Co.* (1st Cir. 1993) 992 F2d 401, 408]

1) [5:126.7] **“Traditional” successor liability rule:** Courts adopting a federal common law generally follow the “traditional” successor liability rule: A successor corporation acquires the seller's CERCLA liabilities *only if:*

- the purchaser expressly or impliedly agrees to assume the liabilities;
- the transaction amounts to a de facto merger or consolidation;
- the transaction is an effort to fraudulently escape liability; *or*
- the purchaser is a “mere continuation” of the seller (*see ¶ 5:126.7a*). [*New York v. National Services Indus., Inc.* (2nd Cir. 2003) 352 F3d 682, 685; see also *PCS Nitrogen Inc. v. Ashley II of Charleston LLC* (4th Cir. 2013) 714

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F3d 161, 173-176—extrinsic evidence established corporate successor intended to assume CERCLA liability for former fertilizer manufacturing site]

a) [5:126.7a] **Successor liability under "mere continuation" (or "de facto merger") rule—"identity" between predecessor and successor corporations:** The federal common law "mere continuation" (or "de facto merger") exception (sometimes referred to as the "identity" test) requires the existence of a single corporation after the transfer of assets, with an identity of stock, stockholders and directors between the successor and predecessor corporations. [*United States v. General Battery Corp., Inc.* (3rd Cir. 2005) 423 F3d 294, 305; *New York v. National Services Indus., Inc.* (2nd Cir. 2003) 352 F3d 682, 685; see *K.C.1986 Ltd. Partnership v. Reade Mfg.* (8th Cir. 2007) 472 F3d 1009, 1025—record did not show CERCLA successor liability under "mere continuation"/"de facto merger" rule]

[5:126.7b - 5:126.7d] ***Reserved.***

2) [5:126.7e] **Alternative "substantial continuity" standard?** The courts appear to be split on whether an alternative "substantial continuity" standard may be applied to impose CERCLA successor liability.

Some circuits reject this approach, finding it inconsistent with general federal common law and *United States v. Bestfoods* (¶ *5:77 ff.*). [See *United States v. General Battery Corp., Inc.* (3rd Cir. 2005) 423 F3d 294, 309 & fn. 12 (collecting cases); *New York v. National Services Indus., Inc.* (2nd Cir. 2003) 352 F3d 682, 685-687]

On the other hand, at least one circuit has not expressly ruled out applying the test because *Bestfoods*, supra, did not directly address corporate successor liability, and thus, "there may yet be contexts in which the substantial continuity test could survive." [*K.C.1986 Ltd. Partnership v. Reade Mfg.* (8th Cir. 2007) 472 F3d 1009, 1022 (discussing cases) (but not deciding issue because facts did not satisfy test even assuming it survived *Bestfoods*)]

In any event, proper application of the test, an "offshoot" of the "mere continuation" test (¶ *5:126.7a*), requires a consideration of the following factors:

• Whether the successor corporation retains:

— the same employees,

— the same supervisory personnel,

— the same production facilities in the same location,

— the same product,

— the same name, and

— a continuity of assets and general business operations;

• Whether the successor corporation holds itself out as a continuation of the previous business;

• Whether the transfer to the successor corporation was an attempt to avoid CERCLA liability; and

• Whether the successor had knowledge of the unremediated contamination. [*K.C. 1986 Ltd. Partnership v. Reade Mfg.*, supra, 472 F3d at 1022-1024]

(b) [5:126.8] **View that state law controls:** Other courts reject application of a "uniform" federal common law in this area, and instead look to state corporation law to determine whether CERCLA clean-up liability for pollution caused by a selling corporation extends to an acquiring corporation. [See *Anspec Co., Inc. v. Johnson Controls, Inc.* (6th Cir. 1991) 922 F2d 1240, 1248 (applying Mich. law in merger situation); but see also *K.C.1986 Ltd. Partnership v. Reade Mfg.* (8th Cir. 2007) 472 F3d 1009, 1025, fn. 4 (collecting cases) (not deciding issue because no assertion in case that applicable state law was any different from federal common law re successor liability)]

1) [5:126.8a] **Rationale:** State rules of decision normally will furnish "an appropriate and convenient measure of the governing federal law." Moreover, developing federal rules for successor liability is not essential to create "national

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uniformity" on the issue because state law does not vary widely on the subject. And, there is no evidence that applying state corporation law to this issue will frustrate CERCLA's objective of providing a clean-up mechanism and imposing clean-up costs on responsible parties. [See *Atchison, Topeka & Santa Fe Ry. Co. v. Brown & Bryant, Inc.* (9th Cir. 1998) 159 F3d 358, 362-363—declining to decide whether federal common law or state law supplied the rule of decision, but noting inherent problems with fashioning federal common law]

Cross-refer: The subject of a surviving corporation's successor liability for its predecessor's obligations under California state law is discussed in detail in Haning, Flahavan, Cheng & Wright, *Cal. Prac. Guide: Personal Injury* (TRG), Ch. 2; and Friedman, Soza & Jann, *Cal. Prac. Guide: Corporations* (TRG), Ch. 8.

(4) [5:126.9] **Cost recovery suits against dissolved corporations; impact of state laws limiting capacity to be sued:** Courts also are split on whether CERCLA preempts state laws limiting a dissolved corporation's capacity to be sued:

• [5:126.9a] An active California corporation could not maintain an action for environmental clean-up costs against a corporation dissolved prior to enactment of CERCLA. This was so even though the dissolved corporation previously owned and polluted the active corporation's real property. Reason: Under California law, a dissolved corporation cannot be sued for causes of action created *after* its dissolution. [*Levin Metals Corp. v. Parr-Richmond Terminal Co.* (9th Cir. 1987) 817 F2d 1448, 1451; see also *Louisiana-Pacific Corp. v. ASARCO, Inc.* (9th Cir. 1993) 5 F3d 431, 433—Washington state statute limiting time within which dissolved corporation retained capacity to be sued *not* preempted by CERCLA statute of limitations]

• [5:126.9b] A Delaware statute generally eliminating a corporation's capacity to be sued after its three-year windup period concludes trumped CERCLA's six-year limitations period under which New York claimed environmental clean-up costs against a defunct corporate polluter and its former shareholders. [*Marsh v. Rosenbloom* (2nd Cir. 2007) 499 F3d 165, 176 (noting "corporate law is overwhelmingly the province of the states")]

• [5:126.9c] Under Minnesota law, a former steel drum manufacturer had no capacity to be sued for contribution under CERCLA three years following the date on which it filed its voluntary dissolution certificate. [*Onan Corp. v. Industrial Steel Corp.* (D MN 1989) 770 F.Supp. 490, 494, aff'd (8th Cir. 1990) 909 F2d 511]

• [5:126.9d] *Compare:* A number of other courts have held otherwise, claiming CERCLA preempts state limits on the capacity of dissolved corporations to be sued in light of congressional intent that CERCLA impose broad-ranging liability. "Congress did not intend to allow corporations, upon discovering new toxic waste sites, to be able to avoid liability simply by dissolving and then hiding behind the shield of state statutes limiting their capacity to be sued." [*Burlington Northern & Santa Fe Ry. Co. v. Consolidated Fibers, Inc.* (ND TX 1998) 7 F.Supp.2d 822, 826-828 (collecting cases); see also *BASF Corp. v. Cent Transp., Inc.* (ED MI 1993) 830 F.Supp. 1011, 1013 (collecting cases)]

(5) [5:126.10] **Scope of awardable "response costs":** A private party's authorized "response cost" recovery includes "necessary costs of response" consistent with the national contingency plan. [42 USC § 9607(a)(4)(B); *City of Colton v. American Promotional Events, Inc.-West* (9th Cir. 2010) 614 F3d 998, 1003; *W.R. Grace & Co.-Conn. v. Zotos Int'l, Inc.* (2nd Cir. 2009) 559 F3d 85, 95; see also *Ameripride Services Inc. v. Texas Eastern Overseas Inc.* (9th Cir. 2015) 782 F3d 474, 490—private party who incurs 42 USC § 9607(a) liability for third party's response costs may seek contribution only for such costs as were "necessary and consistent" with national contingency plan, and private party who enters into settlement agreement discharging its § 9607(a) liability to third party may seek contribution only for settlement costs related to necessary response costs incurred consistent with national contingency plan]

Though CERCLA does not define "necessary costs of response," the phrase has been construed as limited to expenses *reasonably related to the clean-up efforts*. [*Price v. United States Navy* (9th Cir. 1994) 39 F3d 1011, 1015-1017; *Durfey v. E.I. DuPont De Nemours & Co.* (9th Cir. 1995) 59 F3d 121, 125]

(a) General parameters

1) [5:126.11] **Includes cost of clean-up actions taken in response to *threatened contamination:*** CERCLA "response costs" are synonymous with "removal costs," and include the cost of clean-up efforts necessarily taken in response to the *threat* of release of hazardous substances into the environment. [See 42 USC § 9601(23), (25); *Bonnieview Homeowners Ass'n v. Woodmont Builders, LLC* (D NJ 2009) 655 F.Supp.2d 473, 494]

2) [5:126.12] **Objective focus:** In determining whether recovery costs are "necessary" in a private cost-recovery action, only the *objective* circumstances of the particular case should be considered; plaintiff's subjective intent in

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incurring response costs is *irrelevant*. [*Carson Harbor Village, Ltd. v. Unocal Corp.* (9th Cir. 2001) 270 F3d 863, 872 (en banc) (disapproving "ulterior motive" analysis)—proper focus is whether response action addressed threat to human health or environment rather than whether party had business or other motive for clean-up]

3) [5:126.13] **Agency clean-up directives not essential, but relevant:** A directive from a public agency to clean up a site is not necessarily required to render remediation costs incurred "necessary" for purposes of a private cost-recovery suit. "Agency inaction is not dispositive of the question whether contamination presents an environmental risk worthy of response." [*Carson Harbor Village, Ltd. v. Unocal Corp.* (9th Cir. 2001) 270 F3d 863, 872]

However, an agency clean-up order is "*highly relevant* and, in some cases, compelling" on the issue of whether the costs incurred were "necessary." [*Carson Harbor Village, Ltd. v. Unocal Corp.*, supra, 270 F3d at 872 (emphasis added)]

Moreover, in the absence of EPA or state agency action (a government civil suit or administrative clean-up settlement), a PRP may have no right to sue other liable parties under CERCLA for *contribution* (*see*¶ *5:125.4 ff.*).

[5:126.14] ***Reserved.***

4) [5:126.15] **Recoverable expenses must be based on *existing obligation:*** Response costs that have *not yet been incurred* are *not* recoverable. Although a party may "incur" a cost without actually having paid for it, the mere possibility or even certainty that an obligation to pay will arise *in the future* does *not* establish that a cost has been incurred. [*Trimble v. Asarco, Inc.* (8th Cir. 2000) 232 F3d 946, 958 (abrogated on other grounds by *Exxon Mobil Corp. v. Allapattah Services, Inc.* (2005) 545 US 546, 551-552, 558-559, 125 S.Ct. 2611, 2616, 2620)—plaintiffs' "contingent" response costs not recoverable; *see*¶ 5:125.5c (re actions seeking contribution for settlement amounts paid toward future response costs)]

a) [5:126.16] **Compare—liability for *future response costs:*** On the other hand, a party may obtain a *declaratory judgment* to establish liability for the recovery of *future* response costs. *See*¶ 5:132 ff.

5) [5:126.17] **No recovery where compensation received under other federal or state law:** Any person who receives compensation for removal costs pursuant to any *non*-CERCLA federal or state law is *barred* from recovering the same expenses under CERCLA. [42 USC § 9614(b); *Carson Harbor Village, Ltd. v. Unocal Corp.* (CD CA 2003) 287 F.Supp.2d 1118, 1181-1182, aff'd (9th Cir. 2006) 433 F3d 1260—because increased rental income received by property owner seeking recovery of remediation costs not considered compensation for removal costs under state law, owner not precluded from seeking CERCLA recovery; compare *Price v. United States Navy* (SD CA 1992) 818 F.Supp. 1326, 1332-1333, aff'd in part, rev'd in part on other grounds (9th Cir. 1994) 39 F3d 1011—property owners' reimbursement from state and receipt of settlement for clean-up costs found to be made pursuant to state and/or federal laws, requiring setoff and credit to total amount of owners' CERCLA damages]

6) [5:126.18] **"Nexus" between costs and *actual clean-up effort required:*** Costs are not deemed "necessary" absent "some nexus between the alleged response cost and an *actual* effort to respond to environmental contamination." [*Young v. United States* (10th Cir. 2005) 394 F3d 858, 863-864 (emphasis added)—alleged response costs not "necessary" where property continued to be contaminated and owners testified re no intention to spend any money to clean up property]

[5:126.19] ***Reserved.***

(b) Recoverability of specific categories of response costs

1) [5:126.20] **Costs of EPA monitoring/oversight of remedial action:** Amounts awardable in a CERCLA cost-recovery/contribution action include the costs of EPA monitoring or oversight of the PRP's remedial action. [See *United States v. E.I. DuPont De Nemours & Co., Inc.* (3rd Cir. 2005) 432 F3d 161, 162-163; *State of Calif. on Behalf of Calif. Dept. of Toxic Substances Control v. Celtor Chem. Corp.* (ND CA 1995) 901 F.Supp. 1481, 1489-1490]

Indeed, "statutory definitions of remedial action and response unambiguously allow recovery of the costs of government oversight of private party remedial actions under [42 USC § 9607(a)]." [*Atlantic Richfield Co. v. American Airlines, Inc.* (10th Cir. 1996) 98 F3d 564, 567-571; but see *Black Horse Lane Assocs., L.P. v. Dow Chemical Corp.* (3rd Cir. 2000) 228 F3d 275, 298-299 & fn. 13—consultant fees *not* recoverable where private party

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sought reimbursement for costs incurred by environmental consultant retained to oversee another private party's clean-up obligation; *Bonnieview Homeowners Ass'n v. Woodmont Builders, LLC* (D NJ 2009) 655 F.Supp.2d 473, 494-499—homeowners association that retained environmental consultant and attorneys to review work performed by others and provide expertise in litigation not entitled to recover clean-up costs incurred in connection with residential lots (no evidence actions of consultant/counsel furthered clean-up)]

2) [5:126.21] **Medical expenses, income loss:** Purely private damages that have nothing to do with the remediation are *not* recoverable "response costs" under CERCLA. Thus, in a cost recovery or contribution action, plaintiffs cannot be awarded consequential medical expenses, medical monitoring costs or loss of income damages. [*Price v. United States Navy* (9th Cir. 1994) 39 F3d 1011, 1017; *Durfey v. E.I. DuPont De Nemours & Co.* (9th Cir. 1995) 59 F3d 121, 125; see also *Syms v. Olin Corp.* (2nd Cir. 2005) 408 F3d 95, 105; *Daigle v. Shell Oil Co.* (10th Cir. 1992) 972 F2d 1527, 1536—"congress intentionally deleted all personal rights to recovery of medical expenses from CERCLA"]

3) [5:126.22] **Testing and sampling expenses:** Expenses to test and process sampling of material to determine if contamination exists are recoverable response costs so long as the party seeking the recovery had an *objectively reasonable belief* of contamination *and* the testing and sampling procedures were fiscally reasonable and scientifically valid. [*Johnson v. James Langley Operating Co., Inc.* (8th Cir. 2000) 226 F3d 957, 964; *Village of Milford v. K-H Holding Corp.* (6th Cir. 2004) 390 F3d 926, 933]

Provided the above conditions are satisfied, consistency with the NCP (¶ 5:126.1 ff.) is not a prerequisite to the recovery of monitoring and investigation costs. [*Village of Milford v. K-H Holding Corp.*, supra, 390 F3d at 934]

Moreover, testing and sampling expenses may be recoverable as reasonable and necessary costs of response even though they *duplicate* studies previously performed. [*Village of Milford v. K-H Holding Corp.*, supra, 390 F3d at 935—"duplication in itself does not equate to unreasonableness"]

4) [5:126.23] **Expert fees:** The fees of plaintiff's experts are recoverable "necessary" costs so long as they are incurred as a necessary cost of *remediation* (e.g., to identify *additional* PRPs) and not solely in preparation for litigation (¶ *5:128*). [*Gussack Realty Co. v. Xerox Corp.* (2nd Cir. 2000) 224 F3d 85, 92—expert fees not recoverable because not closely tied to actual clean-up, and plaintiffs were able to identify defendant as PRP without using experts; *Castaic Lake Water Agency v. Whittaker Corp.* (CD CA 2003) 272 F.Supp.2d 1053, 1078, fn. 32]

a) [5:126.24] **Experts not required to conduct own testing:** Expert costs can be recoverable under CERCLA even though the experts did not conduct their own testing. Assessing the extent of contamination often involves consulting with experts who simply interpret data gathered by others. [*Gussack Realty Co. v. Xerox Corp.* (2nd Cir. 2000) 224 F3d 85, 92]

5) [5:126.25] **Costs to formulate RCRA plan:** Although costs incurred to formulate a clean-up plan under *RCRA* (¶ *5:125.10 ff.*) may be similar to expenses sought to be recovered in a CERCLA cost-recovery suit, the two categories of costs are distinguishable. RCRA costs are *not* recoverable in a CERCLA cost-recovery or contribution action. [See *Nashua Corp. v. Norton Co.* (ND NY 2000) 116 F.Supp.2d 330, 355]

6) [5:126.26] **Site access maintenance costs:** Costs incurred for routine physical maintenance of the contaminated site to aid in *access* to it are *not* recoverable. [*Syms v. Olin Corp.* (2nd Cir. 2005) 408 F3d 95, 103]

7) [5:126.27] **Compensation for damage caused during clean-up:** Costs incurred to repair damage caused by clean-up crews are not recoverable CERCLA response costs. [*Syms v. Olin Corp.* (2nd Cir. 2005) 408 F3d 95, 103-104—"Repair of damage caused during cleanup of contamination gives rise to an *ordinary tort action*, not a cost recovery action under CERCLA" (emphasis added)]

[5:126.28 - 5:126.29] ***Reserved.***

(6) [5:126.30] **Prejudgment interest on recoverable response costs:** CERCLA expressly provides that amounts awarded in a cost recovery action "shall include" prejudgment interest (42 USC § 9607(a), last para.). This applies as well in a 42 USC § 9613(f)(1) contribution action, because 42 USC § 9613(f) incorporates the liability provisions of 42 USC § 9607. [See *Bancamerica Commercial Corp. v. Mosher Steel of Kansas, Inc.* (10th Cir. 1996) 100 F3d 792, 799–801—liability to be apportioned in § 9613(f)(1) contribution action is that set forth in § 9607(a), "which amount includes interest"; *Ameripride Services Inc. v. Texas Eastern Overseas Inc.* (9th Cir. 2015) 782 F3d 474, 491—courts must apply § 9607(a)'s

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methodology for calculating prejudgment interest rather than relying on equitable considerations; see also *Bancamerica Commercial Corp. v. Mosher Steel of Kansas, Inc.* (10th Cir. 1996) 103 F3d 80, 82 (concerning postjudgment interest)]

(7) [5:127] **Attorney fees recovery:** Under the longstanding "American rule," attorney fees generally are not a recoverable cost of litigation absent explicit congressional authorization (see generally, *Alyeska Pipeline Service Co. v. Wilderness Society* (1975) 421 US 240, 247, 95 S.Ct. 1612, 1616). And while CERCLA authorizes fee awards in certain CERCLA actions (see, e.g., 42 USC § 9659(f) (prevailing party fee award in *citizen suits*), 42 USC §§ 9601(25), 9604(b) (fee award in favor of *government*), and 42 USC § 9606(b)(2)(E) (fee award to party erroneously ordered to pay response costs in government abatement action)), it does *not* contain an express provision for attorney fee awards in a private litigant's costs recovery action. [See *Key Tronic Corp. v. United States* (1994) 511 US 809, 817, 114 S.Ct. 1960, 1966]

Thus, the propriety of an attorney fee award in a CERCLA private cost recovery suit depends on whether attorney fees can be considered a "*necessary cost of response*" (42 USC § 9607(a)(4)(B)). That turns on the *purpose* for which the claimed fees were incurred:

(a) [5:128] **Litigation-related fees *not recoverable:*** Costs of "response" within the meaning of CERCLA are expenses incurred for "removal … and remedial action, … includ[ing] enforcement activities related thereto." [42 USC § 9601(25)]

However, "enforcement activities" for this purpose do *not* encompass a private party's action to recover clean-up costs from other PRPs. Therefore, fees incurred for *prosecuting* a private cost-recovery action are *not* awardable as "necessary costs of response." [*Key Tronic Corp. v. United States* (1994) 511 US 809, 818-819, 114 S.Ct. 1960, 1966-1967]

1) Application

• [5:128.1] For example, consulting fees incurred in preparation for litigation were *not* recoverable as necessary response costs by the purchaser of environmentally distressed property. [*Black Horse Lane Assocs., L.P. v. Dow Chemical Corp.* (3rd Cir. 2000) 228 F3d 275, 294-296]

• [5:128.2] Similarly, consulting fees for reviewing work performed by others, and attorney fees for providing expertise in litigation, were *not* recoverable as necessary response costs by a homeowners association. Neither the association nor its members did any investigation or remediation. [*Bonnieview Homeowners Ass'n v. Woodmont Builders, LLC* (D NJ 2009) 655 F.Supp.2d 473, 494-499]

• [5:128.3] A private party could not recover attorney fees incurred in negotiating an EPA consent decree. The fees were *not* a "necessary cost of response" because they were incurred primarily to protect a private party's interests as a defendant. [*Key Tronic Corp. v. United States* (1994) 511 US 809, 820-821, 114 S.Ct. 1960, 1968; see also *Atlantic Richfield Co. v. American Airlines, Inc.* (10th Cir. 1996) 98 F3d 564, 571]

• [5:128.4] Likewise, attorney fees for negotiating access to a contaminated site for clean-up purposes were not recoverable as response costs because they were incurred primarily to protect a private party's interests as a defendant. [*Syms v. Olin Corp.* (2nd Cir. 2005) 408 F3d 95, 104]

2) [5:129] **Compare—contractual indemnification suits:** The result may be otherwise in a private party's suit for *indemnification*. If the indemnification claim is based on a *contract* between the parties (e.g., buyer sues seller to recoup clean-up costs pursuant to seller's agreement to indemnify buyer for remediation expense, ¶ 5:230), and the contract contains a prevailing party fee-shifting provision, attorney fees would be recoverable *pursuant to the contract* (another exception to the "American rule"). [See Civ.C. § 1717; CCP §§ 1021, 1033.5(a)(10)(A), (c)(5)(B)]

3) [5:129.1] **Compare—RCRA suits:** The RCRA does not contain CERCLA's attorney fees restrictions. To the contrary, RCRA expressly empowers courts, when issuing any final order in actions brought pursuant to 42 USC § 6972, to "award costs of litigation (including reasonable attorney and expert witness fees) to the prevailing or substantially prevailing party, whenever the court determines such an award is appropriate." [42 USC § 6972(e); see *Camellia Park Homeowners Ass'n v. Greenbriar Homes Co.* (ND CA 1995) 882 F.Supp. 150, 151]

Nonetheless, RCRA's litigation attorney fees provision is of no benefit to parties seeking compensation for clean-up efforts, because that remedy is not authorized under RCRA. *See discussion at¶ 5:125.10 ff.*

(b) [5:130] **Awardable fees incurred in searching for other PRPs:** As contrasted with nonrecoverable litigation-related fees, some lawyers' work that is closely tied to the actual clean-up may constitute a "necessary cost of response" within

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the meaning of 42 USC § 9607(a)(4)(B). Notably, that component of a private litigant's fee claim representing work performed in *identifying other PRPs* falls in this category and thus is recoverable in a CERCLA suit. [*Key Tronic Corp. v. United States* (1994) 511 US 809, 820, 114 S.Ct. 1960, 1967; see *Gussack Realty Co. v. Xerox Corp.* (2nd Cir. 2000) 224 F3d 85, 92; *Castaic Lake Water Agency v. Whittaker Corp.* (CD CA 2003) 272 F.Supp.2d 1053, 1078—"search for PRPs serves CERCLA's statutory purpose because it leads to the identification of responsible parties and thereby speeds and encourages complete clean-ups"]

Unlike litigation services for prosecuting the claim, "these efforts might well be performed by engineers, chemists, private investigators or other professionals who are not lawyers … Tracking down other responsible solvent polluters increases the probability that a cleanup will be effective and get paid for. [The private litigant] is therefore quite right to claim that such efforts significantly benefited the entire cleanup effort and served a statutory purpose apart from the reallocation of costs. These kinds of activities *are recoverable costs of response clearly distinguishable from litigation expenses*." [*Key Tronic Corp. v. United States*, supra, 511 US at 820, 114 S.Ct. at 1967-1968 (emphasis added); see *Key Tronic Corp. v. United States* (9th Cir. 1994) 30 F3d 1105, 1106 (upholding portion of CERCLA fee award for services performed in searching for other PRPs and remanding for trial court determination of cost of such services); see also *Village of Milford v. K-H Holding Corp.* (6th Cir. 2004) 390 F3d 926, 936—recoverable attorney fees *not limited* to identification of PRPs so long as activities "for which the fees are incurred could have been performed by a non-attorney, are closely tied to an actual cleanup, are not related to litigation, and are otherwise necessary"]

[5:131] ***Reserved.***

b. [5:132] **Future response costs (cost-recovery actions):** A plaintiff in a 42 USC § 9607(a)*cost-recovery* action may obtain a declaratory judgment establishing liability for future response costs. [42 USC § 9613(g)(2); *State of New York v. Solvent Chem. Co., Inc.* (2nd Cir. 2011) 664 F3d 22, 25]

Circuit courts disagree, however, whether plaintiff must have previously incurred response costs to qualify for such relief. [See *City of Colton v. American Promotional Events, Inc.-West* (9th Cir. 2010) 614 F3d 998, 1005—declaratory relief re liability for future response costs available only if liability for past costs is established; *Gussack Realty Co. v. Xerox Corp.* (2nd Cir. 2000) 224 F3d 85, 91-92 (same); compare *County Line Investment Co. v. Tinney* (10th Cir. 1991) 933 F2d 1508, 1513 (suggesting declaratory relief may be available in absence of recoverable past costs)]

(1) [5:132.1] **Lump-sum payment improper:** But plaintiff may *not* be awarded a lump-sum payment of anticipated future expenses. The proper remedy for future response costs is a *declaratory judgment dividing those costs among the responsible parties*. [*Gussack Realty Co. v. Xerox Corp.* (2nd Cir. 2000) 224 F3d 85, 92]

(2) [5:132.2] **Compare—contribution actions:** A plaintiff in a 42 USC § 9613(f)*contribution* action likewise may obtain a declaratory judgment establishing liability for future response costs. However, circuit courts are unclear concerning the statutory basis for such relief. [See *State of New York v. Solvent Chem. Co., Inc.* (2nd Cir. 2011) 664 F3d 22, 25—manufacturer entitled to declaratory judgment on future contribution issue under 28 USC § 2201(a) (Declaratory Judgment Act); compare *GenCorp, Inc. v. Olin Corp.* (6th Cir. 2004) 390 F3d 433, 451—entry of declaratory judgment for future clean-up costs in contribution action proper under 42 USC § 9613(g)(2); *United States v. Davis* (1st Cir. 2001) 261 F3d 1, 46-47 (same); *Boeing Co. v. Cascade Corp.* (9th Cir. 2000) 207 F3d 1177, 1191-1192 (upholding grant of declaratory judgment in contribution case after recognizing that § 9613(g)(2) does not prohibit declaratory relief for § 9613(f) claims)]

[5:132.3 - 5:132.9] ***Reserved.***

c. [5:132.10] **Standard of proof:** CERCLA cost-recovery plaintiffs must prove their case by a preponderance of the evidence, not with scientific certainty. [*B.F. Goodrich v. Betkoski* (2nd Cir. 1996) 99 F3d 505, 526 (overruled on other grounds by *State of New York v. National Services Indus., Inc.* (2nd Cir. 2003) 352 F3d 682); *Nashua Corp. v. Norton Co.* (ND NY 2000) 116 F.Supp.2d 330, 351]

d. Statute of limitations

(1) [5:133] **CERCLA three-year/six-year limitations periods:** Private party suits under CERCLA are subject to one of two distinct statutes of limitations:

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• a *three-year* statute that applies in 42 USC § 9613(f) contribution actions (*¶ 5:133.1 ff.*); and

• *a maximum six-year* statute, as defined, applicable in initial 42 USC § 9607(a) cost recovery actions (*see¶ 5:133.15 ff.*). [42 USC § 9613(g)(2)(A) (removal actions) & (B) (remedial actions)]

(a) [5:133.1] **Section 9613(f) contribution suits:** There are two corresponding *three-year* limitations periods for 42 USC § 9613(f) contribution actions (*¶ 5:125.3 ff.*). [42 USC § 9613(g)(3); *Cooper Indus., Inc. v. Aviall Services, Inc.* (2004) 543 US 157, 167, 125 S.Ct. 577, 584]

The three-year periods run as follows:

1) [5:133.2] **Three years from underlying judgment:** If the underlying civil action is resolved by a judgment, the PRP's contribution suit must be commenced within three years from the *date of the judgment*. [42 USC § 9613(g)(3)(A); *Cooper Indus., Inc. v. Aviall Services, Inc.* (2004) 543 US 157, 167, 125 S.Ct. 577, 584; *American Cyanamid Co. v. Capuano* (1st Cir. 2004) 381 F3d 6, 11]

a) [5:133.3] **Costs-recovery judgment required:** The 42 USC § 9613(g)(3)(A) statute of limitations is triggered only when there is a judgment for the *recovery of costs*. Thus, the statute does not begin to run from the date of a declaratory judgment holding simply that a party is liable for *future* removal or remedial costs. [*American Cyanamid Co. v. Capuano* (1st Cir. 2004) 381 F3d 6, 12-13]

2) [5:133.4] **Three years from underlying settlement:** If the PRP's liability to the United States is resolved by an administrative or judicially approved settlement, the PRP's contribution suit must be commenced within three years from the *date of the settlement*. [42 USC § 9613(g)(3)(B); *Cooper Indus., Inc. v. Aviall Services, Inc.* (2004) 543 US 157, 167, 125 S.Ct. 577, 584; see also *RSR Corp. v. Commercial Metals Co.* (6th Cir. 2007) 496 F3d 552, 556—consent decree entered as "judicially approved settlement" serves both to authorize contribution actions and commence running of 3-year limitations period]

a) Application

• [5:133.5] A judicially approved settlement agreement between *private parties* to a 42 USC § 9607 cost-recovery action started the clock running on the three-year limitations period. Once the three-year period ran, not even a bankruptcy settlement with the government, fixing the costs of the agreement for the first time, could revive an expired contribution claim. While "[t]he triggering event for [the] statute of limitations … includes judicially approved settlements involving the United States or a State, [it] is not limited to those types of settlements on its face." [See *ASARCO, LLC. v. Celanese Chem. Co.* (9th Cir. 2015) 792 F3d 1203, 1209-1211]

• [5:133.6] A PRP who failed to timely file a contribution claim following entry of a consent decree could not evade the three-year statute of limitations by bringing a contribution claim "under the guise of" a 42 USC § 9607(a) cost-recovery action. [*ITT Indus., Inc. v. BorgWarner, Inc.* (WD MI 2009) 615 F.Supp.2d 640, 646]

[5:133.7 - 5:133.10] *Reserved.*

b) [5:133.11] **Computing end date:** The FRCP 6(a) general rule, commonly referred to as the "anniversary method," applies when calculating the last day a contribution suit may be filed under the three-year statute (under the "anniversary rule," the day of the event triggering the period is excluded for purposes of computing the period's end date; see FRCP 6(a)(1)). Thus, when the limitations period is triggered by a settlement, counting begins the day *after* the judicially approved settlement is entered and ends three years later. [See *ASARCO, LLC v. Union Pac. R.R. Co.* (9th Cir. 2014) 765 F3d 999, 1007-1008 (distinguishing calendar-date method and finding it inapplicable)]

c) [5:133.12] **Settlement must impose response costs sought in contribution action:** A settlement triggers 42 USC § 9613(g)(3)(B)'s limitations period (¶ 5:133.4) only if it imposes the response costs that are the basis for seeking 42 USC § 9613(f)(1) contribution. [*Arconic, Inc. v. APC Investment Co.* (9th Cir. 2020) 969 F3d 945, 949, 952—plaintiffs' 42 USC § 9613(f) contribution action not time-barred because prior settlement with "de minimis" parties did not address response costs plaintiffs were seeking in their contribution action]

[5:133.13 - 5:133.14] *Reserved.*

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(b) [5:133.15] **Section 9607(a) cost-recovery suits:** A maximum six-year statute of limitations, as defined, applies to a private party's initial 42 USC § 9607(a)*cost-recovery* suit (¶ *5:125.2 ff.*). [42 USC § 9613(g)(2); see also *United States v. Atlantic Research Corp.* (2007) 551 US 128, 139, 127 S.Ct. 2331, 2338; *Agere Systems, Inc. v. Advanced Environmental Technology Corp.* (3rd Cir. 2010) 602 F3d 204, 220]

1) [5:133.16] **Accrual:** The accrual date for the cause of action depends on whether plaintiff's response action was "remedial" or "removal":

• [5:133.16a] *Remedial action:* For a "remedial action," the six-year statute commences "after initiation of physical on-site construction of the remedial action"—i.e., suit must be brought within six years after the start of remediation. [See 42 USC § 9613(g)(2)(B); *United States v. Navistar Int'l Transp. Corp.* (7th Cir. 1998) 152 F3d 702, 711—rejecting EPA's suggested "bright line" rule tying commencement of statute of limitations to final written approval of remedial action (rather than when actual remedial work began)]

• [5:133.16b] *Removal action:* For a "removal action," the cost-recovery suit must be brought within three years after completion of the removal or six years "after a determination to grant a waiver under [42 USC § 9604(c)(1)(C)] … for continued response action." [42 USC § 9613(g)(2)(A); *Geraghty & Miller, Inc. v. Conoco Inc.* (5th Cir. 2000) 234 F3d 917, 925 (abrogated on other grounds as recognized by *Vine Street LLC v. Borg Warner Corp.* (5th Cir. 2015) 776 F3d 312, 317); see also *Agere Systems, Inc. v. Advanced Environmental Technology Corp.* (3rd Cir. 2010) 602 F3d 204, 220 & fn. 28—EPA suit to recover costs associated with removal action must be brought within 3 years after removal action completed, subject to three exceptions that extend limitations period (i.e., the § 9613(g)(2)(A) "consistency waiver" exception (above), "subsequent action" exception (¶ *5:133.18*), or as part of "remedial action" exception (¶ *5:133.16a*))]

a) [5:133.17] **Distinguishing between "remedial" and "removal" actions:** Occasionally, it may be difficult to determine whether the response action is "remedial" or "removal":

CERCLA's definitions of the terms (42 USC § 9601(23) and (24)) are expansive enough that certain activities may be covered by both; and industry use of the terms is not synonymous with the statutory definitions. [*Geraghty & Miller, Inc. v. Conoco Inc.* (5th Cir. 2000) 234 F3d 917, 925-927—monitoring wells initially installed to assess contamination that later performed "remedial" activity classified as removal action; see also *General Elec. Co. v. Litton Indus. Automation Systems, Inc.* (8th Cir. 1990) 920 F2d 1415, 1419 (abrogated on other grounds by *Key Tronic Corp. v. U.S.* (1994) 511 US 809, 814-815, 819, 114 S.Ct. 1960, 1964-1965, 1967)—excavation could be remedial or removal activity; *Advanced Micro Devices, Inc. v. National Semiconductor Corp.* (ND CA 1999) 38 F.Supp.2d 802, 813—"hindsight" cannot be used to classify activity]

Although cases addressing the issue tend to be fact-specific, removal actions are generally *time-sensitive (immediate or interim)* responses to public health threats, while remedial actions are *permanent* responses to threats for which an urgent response is not warranted. [*United States v. W.R. Grace & Co.* (9th Cir. 2005) 429 F3d 1224, 1227-1228, 1232—also noting that "tangled language of CERCLA hardly lends itself to clearcut distinctions between the two types of actions"; see also *Valbruna Slater Steel Corp. v. Joslyn Mfg. Co.* (7th Cir. 2019) 934 F3d 553, 564-565—construction of concrete cap to confine pollutants was not "remedial" action, even though "fix may have been permanent," because it was not intended to "substantially resolve" bulk of site's ongoing pollution problems; *OBG Technical Services, Inc. v. Northrop Grumman Space & Mission Systems, Corp.* (D CT 2007) 503 F.Supp.2d 490, 525—clean-up activities deemed remedial in nature (no imminent danger from contamination and clean-up took 14 years to complete, effectuating a *permanent* remedy)]

2) [5:133.18] **Compare—subsequent actions:** A suit seeking recovery of costs incurred in a *subsequent* remedial or removal action may be based on an earlier finding of liability so long as the subsequent action is initiated within *three years* after completion of the initial action and involves the same parties. [42 USC § 9613(g)(2); *United States v. Navistar Int'l Transp. Corp.* (7th Cir. 1998) 152 F3d 702, 709-710—not applicable where "subsequent action" brought against party who was involved in "initial action" only as third party defendant]

[5:133.19] ***Reserved.***

(2) [5:133.20] **Compare—RCRA suits:** The RCRA contains *no* statute of limitations. [See *Meghrig v. KFC Western, Inc.* (1996) 516 US 479, 486, 116 S.Ct. 1251, 1255]

Even so, that omission will rarely provide an alternative remedy to litigants faced with a time-barred cost-recovery or contribution suit under CERCLA. As earlier discussed, there is no private party RCRA damages cause of action to recover costs for *past or ongoing* clean-up efforts. *See*¶ *5:125.10 ff.*

(3) [5:133.21] **Compare—California Superfund actions:** The HSAA similarly contains no statute of limitations for actions under Health & Saf.C. § 79670(a) (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24) (contribution or indemnity by a "person who has incurred response or corrective action costs"). [*Otay Land Co., LLC v. U.E. Ltd., L.P.* (2017) 15 CA5th 806, 851-852, 225 CR3d 119, 155-156 (decided under predecessor statute)]

In *Otay Land Co.*, the court, applying common law accrual rules, determined a § 25363(d) (recodified as Health & Saf.C. § 79670, oper. 1/1/24) action does not accrue until plaintiff *incurs* removal or remedial action costs. "[T]he injury under the HSAA is not the release of contamination, but rather the incurrence of recoverable costs." [*Otay Land Co., LLC v. U.E. Ltd., L.P,* supra, 15 CA5th at 851, 225 CR3d at 155-156 & fn. 33 (noting plaintiffs did not contest, and thus appellate court would not address, trial court's application of CCP § 338(b)'s 3-year limitations period for trespass or injury to real property)]

e. [5:134] **Manner of response cost allocation in contribution suit—equitable factors considered:** The manner of apportioning response cost liability in a contribution action between PRPs is left to the court's discretion, "using such equitable factors as the court determines are appropriate." [42 USC § 9613(f)(1) (CERCLA); Health & Saf.C. § 79670(d) (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24) (in California Superfund contribution or indemnity action court may allocate costs among liable parties using appropriate equitable factors); *United States v. Atlantic Research Corp.* (2007) 551 US 128, 140, 127 S.Ct. 2331, 2339] CERCLA does not limit the equitable factors a court may consider. [*Ameripride Services Inc. v. Texas Eastern Overseas Inc.* (9th Cir. 2015) 782 F3d 474, 480]

There is no set formulation of equitable considerations. "[I]n evaluating contribution claims under § 9613(f), [a court] is free to allocate responsibility according to any combination of equitable factors it deems appropriate." [See *Acushnet Co. v. Mohasco Corp.* (1st Cir. 1999) 191 F3d 69, 78 (internal quotes omitted) (collecting cases)—but equitable allocation must always be justified by the record; *Akzo Nobel Coatings, Inc. v. Aigner Corp.* (7th Cir. 1999) 197 F3d 302, 304—share allocation "is not a mechanical process"; *Nashua Corp. v. Norton Co.* (ND NY 2000) 116 F.Supp.2d 330, 352—using 8 factors to determine allocation; compare *Otay Land Co., LLC v. U.E. Ltd., L.P.* (2017) 15 CA5th 806, 864-865, 225 CR3d 119, 166-167 (California Superfund contribution/indemnity action)—"Whatever factors are appropriate in making an equitable allocation under the HSAA, party responsibility for contributing to the contamination must be part of the analysis"]

(1) [5:134.1] **Voluntary clean-up and cooperation as factors:** In equitably allocating responsibility between PRPs, courts are free to consider, along with other relevant factors, that a PRP itself engaged in voluntary clean-up efforts and the circumstances surrounding those efforts. [See generally, H.R. Rep. No. 99-253, pt. 3, at 19 (1985); *ASARCO LLC v. Atlantic Richfield Co., LLC* (9th Cir. 2020) 975 F3d 859, 868-870 & fn. 7 (reciting "Gore factors" commonly used in determining allocation)—trial court properly considered PRP's non-cooperation both in determining baseline allocation and separately awarding "uncertainty premium" based on PRP's egregious non-cooperation; *Central Maine Power Co. v. F.J. O'Connor Co.* (D ME 1993) 838 F.Supp. 641, 646—cooperation with government officials to prevent further environmental harm is "very important in the contribution analysis"; *but see also*¶ *5:125.4* (no 42 USC § 9613(f) contribution claim for purely voluntary clean-up costs)]

(2) [5:134.2] **"De minimis" pollution activity as factor:** Again, there is no requirement in CERCLA that a defendant be responsible for a minimum or "threshold" quantity of hazardous waste before liability may be imposed. However, courts may consider a PRP's "de minimis" contribution defense in *equitably* apportioning liability among the defendants; and, in an appropriate case, may conclude that, because a particular PRP's pollutants did not contribute more than "background" contamination, it should escape response costs liability altogether (i.e., its equitable or "fair share" of the response costs should be zero). [*Acushnet Co. v. Mohasco Corp.* (1st Cir. 1999) 191 F3d 69, 77-78; *see also* ¶ *5:126h ff.*]

(3) [5:134.3] **Liability not necessarily measured by volume or toxicity of hazardous waste contribution:** Although blameworthiness of a defendant's decisions or omissions that led to the hazardous waste release is relevant to an equitable allocation among the PRPs, courts are not required to allocate liability based on the volume or toxicity of environmental waste attributable to each defendant. [*Browning-Ferris Indus. of Ill., Inc. v. Ter Maat* (7th Cir. 1999) 195 F3d 953, 958-959; *Akzo Nobel Coatings, Inc. v. Aigner Corp.* (7th Cir. 1999) 197 F3d 302, 304-305]

(4) [5:134.4] **Accounting for settlements with some PRPs:** The circuits are split regarding the proper method of apportioning CERCLA contribution liability among PRPs.

(a) [5:134.5] **Discretionary allocation approach:** Some circuits, including the Ninth Circuit, adopt the discretionary allocation approach. Simply put, courts are not required to employ any specific formula in allocating costs between private parties so long as the method used is consistent with CERCLA's purpose and goals—i.e., expeditiously cleaning up hazardous waste and assuring responsible parties pay for clean-up. [See *Ameripride Services Inc. v. Texas Eastern Overseas Inc.* (9th Cir. 2015) 782 F3d 474, 487 (declining to apply any single method in private-party context, while recognizing Congress' preference for pro tanto approach in government settlements); *American Cyanamid Co. v. Capuano* (1st Cir. 2004) 381 F3d 6, 20 & fn. 4 (collecting cases and discussing advantages and disadvantages of "pro tanto" vs. "claim reduction" approaches)—nonsettling PRPs' liability reduced by proportionate share of fault attributed to settling PRPs]

(b) [5:134.6] **"Pro tanto" approach:** Other circuits rely on the "pro tanto" approach, apportioning contribution liability on the basis of the total response (clean-up) costs, *net of plaintiff's settlements* with PRPs; i.e., in determining the total cost to which a defendant PRP must contribute, these courts ascertain plaintiff's total outlay and then *reduce* that amount by sums received or due under third party settlements involving the same site. The claimed advantage is that the pro tanto approach avoids "what could be a complex and unproductive inquiry into the responsibility of missing parties." [*Akzo Nobel Coatings, Inc. v. Aigner Corp.* (7th Cir. 1999) 197 F3d 302, 308 (rejecting "global assessment of responsibility" approach); *K.C. 1986 Ltd. Partnership v. Reade Mfg.* (8th Cir. 2007) 472 F3d 1009, 1017-1018; see also *Friedland v. TIC-The Indus. Co.* (10th Cir. 2009) 566 F3d 1203, 1209-1211—settlement amount paid by one defendant is credited against amount that may be recovered from nonsettling defendants when conduct of multiple defendants results in single injury with common damages (so-called "one satisfaction rule")]

(5) [5:135] **Equitable defenses available:** Whereas defenses to CERCLA liability *to the government* are strictly *statutory* (*¶ 5:120 ff.*), the same is not true in a purely private action between PRPs seeking contribution. Equitable defenses may be asserted against private plaintiffs in allocating CERCLA response costs (damages) among the liable parties. [*Town of Munster, Ind. v. Sherwin-Williams Co., Inc.* (7th Cir. 1994) 27 F3d 1268, 1273 (delay and prejudice); *Smith Land & Improvement Corp. v. Celotex Corp.* (3rd Cir. 1988) 851 F2d 86, 89-90 (caveat emptor)]

(6) [5:135.1] **Parties' contractual obligations as factor:** In apportioning response cost liability, the court may consider any contractual obligations between the parties, even though it may lack jurisdiction to *enforce* them. [*Cadillac Fairview/Calif., Inc. v. Dow Chem. Co.* (9th Cir. 2002) 299 F3d 1019, 1028—district court did not abuse discretion in apportioning 100% of response costs to government pursuant to its hold harmless agreement with other party; see also *TDY Holdings, LLC v. United States* (9th Cir. 2018) 885 F3d 1142, 1148-1149—district court erred in allocating 100% of response costs to government contractor where, among other factors, contract required use of subject chemicals and government had repeatedly agreed to share in clean-up costs at site]

[5:135.2 - 5:135.9] ***Reserved.***

f. [5:135.10] **Possible joint liability among contribution defendants:** Nothing in CERCLA imposes a several liability limit among defendants sued for contribution. The court's power in a CERCLA contribution suit to apply appropriate equitable factors in allocating response costs between PRPs (¶ 5:135 ff.) gives it discretion to decide that the defendants should be held jointly liable. [*Browning-Ferris Indus. of Ill., Inc. v. Ter Maat* (7th Cir. 1999) 195 F3d 953, 956-957 (describing issue as one "of first impression at the appellate level")—"Joint liability thus is optional, rather than unavailable"; see also *Carter-Jones Lumber Co. v. Dixie Distributing Co.* (6th Cir. 1999) 166 F3d 840, 847-848]

g. [5:136] **Settlement shield:** A PRP who has resolved its liability *to the government* in an administrative or judicially-approved *settlement* is *insulated* from contribution claims under CERCLA regarding matters addressed in the settlement. Nonsettling PRPs remain exposed to contribution claims (unless the settlement with the government otherwise provides). [42 USC § 9613(f)(2) & (3)(B); *United States v. Atlantic Research Corp.* (2007) 551 US 128, 140, 127 S.Ct. 2331, 2339; see also *United States v. Coeur d'Alenes Co.* (9th Cir. 2014) 767 F3d 873, 875—PRPs who do not enter into early settlements may ultimately bear disproportionate share of CERCLA liability (¶ 5:136.2); *City of Emeryville v. Robinson* (9th Cir. 2010) 621 F3d 1251, 1264—settlement shield limited to claims by nonparties who are, "at a minimum," PRPs to site at issue (*discussed further at ¶ 5:136.1*); *ASARCO, LLC v. Union Pac. R.R. Co.* (8th Cir. 2014) 762 F3d 744, 752—tolling agreement between

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PRPs did not waive one PRP's statutory contribution shield after it settled its liability with federal government*; United States v. Iron Mountain Mines* (ED CA 2010) 724 F.Supp.2d 1086, 1092–1093—while federal government's settlement with some PRPs insulated them from contribution claims, it did not preclude government from recovering past clean-up costs from nonsettling PRPs]

(1) [5:136.1] **Nonsettling PRPs' right of intervention:** Because their contribution claims can be barred, *nonsettling* PRPs may *intervene as of right* in the CERCLA litigation to challenge a proposed government settlement with other PRPs. The right of intervention lies pursuant to FRCP 24(a)(2) and 42 USC § 9613(i) (CERCLA). [*California Dept. of Toxic Substances Control v. Commercial Realty Projects, Inc.* (9th Cir. 2002) 309 F3d 1113, 1118; *United States v. Aerojet General Corp.* (9th Cir. 2010) 606 F3d 1142, 1150 (agreeing with 8th and 10th Circuits)—nonsettling PRPs have "significant protectable interest" in litigation between government and would-be settling PRPs sufficient to satisfy statutory intervention requirements; and see *City of Emeryville v. Robinson* (9th Cir. 2010) 621 F3d 1251, 1260—nonsettling PRPs facing "imminent extinction" of their state law contribution claims for clean-up costs associated with their property (Site "B") could intervene as of right in federal action to enforce prior court-approved settlement barring any claims for contamination emanating from adjacent property (Site "A") (nonsettling PRPs had no notice of nor involvement in Site "A" litigation and settlement)]

(a) [5:136.2] **Based on inadequate consent decree:** Nonsettling PRPs who intervene in CERCLA litigation may do so on the ground that a proposed consent decree with the settling PRPs is neither procedurally nor substantively "fair, reasonable and consistent" with CERCLA's objectives. Indeed, courts usually "must find that the agreement is 'based upon, and roughly correlated with, some acceptable measure of comparative fault, apportioning liability among the settling parties according to rational (if necessarily imprecise) estimates of how much harm each [potentially responsible party] has done.'" [*Arizona v. City of Tucson* (9th Cir. 2014) 761 F3d 1005, 1011-1012 (brackets in original; internal quotes omitted)—district court abdicated its responsibility to independently scrutinize proposed agreements by deferring completely to state agency's interpretation of CERCLA's mandate; but see *United States v. Coeur d'Alenes Co.* (9th Cir. 2014) 767 F3d 873, 874—government-approved CERCLA settlement based solely on small business' ability to pay approved over intervening PRP's objection]

1) [5:136.3] **Comment:** Although courts normally must engage in some type of comparative fault analysis, CERCLA expressly permits the government to limit a PRP's liability based on its ability to pay (42 USC § 9622(e)(3)(A)). Moreover, "[c]ourts have routinely recognized the important policy considerations served by so-called 'ability to pay' settlements." [*United States v. Coeur d'Alenes Co.* (9th Cir. 2014) 767 F3d 873, 875-875—federal government seeks to avoid settlements that will force small businesses and individuals of modest means into bankruptcy or require them to sell off major assets]

(2) [5:137] **Compare—private settlements:** CERCLA is silent on the issue of whether a settlement solely between *private parties* effects a similar contribution claim bar. [*American Cyanamid Co. v. Capuano* (1st Cir. 2004) 381 F3d 6, 20] However, while varying approaches have been used, the judicial consensus appears to be that private party settlements approved by the court as being "fair and adequate" will likewise release the settling parties from nonsettling parties' contribution claims. [See *Akzo Nobel Coatings, Inc. v. Aigner Corp.* (7th Cir. 1999) 197 F3d 302, 308]

Some courts reach this result by stretching 42 USC § 9613(f)(2) (even though it expressly refers only to settlements with "the United States or a State") in order to further CERCLA's settlement-favoring policy. [See *United States v. SCA Services of Indiana, Inc.* (ND IN 1993) 827 F.Supp. 526, 530-532; *Akzo Nobel Coatings, Inc. v. Aigner Corp.*, supra, 197 F3d at 308; *City of Emeryville v. Robinson* (9th Cir. 2010) 621 F3d 1251, 1265 (noting "overwhelming majority" of courts imposing CERCLA contribution bar in private-party settlements do so only where affected persons were either parties to action, PRPs involved in or aware of settlement discussions, or nonparties who otherwise had "at least constructive notice their contribution claims stood to be extinguished")]

Other courts strictly interpret § 9613(f)(2) as limiting contribution protection to PRPs who settle with the *federal government or a particular state.* [See *Gurley v. City of West Memphis, Arkansas* (ED AR 2007) 489 F.Supp.2d 876, 879—*city's* judicially approved settlement with *other private* PRPs did not bar nonparty business owner's contribution claim against city (also noting nonparty business owner had no opportunity to participate in or object to settlement); *Comerica Bank-Detroit v. Allen Indus., Inc.* (ED MI 1991) 769 F.Supp. 1408, 1413-1415—declining to extend 42 USC

§ 9613 contribution claim bar to strictly private settlements, but allowing similar contribution claim protection under Uniform Comparative Fault Act]

(a) [5:137.1] **Contribution/indemnity claim bar under state law:** Under the California Superfund, a good faith settlement agreement bars any claims for contribution or indemnity against settling PRPs by nonsettling joint tortfeasors … *even if the government is not a party to the underlying action:* "[A]ll claims for indemnity and contribution against the settling parties are barred 'regardless of whether they are brought pursuant to CERCLA or pursuant to any other federal or state statute or common law' [citation] where the settling tortfeasor agrees to comply with a cleanup and abatement order issued by the state 'in regard to the further remediation of the contamination, reducing substantially the possibility of any shortfall created by the approval of these settlements' [citation]." [*Fullerton Redevelop. Agency v. Southern Calif. Gas Co.* (2010) 183 CA4th 428, 435-436, 107 CR3d 396, 401—city's judicially approved good faith settlement with other private PRP barred contribution/indemnity claims against city by nonsettling joint tortfeasor even though State not a party to action]

➪ [5:137.2] ***PRACTICE POINTERFOR NONSETTLING PRPS*:** Because they have no right of contribution against the settling defendants, nonsettling PRPs who want to guard against other PRPs settling for too little (i.e., arguably less than their fair share) must either *intervene* in the suits against them (as in government litigation, *¶ 5:136.1*) "or challenge the *bona fides* of the settlements immediately after they are reached." [See *Akzo Nobel Coatings, Inc. v. Aigner Corp.* (7th Cir. 1999) 197 F3d 302, 308 (emphasis in original)]

[5:137.3 - 5:137.4] ***Reserved.***

(3) [5:137.5] **Compare—settling parties not insulated from § 9607(a) cost-recovery suit:**42 USC § 9613(f)(2) does *not* protect settling PRPs from a *42 USC § 9607(a) cost-recovery suit* (¶ 5:125.2 ff.). [*United States v. Atlantic Research Corp.* (2007) 551 US 128, 140, 127 S.Ct. 2331, 2339]

However, according to the U.S. Supreme Court, permitting settling PRPs to be sued under § 9607(a) for full cost-recovery (a "supposed loophole") does not "eviscerate" the § 9316(f)(2) settlement bar and discourage settlement of CERCLA claims. This is because (a) the PRPs could in turn file a 42 USC § 9613(f) contribution counterclaim to trigger equitable apportionment of liability (*¶ 5:125.9 ff.*), and any prior settlement would undoubtedly be considered as part of the "liability calculus"; (b) the settlement bar "continues to provide significant protection" from contribution suits by PRPs that have inequitably reimbursed the costs incurred by other parties; and (c) settlement "carries the inherent benefit of finally resolving liability as to the United States or a State." [*United States v. Atlantic Research Corp.*, supra, 551 US at 140-141, 127 S.Ct. at 2339]

(4) [5:137.6] **Settling parties' right to bring § 9607(a) cost-recovery claim?** The U.S. Supreme Court has left open the issue whether, in addition to 42 USC § 9113(f) contribution claims, parties who settle with the United States have 42 USC § 9607(a) cost-recovery claims for expenses sustained pursuant to consent decrees entered into following a CERCLA lawsuit. [See *United States v. Atlantic Research Corp.* (2007) 551 US 128, 139, 127 S.Ct. 2331, 2338, fn. 6—"We do not decide whether these compelled costs of response are recoverable under § 113(f), § 107(a), or both"; see also *Agere Systems, Inc. v. Advanced Environmental Technology Corp.* (3rd Cir. 2010) 602 F3d 204, 227]

The Seventh Circuit has concluded if the settlement does *not* "resolve" liability to the government and thereby release a party from liability, that party can pursue a CERCLA cost-recovery claim. [See *Bernstein v. Bankert* (7th Cir. 2012) 733 F3d 190, 202, 206 (noting party is limited to contribution remedy, however, when one is available)]

Several other circuit courts have concluded otherwise: I.e., PRPs who execute consent decrees with the EPA (or any other governmental agency) are *not* entitled to pursue CERCLA cost-recovery claims. [See *Solutia, Inc. v. McWane, Inc.* (11th Cir. 2012) 672 F3d 1230, 1236-1237—42 USC § 9613(f) provides exclusive remedy for PRPs who execute consent decrees*;Morrison Enterprises, LLC v. Dravo Corp.* (8th Cir. 2011) 638 F3d 594, 603 (same); *Niagara Mohawk Power Corp. v. Chevron U.S.A., Inc.* (2nd Cir. 2010) 596 F3d 112, 128 (same); see also *Agere Systems, Inc. v. Advanced Environmental Technology Corp.* (3rd Cir. 2010) 602 F3d 204, 227-229—allowing settling PRPs to bring 42 USC § 9607(a) cost-recovery actions would expose nonsettling PRPs to joint and several liability with no right to contribution due to protection afforded settling parties by their consent decrees with government (*¶ 5:136*)]

Cross-refer—cost-recovery after PRP settlement with third party: See discussion at ¶ 5:125.2b.

6. [5:138] **Environmental Responsibility Acceptance Act (State Law):** California's Environmental Responsibility Acceptance Act (ERAA, Civ.C. § 850 et seq.) provides a detailed procedure to facilitate notification between site owners and PRPs of hazardous substance contamination and expedite remediation by responsible parties. [Civ.C. § 850 et seq.]

The discussion at ¶ 5:138.1 ff. addresses the Act's significant features. However, the statutory scheme is quite complex and should be carefully consulted.

a. [5:138.1] **Definitions:** Various provisions of the ERAA turn on terms having statutorily-defined common meanings. These include:

(1) [5:138.2] **"Actual awareness"** means "actual knowledge of a fact pertaining to an obligation" under the Act, including actual knowledge of a release exceeding the "notification threshold" (*¶ 5:138.6*). [Civ.C. § 850(a)]

(a) [5:138.3] **Imputed knowledge:** Actual awareness by a site owner's employees or representatives will be imputed to the owner only if the employees/representatives are *responsible for monitoring, responding to, or otherwise addressing* the hazardous substance release. [Civ.C. § 850(a)]

Similarly, actual awareness by a PRP's employees or representatives will be imputed to the PRP only if the employees/representatives are *responsible for monitoring, responding to, or otherwise addressing* the hazardous substance release. [Civ.C. § 850(a)]

(2) [5:138.4] **"Notice of potential liability"** means the site owner's notice stating that a hazardous substance release exceeding the "notification threshold" has occurred at the site and the owner believes the "notice recipient" is a responsible party with respect to the release. [Civ.C. § 850(f); *see¶ 5:138.15 ff.*]

(3) [5:138.5] **"Notice recipient"** is either:

• A person who receives a "notice of potential liability" (¶ 5:138.4);

• A person who provides a "release report" pursuant to Civ.C. § 851(b) (*¶ 5:138.35*); or

• A person who offers a "commitment statement" to the site owner pursuant to Civ.C. § 851(c) (¶ *5:138.17, 5:138.45 ff.*). [Civ.C. § 850(g)]

(4) [5:138.6] **"Notification threshold"** means any hazardous substance release of such magnitude that:

• The release is the subject of a "response action" ordered by or being performed by an oversight agency; or

• The release is impeding the site owner's ability to sell, lease or otherwise use the site. [Civ.C. § 850(h)]

(5) [5:138.7] **"Commitment statement"** is a written statement executed by the notice recipient (PRP) expressly reciting the language contained in Civ.C. § 854 (*¶ 5:138.46 ff.*).

[5:138.8] ***Reserved.***

(6) [5:138.9] **"Negative response"** is the notice recipient's (PRP's) written response to a "notice of potential liability" indicating the recipient will not undertake any "response action"; or a "deemed negative response" (per Civ.C. § 851(c), *¶ 5:138.18*) in the event of the recipient's failure to respond. [Civ.C. § 850(d)]

(7) [5:138.10] **"Release report"** is a notice sent by a responsible party to the site owner stating that a hazardous substance release has occurred on the site that is likely to exceed the "notification threshold." [Civ.C. § 850(m)]

(8) [5:138.11] **"Written action"** is any official action by an oversight agency expressly exercising clean-up authority in writing, pursuant to the agency's procedures, directing a response at the site. [Civ.C. § 850(s)]

[5:138.12 - 5:138.13] ***Reserved.***

b. [5:138.14] **Exclusions; effect of prior agency action:** The ERAA ordinarily does not apply to property listed pursuant to Health & Saf.C. § 78760 et seq. (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24) for response action. [See Civ.C. § 851(e)(1) (amended Stats. 2022, Ch. 258, oper. 1/1/24)] Nor does it apply where an oversight agency has issued an order or entered into an enforceable agreement *unless*:

• the order or enforceable agreement is issued or entered into after the owner accepts a commitment statement; *or*

• the agency that issued the order or entered into the agreement gives its written consent. [Civ.C. § 851(e)]

c. [5:138.15] **Site owner's notification to PRPs:** An owner of a contaminated site who has "actual awareness" of a "release exceeding the notification threshold" must take all "reasonable steps" to *expeditiously identify the potentially responsible parties*; and, as soon as reasonably possible after identifying PRPs, *send a notice of potential liability* to those PRPs and the agency that the owner believes to be the appropriate "oversight agency" (as defined in Civ.C. § 850(j)). [Civ.C. § 851(a)]

(1) [5:138.16] **"Reasonable steps"** for this purpose means taking the *least expensive* means available to ascertain the PRPs. [Civ.C. § 850(k)]

If the owner cannot otherwise identify any PRPs, "reasonable steps" include:

• Conducting a title search; and

• Reviewing all environmental reports in the owner's possession of which the owner has actual awareness pertaining to the site. [Civ.C. § 850(k)]

(2) [5:138.17] **Notice recipient's response:** Within 120 days of mailing of the notice of potential liability, notice recipients must respond to the site owner in writing, by certified mail, return receipt requested. [Civ.C. § 851(c)]

The response must take the form of a "commitment statement" (*¶ 5:138.45 ff.*) or a "negative response." [Civ.C. § 851(c)]

(a) [5:138.18] **"Deemed" negative response:** The notice recipient's failure to respond within the 120-day period or to strictly comply with the form of commitment statement prescribed by Civ.C. § 854 "*shall be deemed a negative response*." [Civ.C. § 851(c) (emphasis added)]

(b) [5:138.19] **Extension of 120-day response period:** However, the 120-day response period may be extended (thereby precluding a "deemed" negative response in the interim) by the site owner's written agreement. Also, an extension of up to 120 days "shall be provided" if the notice recipient commits to do a site investigation, "the results of which shall be provided to the owner and the oversight agency." [Civ.C. § 851(c)]

(c) [5:138.20] **No monetary consequences for failure to respond:** Notice recipients (PRPs) cannot incur any damages liability, fines or penalties under the ERAA for failure to make a written response (whether positive or negative) to a notice of potential liability. [Civ.C. § 853(b)]

[5:138.21 - 5:138.24] ***Reserved.***

(3) Consequences of failure to give notice of potential liability

(a) [5:138.25] **No monetary penalties:** Nothing in Civ.C. § 850 et seq. subjects the site owner to damages, fines or penalties for failure to send a notice of potential liability. [Civ.C. § 853(c)]

(b) [5:138.26] **No negligence per se exposure:** Nor can the site owner's failure to send a notice of potential liability subject the owner to liability on a negligence per se theory (presumptive breach of duty; *see¶ 5:170;* and detailed treatment of "negligence per se" in Haning, Flahavan, Cheng & Wright, *Cal. Prac. Guide: Personal Injury* (TRG), Ch. 2). [Civ.C. § 853(c)]

(c) [5:138.27] **Mitigation of owner's damages:** On the other hand, the common law duty to mitigate damages "shall apply" if the site owner fails to give a timely notice of potential liability when required pursuant to Civ.C. § 850 et seq. [Civ.C. § 851(d)(1)]

Where the owner fails to mitigate damages by not giving timely notice, the owner's damage claim "shall be reduced in accordance with common law principles by the amount that the potentially responsible party provides would have likely been mitigated had a timely notice of potential liability been given." [Civ.C. § 851(d)(1)]

1) [5:138.28] **Exception—awareness excusing notice of potential liability:** No notice of potential liability is required by the owner (and hence the common law duty to mitigate damages (¶ 5:138.27) will not be triggered) when the party to whom the notice is owed already has actual awareness of the information required to be transmitted in the notice. [Civ.C. § 851(d)(5)]

[5:138.29 - 5:138.34] ***Reserved.***

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d. [5:138.35] **PRP's obligation to provide site owner with release report:** A PRP who has "actual awareness" of a hazardous materials release likely to exceed the "notification threshold" (*¶ 5:138.6*) must, as soon as reasonably possible after obtaining such actual awareness, provide the site owner with a "release report" (*¶ 5:138.10*). [Civ.C. § 851(b)]

(1) [5:138.36] **Voluntary commitment statement:** Within 120 days after issuance of the release report, the PRP optionally may also issue the site owner a "commitment statement" (*¶ 5:138.45 ff.*). [Civ.C. § 851(b)]

(2) [5:138.37] **Not an admission of liability; no evidentiary effect:** The PRP's issuance of a release report does not amount to an admission of liability and is not admissible evidence against the PRP in any litigation. [Civ.C. § 851(b)]

(3) [5:138.38] **Consequences of failure to issue release report—resulting damages:** Common law principles "shall apply" to the PRP's failure to issue a timely release report; i.e., the PRP "shall be responsible" to the site owner for damages the owner proves are likely caused by that failure. [Civ.C. § 851(d)(2)]

(a) [5:138.39] **Exception—owner's awareness excusing release report:** No release report is required from the PRP (and hence the owner will have no Civ.C. § 851(d)(2) damages cause of action, ¶ 5:138.38) if the site owner already has actual awareness of the information required to be transmitted in the release report. [Civ.C. § 851(d)(5)]

[5:138.40 - 5:138.44] ***Reserved.***

e. [5:138.45] **PRP commitment statement:** As earlier noted, a notified PRP (or a PRP who is otherwise aware of a hazardous substance release) has the option of issuing a "commitment statement" to the site owner (*¶ 5:138.36*).

(1) [5:138.46] **Statutory form and content:** A commitment statement is effective only if executed in "substantially" the form prescribed by Civ.C. § 854. [Civ.C. § 854] The following are the main provisions:

(a) [5:138.47] **Title:** The statement must be labeled "Notice of Assumption of Government Imposed Site Investigation and/or Remedial Action Orders ('Commitment Statement')." [Civ.C. § 854]

(b) [5:138.48] **Commitment to take response action:** The parties must agree to abide by Civ.C. § 850 et seq. And the PRP must commit to undertake response action required by an oversight agency through a written action, directed to the site owner or PRP. [See Civ.C. § 854(a), (b), (c)]

1) [5:138.49] **Covenant running with the land:** The agreed-upon commitment "runs with the land," binding the site owner and all of the owner's successors in interest, including current and future lenders having a security interest in the site. [Civ.C. § 854(c)]

(c) [5:138.50] **"Effectuating agreements":** To facilitate the PRP's response action pursuant to the commitment, the parties must further agree that:

- The PRP will be allowed access to the site as necessary to perform its commitment (but will be liable for physical damage caused in conducting its response action) (Civ.C. § 854(d)(1));

- The parties will provide each other with copies of any communication with an oversight agency in connection with the hazardous materials release at the site (Civ.C. § 854(d)(2));

- Provided the PRP performs all of its obligations under the commitment statement, and except as otherwise provided in Civ.C. § 852(c) and (e) (¶ *5:138.75 ff., 5:138.87*), no damages claim accruing after acceptance of the commitment statement shall be brought against the PRP by the site owner or its successors, heirs and assigns (Civ.C. § 854(d)(3)).

(d) [5:138.51] **Admissibility:** The commitment statement is inadmissible in any proceeding *except* an action to enforce the statement to the extent its contents would be admissible under other applicable law. [Civ.C. §§ 853(a), 854(e)]

(e) [5:138.52] **Standing to enforce:** The commitment statement may be enforced by the site owner, the PRP, and their successors, heirs and assigns. However, *no third party beneficiary rights* are created by the statement. [Civ.C. §§ 853(e), 854(e)]

(f) [5:138.53] **Copy to prospective site transferees; notice:** Until termination of the commitment statement or until all response actions thereunder have been completed, the site owner must provide a copy of the statement to any prospective purchaser or lessee. [Civ.C. § 854(f)]

And, within 14 days of transferring the site, the owner must notify the other parties to the commitment statement, by mail. [Civ.C. § 854(g)]

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(g) [5:138.54] **Effective date:** The commitment statement will become effective if executed by the site owner *within 45 days* after its issuance (*see*¶ *5:138.60*); in that event, its terms take effect upon the PRP's receipt of the owner's acceptance. [Civ.C. § 854(h)]

(h) [5:138.55] **Mediation upon rejection:** Conversely, the site owner's *rejection* of the PRP's commitment statement triggers *mediation* under Civ.C. § 852(b) before any litigation concerning the contamination may be commenced (*see*¶ *5:138.60 ff.*). [Civ.C. § 854(h)]

(i) [5:138.56] **Terminable if no agency "written action" within two years:** If at the end of *two years* from acceptance of the commitment statement, an oversight agency has not issued a "written action" (¶ *5:138.11*) directed to the site owner or notice recipient, the owner has 60 days to terminate the commitment statement; in that event, the statement "shall have no further force or effect." [Civ.C. § 854(i); *see also*¶ *5:138.98*]

(2) [5:138.57] **Mandatory accompanying notice of rights:** The PRP's commitment statement must be accompanied by the following statutory notice (14 point bold type if printed or bold capital letters if typed) (Civ.C. § 852(f)):

> "THIS FORM WAS DEVELOPED AS PART OF A PROCESS ENACTED BY THE CALIFORNIA LEGISLATURE TO PROVIDE OWNERS OF PROPERTY AND POTENTIALLY RESPONSIBLE PARTIES AN ALTERNATIVE TO LITIGATING DISPUTES OVER CONTAMINATION. IT IS YOUR OPTION AS TO WHETHER YOU SIGN THIS FORM OR OTHERWISE PARTICIPATE IN THIS PROCESS. IF YOU CHOOSE NOT TO PARTICIPATE IN THE PROCESS, YOU SHOULD NOTIFY THE PARTY WHO SENT YOU THIS FORM. THIS FORM INVOLVES A TRADEOFF WHEREBY EACH PARTY ACQUIRES AND RELINQUISHES CERTAIN RIGHTS. UNDER THIS FORM, THE PROPERTY OWNER GETS THE ASSURANCE THAT THE POTENTIALLY RESPONSIBLE PARTY IS OBLIGATED TO PERFORM INVESTIGATORY AND CLEANUP ACTIONS IN THE EVENT THAT GOVERNMENT AUTHORITIES ELECT TO REQUIRE THESE ACTIONS. ON THE OTHER HAND, THE PROPERTY OWNER FOREGOES CERTAIN CLAIMS ASSOCIATED WITH RESIDUAL CONTAMINATION THAT GOVERNMENT AUTHORITIES ALLOW TO REMAIN IN PLACE ON THE PROPERTY. IF YOU ELECT NOT TO SIGN THIS FORM, THE PROCESS DEVELOPED BY THE LEGISLATURE CONTEMPLATES THAT YOU WILL ATTEMPT TO MEDIATE ANY DISPUTES REGARDING THE CONTAMINATION. HOWEVER, MEDIATION IS NEITHER MANDATORY NOR BINDING. IF YOU HAVE QUESTIONS ABOUT THE PROCESS, YOU MAY WISH TO CONSULT AN ATTORNEY."

[5:138.58 - 5:138.59] ***Reserved.***

(3) [5:138.60] **Rejection and "deemed rejection" of commitment statement; effect:** The site owner has *45 days* after issuance of a PRP commitment statement to accept by sending an executed copy to the PRP by certified mail, return receipt requested. [Civ.C. § 852(a)]

The statement will be *deemed rejected* if not executed by the site owner within the 45-day period. [Civ.C. § 852(a)]

(a) [5:138.61] **Commitment statement a nullity after rejection:** The PRP (notice recipient) has *no obligation* with respect to the provisions of a *rejected* commitment statement. [Civ.C. § 852(a)]

(b) [5:138.62] **Prelitigation mediation:** Upon a rejection, unless the PRP elects not to proceed with mediation, the owner and PRP "shall participate in a mediation process prior to the commencement of any litigation which pertains to a release covered by the commitment statement." [Civ.C. § 852(b)(1)]

Either the PRP or site owner, however, may elect not to proceed further with the mediation process at any time before completion of the mediation. [Civ.C. § 852(b)(2)]

1) [5:138.63] **Mediator:** A Civ.C. § 852 mediator must be a "neutral third party"—i.e., either an attorney, engineer, environmentalist, hydrologist or retired judge who has served as a mediator. [See Civ.C. § 850(e)]

2) [5:138.64] **Mediator's costs:** Unless the site owner and PRP otherwise agree, the mediator's fees and costs "shall be borne equally" by the parties. [Civ.C. § 852(b)(7)]

3) [5:138.65] **Effect of mediation settlement:** To the extent the mediation results in a mutually-agreeable settlement, allocating liability and assigning owner and PRP rights and obligations in a manner different from or inconsistent with Civ.C. § 850 et seq., the settlement "shall supersede the terms" of Civ.C. § 850 et seq. pursuant to Civ.C. § 853(f) (¶ *5:138.125*). [Civ.C. § 852(b)(3)]

4) Termination of mediation; litigation

a) [5:138.66] **Termination by PRP's failure to participate within 90 days:** If the PRP issuing the commitment statement fails to participate in mediation within 90 days of the owner's rejection of the commitment statement, the owner may proceed with litigation. [Civ.C. § 852(b)(3)]

b) [5:138.67] **Termination by failure to effect settlement within 90 days:** If a settlement of all issues cannot be reached within 90 days after the site owner's rejection of the commitment statement, the mediator "shall declare the mediation process unsuccessful and terminate the process." [Civ.C. § 852(b)(3)]

1/ [5:138.68] **Agreed-upon extension:** The site owner and PRP may mutually agree to extend the mediation process, but must give the mediator written notice thereof. [Civ.C. § 852(b)(3)]

2/ [5:138.69] **Litigation or "other resolution":** After termination of an unsuccessful mediation, the parties are free to litigate "or otherwise resolve" their claims. They may mutually agree to the terms of the commitment statement at any time after termination of an unsuccessful mediation, in which case Civ.C. § 850 et seq. governs the parties' rights and obligations. [Civ.C. § 852(b)(4)]

[5:138.70 - 5:138.74] ***Reserved.***

(4) [5:138.75] **Effect of commitment statement:** Upon taking effect, a commitment statement has the following results (Civ.C. § 852(c)):

(a) [5:138.76] **PRP's binding promise to take response action:** It constitutes the PRP's binding promise to undertake any "response action" required by an oversight agency through a "written action," directed to the owner or PRP, in connection with the hazardous materials release that is the subject of the "notice of potential liability" or "release report." [Civ.C. § 852(c)(1)]

1) [5:138.77] **No prospective release obligations:** But the commitment statement creates no obligations with respect to hazardous substance releases occurring *after the statement is signed*, or with respect to any other release that is *not the subject of the notice of potential liability*. [Civ.C. § 852(c)(1)]

(b) [5:138.78] **Site owner's binding promise to grant access:** The statement also constitutes the site owner's binding promise to provide reasonable site access to the PRP to take any action "reasonably necessary or appropriate" to conduct a "response action." [Civ.C. § 852(c)(2)]

1) [5:138.79] **PRP's damage liability:** The grant of access does not affect the owner's rights if the PRP's onsite activities cause physical damage to the site that the PRP fails to repair within a reasonable period after completing all onsite activities. [Civ.C. § 852(c)(2)]

2) [5:138.80] **Interference with owner's use:** Unless otherwise ordered by the oversight agency, the PRP "shall take all reasonable steps to avoid interfering with the owner's use of the site." [Civ.C. § 852(c)(2)]

(c) [5:138.81] **Stay of related civil actions:** Once a commitment statement has been accepted, the court *shall stay* any action brought by the site owner against the PRP that issued the commitment statement—including, but not limited to, actions in trespass, nuisance, negligence and strict liability—which arise from or relate to a hazardous materials release for which a commitment statement has issued. [Civ.C. § 852(c)(3)]

1) [5:138.82] **Duration:** The stay shall be effective for *up to two years* from the date of acceptance of the commitment statement—but only for so long as the site response action is proceeding to an oversight agency's satisfaction. [Civ.C. § 852(c)(3)]

However, the stay period may be extended pursuant to written agreement between the site owner and PRP. [Civ.C. § 852(c)(3)]

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2) [5:138.83] **Exceptions—certain civil actions not stayed:** No such stay will be ordered with regard to a civil action (i) seeking personal injury or wrongful death actions, or (ii) based on fraud, failure to disclose or misrepresentation related to any transaction between the site owner and PRP, or (iii) for breach of the commitment statement, or (iv) unrelated to the hazardous substance release. [Civ.C. § 852(c)(3)]

(d) [5:138.84] **Tolling of statute of limitations:** *See ¶ 5:138.97*.

(e) [5:138.85] **Site owner's recoverable damages limited:** In an action by a site owner who has accepted a PRP's commitment statement, and which arises from or relates to a hazardous substance release for which a commitment statement has issued, only the following damages are recoverable to the extent otherwise authorized by law (Civ.C. § 852(c)(4)):

• Damages for personal injuries or wrongful death caused by the hazardous substance release;

• Damages for breach of the commitment statement;

• Damages from the failure of a prospective purchaser to perform under a sales contract because of the hazardous substance release, where the nonperformance occurs before issuance of the commitment statement;

• Damages for lost use of the property before issuance of a commitment statement caused by the hazardous substance release;

• Recovery of costs of investigating and responding to the hazardous substance release where those costs are incurred before issuance of the commitment statement;

• Remedies for any breach of a preexisting contract entered into before acceptance of the commitment statement;

• Damages for lost rents and "any other damages recoverable under law associated with lost use of the site caused by any notice recipient during site response action activities." [Civ.C. § 852(c)(4)(A)-(G)]

(f) [5:138.86] **Limited evidentiary effect:** *See ¶ 5:138.51*.

(5) [5:138.87] **Site owner's right of rescission:** The site owner may obtain rescission of a commitment statement if the PRP repudiates its obligations under the statement; in that event, Civ.C. §§ 852 and 854 no longer apply to the site. [Civ.C. § 852(c)(5)]

(6) [5:138.88] **Action for breach of commitment statement:** At any time after acceptance of the commitment statement, the site owner or PRP may bring an action against the other for "material breach of rights and obligations associated with the commitment statement." Subject to the Civ.C. § 852(c)(3) stay (¶ *5:138.81*), the parties may litigate these claims in the same action as any other claims they have in connection with the hazardous materials release that is the subject of the commitment statement. [Civ.C. § 852(e)]

[5:138.89 - 5:138.94] ***Reserved.***

f. [5:138.95] **Tolling of statute of limitations:** Various stages of the Civ.C. § 850 et seq. process trigger a tolling of applicable statutes of limitations:

(1) [5:138.96] **Upon issuance of notice of potential liability, release report or commitment statement:** Any applicable statute of limitations is tolled for *90 days* following issuance of a notice of potential liability, a release report, or a commitment statement. [Civ.C. § 852(b)(5)]

(2) [5:138.97] **Upon acceptance of commitment statement:** Any applicable statute of limitations is tolled for two and one-half years from the date of *acceptance* of the PRP's commitment statement. [Civ.C. § 852(g)]

(a) [5:138.98] **Site owner's option to terminate commitment statement where no agency "written action" within two years:** If at the end of two years from the date of acceptance, an oversight agency has not issued a written action directed to the site owner or PRP, the owner has 60 days in which to terminate the commitment statement; and, in that event, the commitment statement "shall have no further force or effect." [Civ.C. § 852(g)]

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Upon the owner's election to terminate, Civ.C. § 852(c) (regarding effect of an accepted commitment statement, including the stay of related civil actions, ¶ *5:138.75 ff.*) no longer applies to the site and no longer governs the owner's and PRP's rights and obligations. [Civ.C. § 852(g)]

(3) [5:138.99] **Upon rejection of commitment statement and mediation:** Further, any applicable statute of limitations is tolled from the time the site owner *rejects* a commitment statement until termination of the mediation process (¶ *5:138.62 ff.*). However, if mediation is not commenced within 90 days after the owner's rejection, tolling of the statute of limitations terminates unless the parties otherwise agree. [Civ.C. § 852(b)(6)]

[5:138.100 - 5:138.110] ***Reserved.***

g. Related duties and rights

(1) [5:138.111] **No affirmative ERAA duty to discover or investigate hazardous substance release:** The ERAA (Civ.C. § 850 et seq.) does *not itself* impose any affirmative duty on a site owner or PRP to "discover, or determine the nature or extent of, a hazardous materials release at the site." [Civ.C. § 853(d)]

(a) [5:138.112] **Compare—duties under other laws unaffected:** By the same token, such an affirmative duty may exist independently of the ERAA under other laws and is *not affected by the ERAA*. [Civ.C. § 853(d)]

(2) [5:138.113] **Contribution rights:** Subject to authorized CERCLA defenses (¶ *5:101 ff.*), notice recipients (PRPs) have a cause of action under the ERAA against other PRPs to recover reasonable response costs for conducting a response action approved or overseen by an oversight agency or as incurred pursuant to a commitment statement. [Civ.C. § 853(e)]

(a) [5:138.114] **Equitable allocation among PRPs:** This is a *contribution* action (¶ 5:125.4). As such, liability is to be allocated among the PRPs based upon the equitable factors specified in former Health & Saf.C. § 25356.3(c) "as it existed prior to its repeal by Chapter 39 of the Statutes of 2012." [Civ.C. § 853(e) (amended Stats. 2022, Ch. 258, oper. 1/1/24); Civ.C. § 853(e)]

Compare: Under the California Superfund, courts may allocate costs among the liable parties in a contribution action using "appropriate equitable factors" (¶ 5:134). [See Health & Saf.C. § 79670 (recodified & added Stats. 2022, Ch. 257, oper 1/1/24)]

(b) [5:138.115] **Site owner's contribution liability:** No ERAA contribution cause of action lies against a current or former site owner unless that owner *operated a business that caused a hazardous substance release* being addressed by a response action at the site *and* the costs incurred by the PRP plaintiff were in response to a *release caused by the owner*. [Civ.C. § 853(e)]

(c) [5:138.116] **Three-year statute of limitations:** No ERAA contribution recovery may be obtained for costs incurred *more than three years* before filing of the action. [Civ.C. § 853(e)]

[5:138.117 - 5:138.124] ***Reserved.***

(3) [5:138.125] **Superseding owner/PRP agreements:** Nothing in Civ.C. § 850 et seq." affects or limits a site owner's preexisting contractual rights. Nor does the ERAA affect or limit the right of a site owner and PRP to agree to an allocation of liability or to an assignment of rights and obligations that is different from or inconsistent with the ERAA. "Such agreements *shall supersede* the terms of [Civ.C. § 850 et seq.]." [Civ.C. § 853(f) (emphasis added)]

[5:139] ***Reserved.***

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Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 5. Environmental Hazards Liability

D. Common Law Environmental Hazards Liability

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1. [5:140] **In General:** Federal and state statutes (CERCLA, California Superfund, etc.) do not provide the exclusive avenues for legal redress of environmental hazards contamination. Remedies are also available under common law theories, including negligence, nuisance, trespass, and perhaps even strict liability. In some cases, these common law causes of action may fill the gaps left by statutory law on recoverable damages or a private right of action.

a. [5:141] **Remedies for petroleum/gas contamination:** For example, CERCLA and the California Superfund provide no redress for the release of refined and unrefined petroleum products and natural gas or synthetic gas usable for fuel, because these are not "hazardous substances" under those statutory schemes (*¶ 5:90 ff.*). And while those hazardous products are covered by the RCRA, a private party's RCRA remedies are very limited (significantly, no RCRA damages recovery for *past or ongoing* clean-up efforts; *see ¶ 5:125.10 ff.*).

Accordingly, to obtain a complete money judgment for damages suffered as a result of petroleum products contamination, plaintiff's best chance may lie in common law tort claims. [See, e.g., *Wilshire Westwood Associates v. Atlantic Richfield Co.* (1993) 20 CA4th 732, 738, 745-746, 24 CR2d 562, 565, 569-570—subsequent purchasers' claim against former gas station tenant barred by CERCLA "petroleum exclusion" but assertable as continuing nuisance action; *KFC Western, Inc. v. Meghrig* (1994) 23 CA4th 1167, 1177-1182, 28 CR2d 676, 683-686—owner's action against prior owners for gasoline contamination clean-up barred by California Superfund "petroleum exclusion" but assertable on continuing nuisance and continuing trespass theories]

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b. [5:142] **Personal injury and property damage remedies:** CERCLA (and, probably, similar statutes authorizing a private party costs recovery action) does not allow damages for injury to persons or property (except for injury to natural resources) (*see ¶ 5:126.10 ff.*). Therefore, common law tort theories may be the only viable avenue to recover for personal injury (medical expenses, emotional distress, etc.), loss of income or property damage arising from the presence of hazardous substances on the property. [See *Potter v. Firestone Tire & Rubber Co.* (1993) 6 C4th 965, 997, 999-1000, 1009, 25 CR2d 550, 571, 573, 579-590—recognizing potential cause of action for emotional distress damages from fear of cancer resulting from exposure to toxins, as well as damages liability for medical monitoring costs]

c. [5:143] **Overcoming statute of limitations bars on statutory remedy:** Further, PRPs attempting to recover clean-up costs from others responsible for the contamination may face formidable opposition to a statutory remedy in the form of a statute of limitations defense (*see ¶ 5:133 ff.*). Nonetheless, they may have a common law remedy to redress the continuing, ongoing effects of a prior hazardous substance release. [See, e.g., *Newhall Land & Farming Co. v. Sup.Ct. (Mobil Oil Corp.)* (1993) 19 CA4th 334, 341-347, 23 CR2d 377, 380-384—owner's common law action against remote predecessor in title]

(1) [5:143.1] **CERCLA preemption re accrual of cause of action:** Although state statutory and common law causes of action are subject to state statutes of limitations, state law does not necessarily define *accrual* of the cause of action (i.e., when the particular statute of limitations commences to run).

(a) [5:143.2] **Federally-mandated "discovery rule":** Pursuant to CERCLA, all statutes of limitations for personal injury or property damage actions arising from the release of hazardous substances from a facility into the environment (within the meaning of CERCLA, *see ¶ 5:5 ff.*) may commence to run *no earlier* than the date plaintiff *knew or reasonably should have known* that the injury or damage was caused or contributed to by the hazardous substance in issue. Statutes of limitations providing an earlier accrual date are *preempted*, even where plaintiff has not sued under CERCLA, instead pleading only state law claims. [42 USC § 9658(a)(1), (b)(4)(A); *Angeles Chem. Co., Inc. v. Spencer & Jones* (1996) 44 CA4th 112, 122, 51 CR2d 594, 599; *Rivas v. Safety-Kleen Corp.* (2002) 98 CA4th 218, 231, 119 CR2d 503, 513 & fn. 7; see also *Freier v. Westinghouse Elec. Corp.* (2nd Cir. 2002) 303 F3d 176, 203, 205 (rejecting 10th Amendment challenge to federally-mandated discovery-rule accrual)]

Thus, where the applicable state law statute of limitations does not apply the CERCLA "discovery rule" to plaintiff's toxic contamination injury/damage suit, CERCLA mandates that the limitations period begin to run when plaintiff discovers, or should have discovered, the injury and its cause. [*Burlington Northern & Santa Fe R.R. Co. v. Poole Chem. Co.* (5th Cir. 2005) 419 F3d 355, 362—42 USC § 9658 "engrafts" discovery rule on state statutes of limitations; see also *McCoy v. Gustafson* (2009) 180 CA4th 56, 112, 103 CR3d 37, 81—CERCLA preempts state statutes of limitations if applicable state law limitations period provides earlier commencement date than federal law; *Angeles Chem. Co., Inc. v. Spencer & Jones*, supra, 44 CA4th at 123, 51 CR2d at 599-600—CCP § 337.15 maximum 10-year latent construction defect statute of limitations preempted by CERCLA (*¶ 5:160.1*)]

Conversely, there is no federal preemption where the applicable state law statute of limitations applies the discovery rule, so that the limitations period commences on the same date under both state law and CERCLA (*¶ 5:143.5*). [See *Alexander v. Exxon Mobil* (2013) 219 CA4th 1236, 1252, 162 CR3d 617, 630, fn. 7 (concluding personal injury claims were not, as a matter of law, precluded under state discovery rule, making it unnecessary to consider whether federally-mandated discovery rule provided more generous commencement date); *McCoy v. Gustafson*, supra, 180 CA4th at 112-113, 103 CR3d at 81-82—no federal preemption where 3-year state law limitations period for injury to real property by permanent nuisance began running when plaintiff discovered bunker oil]

1) [5:143.3] **Inapplicable to toxic exposure in workplace claims:** By its terms, the preemption statute applies only where the state law suit alleges personal injury or property damage arising out of CERCLA's predicate elements—the "release" of a "hazardous substance" from a "facility" into the "environment" (*¶ 5:5 ff.*). [42 USC § 9658(a)(1)]

Thus, the 42 USC § 9658 preemptive accrual rule does *not* apply to state law claims based on toxic exposure confined within the workplace (no "release" into the "environment"; *see ¶ 5:5.10*). [*Rivas v. Safety-Kleen Corp.* (2002) 98 CA4th 218, 236, 119 CR2d 503, 517]

2) [5:143.4] **Compare—special rule for minors:** Under CERCLA, a minor's action accrues on the later of the date that:

— the action would have accrued under the federally-mandated "discovery rule" (*¶ 5:143.2*); or

— the minor reaches the age of majority or has a legal representative appointed. [42 USC § 9658(b)(4)(B)(i); see also *CTS Corp. v. Waldburger* (2014) 573 US 1, 11, 17, 134 S.Ct. 2175, 2184, 2187 (noting 42 USC § 9658(b)(4)(B) provides for equitable tolling for minor plaintiffs)]

3) [5:143.4a] **Compare—special rule for incompetents:** Similarly, under CERCLA, an incompetent person's action accrues on the later of the date that:

— the action would have accrued under the federally-mandated "discovery rule" (*¶ 5:143.2*); or

— the individual becomes competent or has a legal representative appointed. [42 USC § 9658(b)(4)(B)(ii); see also *CTS Corp. v. Waldburger* (2014) 573 US 1, 11, 17, 134 S.Ct. 2175, 2184, 2187 (noting 42 USC § 9658(b)(4)(B) provides for equitable tolling for incompetent plaintiffs)]

4) [5:143.5] **Application under California law:** The California statute of limitations applicable to actions for injury, illness or death apparently is consistent with the federal "discovery rule":

In a civil action for injury or illness based upon exposure to a hazardous material or toxic substance, the time for commencement of the action shall be no later than the *later of* two years from the date of injury or two years after plaintiff "*becomes aware of, or reasonably should have become aware of*, (1) an injury, (2) the physical cause of the injury, and (3) sufficient facts to put a reasonable person on inquiry notice that the injury was caused or contributed to by the wrongful act of another …" [CCP § 340.8(a) (emphasis added); see also CCP § 340.8(c)—asbestos injury actions subject to CCP § 340.2 (not CCP § 340.8) and medical malpractice actions subject to CCP § 340.5 (not § 340.8); *Alexander v. Exxon Mobil* (2013) 219 CA4th 1236, 1252, 162 CR3d 617, 630—§ 340.8 is "not intended to create a special discovery rule of accrual for claims predicated on exposure to hazardous substances, but rather to clarify that California's traditional discovery rule applies to such claims"]

A similar discovery rule applies in wrongful death actions based upon decedent's exposure to a hazardous material or toxic substance (time for commencement of the action shall be no later than the *later of* two years from date of decedent's death or two years from the first date plaintiff "is aware of, or reasonably should have become aware of, the physical cause of the death and sufficient facts to put a reasonable person on inquiry notice that the death was caused or contributed to by the wrongful act of another …"). [CCP § 340.8(b)]

a) [5:143.6] **Comment:** The first prong of the CCP § 340.8(a) statute of limitations (two years from the date of injury) seems superfluous: As a practical matter, plaintiff's "awareness" of the injury necessarily can only occur *upon or after* the injury, so that plaintiff will always have two years from the date of "awareness" to file suit.

(2) [5:143.7] **CERCLA statute of limitations preemption *inapplicable to statutes of repose:*** Statutes of repose, unlike statutes of limitation, may cut off a claim *before* plaintiffs *discover* they have been wronged or even before any damages have been suffered (e.g., under North Carolina's statutory scheme, no tort action can be commenced more than 10 years after the defendant's last culpable act). "A statute of repose … puts an outer limit on the right to bring a civil action. That limit is measured not from the date on which the claim accrues but instead from the date of the last culpable act or omission of the defendant … The repose provision is therefore equivalent to 'a cutoff,' … in essence an 'absolute … bar' on a defendant's temporal liability …" [*CTS Corp. v. Waldburger* (2014) 573 US 1, 8, 134 S.Ct. 2175, 2182-2183]

CERCLA's preemption of certain state statutes of limitation (*¶ 5:143.2 ff.*) does *not* apply to statutes of repose that operate to bar claims CERCLA's delayed discovery rule was intended to address: "Although there is substantial overlap between the … two types of statute, each has a distinct purpose and each is targeted at a different actor. Statutes of limitations require plaintiffs to pursue 'diligent prosecution of known claims,' …. Statutes of repose effect a legislative judgment that a defendant should 'be free from liability after the legislatively determined period of time.'" [See *CTS Corp. v. Waldburger*, supra, 573 US at 8-9, 18, 134 S.Ct. at 2183, 2188—statutes of repose are not within Congress' preemptive mandate under a proper interpretation of 42 USC § 9658]

[5:144] The sections at ¶ 5:145 ff. discuss some of the common law theories that have been successfully pursued in the environmental hazards context.

2. [5:145] **Strict Liability Cause of Action Predicated on Abnormally Dangerous/Ultrahazardous Activity:** The use of a property for production, storage or disposal of hazardous substances may constitute an "abnormally dangerous" (or "ultrahazardous") activity subject to *strict liability in tort* (Rest.2d Torts § 520).

a. [5:146] **Case-by-case approach:** In deciding whether hazardous substance activity is "abnormally dangerous" for strict liability purposes, most courts align with the Restatement of Torts position in cautioning against "per se" rulings based on the nature of the toxic material (see Rest.2d Torts § 520, comm. f). Rather, the weight of authority approaches the issue on a case-by-case basis, considering the relevant factors listed in Rest.2d Torts § 520. [See *T & E Indus., Inc. v. Safety Light Corp.* (NJ Sup.Ct. 1991) 123 NJ 371, 390-394, 587 A2d 1249, 1259-1261—after considering Restatement factors, court concluded processing, handling and disposal of radium is abnormally dangerous activity subjecting processor to strict liability "under the facts of this case"; *Ashland Oil, Inc. v. Miller Oil Purchasing Co.* (5th Cir. 1982) 678 F2d 1293, 1307-1308—chemical waste disposal company and person with whom it arranged to dispose of hazardous substances pursuant to plan to introduce them into crude oil pipeline were strictly liable for engaging in ultrahazardous activity; see also *Ahrens v. Sup.Ct. (Pacific Gas & Elec. Co.)* (1988) 197 CA3d 1134, 1149, 243 CR 420, 428-429—triable issue of fact whether using, maintaining and operating electrical transformers containing PCBs at high-rise office building is "ultrahazardous"]

b. [5:147] **As between buyers and former owners?** Courts at one time took the position that a strict liability cause of action premised on an abnormally dangerous activity could be maintained only by *neighboring* property owners or other *third party* PRPs. The cause of action would not lie in favor of a buyer of property against a predecessor in title … because, under the doctrine of "caveat emptor," sellers were not liable to their buyers for the condition of the land existing at the time of transfer absent express agreement—i.e., unlike "innocent third parties," the buyer could have inspected the property or insisted on a warranty deed (Rest.2d Torts § 352, comm. (a)). [*Philadelphia Elec. Co. v. Hercules, Inc.* (3rd Cir. 1985) 762 F2d 303, 312; see also *Pinole Point Properties, Inc. v. Bethlehem Steel Corp.* (ND CA 1984) 596 F.Supp. 283, 292, fn. 5—seller not strictly liable for buyer's clean-up costs at alleged hazardous waste disposal site because remediation expense and diminished property value "not the type of harm for which strict liability generally attaches"]

This issue has yet to be squarely decided by a California court. However, out-of-state authority rejects the distinction under contemporary law: "We are not persuaded … that a landowner who engages in abnormally-dangerous activities should be liable only to neighboring property owners." [*T & E Indus., Inc. v. Safety Light Corp.* (NJ Sup.Ct. 1991) 123 NJ 371, 385, 587 A2d 1249, 1256—buyer could assert strict liability/abnormally dangerous activity cause of action against predecessor in title who contaminated property by radium dumping]

(1) [5:148] **Rationale for upholding liability:** In recognizing a buyer's right to state a strict liability cause of action against the seller who created the abnormally dangerous condition, the *T & E* court reasoned as follows:

• [5:148.1] Fundamentally, the policies underlying the abnormally-dangerous-activity doctrine do *not rest on notions of property rights*. The doctrine imposes liability on those who, for their own benefit, introduce an extraordinary risk of harm into the community, reflecting a policy that (i) the risk of loss justifiably be allocated as a cost of business to the enterpriser who engaged in the conduct and (ii) such enterprises are in a better position to absorb the extraordinary risk by passing it onto the public. [*T & E Indus., Inc. v. Safety Light Corp.* (NJ Sup.Ct. 1991) 123 NJ 371, 386-387, 587 A2d 1249, 1257]

• [5:148.2] Further, the doctrine of caveat emptor as applied between real estate buyers and sellers has largely eroded over time. Sellers who conceal or fail to disclose risky conditions on the land can be held liable to buyers who had no reason to know of the condition (Rest.2d Torts § 353).

"The same rationale is just as, if not more, persuasive when a seller who has engaged in an abnormally-dangerous activity and disposed of the byproducts of that activity onto the property markets the land. With knowledge of its activity and of its use of the land, the seller is in a better position to prevent future problems arising from its use of the property … [and] allowing a buyer to recover would place liability on the party responsible for creating the hazardous condition and marketing the contaminated land …" [*T & E Indus., Inc. v. Safety Light Corp.* (NJ Sup.Ct. 1991) 123 NJ 371, 387-389, 587 A2d 1249, 1257-1258]

[5:149] ***Reserved.***

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3. [5:150] **Nuisance Cause of Action:** A "nuisance" is "[a]nything which is injurious to health … or is indecent or offensive to the senses, or an obstruction to the free use of property, so as to interfere with the comfortable enjoyment of life or property …" [Civ.C. § 3479; see *Clary v. City of Crescent City* (2017) 11 CA5th 274, 289-290, 217 CR3d 629, 646—"indecent or offensive to the senses" is sufficiently broad to cover conditions constituting eyesores (¶ 5:154); *McCoy v. Gustafson* (2009) 180 CA4th 56, 63, 103 CR3d 37, 42—interfering with free use and enjoyment of neighbor's property by contamination equals nuisance; *City of Modesto Redevelop. Agency v. Sup.Ct. (Dow Chem. Co.)* (2004) 119 CA4th 28, 39, 13 CR3d 865, 872 & fn. 7—"there is general agreement that [nuisance] is incapable of any exact or comprehensive definition" (internal quotes omitted)]

A nuisance cause of action may lie against those who created or contributed to an environmental hazard, as well as against "innocent" successor landowners who did not create the condition but allowed it to continue. [See *Team Enterprises, LLC v. Western Investment Real Estate Trust* (9th Cir. 2011) 647 F3d 901, 912—nuisance cause of action also lies against those who affirmatively instruct polluting entities to dispose of hazardous substances in an improper/unlawful manner or who manufacture/install disposal systems] Indeed, under California law, "[e]very successive owner of property who neglects to abate a continuing nuisance upon, or in the use of, such property, created by the former owner, is liable therefor in the same manner as the one who created it." [Civ.C. § 3483; see also Rest.2d Torts § 839 (providing essentially the same)]

Moreover, a nuisance cause of action may exist in favor of plaintiff successors in interest seeking to hold former owners and occupiers of the property liable for clean-up costs. [See, e.g., *Shamsian v. Atlantic Richfield Co.* (2003) 107 CA4th 967, 979, 132 CR2d 635, 644 (leaking underground petroleum tanks); *KFC Western, Inc. v. Meghrig* (1994) 23 CA4th 1167, 1182, 28 CR2d 676, 685 (same); *Newhall Land & Farming Co. v. Sup.Ct. (Mobil Oil Corp.)* (1993) 19 CA4th 334, 341-345, 23 CR2d 377, 381-383 (soil contamination resulting from former landowners' operation of natural gas processing plant)]

a. [5:151] **Actionable nuisance on own property:** An actionable nuisance claim is not limited to conduct or activities having their origin on adjoining property. Under California law, a property owner may sue for damages caused by a nuisance created on plaintiff's own property. [*Shamsian v. Atlantic Richfield Co.* (2003) 107 CA4th 967, 979, 132 CR2d 635, 644; *Mangini v. Aerojet-General Corp. (Mangini I)* (1991) 230 CA3d 1125, 1134, 281 CR 827, 832; see also *Wilshire Westwood Associates v. Atlantic Richfield Co.* (1993) 20 CA4th 732, 745-746, 24 CR2d 562, 569-570]

b. [5:152] **Actionable despite trespass:** A nuisance cause of action may be stated even though continuing presence of the environmental contamination also constitutes a trespass. [*Mangini v. Aerojet-General Corp. (Mangini I)* (1991) 230 CA3d 1125, 1136, 281 CR 827, 833—hazardous substance invasion of plaintiff's property, otherwise amounting to trespass, "may also constitute a nuisance under the statutes"; see also Rest.2d Torts § 821D, comm. e]

c. [5:153] **Actionable despite defendant's lack of current possessory interest:** The fact a PRP no longer has (or never had) a possessory interest in the contaminated property, and thus is unable personally to abate the nuisance, is no bar to liability. Damages may be assessed against those who *create* or *assist in creating* the nuisance, as well as against those who *maintain* it. [*Mangini v. Aerojet-General Corp. (Mangini I)* (1991) 230 CA3d 1125, 1137, 281 CR 827, 834; see also *Redevelopment Agency of City of Stockton v. BNSF Ry. Co.* (9th Cir. 2011) 643 F3d 668, 673 (applying Calif. law)—"critical question" is whether defendant created or assisted in creating nuisance, *discussed further at ¶ 5:153.1*; *State of Calif. on behalf of Calif. Dept. of Toxic Substances Control v. Campbell* (9th Cir. 1998) 138 F3d 772, 782—"Unlike CERCLA, California law imposes liability on any person who maintains a nuisance—regardless of whether that person has an interest in the land"]

Nor is nuisance liability defeated by the fact plaintiff did not have an interest in the property at the time the hazardous condition was created. [*Newhall Land & Farming Co. v. Sup.Ct. (Mobil Oil Corp.)* (1993) 19 CA4th 334, 343, 23 CR2d 377, 382]

(1) [5:153.1] **Compare—no nuisance liability for manufacture or distribution of hazardous material:** The "law of nuisance is not intended to serve as a surrogate for ordinary products liability." As such, parties who manufacture and/or distribute hazardous ("defective") products ordinarily cannot be liable under a nuisance theory. [*City of Modesto Redevelop. Agency v. Sup.Ct. (Dow Chem. Co.)* (2004) 119 CA4th 28, 39, 13 CR3d 865, 872-873; see also *Redevelopment Agency of City of Stockton v. BNSF Ry. Co.* (9th Cir. 2011) 643 F3d 668, 674 & fn. 2—public nuisance is not premised on defect in product or failure to warn, but on affirmative conduct that assisted in creation of hazardous condition (railroads not liable under nuisance theory for contamination caused by nearby industrial site even though pollutants flowed through their "french drain" that was installed to remove water from roadbed; railroads' conduct was not "active, affirmative or knowing" with respect to contamination and therefore did not "create or assist in creating" nuisance)]

[5:153.2 - 5:153.4] ***Reserved.***

d. [5:153.5] **No nuisance action against "innocent" lessor landowner:** One court concludes lessor landowners cannot be held liable for a continuing nuisance damaging adjacent land when the condition is the fault of a *tenant* and the lessor landowner neither created nor contributed to the nuisance. Absent the landowner's participation in causing the environmental contamination, "[s]ome form of *negligence* by the landowner is required" (*¶ 5:170 ff.*). [See *Resolution Trust Corp. v. Rossmoor Corp.* (1995) 34 CA4th 93, 99-100, 40 CR2d 328, 331]

(1) [5:153.6] **Comment:** *Resolution Trust Corp.* involved a *lessor landowner* whose property had been leased for gas station usage but who played no role in causing an underground fuel leak that migrated onto adjoining property. In reaching its conclusion, the *Resolution Trust Corp.* court surveyed several California cases upholding nuisance liability for failure to clean up contamination that causes ongoing property damage (*see cases cited at ¶ 5:150*); but none of those cases, according to the *Resolution Trust Corp.* court, held a lessor landowner liable for a nuisance where the lessor "was not an active participant in causing the fuel leak and contamination." [*Resolution Trust Corp. v. Rossmoor Corp.* (1995) 34 CA4th 93, 99, 40 CR2d 328, 331]

(2) [5:153.7] **Successor liability under Civ.C. § 3483 distinguished:** Though the *Resolution Trust Corp.* court nowhere cited Civ.C. § 3483, it is doubtful the same rule (applicable to *lessors* sued for a *tenant's* contamination) could be extended to protect "innocent" *successor landowners* sued on a nuisance theory for contamination caused by *prior owners*. As noted at *¶ 5:150*, Civ.C. § 3483 expressly states that successor landowners who neglect to abate a continuing nuisance created by the former owner are liable "in the same manner as the one who first created it." [Civ.C. § 3483]

[5:153.8 - 5:153.14] ***Reserved.***

e. [5:153.15] **Actions taken pursuant to statute:** Actions taken under *express statutory authority* cannot be deemed a nuisance. [Civ.C. § 3482] Therefore, common law challenges to statutorily-authorized conduct (by way of a *nuisance* suit or otherwise) are precluded. [See *Williams v. Moulton Niguel Water Dist.* (2018) 22 CA5th 1198, 1205-1207, 232 CR3d 356, 361-363—water districts immune from liability for damage to pipes caused by chemical added to water per government-issued permit; *Carson Harbor Village, Ltd. v. Unocal Corp.* (9th Cir. 2001) 270 F3d 863, 888—no nuisance action against government defendants who obtained permits to operate storm water runoff system pursuant to Clean Water Act; *Farmers Ins. Exchange v. State of Calif.* (1985) 175 CA3d 494, 503, 221 CR 225, 230—State and its agents immune from liability for having released chemically destructive spray into atmosphere to eradicate medfly infestation pursuant to governmentally-declared state of emergency]

By the same token, Civ.C. § 3482 immunity is applied *narrowly* and *only* when the alleged nuisance is *exactly what was lawfully authorized*. Thus, a pesticide applicator whose postapplication drift damaged nontarget crops was *not* protected from liability under § 3482 even though its operations were conducted lawfully pursuant to government-issued permits. Indeed, "the permits issued … [were] intended to prevent, not authorize, the very nuisance alleged here." [See *Jacobs Farm/Del Cabo, Inc. v. Western Farm Service, Inc.* (2010) 190 CA4th 1502, 1530-1532, 119 CR3d 529, 549-551—pesticide applicator's conduct was confined to its own economic interests and those of its clients (i.e., there was no public emergency or facts upon which defendant could assert necessity defense; *discussed further at ¶ 5:170*); see also *Otay Land Co., LLC v. U.E. Ltd., L.P.* (2017) 15 CA5th 806, 846-847, 225 CR3d 119, 151-152—although defendant had construction and operation permits, no Civ.C. § 3482 immunity from trespass and nuisance claims that arose from clean-up of shooting range debris]

f. [5:154] **"Public" vs. "private" nuisance; impact on scope of damages recovery:** A nuisance affecting an entire community or neighborhood, "or any considerable number of persons, although the extent of the annoyance or damage inflicted upon individuals may be unequal," is a "*public nuisance*"; otherwise, it is a "*private nuisance.*" [Civ.C. §§ 3480, 3481; see also *City of Los Angeles v. San Pedro Boat Works* (9th Cir. 2011) 635 F3d 440, 452—California follows Restatement in defining *public* nuisance as substantial and unreasonable interference with public right and *private* nuisance as substantial and unreasonable interference with individual plaintiffs' enjoyment of their land; *State of Calif. on Behalf of Calif. Dept. of Toxic Substances Control v. Campbell* (9th Cir. 1998) 138 F3d 772, 782 (applying Calif. law)—*polluted groundwater* is public nuisance; *Clary v. City of Crescent City* (2017) 11 CA5th 274, 289-290, 217 CR3d 629, 646—private, weed-infested lots strewn with trash are public nuisances]

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(1) [5:155] **Personal injury and property damages recoverable for public nuisance—"special injury" limitation:** A public nuisance can support recovery for personal harm and/or property damage; however, plaintiffs suing on a public nuisance theory must demonstrate *special injury different in kind*, and not merely in degree, from that suffered by the general public. [Civ.C. § 3493—private person may maintain action for public nuisance only if "specially injurious to himself"; see *Kempton v. City of Los Angeles* (2008) 165 CA4th 1344, 1349, 81 CR3d 852, 855; *Newhall Land & Farming Co. v. Sup.Ct. (Mobil Oil Corp.)* (1993) 19 CA4th 334, 341-342, 23 CR2d 377, 380-381]

In the environmental hazards context, a property owner's governmentally-mandated testing or remediation expenses are sufficient to allege "special injury." [*Mangini v. Aerojet-General Corp. (Mangini I)* (1991) 230 CA3d 1125, 1138, 281 CR 827, 834]

(2) [5:156] **Compare—private nuisance:** By contrast, a *private nuisance* supports recovery only for damage to *property* or a right incidental thereto (not for personal injury). But plaintiffs suing on this theory need only allege and prove the environmental hazard *interfered with a property interest;* they need *not* prove they suffered damage different in kind from that suffered by the general public. [*Newhall Land & Farming Co. v. Sup.Ct. (Mobil Oil Corp.)* (1993) 19 CA4th 334, 342, 23 CR2d 377, 381; see also *Vanderpol v. Starr* (2011) 194 CA4th 385, 396, 123 CR3d 506, 514—plaintiffs must show their property was "injuriously affected" or their "personal enjoyment lessened" in order to prevail on private nuisance claim]

[5:156.1 - 5:156.4] ***Reserved.***

g. [5:156.5] **"Permanent" vs. "continuing" nuisance; impact on scope of damages recovery:** A nuisance may be either "permanent" or "continuing" in nature. The distinction affects both the applicable statute of limitations (¶ *5:157 ff.*) and the amount of recoverable damages (¶ 5:156.6 ff.). [See *McCoy v. Gustafson* (2009) 180 CA4th 56, 63, 103 CR3d 37, 42-43]

(1) [5:156.6] **Permanent nuisance—past and prospective damages recoverable:** Where the hazardous condition (the nuisance) *cannot* be reasonably discontinued or abated, it is "permanent" in character. [*Mangini v. Aerojet-General Corp. (Mangini II)* (1996) 12 C4th 1087, 1097, 51 CR2d 272, 278; *Shamsian v. Atlantic Richfield Co.* (2003) 107 CA4th 967, 979, 132 CR2d 635, 644 (distinguishing "permanent" from "continuing nuisance"); see also *McCoy v. Gustafson* (2009) 180 CA4th 56, 84, 103 CR3d 37, 58—"crucial test" of permanency is whether nuisance can be abated]

Plaintiffs proceeding on a permanent nuisance theory are entitled to recover *all* damages—past, present *and future*—legally caused by the condition. Indeed, they *must* seek such damages in a single action because successive suits predicated on the same permanent nuisance are not allowed. [*Spaulding v. Cameron* (1952) 38 C2d 265, 267-268, 239 P2d 625, 627-628; *Gehr v. Baker Hughes Oil Field Operations, Inc.* (2008) 165 CA4th 660, 667, 81 CR3d 219, 224; see also *Shamsian v. Atlantic Richfield Co.*, supra, 107 CA4th at 979, 132 CR2d at 647—damages for permanent nuisance are "assessed once and for all"]

(2) [5:156.7] **Continuing nuisance—no prospective damages:** On the other hand, if the environmental contamination (the nuisance) can be *remedied at a reasonable cost by reasonable means*, it is "continuing" in nature. [*Mangini v. Aerojet-General Corp. (Mangini II)* (1996) 12 C4th 1087, 1103, 51 CR2d 272, 281-282; *McCoy v. Gustafson* (2009) 180 CA4th 56, 63, 103 CR3d 37, 43; see also *Shamsian v. Atlantic Richfield Co.* (2003) 107 CA4th 967, 979, 132 CR2d 635, 644—nuisance involving use that may be discontinued at any time is continuing]

Recovery on a continuing nuisance theory is limited to damages already accrued; plaintiff's prospective (future) damages are *not* awardable. [*Mangini v. Aerojet-General Corp. (Mangini II)*, supra, 12 C4th at 1103, 51 CR2d at 282; see also *McCoy v. Gustafson*, supra, 180 CA4th at 84, 103 CR3d at 58—while injured party is entitled to bring series of successive actions, each seeking damages for new injuries occurring within 3 years of filing said actions (¶ *5:158*), recoverable damages do not include decrease in market value; and *Beck Develop. Co., Inc. v. Southern Pac. Transp. Co.* (1996) 44 CA4th 1160, 1216-1222, 52 CR2d 518, 556-560 (distinguishing "continuing" from "permanent" nuisance for damages and statute of limitations purposes)]

(a) [5:156.8] **No diminution in value damages:** For that reason, diminution in value damages (which, by their nature, compensate for *future* loss) are *not* recoverable in a continuing nuisance action. [*Santa Fe Partnership v. ARCO Products Co.* (1996) 46 CA4th 967, 977-978, 54 CR2d 214, 220—no damages recovery for diminution in market value caused by stigma of contaminated land where nuisance abatable and thus temporary in nature rather than permanent or indefinite; see also *Gehr v. Baker Hughes Oil Field Operations, Inc.* (2008) 165 CA4th 660, 668-670, 81 CR3d 219, 225-227—

plaintiff's claim for interest rate differential damages was actually a diminution in value damages claim and therefore not recoverable under loss of use theory (*¶ 5:156.9*)]

Another reason for disallowing these types of damages in a continuing nuisance action is to prevent plaintiffs from obtaining *double* recoveries—i.e., recovering for the depreciation in value and also having the cause of that depreciation removed. Moreover, where defendants are willing and able to abate nuisances, it would be unfair to award damages on the theory the nuisances will continue. [*Gehr v. Baker Hughes Oil Field Operations, Inc.,* supra, 165 CA4th at 668, 81 CR3d at 225]

(b) [5:156.9] **Loss of use damages distinguished:** Plaintiffs prevailing on a continuing nuisance theory are entitled to recover damages for *loss of use* of their property. [*Mangini v. Aerojet-General Corp. (Mangini II)* (1996) 12 C4th 1087, 1103, 51 CR2d 272, 282; *Shamsian v. Atlantic Richfield Co.* (2003) 107 CA4th 967, 982, 132 CR2d 635, 647; and see *Gehr v. Baker Hughes Oil Field Operations, Inc.*, supra—loss of use damages entails physical injury to property resulting in actual physical loss of use]

h. [5:157] **Statute of limitations:** An action claiming property damage on a nuisance theory is subject to the CCP § 338(b) three-year statute of limitations. Accrual of the cause of action, however, and hence the date on which the statute commences to run, depends on whether plaintiff alleges and proves a "permanent" or "continuing" nuisance. [*Mangini v. Aerojet-General Corp. (Mangini II)* (1996) 12 C4th 1087, 1096, 51 CR2d 272, 277; see also *McCoy v. Gustafson* (2009) 180 CA4th 56, 63, 103 CR3d 37, 42-43; *Shamsian v. Atlantic Richfield Co.* (2003) 107 CA4th 967, 979, 132 CR2d 635, 644]

(1) [5:157.1] **Permanent nuisance—statute commences on discovery:** With respect to a permanent nuisance (condition cannot reasonably be abated, *¶ 5:156.6*), the statute of limitations commences to run on the date plaintiff discovered, or should have discovered, the contamination. [*Mangini v. Aerojet-General Corp. (Mangini II)* (1996) 12 C4th 1087, 1096, 51 CR2d 272, 277—3-year statute barred plaintiff's damages claims under nuisance and trespass theories for contamination of land through toxic waste (dumping); see also *Gehr v. Baker Hughes Oil Field Operations, Inc.* (2008) 165 CA4th 660, 667, 81 CR3d 219, 224—if nuisance inflicted permanent injury on land, plaintiff must bring single action within 3 years of its creation; *Beck Develop. Co., Inc. v. Southern Pac. Transp. Co.* (1996) 44 CA4th 1160, 1216-1223, 52 CR2d 518, 556-560—contamination constituted permanent nuisance as to which 3-year statute had long since run]

A plaintiff is charged with "presumptive knowledge" of contamination so as to commence the running of the statute of limitations once the plaintiff "has notice or information of circumstances to put a reasonable person on inquiry, or has the opportunity to obtain knowledge from sources open to [the plaintiff's] investigation." [*Shamsian v. Atlantic Richfield Co.* (2003) 107 CA4th 967, 980, 132 CR2d 635, 645 (internal quotes omitted)]

(2) [5:158] **Continuing nuisance—successive actions allowed:** By contrast, if plaintiff can plead a *continuing* nuisance (or trespass) theory (*¶ 5:156.7*), every continuation of the nuisance (or trespass) gives rise to a *separate* damages claim. An action alleging a continuing nuisance may be maintained at any time before the nuisance is abated or within three years thereafter. [*Mangini v. Aerojet-General Corp. (Mangini II)* (1996) 12 C4th 1087, 1093, 51 CR2d 272, 275; *Baker v. Burbank-Glendale-Pasadena Airport Authority* (1985) 39 C3d 862, 869, 218 CR 293, 297; and see *Gehr v. Baker Hughes Oil Field Operations, Inc.* (2008) 165 CA4th 660, 667, 81 CR3d 219, 224—recovery limited to actual injury suffered prior to commencement of each action]

(a) [5:158.1] **Plaintiff's burden to show condition reasonably abatable:** Plaintiffs proceeding on a continuing nuisance theory bear the burden of establishing by substantial evidence that the nuisance is "abatable"—i.e., that the environmental contamination can be *remedied at a reasonable cost by reasonable means*. [*Mangini v. Aerojet-General Corp. (Mangini II)* (1996) 12 C4th 1087, 1103-1104, 51 CR2d 272, 282—P's case succumbed to "permanent" nuisance statute of limitations because no substantial evidence that toxic dumping contamination was subject to clean-up and that remediation cost would be "reasonable"; *McCoy v. Gustafson* (2009) 180 CA4th 56, 90, 103 CR3d 37, 63-64—P's case succumbed to "permanent" nuisance statute of limitations where jury found it was *unknown* whether property contamination could be abated]

(b) [5:159] **Plaintiff's election in doubtful cases:** Several appellate decisions conclude that in *doubtful cases*, plaintiffs should have the right to elect whether to treat the nuisance as permanent or continuing and that courts are inclined to favor plaintiff's right to pursue successive actions. [See *Mangini v. Aerojet-General Corp. (Mangini I)* (1991) 230 CA3d 1125, 1144, 281 CR 827, 839; *Wilshire Westwood Associates v. Atlantic Richfield Co.* (1993) 20 CA4th 732, 744, 24

CR2d 562, 569; *Capogeannis v. Sup.Ct. (Spence)* (1993) 12 CA4th 668, 679, 682, 15 CR2d 796, 802, 804; *Beck Develop. Co., Inc. v. Southern Pac. Transp. Co.* (1996) 44 CA4th 1160, 1217, 52 CR2d 518, 556]

1) [5:159.1] **Limitation—plaintiff's evidentiary burden:** However, any election by a plaintiff to proceed on a continuing nuisance theory cannot withstand a statute of limitations challenge where there is no *substantial evidence* that the contamination at issue is reasonably abatable. [*Mangini v. Aerojet-General Corp. (Mangini II)* (1996) 12 C4th 1087, 1104, 51 CR2d 272, 282]

Plaintiff cannot simply allege that a nuisance is continuing in order to avoid the bar of the statute of limitations. "While a plaintiff's election of remedies is entitled to deference in doubtful cases, that choice must nevertheless be supported by evidence that makes it reasonable under the circumstances … It is only where the evidence would reasonably support either classification that the plaintiff may choose which course to pursue." [*Beck Develop. Co., Inc. v. Southern Pac. Transp. Co.* (1996) 44 CA4th 1160, 1217, 52 CR2d 518, 556-557]

(3) [5:160] **Application of latent defect 10-year statute of limitations:** Where the toxic contamination results from a *latent construction defect*, CCP § 337.15 might defeat any otherwise viable cause of action pled on a continuing nuisance (or continuing trespass) theory. Suits subject to CCP § 337.15 are time-barred unless commenced no later than *10 years* after "substantial completion" of the construction project. [CCP § 337.15]

One court of appeal so held in a landowner's action seeking indemnification for abating diesel fuel pollution caused by the defective installation of underground storage tanks. Plaintiff's suit, brought some 19 years after installation of the tanks, was maintained on a continuing nuisance (and continuing trespass) theory. But for CCP § 337.15, the action would have been timely because commenced within three years after abatement of the contamination. However, the appellate court concluded the 10-year latent defect statute controlled and dismissed the suit as untimely. [*Chevron U.S.A. Inc. v. Sup.Ct. (DiSalvo Trucking Co.)* (1994) 44 CA4th 1009, 1017-1020, 54 CR2d 324, 328-330; compare *Estuary Owners Ass'n v. Shell Oil Co.* (2017) 13 CA5th 899, 916-919, 221 CR3d 190, 203-206—§ 337.15 did not apply to nuisance claim alleging contamination from negligent *operation* of facility, as opposed to defect in defendant's *construction* of facility]

(a) [5:160.1] **CERCLA "discovery rule" preemption:** Cases involving the "release" of a "hazardous substance" from the "facility" into the "environment" within the meaning of CERCLA (*¶ 5:5 ff.*) are subject to CERCLA's "discovery rule" preemption with regard to any otherwise applicable statute of limitations (*¶ 5:143.2*). This will "trump" the CCP § 337.15 10-year statute in such cases because it runs without regard to when or whether plaintiff discovered (or should have discovered) the contamination. [*Angeles Chem. Co., Inc. v. Spencer & Jones* (1996) 44 CA4th 112, 123, 51 CR2d 594, 599]

(This issue most likely did not arise in the *Chevron U.S.A.* case, supra, because the contamination involved leaking underground fuel, apparently within the petroleum exclusion and thus not subject to CERCLA (*¶ 5:90*).)

[5:161 - 5:164] ***Reserved.***

4. [5:165] **Continuing Trespass Cause of Action:** A trespass is "an invasion" of someone else's interest in the exclusive possession of land. The "essence" of the cause of action for trespass is the *unauthorized* entry onto the land of another. Under California law, trespass may include invasion by pollutants. [See *Team Enterprises, LLC v. Western Investment Real Estate Trust* (9th Cir. 2011) 647 F3d 901, 912]

Moreover, the continued presence of contaminants may support a property owner's cause of action against former owners and occupiers on a *continuing trespass theory.* [See *Mangini v. Aerojet-General Corp. (Mangini I)* (1991) 230 CA3d 1125, 1148-1149, 281 CR 827, 842 (owner vs. former tenant); *KFC Western, Inc. v. Meghrig* (1994) 23 CA4th 1167, 1181-1182, 28 CR2d 676, 685-686 (owner vs. immediate predecessor in title); *Newhall Land & Farming Co. v. Sup.Ct. (Mobil Oil Corp.)* (1993) 19 CA4th 334, 345-347, 23 CR2d 377, 383-384 (owner vs. remote predecessor in title)]

a. [5:166] **Actionable despite lawful possession at time of contamination:** Again, a trespass is a tort against *another's* right of exclusive possession. Thus, a continuing contamination traceable to a former owner or occupier (who had exclusive possession at the time) will support a later *continuing trespass* action by a subsequent possessor of the land. [*Mangini v. Aerojet-General Corp. (Mangini I)* (1991) 230 CA3d 1125, 1141, 281 CR 827, 837; *Newhall Land* & Farming Co. *v. Sup.Ct. (Mobil Oil Corp.)* (1993) 19 CA4th 334, 345-347, 23 CR2d 377, 383-384; see also *9201 San Leandro, LLC v. Precision*

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Castparts Corp. (ND CA 2008) 548 F.Supp.2d 732, 736 (acknowledging split of authority whether former property owners can be liable for trespassing their own property, but concluding more recent authority supports imposing liability)]

b. [5:167] **"Consent" no defense as against subsequent possessor:** Hazardous substance contamination of the land amounts to a continuing trespass as to a successor in interest even though the contamination occurred with the prior owner's/possessor's consent (e.g., former owner polluting own property or tenant engaging in activity permitted by its lease). Continuing trespass may be committed by the "continued presence on the land of a … thing … placed on the land … with the consent of the person then in possession of the land, if the actor fails to remove it after the consent [is] terminated." [Rest.2d Torts § 160; *Mangini v. Aerojet-General Corp. (Mangini I)* (1991) 230 CA3d 1125, 1141-1142, 281 CR 827, 837; see also *Newhall Land & Farming Co. v. Sup.Ct. (Mobil Oil Corp.)* (1993) 19 CA4th 334, 347, 23 CR2d 377, 384; *KFC Western, Inc. v. Meghrig* (1994) 23 CA4th 1167, 1182, 28 CR2d 676, 686—"concept of consent is unavailing to a former owner whose activities contaminated the property"]

[5:167.1 - 5:167.4] ***Reserved.***

c. [5:167.5] **Compare—not actionable against "innocent" lessor landowner:** Just as a continuing nuisance cause of action will not lie against an "innocent" lessor landowner for contamination caused by a tenant (¶ *5:153.5*), lessor landowners cannot be held liable on a continuing trespass theory unless they actively caused or contributed to the contamination. "[T]respass requires an act which is intentional, reckless, negligent or the result of ultrahazardous activity." [*Resolution Trust Corp. v. Rossmoor Corp.* (1995) 34 CA4th 93, 100, 40 CR2d 328, 331]

d. [5:168] **Statute of limitations—general considerations:** Trespass actions are subject to a three-year statute of limitations (CCP § 338(b)). And because the gravamen of a trespass claim is that real property (not any particular owner) has been injured, the limitations period is not revived each time the property changes owners or occupants. [*McCoy v. Gustafson* (2009) 180 CA4th 56, 105, 110, 103 CR3d 37, 75, 79—owners of contaminated property must bring claims to court within statutory period or actions will be barred for them and all subsequent owners; see also *Chubb Custom Ins. Co. v. Space Systems/Loral, Inc.* (9th Cir. 2013) 710 F3d 946, 972 (applying Calif. Law)—limitations period begins to run when injury to property occurs]

(1) [5:168.1] **Application to subrogation suits:** The same three-year limitations period applies when an insurance company files subrogated claims against third parties believed to be responsible for the wrongful conduct. Because the insurance company has not suffered an injury itself, but instead is asserting the claims of its insured in subrogation, the limitations period begins to run when the insured knew, or should have known, of the wrongful conduct. [See *Chubb Custom Ins. Co. v. Space Systems/Loral, Inc.* (9th Cir. 2013) 710 F3d 946, 972 (applying Calif. Law)—limitations period began to run when insured new, or should have known, of release of hazardous substances on its properties]

(2) [5:168.2] **Compare—pleading "continuing trespass" theory:** Plaintiffs who successfully plead a "continuing trespass" theory can circumvent the statute of limitations bar to relief. [*McCoy v. Gustafson* (2009) 180 CA4th 56, 63, 103 CR3d 37, 42-43—new action can be filed every three years for damages caused by continuing trespass; *Baugh v. Garl* (2006) 137 CA4th 737, 747, 40 CR3d 539, 546—where trespass is continuing, statute does not bar action until three years after last act of trespass]

Indeed, the continued failure to remove a thing tortiously placed on land "constitutes a continuing trespass for the entire time during which the thing is on the land and … confers … an option to maintain a succession of actions based on a theory of continuing trespass or to treat [continued presence] as an aggravation of the original trespass." [Rest.2d Torts § 161, comm. b; see also *Mangini v. Aerojet-General Corp. (Mangini I)* (1991) 230 CA3d 1125, 1148-1149, 281 CR 827, 842; *Capogeannis v. Sup.Ct. (Spence)* (1993) 12 CA4th 668, 681, 15 CR2d 796, 804; *Starrh & Starrh Cotton Growers v. Aera Energy LLC* (2007) 153 CA4th 583, 597-598, 63 CR3d 165, 175—by "choosing" to continue tortious ponding practices, defendant eliminated its statute of limitations claim (*discussed further at ¶ 5:168.4*)]

(a) [5:168.3] **Abatability essential to "continuing trespass" cause of action:** Notwithstanding the foregoing, plaintiffs seeking to prevail on a continuing trespass theory must present evidence confirming the trespass can be abated. In this regard, courts apply one or more of the following tests:

— Whether the offensive activity is currently continuing;

— Whether the condition's impact will vary (i.e., worsen) over time; *and/or*

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— Whether the condition can be remedied in a reasonable manner and for a reasonable cost compared with the benefits and detriments to be gained by abatement. [*Starrh & Starrh Cotton Growers v. Aera Energy LLC* (2007) 153 CA4th 583, 593-595, 63 CR3d 165, 172-173; see also *McCoy v. Gustafson* (2009) 180 CA4th 56, 84, 90, 103 CR3d 37, 58, 63—"crucial test" is whether trespass can be abated at reasonable cost]

1) Application

• [5:168.4] A "classic continuing trespass" existed where waste water produced from oil production activities on one land parcel began migrating into the aquifers underlying an adjacent property more than three years before its owner filed suit. The offensive activity was continuing in nature and the impact of the subsurface migration would worsen as time passed. [*Starrh & Starrh Cotton Growers v. Aera Energy LLC* (2007) 153 CA4th 583, 588, 595, 63 CR3d 165, 167-168, 173]

• [5:168.5] *Compare:* No "continuing trespass" was established where a prior owner dumped toxic materials on land more than three years before its current owner filed suit. Plaintiff failed to offer any evidence on the reasonableness of possible abatement—i.e., the only applicable test had not been proven (the harmful activity had stopped long ago and there was no evidence the impact of the toxic materials would vary over time). [See *Mangini v. Aerojet-General Corp. (Mangini II)* (1996) 12 C4th 1087, 1090, 51 CR2d 272, 273 (limiting its decision to cases where property owners seek to maintain actions after limitations period expires)]

[5:168.6 - 5:168.9] ***Reserved.***

(b) [5:168.10] **Subject to latent defect 10-year statute of limitations; CERCLA preemption limitation:** The CCP § 338(b) three-year limitations period for continuing trespass (like a continuing nuisance cause of action) may be "trumped" by the CCP § 337.15 latent construction defect 10-year statute where the toxic contamination arises from faulty construction completed more than 10 years before suit was filed. [*Chevron U.S.A. Inc. v. Sup.Ct. (DiSalvo Trucking Co.)* (1994) 44 CA4th 1009, 54 CR2d 324; *see* ¶ *5:160*]

But because it runs without regard to plaintiff's discovery of the contamination, the CCP § 337.15 statute is *preempted* by CERCLA in any case involving the "release" of a "hazardous substance" from a "facility" into the "environment" within the meaning of CERCLA (¶ *5:5 ff.*). *See* ¶ *5:143.2*.

e. [5:169] **Measure of damages; general considerations:** In any trespass case, the proper measure of damages is one that will fully compensate plaintiff for damages that have occurred or can with certainty be expected to occur as a result of the trespass. [*Starrh & Starrh Cotton Growers v. Aera Energy LLC* (2007) 153 CA4th 583, 599, 63 CR3d 165, 176]

If the trespass definitely will continue into the future because it cannot be abated, damages can be fully ascertained and full recovery is available for all harm suffered (i.e., a permanent measure of damages may be awarded). [*Starrh & Starrh Cotton Growers v. Aera Energy LLC*, supra, 153 CA4th at 598, 63 CR3d at 175]

On the other hand, if it cannot be determined whether the harm will continue because it is possible to terminate (abate) the trespass, the law will not presume the trespass *actually* will be discontinued. Here, there is no way to ascertain the full extent of future damages—i.e., a permanent measure of damages (which includes future harm) is not an appropriate choice. [*Starrh & Starrh Cotton Growers v. Aera Energy LLC*, supra, 153 CA4th at 598-599, 63 CR3d at 175-176]

(1) [5:169.1] **Statutory measure:** In California, when the trespass involves a wrongful occupation of land, the measure of damages is the value of the use of the property (for up to five years preceding commencement of the action), plus the reasonable cost of repairing or restoring the property to its original condition and the costs, if any, of recovering possession. [Civ.C. § 3334(a)]

Generally, the "value of the use" is the greater of the reasonable rental value of the property or the benefit obtained by reason of the wrongful occupation. [Civ.C. § 3334(b); see also *Watson Land Co. v. Shell Oil Co.* (2005) 130 CA4th 69, 78-79, 29 CR3d 343, 350-351—"benefit" damages not recoverable under Civ.C. § 3334 unless trespass provided defendant with financial or business advantage; *Starrh & Starrh Cotton Growers v. Aera Energy LLC* (2007) 153 CA4th 583, 604, 63 CR3d 165, 180-181—"benefit" damages include profits directly linked to defendant's wrongful trespass ("direct link" requires some showing that portion of profit is tied to decision leading to trespass)]

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(a) [5:169.2] **Restoration costs must be reasonable; "diminution in value" alternative:** In order to restore property to its original condition (i.e., abate a trespass), the contamination must be cleaned up. The clean-up costs are recoverable as statutory damages only if they are *reasonable*. [See *Starrh & Starrh Cotton Growers v. Aera Energy LLC* (2007) 153 CA4th 583, 599-601, 63 CR3d 165, 176-178 (noting case law also requires that costs (damages) bear reasonable relationship to harm caused by trespass)]

When restoration costs are not reasonable, diminution in value of the subject property may be an appropriate measure of damages. [*Starrh & Starrh Cotton Growers v. Aera Energy LLC*, supra, 153 CA4th at 602, 63 CR3d at 178]

1) [5:169.3] **Compare—CERCLA PRPs may require EPA approval:** If a party is a CERCLA PRP (¶ 5:60) and is seeking restoration damages for property that is subject to an ongoing CERCLA cleanup (i.e., a remedial investigation and feasibility study has been initiated), the party cannot seek restoration damages without EPA approval of their restoration plan. This is so even if the party is not asserting any claim under CERCLA and is only seeking relief under state common law. [42 USC § 9622(e)(6); *Atlantic Richfield Co. v. Christian* (2020) 590 US _, _, 140 S.Ct. 1335, 1352, 1357 (¶ 5:12, 5:123.1)]

[5:169.4 - 5:169.9] ***Reserved.***

f. [5:169.10] **Attorney fees; agricultural cases:** The prevailing plaintiff in an action for trespass to land "under cultivation," or intended or used for "raising livestock," is entitled by statute to a reasonable attorney fee award. [CCP § 1021.9; see also *Starrh & Starrh Cotton Growers v. Aera Energy LLC* (2007) 153 CA4th 583, 606-607, 63 CR3d 165, 182-183—§ 1021.9 attorney fees recoverable for both surface and subsurface trespasses; compare *Belle Terre Ranch, Inc. v. Wilson* (2015) 232 CA4th 1468, 1475-1477, 182 CR3d 393, 398-400—§ 1021.9 attorney fees not recoverable where nominal ("symbolic") damages were awarded vineyard based on technical invasion of its property with no proof of injury (trespass must result in some tangible harm to real or personal property)]

5. Negligence Cause of Action

a. [5:170] **"Negligence per se" based on statutory violation:** Violation of a statute may raise a presumption that the violator was negligent. The presumption arises if (1) defendant violated a statute; (2) the violation proximately caused plaintiff's injury; (3) the injury resulted from the kind of occurrence the statute was designed to prevent; and (4) plaintiff was among the class of persons the statute was intended to protect. [See Ev.C. § 669; *Jacobs Farm/Del Cabo, Inc. v. Western Farm Service, Inc.* (2010) 190 CA4th 1502, 1526-1527, 119 CR3d 529, 546-547—farmer stated negligence per se claim against pesticide applicator for violating statutory duty to first evaluate likelihood of damage and then defer or halt pesticide application if there was "reasonable possibility" of damage to nontarget crops]

Moreover, where environmental contamination of property violates a statute, the current owner (if among the class of persons the statute was intended to protect) may be able to prevail against predecessors in the chain of title/possession on a theory of *negligence per se.* [See *Newhall Land & Farming Co. v. Sup.Ct. (Mobil Oil Corp.)* (1993) 19 CA4th 334, 347-348, 23 CR2d 377, 384-385—remote successor in title stated negligence per se cause of action based on violation of Water C. § 13000 et seq.; *City of Modesto Redevelop. Agency v. Sup.Ct. (Dow Chem. Co.)* (2004) 119 CA4th 28, 44-45, 13 CR3d 865, 877—city stated negligence per se claim for clean-up costs against dry cleaning solvent and equipment manufacturers and distributors responsible for dry cleaners' discharge of chlorinated solvents into public sewer systems in violation of Water C. § 13350(b)(1)]

Cross-refer: For a detailed discussion of "negligence per se" liability, see Haning, Flahavan, Cheng & Wright, *Cal. Prac. Guide: Personal Injury* (TRG), Ch. 2 Part II.

[5:170.1 - 5:170.4] ***Reserved.***

b. [5:170.5] **Negligence based on breach of duty to disclose:** A former owner may also be liable to successors in the chain of title on a theory of *breach of duty to disclose environmental defects* when it was foreseeable that nondisclosure would affect subsequent buyers. [*Newhall Land & Farming Co. v. Sup.Ct. (Mobil Oil Corp.)* (1993) 19 CA4th 334, 349-351, 23 CR2d 377, 386-387]

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Privity of title is not a prerequisite to the culpable former owner's nondisclosure liability. So long as it was foreseeable that subsequent sales would occur and, consequently, that the nondisclosure would be passed on, the former owner who breached the duty of disclosure remains liable even to *remote subsequent purchasers*. Liability for damages resulting from negligence based on breach of the duty to disclose does not "vanish simply because of the fortuitous event of an intervening resale." [*Newhall Land & Farming Co. v. Sup.Ct. (Mobil Oil Corp.)*, supra, 19 CA4th at 350-351, 23 CR2d at 387]

c. [5:171] **Negligent misrepresentation:** A cause of action may lie against a former property owner for negligent misrepresentations made on its behalf by an environmental services company retained to prepare a report regarding efforts to remediate contamination on the property. [*Shamsian v. Atlantic Richfield Co.* (2003) 107 CA4th 967, 983-984, 132 CR2d 635, 647-648]

Recovery for negligent misrepresentation requires plaintiffs to prove (1) misrepresentation of a past or existing material fact, without reasonable ground for believing it to be true, and with intent to induce reliance on the fact misrepresented; (2) ignorance of the truth and justifiable reliance on the misrepresentation by the party to whom it was directed; and (3) resulting damage. [See *Shamsian v. Atlantic Richfield Co.*, supra, 107 CA4th at 983-984, 132 CR2d at 647-648—plaintiffs' failure to allege that environmental report falsely represented removal of contaminants, test results or any other fact was fatal to negligent misrepresentation cause of action]

(1) [5:171a] **Possible fraud liability for "misleading" representations:** A negligent misrepresentation cause of action cannot be predicated on statements that are simply *misleading*. But a fraud cause of action is broader and may lie in circumstances where a negligent misrepresentation cause of action will not: A person can be liable for fraud for the "suppression of a fact, by one who is bound to disclose it, or who gives information of other facts which are likely to mislead for want of communication of that fact" (Civ.C. § 1710). [See *Shamsian v. Atlantic Richfield Co.* (2003) 107 CA4th 967, 983-984, 132 CR2d 635, 648—court noted that if plaintiff had alleged environmental report was *misleading*, a fraud cause of action could have been asserted against property owner]

d. Negligence liability to adjacent property owners

(1) [5:171.1] **General negligence principles apply:** Whether property owners who are damaged from contamination originating on adjacent land can state a negligence cause of action against the neighboring landowner turns on general common law negligence principles: i.e., plaintiff must show the defendant landowner *owed the plaintiff a duty* of due care, that defendant *breached that duty*, that plaintiff *suffered injury*, and that the breach *proximately caused* plaintiff's injury. [See *Resolution Trust Corp. v. Rossmoor Corp.* (1995) 34 CA4th 93, 101, 40 CR2d 328, 332—leakage from underground diesel storage tank migrated onto adjoining property]

(2) [5:171.2] **Landlord's negligence liability for tenant's contamination:** As discussed, a *lessor landowner* cannot be held liable on a nuisance theory or a trespass theory for a *tenant's* hazardous waste contamination where the lessor did not participate in causing the contamination (¶ *5:153.5, 5:167.5*). In such cases, the lessor's liability to adjacent property owners can only rest on a *negligence* theory. [*Resolution Trust Corp. v. Rossmoor Corp.* (1995) 34 CA4th 93, 100-101, 40 CR2d 328, 332]

However, plaintiffs may have a difficult time proving the neighboring lessor landowner owed them a duty of care:

(a) [5:171.3] **Control, knowledge and ability to remediate required:** A lessor owes no duty to third persons concerning dangerous conditions on the premises that came into existence after the tenant took possession *unless* the lessor *controlled the premises* to such a degree that the lessor *knew* of the specific condition and was *able to do something to obviate it*. [*Uccello v. Laudenslayer* (1975) 44 CA3d 504, 512, 118 CR 741, 746]

Among the relevant factors are the likelihood of injury, the probable seriousness of such injury, the burden of reducing or avoiding the risk, and the lessor's degree of control over the risk-creating condition. [See *Mora v. Baker Commodities, Inc.* (1989) 210 CA3d 771, 779, 258 CR 669, 674]

1) [5:171.4] **Impact of duty to inspect at inception of lease:** Lessors have a duty to inspect their premises at the inception of a lease to ensure the property is reasonably safe from dangerous conditions. [*Mora v. Baker Commodities, Inc.* (1989) 210 CA3d 771, 781, 258 CR 669, 675]

But this duty charges the landlord only with knowledge of such matters as would have been disclosed by a *reasonable* inspection. What is reasonable is determined on a case-by-case basis in light of the burden of reducing or avoiding the risk and the likelihood of injury. The lessor need not take extraordinary measures or make unreasonable

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expenditures of time and money in trying to discover hazards where the potential for serious danger is not foreseeable. [*Mora v. Baker Commodities, Inc.*, supra, 210 CA3d at 782, 258 CR at 675-676; see *Resolution Trust Corp. v. Rossmoor Corp.* (1995) 34 CA4th 93, 103, 40 CR2d 328, 333]

2) [5:171.5] **Impact of right of reentry:** A lessor without direct control over the occupation or operation of the rented premises may nonetheless retain some control over the property based on a *right of reentry*. [See, e.g., *Sachs v. Exxon Co., U.S.A.* (1992) 9 CA4th 1491, 1496-1498, 12 CR2d 237, 241-242—gas station lease requiring tenant to comply with all laws applicable to premises impliedly gives landlord reasonable right of reentry to inspect for fuel contamination]

However, a lessor's right of reentry does not necessarily establish a duty to adjacent landowners. The lessor must still be aware of the *specific dangerous condition* and be able to do something about it. [*Resolution Trust Corp. v. Rossmoor Corp.* (1995) 34 CA4th 93, 102, 40 CR2d 328, 333]

(b) [5:171.6] **Application—gasoline leakage from leased premises:** Lessors who rented out property for use as a gas station could not be held liable on a negligence theory to an adjacent property owner who suffered damage from diesel fuel that migrated from Tenant's underground storage tank. [*Resolution Trust Corp. v. Rossmoor Corp.* (1995) 34 CA4th 93, 40 CR2d 328]

• [5:171.7] Lessors had no duty to enter and inspect at the outset of the lease simply because a gas station was to be operated and some potential for leakage is inherent in the business. Plaintiff made no showing the gas station or storage tank was in place to be inspected at the inception of the lease; and the only thing Lessors could have done to prevent the later leakage was to refuse to rent to a gas station. "That course of action would be unreasonable for the landlord and for a society which depends on gas stations to function." [*Resolution Trust Corp. v. Rossmoor Corp.* (1995) 34 CA4th 93, 103, 40 CR2d 328, 333]

• [5:171.8] Nor, under the circumstances, could Lessors be found negligent for failure to terminate Tenant's lease or perform rigorous testing upon learning of the gasoline leaks: Earlier leaks had been promptly remedied and Lessors had no reason to know the leakage was likely to contaminate adjoining property. Moreover, "as a matter of public policy, we will not place a duty on the landlord to do extensive and expensive soil testing to determine whether a spill has migrated to adjoining property. A landlord's duty to act arises only if the landlord knows or has reason to know the leakage has not been stopped or damage to adjoining property is imminent and avoidable. That is particularly true where, as here, the landlord has limited control over the property." [*Resolution Trust Corp. v. Rossmoor Corp.* (1995) 34 CA4th 93, 103-104, 40 CR2d 328, 333-334]

At most, upon learning of a leak, Lessors had a duty to ascertain whether the condition had been corrected and whether damage to third parties was imminent and preventable. In this case, there was no evidence showing a breach of that duty. [*Resolution Trust Corp. v. Rossmoor Corp.*, supra, 34 CA4th at 104, 40 CR2d at 334]

• [5:171.9] Finally, even assuming Lessors owed a duty to plaintiff after the leaks occurred and breached that duty, plaintiff failed to show the breach *caused* its injury. Plaintiff made no showing the diesel migration to its property occurred *after* Lessors knew of the leakage, which was a *prerequisite* for them to *prevent* it. [*Resolution Trust Corp. v. Rossmoor Corp.* (1995) 34 CA4th 93, 104-105, 40 CR2d 328, 334]

Cross-refer: For a more detailed treatment of landlord negligence liability for hazards created by tenants, see Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 6.

[5:172 - 5:179] ***Reserved.***

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Chapter 5. Environmental Hazards Liability

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[5:180] Because the consequences of PRP liability under federal/state statutory and common law can be quite severe, real property buyers and sellers must focus careful attention on the environmental condition of the property in the context of their purchase and sale transaction.

1. [5:181] **Buyers' Concerns:** From an environmental hazards perspective, a prospective buyer's goal in a purchase and sale transaction is to *avoid becoming a PRP* with respect to environmentally-troubled property. Once in the chain of title, a buyer will automatically become a PRP, regardless of whether the buyer was in any way responsible for the contaminated condition (*see* ¶ 5:63 ff.). Fortunately, a prospective buyer is in the best position to avoid purchasing an environmental liability by undertaking a *thorough site investigation and assessment before taking title* (*see* ¶ 5:235 ff.).

a. [5:182] **"Innocent landowner defense":** If a careful environmental assessment of the property before purchase fails to disclose any hazardous substance condition, the buyer is eligible to raise the "innocent landowner defense" to CERCLA and California Superfund liability (42 USC § 9601(35)). As discussed, however, this defense is difficult to assert successfully because it depends, in part, upon the buyer having made an *adequate effort* to discover the environmental condition prior to purchase (*¶ 5:110 ff.*).

➪ [5:183] ***PRACTICE POINTER:*** The buyer's dilemma is that, if hazardous substances not revealed by a preclosing investigation are ultimately found to exist on the property, the adequacy of the buyer's environmental assessment might be challenged by the government or a plaintiff PRP. For this reason, buyers are best advised not to rely solely on the protection

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of the innocent landowner defense; instead, they should focus their efforts on (i) discovering any environmental hazards problems that may exist and (ii) *negotiating an acceptable allocation of environmental risks* with the seller (*see ¶ 5:220 ff.*).

[5:183.1 - 5:183.4] ***Reserved.***

b. [5:183.5] **"Bona fide prospective purchaser" exemption (post-1/11/02 acquisitions):** PRPs not eligible to raise CERCLA's "innocent landowner defense" may nonetheless be protected by CERCLA's "bona fide prospective purchaser" exemption (42 USC § 9607(r)(1)) if they acquired the property after January 11, 2002. Very detailed criteria must be satisfied, however, for a buyer to qualify as a "bona fide prospective purchaser" (42 USC § 9601(40)). *See discussion at ¶ 5:86 ff.*

c. [5:184] **Private right of action against others:** A buyer who takes title to a property determined to be contaminated may be able to recover all or a portion of its clean-up costs from the seller (and others in the chain of title) by seeking *indemnity or contribution* under CERCLA or the California Superfund or, perhaps, a common law theory.

➪ [5:185] ***PRACTICE POINTER:*** In negotiating with the seller regarding environmental hazards liability, the buyer should strive for a provision indefinitely preserving all of its rights against the seller, thus ensuring that an indemnity or contribution suit can be brought if the property is unexpectedly found to be contaminated. Of course, the value of such a suit necessarily depends on the continued existence and financial strength of the seller and other PRPs (*¶ 5:197*).

Remember that a buyer can procure from a title insurance company a search of the chain of title to determine prior owners of the property.

d. [5:186] **Structuring transaction around environmental hazards:** In some cases, a buyer will learn of the presence of hazardous substances on the property before taking title—either because the buyer's environmental assessment detects contamination or because the seller discloses the condition. Buyers in such a scenario have various options. (They may alternatively take steps to qualify under CERCLA's "bona fide purchaser" exemption. *See ¶ 5:86 ff.*)

Although the proper course of action is entirely deal-specific and depends on the scope and complexity of (and cost to cure) the particular toxic problem, the following are some alternative solutions:

(1) [5:187] **Seller's deposit in escrow:** The buyer can attempt to get an accurate fix on the remediation cost through an environmental consultant's preclosing site assessment. In turn, as a *condition of the sale*, the buyer might require the seller to deposit in escrow funds sufficient to cover the estimated clean-up expense.

(a) [5:188] **Disadvantage:** This approach may be attractive to a buyer who cannot afford to delay the closing pending the seller's complete remediation (¶ 5:189 ff.). However, this option also poses a serious risk: The seller's deposit may turn out to fall far *short* of the actual clean-up costs, leaving the buyer exposed to significant PRP liability, with no recourse other than to incur the expense of litigation in an attempt to shift the cost to other PRPs. [See *Long Beach Unified School Dist. v. Dorothy B. Godwin Calif. Living Trust* (9th Cir. 1994) 32 F3d 1364, 1365—shortsightedness in estimating clean-up expense left buyer "holding a rather contaminated bag," necessitating CERCLA contribution litigation]

(2) [5:189] **Delay closing pending remediation:** Alternatively, the buyer might insist that the seller remedy the environmental problem at the seller's sole expense before closing and delay the closing in order to allow completion of full remediation.

(a) [5:190] **Advantages:** Delaying closing pending remediation is theoretically the buyer's most desirable approach because it allows the buyer to avoid purchasing a property known to be contaminated, while at the same time shielding the buyer from possible CERCLA and/or California Superfund liability arising from transportation and disposal of the hazardous materials removed from the property (42 USC § 9607(a)(3) & (4), *¶ 5:60*).

This approach also ensures the buyer will not be "left holding a contaminated bag" in the event the actual clean-up expense far exceeds the amount originally estimated (*¶ 5:188*).

(b) [5:191] **Disadvantages:** Unfortunately, this option often is not a practical solution for buyers. Clean-up of even a minor toxic problem on a property can take months; a serious toxic problem might require years to resolve to the satisfaction of appropriate governmental entities. Thus, unless the environmental concern is truly minimal and well-contained, it frequently will not be feasible for the parties to delay the purchase transaction pending full remediation.

(3) [5:192] **Restructure transaction pending remediation:** If the environmental condition can adequately be remedied, but the buyer cannot delay taking possession pending full remediation, the parties might consider altering the purchase and sale transaction in certain ways.

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For example, the transaction could be restructured as a *lease with an option to purchase* at such time as the environmental condition has been remediated to the buyer's satisfaction.

(a) [5:193] **Advantages:** Such a restructuring keeps the buyer out of the chain of title, thus ensuring against "owner" liability under CERCLA and the California Superfund; at the same time, it permits the buyer to take possession while the seller continues its clean-up effort and incurs the additional cost and liability risks associated therewith.

(b) [5:194] **Disadvantages:** By the same token, this approach is not without its attendant risks: The buyer may still be a PRP as an "operator" of the property. And even though not incurring the clean-up expense, the buyer will have to cope with other environmental issues—such as disclosure of the hazardous substance condition to employees and contractors under California's Proposition 65 (*¶ 5:43*) and the Asbestos Notification Law (*¶ 5:44*).

(4) [5:195] **Buyer-seller contractual allocation of risks:** CERCLA and the California Superfund allow private parties to *contractually allocate* the risks of hazardous materials liability (*see ¶ 5:220 ff.*). This is frequently accomplished through environmental indemnifications, releases and "as is" clauses, as well as by more tailormade provisions that specifically set forth the parties' intentions with respect to a known environmental hazard (*see ¶ 5:223 ff.*).

Whether or not it is known prior to closing that the subject property contains an environmental hazard, it may be advisable for the parties to identify in their transactional documents the party who will bear the risks of any *after-discovered* contamination on the property, and to back up their risk allocation with appropriate indemnifications and releases. However, this approach is not without considerable problems:

(a) [5:196] **No protection against liability to government or third parties:** Such contractual risk allocations are binding and effective only between the *contracting parties*. No private contractual arrangement will affect the ability of the *government or a third party* to seek recovery from the contractually-protected PRP. (*See ¶ 5:221*.)

(b) [5:197] **No guarantees on indemnitor's financial stability:** In addition, an indemnification is only of value to the extent the indemnifying party continues in existence and remains financially able to respond. Neither party, of course, can forecast with certainty what might transpire in the future.

e. [5:198] **"Prospective purchaser agreements":** "Prospective purchaser agreements" (PPAs) between the buyer and applicable environmental agencies are another avenue through which buyers may be able to acquire contaminated property with little or no risk of future environmental liability to the government.

PPAs have been entered into with the federal government (pursuant to 42 USC § 9622) and the State of California (pursuant to Health & Saf.C. §§ 25187, 70955 (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24)) and 79055 (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24). Under a PPA, the buyer basically agrees to pay for or perform a site clean-up and the government agrees to otherwise not proceed against the buyer.

➪ [5:198.1] ***PRACTICE POINTER:*** While theoretically a promising option, the burdens and expense of the PPA process are likely to outweigh its benefits. Buyers typically must be prepared for lengthy negotiations with the governmental agencies; and ultimately will end up incurring hefty clean-up burdens and steep financial obligations. The process is often quite time-consuming and thus, depending on the buyer's goals, may interfere with the ability to timely close the purchase and sale transaction.

Also, entering into a voluntary PPA, thus avoiding any subsequent civil suit or administrative action by the government, might preclude a post-clean-up contribution action against other PRPs (*see discussion at ¶ 5:125.6 ff.*).

[5:199] ***Reserved.***

2. [5:200] **Sellers' Concerns:** The development of environmental regulations has changed the nature of purchase and sale transactions far more dramatically for sellers than for buyers. A buyer has always been motivated to determine if the physical condition of the property is satisfactory and in compliance with applicable laws. On the other hand, sellers historically had relatively few concerns regarding the condition of the property being sold. It was largely up to the prospective buyer to discover unacceptable conditions affecting the property and, once the deed was recorded, the seller could generally walk away from the property with impunity.

California statutory and common law has largely eroded this traditional "caveat emptor" seller's protection in connection with defective conditions generally (*see ¶ 4:353 ff.* re seller's duties of disclosure). More particularly, sellers now have significant disclosure obligations and liability exposure under environmental laws.

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a. [5:201] **Disclosure requirements:** CERCLA, the California Superfund and the entire body of state and federal regulations have eliminated the notion of "caveat emptor" as it affects the sale of a contaminated property. Sellers have affirmative obligations to *disclose* to their buyers the presence of known hazardous waste on the property.

Indeed, a seller's failure to disclose to a buyer relevant information concerning hazardous substances which the seller knows, or has reason to believe, have been released on the property, leaves the seller forever vulnerable to liability for the contamination—not only to the buyer, but also to the government and third parties. (*See ¶ 5:66 ff.*)

(1) [5:202] **Failure to disclose waives CERCLA defense:** A seller who does not disclose to the buyer known hazardous substance conditions on the property forfeits its right to assert any statutory defenses to CERCLA and California Superfund liability. [42 USC § 9601(35)(C); ¶ *5:67, 5:119*]

(2) [5:203] **Statutory damages and civil penalties:** Further, under the California Superfund, a seller of nonresidential real property who fails to disclose to the buyer the presence of any hazardous substance (which the seller knows or has reasonable cause to believe has been released on or under the property) is liable for the buyer's actual damages resulting from the nondisclosure. In the case of a seller's intentional failure to disclose a known, material environmental hazard, civil penalties of up to $5,000 for each violation may be assessed. [Health & Saf.C. § 78700 (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24); *see also* ¶ 5:29 & 5:68]

➪ [5:204] ***PRACTICE POINTER:*** Some practitioners suggest a seller might take one or two further steps in an effort to limit the possibility of continuing environmental hazards liability to subsequent buyers:

• One possibility is to disclose the existence of the environmental contamination in the *grant deed* (or other conveyancing instrument). Because the grant deed is recorded, this would put subsequent buyers on notice of the existing conditions.

• A second approach is to record a *covenant running with the land* that restricts use of the property so as not to cause a release of hazardous substances. Environmental restrictions limiting the permissible use of contaminated property are expressly recognized by statute as recordable covenants running with the land. [Civ.C. § 1471; *see* ¶ *5:218*]

If such a covenant were properly created and recorded, a seller who is sued by a remote buyer might be able to seek indemnification from successive intervening owners.

b. Liability after closing

(1) [5:205] **PRP liability despite transfer of title:** Following the transfer of title, a seller remains a PRP under CERCLA and the California Superfund in two situations: (1) when the contaminated condition of the property was created, in whole or in part, during the time the seller owned the property (42 USC § 9607(a)(2)); or (2) when the seller knew of the contaminated condition of the property (whether or not the contamination occurred during the time the seller owned the property) and failed to disclose the presence of the hazardous substances to the buyer (42 USC § 9601(35)(C)).

(a) [5:206] **Disclosure to avoid additional penalties:** Although disclosure does not limit a seller's PRP liability if the seller *owned the property at the time the hazardous substances were released*, it will enable the seller to avoid additional penalties under other sections of the California Superfund and other laws requiring disclosure of hazardous waste.

(2) [5:207] **Compare—conditions negating PRP status:** On the other hand, a seller is *not* a PRP under CERCLA or the California Superfund, and thus should be free from environmental hazards liability, once title passes if the seller can prove that:

• The hazardous substances on the property were *not released during the time the seller owned or operated* the property; *and*

• *Either* (i) the seller *disclosed* to the buyer all knowledge that the seller had concerning the contaminated condition of the property, *or* (ii) the seller *never had any knowledge or reason to know* of the presence of the hazardous substances on the property. [42 USC § 9601(35); *see* ¶ *5:110 ff.* re conditions to "innocent landowner defense"]

[5:208 - 5:209] ***Reserved.***

c. [5:210] **Structuring transaction around environmental hazards:** Sellers often know, or learn during the course of a purchase and sale transaction, of the presence of hazardous substances on the property. Sometimes, sellers first acquire such

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knowledge after the purchase agreement is signed, but prior to the closing. Under those circumstances, the seller will be deemed to have knowledge of the contaminated condition of the property and will be bound by all reporting, notification and disclosure requirements. In the event the seller is unable to consummate its pending sale with the buyer, the seller will then have to disclose the presence of the hazardous substances to any succeeding prospective buyers of the property.

(If the seller thereafter fails to disclose the environmental condition, it will be subject to enormous risks associated with (1) violating the CERCLA and California Superfund disclosure provisions; (2) indefinite PRP status with respect to the property; and (3) having forfeited the CERCLA and California Superfund defenses to liability.)

There are, however, various options for structuring the purchase and sale transaction to take into account the contaminated condition of the property from a seller's perspective.

➪ [5:211] ***PRACTICE POINTER:*** Once the presence of hazardous substances on the property is known by both buyer and seller, the seller's goal will be to structure the transaction in such a way as to relieve the seller of liability for the condition to the greatest extent possible.

If the seller is confident that it can prove the hazardous substances were not released onto the property during the time the seller owned the property, simple disclosure of the condition may be sufficient to insulate the seller from ongoing liability.

On the other hand, if the hazardous substance release occurred during the time the seller owned the property (or if there is a concern the seller may not be able to prove the release did not occur during the seller's ownership of the property), the seller may wish to take steps toward remediation in the hope of minimizing its future liability.

(1) [5:212] **Delay closing pending remediation:** If, as part of the purchase and sale transaction, the seller is to take responsibility for cleaning up the contamination, one option is to delay the closing until the remediation has been completed.

(a) [5:213] **Advantage:** This approach may be particularly attractive to sellers because it ensures the *seller* will retain *control* of the clean-up operation. If the clean-up work is being performed by a company of the seller's choosing and at the seller's direction, the seller will be in a much better position to control both the quality of the remediation and the cost to complete it.

(b) [5:214] **Disadvantages:** Of course, even minor hazardous waste problems may require substantial remediation time and expense; and clean-up of serious contamination can take several years. As a practical matter, a substantial delay may effectively kill the purchase and sale transaction.

In addition, remediation costs typically are not easy to estimate until the work is under way; often, the actual expense far exceeds the original estimate. For this reason, a seller who decides to clean up any contamination prior to closing may wish to consider entering into an agreement with the buyer allocating between the parties the cost to complete the work.

(2) [5:215] **Close transaction and remediate pursuant to agreement:** Another option is for the seller and buyer to consummate the transfer of title and remediate the contamination postclosing pursuant to an agreement entered into prior to the closing.

(a) [5:216] **Advantages:** This approach has the advantage of (i) avoiding the substantial closing delays that could be occasioned by a preclosing clean-up; and (ii) providing a motivation to the buyer to make certain the remediation is completed thoroughly and in accordance with law (since the buyer automatically becomes a PRP upon taking title to the property).

(b) [5:217] **Disadvantages:** However, this approach also carries significant disadvantages for the seller:

- The seller loses control over the clean-up process since it no longer owns and (in most cases) will no longer have free access to the property. It will therefore be far more difficult for the seller to oversee satisfactory completion of the remediation. This is of concern to the seller because the seller still remains a PRP with respect to the property following the sale.

- Even if the buyer agrees to accept responsibility for the contamination and releases the seller from further liability, such agreements are *not binding on the state or federal governments or third parties* (¶ *5:221*), any of whom could still assert claims against the seller if the buyer fails to correctly remediate the environmental condition. Accordingly, the seller will want to remain somewhat involved in the clean-up process.

➪ [5:217.1] ***PRACTICE POINTER:*** Because it is usually difficult to predict the extent of the contamination, much less the cost to remediate, any such agreement between seller and buyer relating to postclosing clean-up should specifically address (i) the scope of work to be completed; (ii) the standards of compliance; and (iii) the parties' respective monetary obligations for the clean-up.

(3) [5:218] **Record environmental restriction based on government-approved risk management plan assessment:** Some contaminated conditions are so pervasive as to make full remediation prohibitively expensive and unfeasible. Were a complete clean-up required, the property might, for all practical purposes, be unsalable. In these cases, after conducting a risk assessment, applicable governmental authorities might be willing to agree to something less than full eradication of the contamination for so long as use of the property is not changed in a manner that would cause a disturbance or release of the hazardous substance or further endanger human safety and the environment (e.g., limiting use of industrial property to industrial purposes and precluding future development or use as a school, health care facility, etc.). (*See also* *¶ 5:198* re "prospective purchaser agreements" between buyer and governmental agencies.)

By statute, sellers may obtain from their buyers covenants restricting use of the subject property for the purpose of protecting human health/safety or the environment and *record* the instrument to create enforceable *covenants running with the land*. When properly created and expressly labeled "environmental restrictions," the recorded covenants are binding on all successors in interest to the burdened parcel even though the seller/covenantee owns no adjacent property that would be benefited by the restrictions (thus excepting these types of covenants from the normal requirements for enforceable covenants running with the land). [Civ.C. § 1471; *see discussion at* *¶ 4:66.5*]

This approach gives the seller some measure of control over the property no matter how many times it thereafter changes hands; and also may provide a basis for recourse against successors in the chain of title should they violate the recorded restrictions in a manner that exposes the seller (original covenantee) to clean-up liability.

➪ [5:218.1] ***PRACTICE POINTER:*** Nothing in the law prevents the seller/covenantee from also including in the recorded instrument the seller's (or other PRP's) *remedies* against successors who breach the environmental restrictions —including damages, an injunction requiring removal or abatement of the condition that breaches the restrictions, etc.

[5:219] ***Reserved.***

3. [5:220] **Buyer-Seller Contractual Risk Allocation:** Because the statutes create a broad and inclusive class of PRPs (*¶ 5:60 ff.*) and the defenses to liability are very narrow and difficult to assert (*¶ 5:100 ff.*), counsel for buyer and seller can do their clients a great service by negotiating for a clear and detailed allocation of the risks associated with hazardous materials in the transactional documents.

a. [5:221] **Contractual apportionment of risks allowed under CERCLA and state law:** PRPs may not, by private agreement, contract away or limit their CERCLA liability *to the government* or *to third parties*. However, CERCLA preserves the right of private parties to contractually apportion environmental risks *as between themselves*. [42 USC § 9607(e); see *Mardan Corp. v. C.G.C. Music, Ltd.* (9th Cir. 1986) 804 F2d 1454, 1461-1463; *Teleflex Inc. v. Collins & Aikman Products Co., Inc.* (D CT 1996) 961 F.Supp. 368, 372, aff'd (2nd Cir. 1997) 125 F3d 845]

California state law likewise recognizes the right of private parties to allocate hazardous materials release liability as between themselves (*see* *¶ 5:138.125*).

b. [5:222] **Allocation approaches:** The possible approaches to apportioning environmental risks in a purchase and sale context theoretically are as endless as counsel's imagination. A few of the more common approaches are discussed at ¶ 5:223 ff.

(1) [5:223] **"As is" clauses:** The apportionment of environmental risks may be accomplished by including a so-called "as is" clause in the purchase and sale agreement. An "as is" clause typically provides that the buyer is accepting the property in its current condition, subject to any defects, without any representation by the seller as to the condition of the property and without any obligation of the seller to repair/remediate any defects. (*See* *¶ 4:351 ff.* for discussion of "as is" sales generally.)

The enforceability of such a clause with respect to a seller's environmental hazards liability is unsettled.

(a) [5:224] **Traditional environmental conditions exclusion:** Cases have held that an "as is" clause operates only as a disclaimer of warranties and will not preclude a buyer's suit against the seller with respect to environmental issues.

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[See *Wiegmann & Rose Int'l Corp. v. N.L. Indus.* (ND CA 1990) 735 F.Supp. 957, 961-962; *International Clinical Laboratories, Inc. v. Stevens* (ED NY 1989) 710 F.Supp. 466, 469-470]

An important factor in *Wiegmann*, supra, was that it was unclear from the standard "boilerplate" language of the "as is" clause whether the parties *specifically contemplated* environmental hazards. The court was also persuaded by the fact the purchase and sale transaction was consummated five years before the enactment of CERCLA … so that CERCLA liability, in particular, could not have been anticipated when the "as is" provision was agreed to. [See *Wiegmann & Rose Int'l Corp. v. N.L. Indus.*, supra, 735 F.Supp. at 961]

(b) [5:225] **Emerging trend favoring application to specifically-contemplated environmental conditions:** However, a growing trend of authority holds "as is" clauses to be enforceable in effectively releasing sellers from environmental hazards liability to their buyers where the provision *specifically references* that actual or potential environmental hazards are among the conditions as to which the buyer is taking the property "as is" and without warranty. [See *Niecko v. Emro Marketing Co.* (6th Cir. 1992) 973 F2d 1296, 1300, 1303—"as is" provision expressly stating buyers "assume all responsibility for any damages caused by the conditions on the property upon transfer of title" held to evidence that parties' specifically contemplated seller be released from liability for gasoline leakage soils contamination (more than a mere warranty disclaimer); see also *La Placita Partners v. Northwestern Mut. Life Ins. Co.* (ND OH 1990) 766 F.Supp. 1454, 1458-1459—"as is" clause effectively released seller from liability for asbestos contaminates where buyer's inspection had disclosed possible presence of asbestos; *Holly Hill Holdings v. Lowman* (1993 CT) 226 Conn. 748, 756-757, 628 A2d 1298, 1302-1303]

On the other hand, courts are reluctant to hold buyers to the consequences of a broadly-worded, generic "as is" clause with respect to environmental liabilities where there is no evidence the particular condition was known to the buyer at the time the transaction closed. [See *Car Wash Enterprises, Inc. v. Kampanos* (Wash. App. 1994) 74 Wash.App. 537, 547, 874 P2d 868, 874—"as is" clause ineffective to allocate environmental hazards liability to buyer where buyer unaware of contamination until after title had passed; and *Amland Properties Corp. v. Aluminum Co. of America* (D NJ 1989) 711 F.Supp. 784, 803, fn. 20—party ignorant of presence of abnormally dangerous condition cannot "be held to have contractually assumed the risk posed by that condition merely by signing an 'as is' purchase contract"]

➪ [5:226] ***PRACTICE POINTER:*** The law in this area is not yet settled, and the results have largely been fact-specific. Therefore, where the parties intend that the buyer assume responsibility for environmental hazards, the most prudent approach is to *combine* an "as is" clause with an *environmental release* (*¶ 5:227*) and an *environmental indemnity* (*¶ 5:230*).

Further, the "as is" clause should *recite the parties' intent* that it be effective specifically with respect to the environmental condition of the property; and should also state the parties have *contemplated the consequences* of the presence of environmental hazards on the property in agreeing to the "as is" provision.

(2) [5:227] **Environmental liability releases:** Once the parties have determined how they will apportion the environmental risks, they may wish to release one another from liability for certain hazards.

While federal law governs the validity of a release of federal causes of action, the breadth of a purported release and the parties' intent to release particular causes of action is interpreted under state law. [*Olin Corp. v. Consolidated Aluminum Corp.* (2nd Cir. 1993) 5 F3d 10, 15; see *Teleflex Inc. v. Collins & Aikman Products Co., Inc.* (D CT 1996) 961 F.Supp. 368, 372, aff'd (2nd Cir. 1997) 125 F3d 845]

(a) [5:228] **Specific reference to environmental contamination required:** Releases of liability for environmental hazards have been upheld. [See *Village of Fox River Grove, Ill. v. Grayhill, Inc.* (ND IL 1992) 806 F.Supp. 785, 795—release may effectively bar CERCLA contribution claim even though executed before enactment of CERCLA] However, as with "as is" provisions, it is important that the language of the release *specifically state* the parties intend it to be effective with respect to any potential claims relating to environmental contamination. [See *Mardan Corp. v. C.G.C. Music, Ltd.* (9th Cir. 1986) 804 F2d 1454, 1461-1463]

(b) [5:228.1] **Compare—viable fraud claim despite "environmental" and "common law" claims release:** A release of "environmental claims" or, more broadly, federal and state "common law claims," will *not* necessarily waive a claim for *fraud in the inducement*—i.e., a cause of action premised on *fraud in the procurement of the release* (or the underlying agreement containing the release). Whether the language of the release in fact waives such a fraud claim is a question

of *state law*. [*Teleflex Inc. v. Collins & Aikman Products Co., Inc.* (D CT 1996) 961 F.Supp. 368, 371-372, aff'd (2nd Cir. 1997) 125 F3d 845]

1) [5:228.2] **Application:** An environmental claims release between Buyers and Sellers in a purchase agreement clearly allocated the risk of CERCLA liability to Buyers, precluding Buyers' CERCLA cost recovery action against Sellers. But, applying New York law, the court also determined that neither the environmental release *nor* an additional release of related common law causes of action barred Buyers' *fraud* claim premised on Sellers' alleged misrepresentations concerning the environmental condition of the property that *induced* Buyers to sign the purchase agreement and assume environmental liabilities. [*Teleflex Inc. v. Collins & Aikman Products Co., Inc.* (D CT 1996) 961 F.Supp. 368, 371-372, 373—but also holding Sellers' alleged fraud does *not vitiate* otherwise valid waiver of CERCLA claims]

2) [5:228.3] **Compare—election to rescind for fraud:** Pursuit of a damages claim based on fraud, of course, is an election to *affirm* the underlying agreement, thereby binding the plaintiff buyer to the contractual terms (including the otherwise valid waivers of rights and causes of action against the seller) (*see* ¶ *11:10 ff., 11:351 ff.*). To avoid this result, plaintiff may instead seek to *rescind* the contract based on fraud (*see* ¶ *11:460 ff.*). [*Teleflex Inc. v. Collins & Aikman Products Co., Inc.* (D CT 1996) 961 F.Supp. 368, 372, 373; see also *Keywell Corp. v. Weinstein* (2nd Cir. 1994) 33 F3d 159, 165]

(c) [5:229] **Caveat re "unknown" risks:** Pursuant to Civ.C. § 1542, "[a] general release does not extend to claims that the creditor or releasing party does not know or suspect to exist in his or her favor at the time of executing the release and that, if known by him or her, would have materially affected his settlement with the debtor or released party." This provision could be a serious trap for the party counting on a release agreement to provide complete insulation from hazardous substance liability vis a vis the other party to the transaction.

In the environmental context, the *unknown* risks are usually of more concern than the known risks. Therefore, in a California transaction, it is especially critical that the party receiving the release have the releasing party *waive the effect of Civ.C. § 1542* to ensure its application to all environmental risks—whether known *or unknown*.

(3) [5:230] **Environmental indemnities:** Another method for allocating environmental risks is an *indemnity agreement* relating specifically to costs incurred in responding to and remediating environmental contamination. Under such an indemnification, one party agrees to indemnify (reimburse) the other party for all costs, losses, damages, etc. incurred by the indemnified party as a result of the presence of hazardous substances on the property.

Such indemnities are particularly important because contractual risk allocations are binding *only* on the *contracting parties;* i.e., even if one party is released from liability to the other party, the released party still has potential liability to state and federal governments as well as to third parties (¶ *5:221*). By obtaining an indemnity, the released party (indemnitee)—at least as between buyer and seller—can effectively shift its liability to the indemnitor.

➪ [5:231] ***PRACTICE POINTER:*** Like any other kind of indemnity, an environmental liability indemnity agreement is only as valuable as the financial condition of the indemnitor. This is of particular concern in the environmental context: Even if the indemnitor's financial worthiness appears strong at the time the indemnity is given, it may be many years before a hazardous substance condition is discovered and the indemnitee seeks to enforce the indemnification agreement. At that time, the indemnitor's financial condition may have drastically changed for the worse.

Accordingly, although an environmental indemnity is prudent, it should not be considered a substitute for *careful environmental investigation* prior to closing of the purchase and sale transaction.

[5:232 - 5:234] ***Reserved.***

4. [5:235] **Buyer's Environmental Due Diligence:** Prospective buyers should conduct *thorough due diligence* regarding the environmental condition of the property prior to closing of the transaction. Careful due diligence may significantly impact the buyer's decision to proceed with the transaction. It also positions the buyer to qualify for the "contiguous property owner" exemption (¶ *5:85 ff.*) or the "bona fide prospective purchaser" exemption (¶ *5:86 ff.*), or to assert the "innocent landowner defense" (¶ *5:110 ff.*).

a. [5:236] **General approaches:** A buyer's due diligence typically commences with hiring an environmental consultant to perform a site assessment. This may be supplemented by reviewing the seller's records and recorded documents with respect to the real property and obtaining a completed environmental questionnaire from the seller.

The scope of a proper environmental due diligence generally is defined by the past use of the property. For example, property known to have been used as a gas station (a particularly environmentally-risky acquisition) should require a far more penetrating environmental investigation than would property that has been undeveloped and has no industrial history. In the mid-range between these two types of properties, an office building, though not an industrial site, should minimally be surveyed for the presence of asbestos-related materials.

➪ [5:237] ***PRACTICE POINTER FOR SELLERS:*** Obtaining an environmental site assessment prior to consummation of the purchase and sale transaction will allow the seller and buyer to create a record of the environmental condition of the property existing at the time of the sale. In so doing, the seller risks learning of a previously unknown environmental hazard on the property, in turn imposing upon the seller the full panoply of federal and state reporting, notification and disclosure obligations.

As a general rule, however, in the environmental context, early knowledge is always better than ignorance. If contamination is found or suspected, a seller is ordinarily far better off being in a position to quantify the contamination and to formulate a remediation plan before the sale than if the condition were first revealed after the closing (at a time when the seller will most likely learn of the contamination as defendant in a lawsuit brought by the government, a third party or the buyer).

In addition, if the buyer further contaminates the property, the condition may be far worse by the time the seller learns of it; and without a "baseline" environmental assessment describing the condition of the property at the time of the sale, the seller will have a hard time proving it is responsible for only a portion of the contamination. (*See ¶ 5:72 ff.* re joint and several CERCLA liability.)

b. [5:238] **Environmental site assessments:** It is recommended that prospective buyers of real property obtain an environmental site assessment prior to closing.

Different levels of site assessments can be obtained, varying in price and scope of invasiveness to the property. The least expensive and least invasive is generally referred to as a "Phase I" site assessment, with a "Phase II" assessment being the next level of investigation, and so on.

Each type of site assessment should culminate in a *written report* that describes the scope of work performed, the information learned, and any recommendations for remediation and/or further investigation. Prospective buyers seeking to qualify for the "contiguous property owner" or "bona fide prospective purchaser" exemptions, or to assert the "innocent landowner defense," should verify that the site investigation, assessment and report comply with federal regulations governing an "appropriate inquiry" (*see* ¶ *5:85.6 ff., 5:86.5, 5:114*).

➪ [5:239] ***PRACTICE POINTER:*** The precise work done under the umbrella of "Phase I," "Phase II," etc. varies within the industry and among consultants. Accordingly, to ensure the investigation will meet your client's needs, do not simply rely on a consultant's "labels" to define the scope of work to be performed.

(1) [5:240] **"Phase I" assessment:** A prospective buyer typically begins the environmental investigation of a property by obtaining a "Phase I" site assessment performed by an environmental consultant. The California Superfund defines it as a *preliminary assessment* of the property to determine whether there has been, or may have been, a hazardous substance release based on reasonably available information about the property and general vicinity. [Health & Saf.C. § 78090 (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24)]

➪ [5:240.1] ***PRACTICE POINTER:*** Prospective buyers of property *known* to be contaminated traditionally have not obtained Phase I assessments. However, in order to qualify for the "bona fide prospective purchaser" exemption, such an assessment may be essential. *See ¶ 5:86.6*.

(a) [5:241] **General scope of work:** A Phase I environmental assessment customarily involves (but is not limited to) a review of documentary information concerning the property (private and public records) and current and historical land uses on the property and in the vicinity; and visual and other surveys and inspections of the property and general vicinity (often including interviews with current and previous owners, operators and on-site maintenance personnel). [See Health & Saf.C. § 78090 (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24)]

In addition, a Phase I assessment may or may not include an inspection of the property improvements for asbestos and/or radon gas. But it typically does *not* include actual sampling or testing of soil or ground water (see Health & Saf.C. § 78090 (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24)). It is therefore the least invasive of the site assessments.

➪ [5:241.1] ***PRACTICE POINTER:*** It is usually preferable for the consultant's site visit to occur after the consultant has had an opportunity to review the documentary information. This will enable the consultant to focus the survey and inspection in particular on any "red flags" that may have been raised in the documents reviewed.

(b) [5:242] **Chain of title review:** The documents reviewed by the consultant in a Phase I investigation should include a 40-to-50-year title history of the property. The chain of title history will assist the consultant in identifying the past owners and uses of the subject property.

A history of prior ownership is important in two respects:

- It gives the consultant guidance as to what types of problems require particular attention. For example, if the history of title reveals that the property was owned by (or leased to) the operator of a car wash or gasoline station, the consultant will have particular concerns relating to the types of contamination commonly associated with those uses (gasoline leakage from underground storage tanks, etc.).

- Also, to be in a position to qualify for the "contiguous property owner" or "bona fide prospective purchaser" exemption, or to assert the "innocent landowner defense," a buyer must be able to show that it made "all appropriate inquiry" regarding the property (*see* ¶ *5:85.6 ff., 5:86.6, 5:113 ff.*).

The history of title in the Phase I report will thus assist the buyer in evidencing that it made an inquiry as to prior ownership and uses of the property. (Environmental consultants often supplement the information contained in the title history with old aerial photographs of the subject site obtained from governmental mapping and survey agencies.)

(c) [5:243] **Associated governmental records:** The documentary information reviewed by the Phase I consultant should also include governmental records relating to the subject property. Certain federal, state and local agencies maintain various lists of properties with known environmental problems. The Phase I written report should state whether the subject property, as well as other properties in the adjoining area, are on any of these governmental lists.

In addition, certain governmental agencies are granted the authority under CERCLA and certain state Superfund laws to impose liens on contaminated properties to provide a means for the government to recoup its costs in remediating the condition if PRPs with respect to the property either cannot or will not reimburse the government. The Phase I report should state whether any state or federal liens relating to environmental remediation affect the subject property.

(d) [5:244] **Seller's environmental questionnaire responses:** Finally, the Phase I report may include the seller's responses to an environmental questionnaire designed to help the consultant learn whether any activities have taken place on the property that might cause it to be contaminated.

➪ [5:245] ***PRACTICE POINTER FOR BUYERS:*** Some sellers may be reluctant to cooperate in responding to such a questionnaire. Buyers may therefore find it prudent to make the seller's completion of an environmental questionnaire (and buyer's acceptance of the contents thereof) a condition to the buyer's obligation to close the transaction. Moreover, the contents of any questionnaire completed by a seller should be included as part of the seller's representations and warranties.

(2) [5:246] **"Phase II" assessments:** A "Phase II" site assessment is usually obtained only when there is a known or suspected environmental impairment of the property that needs to be analyzed and quantified. Typically, a Phase II investigation is conducted on recommendation of the environmental consultant who prepares the Phase I report (¶ 5:240 ff.).

Phase II usually involves actual testing of materials known or suspected to contain contamination—soil, groundwater, the building structure (for asbestos) or air (for radon gas or other emissions). The scope of work to be performed will be specifically tailored to respond to concerns noted in the Phase I report.

➪ [5:247] ***PRACTICE POINTER:*** Because a Phase II investigation involves actual sampling and testing in, on and around the property, it can be costly and may take several weeks to complete. As a result, buyers and sellers are often reluctant to invest the necessary time and money. Bear in mind, however, that the time and expense required to obtain a Phase II audit is only a fraction of the time and cost that will be incurred if the property is actually environmentally impaired.

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➪ [5:247.1] ***FURTHER POINTER FOR SELLERS:*** Since a Phase II audit usually includes some invasive testing of the property, the seller may want to include in the purchase and sale agreement a covenant that (i) following the testing, the property will be returned to the same condition it was in before the testing (at the buyer's expense); and (ii) the buyer will indemnify the seller for any damage to the property or injury to persons resulting from the testing.

(3) [5:248] **Providing "legally required notices" of discovered contamination:** A prospective buyer of contaminated property who seeks to qualify for the "contiguous property owner" or "bona fide prospective purchaser" exemption must give all "legally required notices" upon discovery of a hazardous substance release at the property (¶ *5:85.1, 5:86.1*). According to the EPA, such notices may include those required under federal, state *and* local laws. Because the reporting requirements are numerous, complex and often ambiguous, buyers should begin *immediately to* evaluate them so that any necessary notices can be timely given.

[5:249] ***Reserved.***

5. Insurance for Environmental Hazards

Cross-refer: The sections at ¶ 5:250 ff. overview the applicable law concerning environmental hazards insurance coverage. For a detailed treatment of this subject, see Croskey, Heeseman, Ehrlich & Klee, *Cal. Prac. Guide: Insurance Litigation* (TRG).

a. [5:250] **Coverage under commercial (comprehensive) general liability (CGL) policies:** A standard commercial general liability (CGL) insurance policy (formerly called a comprehensive general liability policy) provides insurance for liability to *third parties*. (This is distinct from a "first party policy," such as fire, theft and casualty insurance, which provides coverage for loss or damage sustained directly by the insured.)

Third party CGL policies typically cover sums the insured becomes "legally obligated to pay as damages" because of bodily injury or property damage (covered by the policy) caused by an "occurrence"; and "occurrence" is typically defined as an "accident" or "loss" (including "continuous or repeated exposure to conditions") that results in bodily injury or property damage neither expected nor intended from the insured's standpoint. [See generally, *Montrose Chemical Corp. of Calif. v. Admiral Ins. Co.* (1995) 10 C4th 645, 663-664, 42 CR2d 324, 332-333; *Aerojet-General Corp. v. Transport Indem. Co.* (1997) 17 C4th 38, 56, 70 CR2d 118, 128; *Westoil Terminals Co., Inc. v. Industrial Indemnity Co.* (2003) 110 CA4th 139, 147, 1 CR3d 516, 521-522]

Whether and to what extent a CGL policy covers the insured's third party liabilities—including clean-up expense and governmental response costs—arising from an environmentally impaired property has been the subject of much litigation. Fundamentally, the coverage issues turn on the specific policy language and, in particular, the policy's specific exclusions from coverage.

(1) [5:251] **Response costs awarded by judgment to government as covered "damages":** Response costs awarded to the government in its suit against the insured for amounts the government incurred in cleaning up contamination caused by the insured are "damages" the insured has become "legally obligated to pay … because of property damage" within the meaning of a CGL policy. [*AIU Ins. Co. v. Sup.Ct. (FMC Corp.)* (1990) 51 C3d 807, 843, 274 CR 820, 846-847; *Aetna Cas. & Sur. Co., Inc. v. Pintlar Corp.* (9th Cir. 1991) 948 F2d 1507, 1513-1515 (decided under Idaho law)]

(a) [5:251a] **Legal or equitable proceedings:** So long as the insured's response costs liability was determined by *court judgment or order*, it is immaterial whether the government's suit was in equity or an action at law. The term "legally obligated" in a CGL policy covers equitable as well as legal proceedings. [*AIU Ins. Co. v. Sup.Ct. (FMC Corp.)* (1990) 51 C3d 807, 824-825, 274 CR 820, 833-834; see *Certain Underwriters at Lloyd's of London v. Sup.Ct. (Powerine Oil Co., Inc.)* (2001) 24 C4th 945, 966, 103 CR2d 672, 686]

1) [5:251b] **Compare—clean-up costs incurred pursuant to administrative order:** The insurer's promise in a CGL policy to indemnify the insured for sums it becomes "legally obligated" to pay "as damages" because of "property damage" from covered acts refers exclusively to an obligation established by judgment or order in a court of law. The duty to indemnify under the policy does *not* extend to costs the insured incurs pursuant to a compulsory coercive clean-up order issued by an environmental agency *without a court order*. [*Certain Underwriters at Lloyd's of London v. Sup.Ct. (Powerine Oil Co., Inc.)* (2001) 24 C4th 945, 951, 103 CR2d 672, 675 (expenses ordered by Regional

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Water Boards pursuant to the Porter-Cologne Act); *CDM Investors v. Travelers Cas. & Sur. Co.* (2006) 139 CA4th 1251, 1259, 43 CR3d 669, 674]

The same result obtains under a "nonstandard" excess liability policy requiring the insurer to indemnify the insured for all sums the insured becomes obligated to pay by reason of liability imposed by law for "damages": The insuring clause does *not* cover expenses associated with responding to administrative clean-up orders outside the context of a government-initiated lawsuit. [*County of San Diego v. Ace Prop. & Cas. Ins. Co.* (2005) 37 C4th 406, 421, 33 CR3d 583, 593-594]

Distinguish—broader insuring clause: But the result is otherwise (agency-ordered response costs are covered) where the central insuring agreement also extends to the total sum the insured becomes obligated to pay "either through adjudication or compromise," including "settlement, adjustment and investigation of claims …" [*Powerine Oil Co., Inc. v. Sup.Ct. (Central Nat'l Ins. Co. of Omaha)* (2005) 37 C4th 377, 395-398, 33 CR3d 562, 576-577 (excess/umbrella policies)]

➪ [5:251c] ***PRACTICE POINTER:*** Under a CGL-type policy (limiting indemnification to court-ordered money judgments), possible recourse for the insured short of litigation is to invoke the insurer's obligation to *settle* claims rather than its duty to indemnify:

"If the carrier agrees to 'settle' the 'claim' by authorizing the policyholder to comply with the administrative order, then it appears that the carrier would be obligated to pay the cost of this 'settlement,' subject to policy provisions regarding deductible amounts, coverage limits, and so forth. If the carrier declines to 'settle' the 'claim' by providing the policyholder with the funds needed to comply with agency demands, the policyholder … may comply with the agency directive by using its own funds and then seek to recover these costs by bringing suit against the insurer, not for breach of the duty to indemnify, but for breach of the duty to accept a reasonable settlement." Concededly, however, the "bad faith" case may be difficult to prove. [See *Certain Underwriters at Lloyd's of London v. Sup.Ct. (Powerine Oil Co., Inc.)* (2001) 24 C4th 945, 981, 103 CR2d 672, 697 (J. Kennard dissent.opn.)]

(b) [5:251.1] **Response costs incurred under consent decree:** At least one federal court has extended *AIU*, supra, 51 C3d 807, 274 CR 820, to costs incurred by the insured in cleaning up toxic waste pursuant to a *consent decree* (settlement) with the government. According to this court, although *AIU* involved injunctive and reimbursement relief in a contested action in equity, the same reasoning would be applied by the California Supreme Court to consent decrees. [*Intel Corp. v. Hartford Acc. & Indem. Co.* (9th Cir. 1991) 952 F2d 1551, 1563-1565—clean-up expenses incurred pursuant to consent decree are covered "damages" under CGL policy]

➪ [5:251.1a] ***CAUTION:*** The *Intel* reasoning may be correct on the theory a consent decree (at least arguably) results in a *judicial order* that might qualify the procedure as a "suit" resulting in a "legal obligation to pay as damages" even though arrived at by settlement. Practitioners should bear in mind, however, that the Cal. Supreme Court has not ruled on the issue.

(c) [5:251.2] **Site investigation expenses as response costs and defense costs:** Site investigation expenses—i.e., expenses for determining the existence, nature, extent, effect, etc. of the discharge of hazardous substances at a location —may be included within "response costs" under CERCLA. Such expenses can *also* be *defense costs* that a CGL insurer must incur in satisfying its duty to defend. [*Aerojet-General Corp. v. Transport Indem. Co.* (1997) 17 C4th 38, 60-65, 70 CR2d 118, 131-135; *see also* ¶ *5:268 ff.* re duty to defend]

"[I]f and to the extent that the insured's site investigation is conducted within the temporal limits of the insurer's duty to defend [i.e., between tender of the defense and conclusion of the action] and amounts to a reasonable and necessary effort to avoid or at least minimize liability, the related site investigation expenses may possibly be defense costs that the insurer must incur in fulfilling its duty to defend." [*Aerojet-General Corp. v. Transport Indem. Co.*, supra, 17 C4th at 61, 70 CR2d at 131]

(d) [5:251.3] **Compare—reduction in property value based on future remediation expense:** An insurer is *not* obligated to defend a claim brought by an insured for the *reduction in market value* of contaminated property based on estimated future clean-up costs. Any such reduction in value is not the equivalent of the *actual expenditure of money* to compensate a government agency for loss or detriment suffered by it, and does not amount to a "constructive expenditure" or a defensible "set-off claim." [*Block v. Golden Eagle Ins. Corp.* (2004) 121 CA4th 186, 193-200, 17

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CR3d 13, 19-25—insurers had no duty to defend insured in eminent domain action where amount offered for property reduced by estimated costs to remediate property]

(2) [5:252] **Exclusion issues:** Insurance companies have relied primarily on two policy exclusions in an attempt to deny CGL coverage for environmental hazards: the pollution exclusion and the "owned property" exclusion.

(a) [5:253] **Pollution exclusion; "sudden and accidental" occurrence exception:** The pollution exclusion typically is written to exclude from coverage property damage arising from the release of hazardous materials (e.g., "This insurance does not apply to bodily injury or property damage arising out of the discharge, dispersal, release or escape of … [toxic waste materials] into or upon the land, air or water."). However many such exclusions also contain an *exception* for a "*sudden and accidental"* dispersal of hazardous substances (e.g., "… but this exclusion does not apply if such discharge, dispersal, release or escape is sudden and accidental …"). [See *Aydin Corp. v. First State Ins. Co.* (1998) 18 C4th 1183, 1186-1187, 77 CR2d 537, 538; *Westoil Terminals Co., Inc. v. Industrial Indemnity Co.* (2003) 110 CA4th 139, 148, 1 CR3d 516, 522; *Venoco, Inc. v. Gulf Underwriters Ins. Co.* (2009) 175 CA4th 750, 757-758, 96 CR3d 409, 414-415—pollution exclusion "buy-back" provision conditioned on, among other things, 60-day reporting requirement and occurrence being "accidental" and "neither expected nor intended"]

1) [5:253a] **Burden of proof:** Because it negates the pollution exclusion (effectively reinstating coverage where it otherwise would not exist), the "sudden and accidental" occurrence exception is properly construed as a *coverage* provision when allocating the burden of proof.

Thus, in an action seeking indemnity under a standard CGL policy, once the insurer carries its burden of proving the pollution exclusion applies, the *insured* bears the burden of proving the insured's claim comes within the "sudden and accidental" exception (i.e., the insured must demonstrate that the damage is not the result of gradual or incremental contamination; *see ¶ 5:254*). [*Aydin Corp. v. First State Ins. Co.* (1998) 18 C4th 1183, 1191-1192, 77 CR2d 537, 541-542, 543; *Aeroquip Corp. v. Aetna Cas. & Sur. Co., Inc.* (9th Cir. 1994) 26 F3d 893, 895 (per curiam)]

2) [5:253.1] **Relevant "discharge":** The pollution exclusion focuses on a *discharge* of pollutants into or upon the land, air or water—*not* on the *environmental damage* caused by the discharge. Thus, the fact consequential damage may be unexpected or unintended is irrelevant to application of the "sudden and accidental" occurrence exception. [*Standun, Inc. v. Fireman's Fund Ins. Co.* (1998) 62 CA4th 882, 890, 73 CR2d 116, 121]

a) [5:253.2] **Application to waste disposal in landfills:** Where the coverage dispute concerns contamination caused by escaping pollutants from a landfill, the relevant "discharge" for purposes of the pollution exclusion is the *initial disposal of waste* into the landfill—*not* the subsequent release of hazardous materials from the landfill into the surrounding environment. [*Standun, Inc. v. Fireman's Fund Ins. Co.* (1998) 62 CA4th 882, 890-891, 73 CR2d 116, 121]

Thus, notwithstanding a "sudden and accidental" occurrence exception in the CGL policy, the pollution exclusion bars coverage where the insured *purposefully* deposited its waste products into a landfill, or *purposefully* gave its waste products to transporters who, as expected, brought it to the landfill where it was released directly into the land. The fact the waste *thereafter* escaped the landfill unexpectedly, contaminating the environment, does *not* trigger the exclusion's "sudden and accidental" occurrence exception; rather, that event constitutes the *damages* arising *out of the discharge* of pollutants onto the land. [*Standun, Inc. v. Fireman's Fund Ins. Co.*, supra, 62 CA4th at 891-892, 73 CR2d at 121-122]

b) [5:253.3] **Compare—tank storage of hazardous waste:** On the other hand, where hazardous waste is deposited into storage containers and subsequently released into the environment, the relevant "discharge" is the *release from the storage containers* … because the original disposal of waste into the containers is not a discharge into or upon the land, air or water. [*St. Paul Fire & Marine Ins. Co. v. Warwick Dyeing Corp.* (1st Cir. 1994) 26 F3d 1195, 1205; see *Standun, Inc. v. Fireman's Fund Ins. Co.* (1998) 62 CA4th 882, 891, 73 CR2d 116, 121 (distinguishing waste dumping in landfills)—"A landfill is not a similar containment vessel, because the landfill vessel is itself land"]

3) [5:254] **Exception inapplicable to gradual pollution occurrences:** Though there has been much debate and extensive litigation over the meaning of the phrase "sudden and accidental," California courts find the phrase unambiguous: The exception triggers potential coverage only if the pollution occurrence (the "discharge," ¶ 5:253.1) is *both* "sudden" *and* "accidental." It must be an "*unexpected and unintended*" event and "*abrupt and*

immediate" (temporal) in nature. The exception does *not* apply to *gradual pollution*. [*American States Ins. Co. v. Sacramento Plating, Inc.* (ED CA 1994) 861 F.Supp. 964, 969-970, aff'd (9th Cir. 1995) 99 F3d 1145; *Shell Oil Co. v. Winterthur Swiss Ins. Co.* (1993) 12 CA4th 715, 755, 15 CR2d 815, 841; see *Truck Ins. Exchange v. Pozzuoli* (1993) 17 CA4th 856, 860-861, 21 CR2d 650, 652—exception inapplicable where pollution process was both continuous and long-term; *ACL Technologies, Inc. v. Northbrook Prop. & Cas. Ins. Co.* (1993) 17 CA4th 1773, 1787-1789, 22 CR2d 206, 214-216—exception inapplicable where pollutants escaped from underground tank through leaks caused by corrosion that occurred gradually over extended period]

A growing trend of other federal circuits and states are in accord—i.e., the "sudden and accidental" exception is triggered only by a temporal occurrence that happens quickly, abruptly and without warning. [See, e.g., *United States Fid. & Guar. Co. v. Star Fire Coals, Inc.* (6th Cir. 1988) 856 F2d 31, 34-35; *State of New York v. Amro Realty Corp.* (ND NY 1988) 697 F.Supp. 99, 110, aff'd in part (2nd Cir. 1991) 936 F2d 1420, 1426-1429; *Technicon Electronics Corp. v. American Home Assur. Co.* (2nd Dept. 1988) 141 AD2d 124, 137, 143, 533 NYS2d 91, 99, 103, aff'd (1989) 74 NY2d 66, 74, 542 NE2d 1048, 1051]

a) [5:254.1] **Unexpected *and unintended:*** As stated, the discharge is not "accidental" unless *both* unexpected *and* unintended. An "unexpected" event is one that the insured did not know or believe to be substantially certain or highly likely to occur. [*A-H Plating, Inc. v. American Nat'l Fire Ins. Co.* (1997) 57 CA4th 427, 439, 67 CR2d 113, 119]

The exception is not triggered by an unintended discharge of pollutants if the discharge was nonetheless expected. [*Shell Oil Co. v. Winterthur Swiss Ins. Co.* (1993) 12 CA4th 715, 755, 15 CR2d 815, 841]

b) [5:254.2] **Exception not automatically negated by insured's precautionary measures:** On the other hand, the mere fact the insured took precautionary safety measures—whether mandated or voluntarily adopted—to prevent the possible escape of pollutants or to respond quickly to a potential environmental hazard does *not automatically* rule out the occurrence of "accidents." Such safety measures do not necessarily mean the insured knows or believes a particular incident is substantially certain or highly likely to occur. [*A-H Plating, Inc. v. American Nat'l Fire Ins. Co.* (1997) 57 CA4th 427, 439-440, 67 CR2d 113, 119-120—"By taking precautionary measures to protect the environment, a company does not eliminate the possibility of 'accidents'"; but see *American States Ins. Co. v. Sacramento Plating, Inc.* (ED CA 1994) 861 F.Supp. 964, 969-971, aff'd (9th Cir. 1995) 99 F3d 1145]

To hold otherwise, in the extreme, would render all accident-based insurance policies worthless. "A company typically purchases a commercial general liability policy to provide some means of protection against injury-producing events. Naturally, the company would not have obtained insurance in the first place unless it had 'expected' such an event. An 'expected' event cannot constitute an 'accident.' Thus, the insurance would provide no coverage at all. Plainly, we cannot accept this interpretation of 'expect' since it would lead to absurd consequences." [*A-H Plating, Inc. v. American Nat'l Fire Ins. Co.*, supra, 57 CA4th at 439-440, 67 CR2d at 119-120]

1/ [5:254.3] **Application—electroplating facility spills; fact-specific inquiry required:** An electroplating company does not necessarily "expect" a *particular* spill into the environment just because it has adopted procedures to prevent, contain and clean up spills *in general*. The company does not ipso facto eliminate the possibility of "accidents" simply by taking precautionary steps to protect the environment. [*A-H Plating, Inc. v. American Nat'l Fire Ins. Co.* (1997) 57 CA4th 427, 440, 67 CR2d 113, 120]

The *circumstances surrounding a particular spill*—such as its cause, its likelihood, its similarity to other spills, and the frequency of similar spills—must be examined to determine whether the insured knew or believed the *subject spill* was "expected" (substantially certain or highly likely to occur). [*A-H Plating, Inc. v. American Nat'l Fire Ins. Co.*, supra, 57 CA4th at 440, 67 CR2d at 120; but see *American States Ins. Co. v. Sacramento Plating, Inc.* (ED CA 1994) 861 F.Supp. 964, 969-971 (contra)—"sudden and accidental" exception held inapplicable based on district court's finding that leaks at electroplating facility were "expected" because insureds had taken precautions to contain such discharges]

4) [5:255] **Compare—"sudden and accidental" discharge despite gradual contamination in routine business operations:** The fact the insured's regular business practices involve the disposal of hazardous materials does not eliminate the *possibility* that at least *some* of the environmental damage might have resulted from a "sudden and

accidental" cause (such as an explosion or fire). [*Montrose Chemical Corp. of Calif. v. Sup.Ct. (Canadian Universal Ins. Co., Inc.)* (1993) 6 C4th 287, 304-305, 24 CR2d 467, 478; *Staefa Control-System, Inc. v. St. Paul Fire & Marine Ins. Co.* (ND CA 1994) 847 F.Supp. 1460, 1469-1470, amended on other grounds (ND CA 1994) 875 F.Supp. 656; see *Reese v. Travelers Ins. Co.* (9th Cir. 1997) 129 F3d 1056, 1062]

Similarly, the fact the discharge of pollutants occurred over a lengthy period "does not automatically mean that the suddenness element cannot be met …" [*Vann v. Travelers Cos.* (1995) 39 CA4th 1610, 1617, 46 CR2d 617, 621 (alleged groundwater contamination from insured's pollutants disposal in operation of auto body repair business); see also *Shell Oil Co. v. Winterthur Swiss Ins. Co.* (1993) 12 CA4th 715, 756, 15 CR2d 815, 841—"'sudden' refers to the pollution's commencement and does not require that the polluting event terminate quickly or have only a brief duration"]

[5:255.1 - 5:255.4] ***Reserved.***

5) [5:255.5] **Requiring discharge** ***and resulting damage during policy period permissible:*** A "sudden and accidental" occurrence exception to a pollution exclusion that applies only if the release of contaminants *and* the resulting damage both occur during the relevant policy period is valid and enforceable. [*Westoil Terminals Co., Inc. v. Industrial Indemnity Co.* (2003) 110 CA4th 139, 149, 1 CR3d 516, 523—also holding policy was not ambiguous because exclusion did not conflict with policy's definition of "occurrence"]

(b) [5:256] **Absolute ("total") pollution exclusion:** Most CGL policies issued after 1985 contain an *absolute* (or "total") pollution exclusion with *no exception* for "sudden and accidental" occurrences. [See *MacKinnon v. Truck Ins. Exchange* (2003) 31 C4th 635, 639, 644, 3 CR3d 228, 231, 235 & fn. 3—but noting that pre-1985 "qualified pollution" (*¶ 5:253 ff.*) and post-1985 "absolute pollution" exclusions are never designated as such in policies; *Foster-Gardner, Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa.* (1998) 18 C4th 857, 865, 77 CR2d 107, 111, fn. 3; see also *Griffin Dewatering Corp. v. Northern Ins. Co.* (2009) 176 CA4th 172, 97 CR3d 568, fn. 3—to degree there is any difference between "total" and "absolute" pollution exclusion, "total" apparently excludes a "little more"]

These exclusions are enforced according to their terms, generally relieving the insurer of any obligation to defend against or indemnify for governmentally-imposed clean-up or monitoring costs or other third party toxic contamination claims. [See *Legarra v. Federated Mut. Ins. Co.* (1995) 35 CA4th 1472, 1480-1482, 42 CR2d 101, 105-107—absolute pollution exclusion barred coverage for government-ordered response costs to remediate groundwater contamination caused by discharge of fuel pollutants from insured's property; *CDM Investors v. Travelers Cas. & Sur. Co.* (2006) 139 CA4th 1251, 1261-1262, 43 CR3d 669, 675-676—no coverage for costs incurred by insured to test property for pollutants as ordered by Water Quality Control Board because language of absolute pollution exclusion was "non-specific and all-encompassing"]

1) [5:256.1] **Purpose:** Absolute pollution exclusion clauses were promulgated to eliminate insurance coverage for gradual environmental degradation and government-mandated cleanups under the Superfund legislation. They were never intended to (nor do they) bar coverage for ordinary acts of negligence involving toxic substances not commonly thought of as environmental pollution. [See *MacKinnon v. Truck Ins. Exchange* (2003) 31 C4th 635, 645, 653, 3 CR3d 228, 236, 242; *and discussion at ¶ 5:258 ff.*]

2) [5:257] **Coverage in concurrent cause cases—"efficient proximate cause" analysis:** In a narrow class of cases, there may be CGL policy coverage for toxic contamination damage notwithstanding an unambiguous absolute pollution exclusion. This occurs where the damage is caused by *both* covered and noncovered occurrences:

"When a loss is caused by a combination of a covered and specifically excluded risks, the loss is covered if the *covered risk* was the *efficient proximate cause* of the loss." The "efficient proximate cause" is the cause that sets the other cause in motion. [*State Farm Fire & Cas. Co. v. Von Der Lieth* (1991) 54 C3d 1123, 1131-1132, 2 CR2d 183, 189 (emphasis added)]

• [5:257.1] For example, plaintiff had a business premises liability policy that included earthquake coverage but also contained an absolute pollution exclusion. The release of contaminants on plaintiff's property came from a leaking underground storage tank that cracked as a result of an earthquake. The court concluded the case involved two distinct causes (earthquake and leaking tank) as to which an "efficient proximate cause" analysis applied; and that if the earthquake was the efficient cause of the cracking and subsequent leaking, plaintiff's clean-up expense

would be covered notwithstanding the absolute pollution exclusion. [*Brian Chuchua's Jeep, Inc. v. Farmers Ins. Group* (1992) 10 CA4th 1579, 1582-1583, 13 CR2d 444, 445-446]

3) [5:258] **Applies only to "traditional" environmental pollution:** The standard absolute pollution exclusion is targeted at, and limited to, "traditional" or "conventional" environmental industrial pollution—i.e., events "commonly thought of" as environmental pollution. [*MacKinnon v. Truck Ins. Exchange* (2003) 31 C4th 635, 641, 653-654, 3 CR3d 228, 233, 242-243 & fn. 1; *American Cas. Co. of Reading, Penn. v. Miller* (2008) 159 CA4th 501, 508, 71 CR3d 571, 575]

a) Examples

• [5:258.1] Groundwater contamination from industrial operations and sewage-borne bacteria are classic examples of "traditional" environmental pollution. An insured's liability for injuries arising from these kinds of pollution is excluded from coverage under a standard absolute pollution exclusion clause. [See *MacKinnon v. Truck Ins. Exchange*, supra (collecting cases)]

• [5:258.2] Widespread dissemination of silica dust as an incidental byproduct of industrial sandblasting operations also is considered "traditional" environmental pollution and therefore excluded from coverage under a standard absolute pollution exclusion clause. [*Garamendi v. Golden Eagle Ins. Co.* (2005) 127 CA4th 480, 485-486, 25 CR3d 642, 645-646]

• [5:258.3] Similarly, an absolute pollution exclusion clause bars coverage for injuries arising from the widespread dissemination of dust and offensive odors as a persistent byproduct of a compost facility's operations: "Odors in general, and compost odors in particular, are recognized as pollutants under California law [Health & Saf.C. §§ 39013 & 41705(a)(2)]." [*Cold Creek Compost, Inc. v. State Farm Fire & Casualty Co.* (2007) 156 CA4th 1469, 1483-1486, 63 CR3d 216, 227-229]

• [5:258.4] The release of methylene chloride into a public sewer by a furniture stripping company is an event "commonly thought of as environmental pollution," and thus excluded from coverage under an absolute pollution exclusion clause. [See *American Cas. Co. of Reading, Penn. v. Miller* (2008) 159 CA4th 501, 516, 71 CR3d 571, 581-582]

• [5:258.5] Placing rocks and dirt along a washed out access road constitutes "environmental pollution" within the meaning of a standard absolute pollution exclusion clause if the placement results in a damaging discharge of fill material into nearby waterways. [*Ortega Rock Quarry v. Golden Eagle Ins. Corp.* (2006) 141 CA4th 969, 990, 46 CR3d 517, 532]

• [5:258.6] The release and airborne dissemination of asbestos fibers from scraping and removing acoustical "popcorn" ceilings is considered "traditional" environmental pollution, precluding coverage under a standard pollution exclusion clause. [See *Villa Los Alamos Homeowners Ass'n v. State Farm Gen. Ins. Co.* (2011) 198 CA4th 522, 533, 130 CR3d 374, 381 (applying general principles re pollution exclusion clauses in standard thirdparty liability CGL policies to comparable clauses in first party property insurance policies; ¶ *5:259*)]

[5:258.7 - 5:258.9] ***Reserved.***

b) [5:258.10] **Compare—injuries from "ordinary acts of negligence":** Giving effect to the insured's "reasonable expectations," the standard absolute pollution exclusion clause in a CGL policy does *not* exclude coverage for injury arising from ordinary acts of negligence involving toxic chemicals—i.e., from negligent acts not "commonly thought of as pollution" or "environmental pollution." [*MacKinnon v. Truck Ins. Exchange* (2003) 31 C4th 635, 649-654, 3 CR3d 228, 239-244—exclusion inapplicable to injury from negligent spraying of pesticides around apartment to kill yellow jackets (unlikely "reasonable" policyholder would equate such spraying with environmental pollution); compare *American Cas. Co. of Reading, Penn. v. Miller* (2008) 159 CA4th 501, 504, 71 CR3d 571, 572—exclusion applicable to injury from negligent release of methylene chloride into public sewer (ordinary insureds would "reasonably" expect such release to constitute environmental pollution); see also *Cold Creek Compost, Inc. v. State Farm Fire & Casualty Co.* (2007) 156 CA4th 1469, 1479, 63 CR3d 216, 223]

In fact, extending the exclusion to all acts of negligence would lead to "absurd results" because "[v]irtually any substance can act under the proper circumstances as an irritant or contaminant." [*MacKinnon v. Truck Ins.*

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Exchange, supra, 31 C4th at 650, 3 CR3d at 240 (internal quotes omitted); *American Cas. Co. of Reading, Penn. v. Miller*, supra, 159 CA4th at 510, 71 CR3d at 576]

4) [5:258.11] **Exclusion not limited to catastrophic events or extensive injuries:** Application of the absolute pollution exclusion is not limited to large scale environmental pollution: "[T]here need not be wholesale environmental degradation, such as occurred at, for example, Love Canal, or the Stringfellow Acid Pits to constitute pollution" for exclusion purposes. [*American Cas. Co. of Reading, Penn. v. Miller* (2008) 159 CA4th 501, 516, 71 CR3d 571, 581 (original emphasis and internal quotes omitted)]

Likewise, the extent of environmental damage or injury does not determine whether the absolute pollution exclusion applies. Rather, the "type of pollutant and how it is released into the environment" is controlling. [*American Cas. Co. of Reading, Penn. v. Miller*, supra]

5) [5:259] **Effect of separate endorsement excluding asbestos claims:** In addition to the "total" pollution exclusion, some policies contain a separate endorsement excluding claims based on exposure to asbestos. Inclusion of that endorsement "cannot reasonably be understood to mean that the pollution exclusion is inapplicable to *other* pollutants not specifically designated in a separate endorsement." [*Garamendi v. Golden Eagle Ins. Co.* (2005) 127 CA4th 480, 488, 25 CR3d 642, 648 (emphasis added)—asbestos endorsement did not make "total" pollution exclusion inapplicable to claims based on exposure to natural product similar to asbestos, silica dust]

Similarly, failure to include a separate asbestos exclusion endorsement does *not* restrict the scope of a generalized "total" pollution exclusion clause. Indeed, notwithstanding the fact an asbestos endorsement is available but not incorporated into a policy, the scope of a generalized "total" pollution exclusion encompasses claims based on exposure to asbestos. [See *Villa Los Alamos Homeowners Ass'n v. State Farm Gen. Ins. Co.* (2011) 198 CA4th 522, 541, 130 CR3d 374, 388—release of asbestos constituted environmental pollution within meaning of generalized pollution exclusion clause contained in first party property insurance policy, precluding coverage for remediation clean-up work]

(c) [5:260] **"Owned property" exclusion:** The "owned property" exclusion in a CGL policy operates independently of the pollution exclusion. It typically excludes coverage for damage to property (i) owned, occupied or rented by the insured, (ii) used by the insured, or (iii) in the care, custody or control of the insured. [See *A-H Plating, Inc. v. American Nat'l Fire Ins. Co.* (1997) 57 CA4th 427, 441-442, 67 CR2d 113, 121; *Vann v. Travelers Cos.* (1995) 39 CA4th 1610, 1618, 46 CR2d 617, 622]

1) [5:260.1] **Application:** The owned property exclusion precludes coverage for clean-up costs incurred solely to remediate property belonging to or leased by the insured. [See *Shell Oil Co. v. Winterthur Swiss Ins. Co.* (1993) 12 CA4th 715, 758, 15 CR2d 815, 843]

The exclusion likewise eliminates coverage for costs of removing solid wastes stored on the insured's property and which pose no risk to the property of others. [*Titan Corp. v. Aetna Cas. & Sur. Co.* (1994) 22 CA4th 457, 474, 27 CR2d 476, 484; see also *State of New Jersey, Dept. of Environmental Protection v. Signo Trading Int'l, Inc.* (App.Div. 1989) 235 NJ Super. 321, 330-336, 562 A2d 251, 256-260]

2) [5:261] **Coverage where pollution threatens adjoining property or groundwater:** On the other hand, the owned property exclusion does not defeat CGL coverage for environmental hazards remediation simply because the contamination originates on the insured's property. There is at least *potential* coverage (thus triggering the insurer's duty to defend) if the contamination threatens the *surrounding environment* or *public or private water supplies*. [*Vann v. Travelers Cos.* (1995) 39 CA4th 1610, 1618-1619, 46 CR2d 617, 622; see *A-H Plating, Inc. v. American Nat'l Fire Ins. Co.* (1997) 57 CA4th 427, 442, 67 CR2d 113, 121 (groundwater pollution from insured's business operations potentially covered despite owned property exclusion)—state and federal governments, not the insured, own groundwater; *Reese v. Travelers Ins. Co.* (9th Cir. 1997) 129 F3d 1056, 1061 (same)]

"Allegations of potential groundwater contamination may reasonably be read to include concerns for *off-site contamination* and such allegations are thus not necessarily limited to property occupied or controlled by [the insured]. *Even if off-site migration has not yet occurred* …, we do not believe that the standard 'owned property' exclusion should automatically defeat coverage in suits seeking 'cleanup' costs designed to prevent damage to third parties …" [*Vann v. Travelers Cos.*, supra, 39 CA4th at 1618-1619, 46 CR2d at 622 (emphasis added); see also *Shell Oil Co. v. Winterthur Swiss Ins. Co.* (1993) 12 CA4th 715, 758-759, 15 CR2d 815, 843-844—"remedial

measures on [insured's] property to prevent imminent danger to others could be covered"; *Intel Corp. v. Hartford Acc. & Indem. Co.* (9th Cir. 1991) 952 F2d 1551, 1565-1566]

[5:261.1 - 5:261.4] ***Reserved.***

3) [5:261.5] **Coverage where State-insured's operation of toxic waste facility contaminates groundwater?** There is no definitive answer whether the owned property exclusion eliminates coverage where the insured is the State of California whose maintenance or operation of a toxic waste facility has contaminated the groundwater. While the State "owns" the groundwater in its natural condition, that is not "ownership" as the term is commonly understood; the State has the power to control and regulate use of the groundwater, but does not have a proprietary interest in it or the right to exercise physical dominion over it. [*State of Calif. v. Sup.Ct. (Underwriters at Lloyd's of London)* (2000) 78 CA4th 1019, 1027-1032, 93 CR2d 276, 283-287; *see discussion at ¶ 4:56 ff.*]

Whether this type of "hybrid" ownership triggers the owned property exclusion is a question of *policy interpretation*, to be decided under well-settled principles of insurance policy construction. [See *State of Calif. v. Sup.Ct. (Underwriters at Lloyd's of London)*, supra, 78 CA4th at 1033-1034, 93 CR2d at 287-288 (remanded on this issue)—holding only that State does not "own" the groundwater so as to make the exclusion applicable as a matter of law]

➪ [5:262] ***PRACTICE POINTER FOR INSUREDS:*** Under California law, *ambiguities* in an insurance policy generally are to be construed *against the insurer* (i.e., in favor of coverage) regardless of the insured's sophistication. [See *AIU Ins. Co. v. Sup.Ct. (FMC Corp.)* (1990) 51 C3d 807, 822-824, 274 CR 820, 831-833] This rule may give insureds a basis for arguing environmental hazards coverage even if there is a pollution exclusion or an owned property exclusion in the policy. (*But see ¶ 5:254* for cases concluding "sudden and accidental" occurrence exception to pollution exclusion is *not* ambiguous.)

[5:263] ***Reserved.***

(3) [5:264] **Coverage under personal injury endorsement despite pollution exclusion?** Many CGL policies contain a "personal injury endorsement," providing separate coverage for "personal injury" liability; "personal injury" is defined by the policy to include "wrongful entry or eviction *or other invasion of the right of private occupancy*." [See *Legarra v. Federated Mut. Ins. Co.* (1995) 35 CA4th 1472, 1482, 42 CR2d 101, 107; *Martin Marietta Corp. v. Insurance Co. of No. America* (1995) 40 CA4th 1113, 1118, 47 CR2d 670, 672]

Cases are split on the application of personal injury coverage to pollution claims (the argument being that migrating pollution is a "wrongful entry" notwithstanding the absence of intent to dispossess another of their land):

• [5:264.1] *View that pollution exclusion defeats coverage:* At least where the policy contains an *unambiguous pollution exclusion*, most courts conclude an additional personal injury endorsement does *not* provide coverage for environmental damage clean-up costs. To hold otherwise would render the pollution exclusion meaningless. [*Lakeside Non-Ferrous Metals, Inc. v. Hanover Ins. Co.* (9th Cir. 1999) 172 F3d 702, 705-706 (applying Calif. law); *Legarra v. Federated Mut. Ins. Co.* (1995) 35 CA4th 1472, 1485-1486, 42 CR2d 101, 109; *Titan Corp. v. Aetna Cas. & Sur. Co.* (1994) 22 CA4th 457, 474-476, 27 CR2d 476, 485-487; *Union Oil Co. of Calif. v. International Ins. Co.* (1995) 37 CA4th 930, 940, 44 CR2d 4, 10]

• [5:264.2] *View finding potential coverage:* A contrary line of authority takes a more expansive view of "wrongful entry," holding that contamination of neighboring property can fall within "personal injury" coverage. But in most of these cases the policy either contained no conflicting pollution exclusion or contained ambiguous exclusion language, leading the court to conclude the insured might reasonably have expected coverage under the circumstances. [See *Martin Marietta Corp. v. In-surance Co. of No. America* (1995) 40 CA4th 1113, 1136, 47 CR2d 670, 684 (collecting cases); *Block v. Golden Eagle Ins. Corp.* (2004) 121 CA4th 186, 200-201, 17 CR3d 13, 25-26—insured's claim not covered because it did not involve "wrongful entry" claims brought by adjacent landowners]

(a) [5:264.3] **Effect of policy definition of "property damage":** Where the policy defines "property damage" to include "loss of use," actions involving the diminished use and enjoyment of the property (e.g., nuisance, trespass, disturbance of quiet enjoyment, etc.) fall "squarely within the definition" of *property damage* and therefore do *not* constitute "personal injury." [*Lakeside Non-Ferrous Metals, Inc. v. Hanover Ins. Co.* (9th Cir. 1999) 172 F3d 702, 706—

no coverage where underlying nuisance claim (insured's contamination interfered with plaintiff's ability to "use, develop, sell, let or encumber") fit squarely within definition of "property damage" and was expressly excluded by pollution exclusion]

(4) [5:265] **Trigger of coverage issues—progressively deteriorating losses:** Another coverage problem arises where the damage caused by pollution, though otherwise a covered peril under the CGL policy, continues undiscovered over a long period of time involving several policy periods and several different insurers on the risk.

The issue is one of "trigger of coverage." In the third party liability insurance (CGL) context, "trigger of coverage" refers to the circumstances that activate the insurer's defense and indemnity obligations under the policy—i.e., it is "a term of convenience used to describe 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. The issue is largely one of time—what must take place *within the policy's effective dates* for the potential of coverage to be 'triggered'?" [*Montrose Chemical Corp. of Calif. v. Admiral Ins. Co.* (1995) 10 C4th 645, 655, 42 CR2d 324, 326, fn. 5 (emphasis in original)]

(a) [5:266] **Continuous injury trigger of coverage approach:** As an "occurrence-based" type of policy, standard CGL coverage does not restrict the period during which a *claim* may be made; it covers losses for which the insured is liable so long as the damage "occurs" during the policy period, irrespective of when the insured's allegedly wrongful conduct may have taken place. (This is distinguished from a "claims-made" policy, which covers third party claims "asserted" against the insured during the policy period regardless of when the underlying damage occurred.) [*Montrose Chemical Corp. of Calif. v. Admiral Ins. Co.* (1995) 10 C4th 645, 668-669 675 688, 42 CR2d 324, 336, 340, 349; see *A.C. Label Co., Inc. v. Transamerica Ins. Co.* (1996) 48 CA4th 1188, 1192, 56 CR2d 207, 209]

With regard to standard occurrence-based CGL coverage, the Cal. Supreme Court has adopted a "*continuous injury trigger of coverage*" approach in these continuing loss cases; i.e., bodily injury or property damage that is continuous or progressively deteriorating throughout successive policy periods is potentially covered (up to the policy limits) by *all policies in effect during those periods*. It is immaterial that the loss from the contamination commenced before the particular policy took effect. [*Montrose Chemical Corp. of Calif. v. Admiral Ins. Co.*, supra, 10 C4th at 689, 42 CR2d at 350; see also *County of San Bernardino v. Pacific Indem. Co.* (1997) 56 CA4th 666, 681-682, 65 CR2d 657, 666]

• [5:266.1] This approach is supported by standard CGL policy language. The insuring clause does not impose, as a condition of coverage, a requirement that the damage or injury be discovered at any particular point in time. Rather, it provides coverage for injury or damage caused by an "occurrence," and typically defines "occurrence" as an "accident," including "a continuous or repeated exposure to conditions," which results in bodily injury or property damage during the policy period.

Pursuant to this language, it is a third party's injury or property damage, alleged to have been continuous or progressively deteriorating through the insurer's policy period(s), and which allegedly resulted from the continuous and repeated exposure to pollution for which the insured is allegedly responsible, that triggers potential coverage under the policy. [*Montrose Chemical Corp. of Calif. v. Admiral Ins. Co.* (1995) 10 C4th 645, 668-669, 42 CR2d 324, 335-336; see *County of San Bernardino v. Pacific Indem. Co.* (1997) 56 CA4th 666, 681, 65 CR2d 657, 666]

1) [5:266.2] **Coverage where contaminated property acquired after policy period?** Although the California Supreme Court has not yet addressed the issue, several cases hold there is no coverage under a CGL policy that *expired before the insured acquired the contaminated property;* it is *immaterial* that the pollution on the subject property occurred *during* the policy period. CGL coverage is not triggered during the policy period because the insured "had no connection to or nexus with the damage caused by contamination that occurred on *the subsequently acquired property* during the policy period." [*A.C. Label Co., Inc. v. Transamerica Ins. Co.* (1996) 48 CA4th 1188, 1193-1194, 56 CR2d 207, 210 (emphasis added) (distinguishing *Montrose*, supra); *Tosco Corp. v. General Ins. Co. of America* (2000) 85 CA4th 1016, 1023, 102 CR2d 657, 662; *FMC Corp. v. Plaisted & Cos.* (1998) 61 CA4th 1132, 1150, 72 CR2d 467, 477 (disapproved on other grounds by *State of Calif. v. Continental Ins. Co.* (2012) 55 C4th 186, 201, 145 CR3d 1, 11)]

However, a Ninth Circuit case reached the opposite conclusion, *predicting* that the California Supreme Court will hold a CGL policy covers property damage occurring during the policy period caused by property the insured acquired *after* the policy expired. Rationale: *Damage to the claimant* is the event that triggers coverage. [*In re K.F. Dairies, Inc. & Affiliates* (9th Cir. 2000) 224 F3d 922, 925 (applying Calif. law)—policy covered damage to state-owned groundwater occurring within policy period even though insured purchased property after policy period]

2) [5:266.3] **Application to successor liability:** A successor corporation's *contractual assumption* of its predecessor's liabilities does not automatically (by operation of law) also entitle the successor to defense and indemnity coverage under the *predecessor's* CGL occurrence-based policies for injury or damage arising out of the predecessor's business during those policy periods. If the policy contains a consent-to-assignment provision and liability *has already been determined* for the loss in question, the party who agreed to assume the insured's liabilities without the insurer's consent to an assignment of policy rights has *no coverage* under that policy (Ins.C. § 520). However, if the insured's liability has *not yet been determined*, the insurer's consent to assignment is *not* required. [See *Fluor Corp. v. Sup.Ct. (Hartford Acc. & Indem. Co.)* (2015) 61 C4th 1175, 1219, 1224, 191 CR3d 498, 532, 536 (overruling *Henkel Corp. v. Hartford Acc. & Indem. Co.* (2003) 29 C4th 934, 129 CR2d 828); see also Croskey, Heeseman, Ehrlich & Klee, *Cal. Prac. Guide: Insurance Litigation* (TRG), ¶ 7:430.5 ff.]

a) [5:266.4] **Result where successor liability imposed by operation of law?** In a few limited situations, successor liability for the predecessor's torts is imposed *involuntarily by operation of law* (e.g., CERCLA imposes liability upon successor corporations without regard to contract; see *SmithKline Beecham Corp. v. Rohm & Haas Co.* (3rd Cir. 1996) 89 F3d 154, 163). Whether, in such cases, the predecessor's applicable policy benefits should likewise pass to the successor by operation of law has not yet been decided by the Cal. Supreme Court. [See *Henkel Corp. v. Hartford Acc. & Indem. Co.* (2003) 29 C4th 934, 941, 129 CR2d 828, 833 (overruled on other grounds by *Fluor Corp. v. Sup.Ct. (Hartford Acc. & Indem. Co.)* (2015) 61 C4th 1175, 1219, 1224, 191 CR3d 498, 532, 536) (raising but not deciding issue because successor's liability did not arise by operation of law but was assumed by contract)]

(b) [5:267] **Compare—first party insurance (manifestation of loss approach):** In *first party* property insurance cases (coverage for loss or damage sustained directly by the insured, as distinguished from a CGL third party liability policy), a "*manifestation of loss*" rule applies: The insurer insuring the property at the time *appreciable property damage becomes manifest* is solely responsible for indemnifying the insured once coverage is established. [*Prudential-LMI Commercial Ins. v. Sup.Ct. (Lundberg)* (1990) 51 C3d 674, 699, 274 CR 387, 403-404; see *Montrose Chemical Corp. of Calif. v. Admiral Ins. Co.* (1995) 10 C4th 645, 663-665, 42 CR2d 324, 332-334]

Thus, there is no first party coverage where damage caused by environmental contamination first becomes manifest after the policy in question has expired. [*Stanton Road Assocs. v. Pacific Employers Ins. Co.* (1995) 36 CA4th 333, 341, 43 CR2d 1, 5—no first party coverage for progressive environmental contamination to insured's property from adjoining dry cleaning plant because contamination not manifested until after expiration of policy periods]

(5) Duty to defend issues

(a) [5:268] **No duty to defend prelawsuit proceedings:** Although a CGL insurer owes a duty to defend "suits," it has *no duty* to defend "claims" that have not yet become "suits." Instead, the insurer has *discretion* to investigate and settle "claims" as it deems expedient (*¶ 5:268.2*). [*Foster-Gardner, Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa.* (1998) 18 C4th 857, 885, 77 CR2d 107, 126]

1) [5:268.1] **Includes proceedings before environmental protection agencies:** Environmental claims usually begin when an oversight agency notifies a landowner (or former landowner) that it is a PRP for designated hazardous wastes and orders a clean-up. [See generally Health & Saf.C. § 78650 (recodified & added Stats. 2022, Ch. 257, oper. 1/1/24)]

Such orders may have the "functional effect" of a judgment because facts determined therein may be given collateral estoppel effect in subsequent judicial proceedings.

Even so, a liability insurer owes *no duty to investigate or defend* the insured against an administrative pollution clean-up order. Until the agency files a "suit" within the meaning of a CGL policy—i.e., an adversarial proceeding *commenced in a court of law*—a CGL insurer is not obligated to defend. [*Foster-Gardner, Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa.* (1998) 18 C4th 857, 885, 77 CR2d 107, 126 (decided under predecessor statute); *Certain Underwriters at Lloyd's of London v. Sup.Ct. (Powerine Oil Co., Inc.)* (2001) 24 C4th 945, 959-960, 103 CR2d 672, 681-682 (decided under predecessor statute); *Lockheed Martin Corp. v. Continental Ins. Co.* (2005) 134 CA4th 187, 194, 35 CR3d 799, 803 (disapproved on other grounds by *State of Calif. v. Allstate Ins. Co.* (2009) 45 C4th 1008, 1036, 90 CR3d 1, 25, fn. 11)]

a) [5:268.1a] **Compare—Ninth Circuit treats EPA's PRP notice as "functional equivalent of a suit":** Applying Oregon law, the Ninth Circuit has determined receipt of two letters from the EPA seeking to hold a property owner

liable for environmental contamination triggered its insurer's duty to provide a legal defense for activities covered under its CGL policies. Reason: Nonsettling PRPs may be held jointly and severally liable for the entire amount of response costs minus the amount of the settlement, and they may not file a contribution action against settling PRPs regarding matters addressed in the settlement (*¶ 5:136*). [See *Anderson Bros., Inc. v. St. Paul Fire & Marine Ins. Co.* (9th Cir. 2013) 729 F3d 923, 930 (noting "huge majority" of U.S. courts have held policyholder's receipt of EPA's PRP notice constitutes "functional equivalent" of a "suit")]

2) [5:268.1b] **Compare—quasi-judicial *adjudicative proceedings:*** A federal *adjudicative* administrative agency proceeding held to resolve government demands against insured parties is a "suit" for purposes of triggering an insurer's duty to defend. In contrast to mere claims, remedial orders or threats to take legal action that do not obligate the insurer (¶ 5:268 ff.), quasi-judicial administrative proceedings require the filing of a complaint, are heard and determined by administrative law judges, and may involve days of trial, numerous witnesses and substantial evidence. In short, "[a] reasonable policyholder would recognize such proceedings as a suit and would expect to be defended and, if necessary, indemnified by its insurer." [See *Ameron Int'l Corp. v. Insurance Co. of State of Penn.* (2010) 50 C4th 1370, 1374-1375, 1386-1387, 118 CR3d 95, 97, 107 (decided under predecessor statute)]

Moreover, "[g]iven insurers' reliance on a 'complaint' for coverage determinations, and [the Supreme Court's] policy of emphasizing substance over form in characterizing pleadings, it is reasonable for all parties to a liability insurance policy that does not define the term 'suit' to expect a federal adjudicative administrative agency board proceeding to trigger the defense and indemnity provisions in the policy." [See *Ameron Int'l Corp. v. Insurance Co. of State of Penn.*, supra, 50 C4th at 1386, 118 CR3d at 107 (upholding *Foster-Gardner* decision as it applies to "actions involving pollution remediation *orders*, or any matters that involve threats to take legal action only, rather than to 'suits'" (emphasis added))]

3) [5:268.2] **Distinguish—broader insuring clauses:** The principles set forth at ¶ 5:268 ff. apply under a standard comprehensive general liability policy. The result may be different, however, in the event the insuring clause more broadly defines "suit" to include administrative clean-up orders. [See *Ortega Rock Quarry v. Golden Eagle Ins. Corp.* (2006) 141 CA4th 969, 979, 46 CR3d 517, 524—even assuming negotiations and letter exchange with EPA constituted a "suit" within meaning of policies that defined "suit" to include alternative dispute resolution proceedings, insurers had no duty to defend insured in EPA administrative proceedings because insurers did not consent to submit to such proceedings as required by policies' unambiguous definition of "alternative dispute resolution proceedings"]

4) [5:268.3] **Compare—affirmative defense asserted as setoff:** Under ordinary, duty-to-defend policy language, an insurer has no duty to defend against affirmative defenses raised in response to a lawsuit brought by its insured. However, an affirmative defense asserted as a *setoff claim* may constitute the functional equivalent of a suit seeking damages triggering a duty to defend under a CGL policy if the affirmative defense (i) would "unquestionably have been a suit for damages if asserted in a court of law" *and* (ii) fell within the scope of the policy's insuring clause. [*CDM Investors v. Travelers Cas. & Sur. Co.* (2006) 139 CA4th 1251, 1268-1269, 43 CR3d 669, 680-681—where property owner sued its tenants for indemnification of response costs incurred pursuant to Water Quality Control Board order and tenants asserted affirmative defense of setoff against owner, tenants' claim was "purely defensive" and not "functional equivalent" of suit for damages that would trigger duty to defend]

5) [5:268.4] **Compare—insurer's option to intervene before "suit":** Even though there is no *duty* to defend, insurers have discretion to investigate and settle prelawsuit claims. Insurers often find it in their interest to assist their insureds in administrative proceedings that could lead to an award of damages in subsequent civil proceedings that they will ultimately have to indemnify. [*Foster-Gardner, Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa.* (1998) 18 C4th 857, 883-884, 77 CR2d 107, 125]

[5:268.4a] ***Reserved.***

(b) [5:268.4b] **Triggered by *potential coverage:*** The insurer's duty to defend is broader than its duty to indemnify. An insurer may have a duty to defend under a CGL policy even when it ultimately has no obligation to indemnify (either because no damages are awarded in the underlying action against the insured or because the judgment is for damages not covered by the policy). [*Montrose Chemical Corp. of Calif. v. Sup.Ct. (Canadian Universal Ins. Co., Inc.)* (1993) 6 C4th 287, 295, 24 CR2d 467, 471; *Scottsdale Ins. Co. v. MV Transp.* (2005) 36 C4th 643, 654, 31 CR3d 147, 153]

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The insurer's duty to defend is triggered when a third party suit alleges a claim that *potentially* or even *possibly* could subject the insured to liability for covered damages. In such cases, the insurer must defend "unless and until the insurer can demonstrate, by reference to 'undisputed facts' that the claim *cannot* be covered." [*Vann v. Travelers Cos.* (1995) 39 CA4th 1610, 1614, 46 CR2d 617, 619 (emphasis added); see *Montrose Chemical Corp. of Calif. v. Sup.Ct. (Canadian Universal Ins. Co., Inc.)*, supra, 6 C4th at 295, 24 CR2d at 471—duty to defend "may exist even where coverage is in doubt and ultimately does not develop"; *Scottsdale Ins. Co. v. MV Transp.*, supra, 36 C4th at 655, 31 CR3d at 154]

To defeat the insurer's duty to defend, the evidence (whether based on facts alleged in the underlying third party complaint or on undisputed extrinsic facts known to the insurer at the time of tender) must "*conclusively eliminate* a potential for [covered] liability." [*Wausau Underwriters Ins. Co. v. Unigard Security Ins. Co.* (1998) 68 CA4th 1030, 1037, 80 CR2d 688, 692 (emphasis and brackets in original; internal quotes omitted); see *Scottsdale Ins. Co. v. MV Transp.*, supra, 36 C4th at 655, 31 CR3d at 154]

1) [5:268.4c] **Burden of proof?** It is not clear who bears the burden of proof on the issue. Most courts place the initial burden on the insured to establish the existence of *potential* coverage; the burden then shifts to the insurer to establish that the underlying claim *cannot* fall within policy coverage. [*Montrose Chemical Corp. of Calif. v. Sup.Ct. (Canadian Universal Ins. Co., Inc.)* (1993) 6 C4th 287, 300, 24 CR2d 467, 475; *Wausau Underwriters Ins. Co. v. Unigard Security Ins. Co.* (1998) 68 CA4th 1030, 1037, 80 CR2d 688, 692; but see also *Aydin Corp. v. First State Ins. Co.* (1998) 18 C4th 1183, 1194, 77 CR2d 537, 543, fn. 6—expressly declining to express opinion on which party should bear burden of proof]

(c) [5:268.5] **"Mixed claim" cases:** In "mixed claim" cases where one or some of the claims are potentially covered and others are not, the insurer nevertheless has a duty to defend the *entire* action—including those claims for which there is no potential policy coverage. [*Buss v. Sup.Ct. (Transamerica Ins. Co.)* (1997) 16 C4th 35, 48, 65 CR2d 366, 375]

It is enough that a *single claim* is potentially covered; the insurer owes a duty to defend even if all other claims against the insured clearly are not covered. This is not a contractual duty (because the insured has not paid premiums for a defense of claims not even potentially covered) but an obligation *implied by law* in support of the policy (a "*prophylactic* rule") … because "to defend meaningfully, [the insurer] must defend immediately, and to defend immediately, it must defend entirely." [*Buss v. Sup.Ct. (Transamerica Ins. Co.)*, supra, 16 C4th at 48, 65 CR2d at 375; see also *Aerojet-General Corp. v. Transport Indem. Co.* (1997) 17 C4th 38, 59-60, 70 CR2d 118, 130-131]

1) [5:268.6] **Costs of defending noncovered claim reimbursable from insured:** Because it has *no contractual* duty to defend noncovered claims (as distinct from its "prophylactic" duty "implied in law," ¶ 5:268.5), the insurer's defense costs attributable exclusively to claims *not even potentially covered* by the policy properly can be allocated to the insured (provided the insurer "reserved its rights" when it accepted defense of the third party claim). But the burden of proof is on the *insurer* to show (by a preponderance of the evidence) that the specific defense costs sought to be reimbursed can be allocated *solely* to the claims that are not even potentially covered. [*Buss v. Sup.Ct. (Transamerica Ins. Co.)* (1997) 16 C4th 35, 50-53, 65 CR2d 366, 376-378; *Aerojet-General Corp. v. Transport Indem. Co.* (1997) 17 C4th 38, 69, 70 CR2d 118, 137]

Cross-refer: The scope of an insurer's duty to defend, along with the rights and obligations incident thereto, is an exceedingly complex area of the law. For a comprehensive treatment of the subject, see Croskey, Heeseman, Ehrlich & Klee, *Cal. Prac. Guide: Insurance Litigation* (TRG), Ch. 7B.

[5:269] ***Reserved.***

b. [5:270] **Limited title insurance coverage:** Title insurance companies will not insure against the existence of hazardous materials. However, a buyer can obtain an endorsement to its title policy, insuring that there are no liens or notices of record that disclose the existence of hazardous materials (or that disclose claims or violations regarding environmental conditions). (*See ¶ 3:89 ff.*)

Nonetheless, such an endorsement provides little protection for buyers because it simply insures the *state of title*, not the physical environmental condition of the property.

[5:271 - 5:279] ***Reserved.***

c. [5:280] **Other types of coverage:** New forms of environmental insurance are becoming increasingly available. For example:

- Property transfer liability insurance provides coverage for the cost of cleaning up existing hazardous substances not discovered by the consultant who conducted the environmental site assessment.

- Pollution legal liability insurance provides coverage for third party bodily injury or property damage caused by environmental conditions created from ongoing business operations.

- Other forms of environmental insurance include asbestos abatement coverage; above ground storage tank coverage; underground storage tank liability and cleanup coverage; directors and officers environmental liability coverage; and environmental professional liability coverage.

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California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 6. Financing and Appraisals

A. Introduction and Role of Counsel in Financing Transactions

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1. [6:1] **Scope Overview:** Buyers rarely purchase real property without concurrently procuring a loan, secured by the acquired property, to fund most of the purchase price. The structure, negotiation and documentation of a real property secured loan is therefore an integral part of the purchase and sale process.

➪ [6:2] ***PRACTICE POINTER:*** This Chapter discusses real property secured financing from the perspective of *counsel's role* in negotiating, reviewing and documenting various instruments evidencing loans obtained in purchase and sale transactions. The subject of secured real property financing is vast and includes a broad range of issues not covered in this Practice Guide. General practitioners new to the subject are well-advised to associate or consult with appropriate experts before launching too deeply into financing transactions.

a. [6:3] **Financing despite “all-cash” transaction:** Many purchase and sale matters are commonly referred to as “all-cash” transactions; but this does not necessarily mean the buyer is not procuring a loan. The term “all cash” is used generically to refer to the fact the *seller* will be “cashed out.” In other words, “all cash” often simply means the total purchase price will be paid to the seller in cash at the closing (as opposed to the seller taking back a promissory note for part of the purchase price).

b. [6:4] **Seller-related financing issues:** Buyer's counsel typically deals with financing issues; however, seller's counsel often has an agenda of financing issues as well. For example:

- The seller usually must make arrangements to *pay off its existing loan* concurrent with the closing. This entails such things as arranging for reconveyance of the deed of trust, return of the original promissory note and deed of trust to the seller and, sometimes, payment to the lender of a prepayment charge (*¶ 6:250 ff.*).

- In addition, if the seller accepts a portion of the purchase price in the form of a loan to the buyer (i.e., seller financing), seller's counsel will usually be responsible for documenting that loan.

- Other seller-related financing issues arise if the buyer wants to take over the seller's existing financing (*see ¶ 6:310 ff.*).

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2. Counsel's Role

a. [6:5] **Factors affecting counsel's role:** As with other aspects of a purchase and sale transaction, counsel's role in connection with financing will be determined by such things as the client's level of sophistication, the complexity and type of loan, cost considerations, timing issues, etc.

(1) [6:6] **Type of property:** Perhaps the most important factor in determining counsel's involvement with financing is the kind of property involved. For example, in single family residence transactions financed by institutional lenders, the loan application process is fairly straightforward, and the loan documentation is standard and generally nonnegotiable. Consequently, in such transactions, counsel will at best be only minimally involved in the financing process.

By contrast, counsel's role tends to broaden in multifamily or commercial loan transactions and as the financing becomes more complex.

(2) [6:7] **Seller financing:** The role of counsel (for both buyer and seller) is most intensive in a seller-financed transaction. Here, the parties have relatively equal bargaining strength, more issues are susceptible to negotiation, and the documentation is not precast in the lender's standard, nonnegotiable, preprinted form.

b. [6:8] **Procuring financing:** Procuring financing—and certainly procuring the "best" financing—is a time-consuming process. It is rarely a process that should be handled by counsel.

If an attorney billing at an hourly rate handles this task, obtaining a loan becomes inordinately expensive. Equally important, however, is the fact lawyers are generally not the most qualified people to procure loans. Lawyers generally do not keep current on rapidly-changing interest rate fluctuations; they do not necessarily maintain strong, ongoing relationships with lenders; and they are usually not up to date on the latest changes in lending practices.

In most cases, the buyer either procures financing itself, uses the services of its real estate broker, or employs a professional loan broker (*see* *¶ 6:160 ff.*).

c. [6:9] **Overseeing loan application and processing of loan approval:** Counsel frequently needs to assist the borrower in garnering and organizing appropriate information for the loan application (appraisals, financial information, purchase agreements, title documents, leases, estoppel certificates, escrow instructions, etc.). Thereafter, counsel may need to review the loan commitment (if one is to be issued); assist the buyer in satisfying prefunding conditions of the loan; review title and negotiate title endorsements; and coordinate with the lender and the escrow officer so that the loan is funded concurrently with the closing of the purchase and sale.

d. [6:10] **Negotiating terms of loan and reviewing loan documents:** Once a prospective lender is designated, counsel might become involved in negotiating economic and other material terms of the loan and reviewing and negotiating the loan documents. As a practical matter, however, the role of borrower's counsel in negotiating loan documentation is often quite limited; this is chiefly because institutional lenders are extremely reluctant to modify their standard form loan documents.

➪ [6:10.1] ***PRACTICE POINTER:*** While there is little room to negotiate residential loan documents, lenders often will negotiate certain provisions in commercial loan documents (e.g., financial covenants).

e. [6:11] **Resolving title insurance matters:** Because lenders invariably require a lender's policy of title insurance (*see Ch. 3*), title issues need to be addressed by the buyer.

Although the condition of title to the property might be acceptable to the buyer, it might not be acceptable to a third party lender. Institutional lenders in particular are quite conservative about title matters; buyer's counsel is therefore cautioned to consider a lender's concerns when reviewing the state of title.

(For example, a buyer might not be concerned about an easement over the property running in favor of an adjoining landowner; but the easement may be the stumbling block to a lender's willingness to finance the purchase.)

f. [6:12] **Borrower's counsel's opinion letter:** In certain commercial property loan transactions, borrower's counsel is called upon to render a formal legal opinion concerning various matters pertaining to the borrower, the property, the loan transaction and the loan documents. This subject is covered in detail in *Ch. 9*. By way of summary, borrower's counsel's opinion letter may cover such issues as:

• the lawful existence and good standing of the borrowing entity;

- the authority of the parties signing the loan documents to bind the borrower;
- the absence of any legal proceedings involving the borrower which might adversely affect the property or the borrower's ability to pay the loan;
- the absence of any contract, law or regulation by which the borrower is bound that would preclude the borrower from entering into or satisfying the loan;
- the validity and enforceability of the loan documents;
- the loan not being usurious; and
- the property's compliance with various environmental, zoning and other pertinent land use laws.

g. [6:13] **Mortgage broker's fees:** In the more sophisticated and sizable loan transactions, a buyer might retain the services of a professional loan broker. The loan broker is usually paid a fee based on a percentage of the amount of the loan. The relationship between the property owner and the loan broker is—or at least should be—reflected in a written agreement. The negotiation, preparation or revision of the loan broker's contract might therefore be one of the functions of buyer's counsel. (*See ¶ 6:160 ff.; and Form 6:E.*)

[6:14 - 6:19] ***Reserved.***

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Chapter 6. Financing and Appraisals

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1. [6:20] **General Financing Sources:** Financing may be obtained in any of the following ways:

a. [6:21] **Third-party financing:** In a third-party financing transaction, the buyer procures its loan from a third party (typically, but not necessarily, an institutional lender).

(1) [6:22] **"Institutional" vs. "private" lenders:** The term "institutional lender" refers to an entity such as a bank, savings and loan association, insurance company, large pension fund, real estate investment trust, or the like which *regularly engages in the business of making real property secured loans*. These lenders are distinguished from "private lenders" who are not regularly in the lending business.

(2) [6:22.1] **Government loans and grants:** Occasionally, real property purchases are funded by government loans and grants. Given the gravity and persistence of California's affordable housing crisis, legislation seeking to direct both federal and state aid to affordable housing providers has been and continues to be enacted. While a full treatment of all current housing support laws is beyond the scope of this Practice Guide, a few examples follow:

(a) [6:22.2] **Cal-Vet Program:** California veterans are eligible for low-interest, long-term loans through the Department of Veterans Affairs' "Cal-Vet" program. [See Mil. & Vet.C. § 987.50 et seq.; *and ¶ 6:337.4 ff.*]

(b) [6:22.3] **California Homebuyer's Downpayment Assistance Program:** Low-income, first-time homebuyers are eligible for downpayment assistance in the form of deferred-payment, low-interest, junior mortgage loans. [See Health & Saf.C. § 51500 et seq.]

(c) [6:22.4] **Department of Housing and Community Development programs:** The 2012 reorganization of state government created the Department of Housing and Community Development (HCD) as part of the Business Consumer Services and Housing Agency (Health & Saf.C. § 50400 (added Stats. 2012, Ch. 147). HCD has broad powers to

administer both federal and state housing programs that provide loans and grants to create rental and homeownership opportunities. [Health & Saf.C. § 56406; see also the HCD website at *hcd.ca.gov* (listing active programs and available funding opportunities)]

The 2022 legislative session enhanced HCD's powers and responsibilities in order to accelerate funding of affordable housing programs (¶ 6:22.5 ff.).

1) [6:22.5] **Facilitating access to federal grants:** Among HCD's responsibilities is the administration of federal grants for purposes of funding the acquisition of property to develop or preserve affordable housing. In order to accelerate the process, HCD has the power to publish notice of funding opportunities and application deadlines ahead of, and contingent upon, the availability of funding. [Health & Saf.C. § 50406.9]

HCD may disburse awards up-front, rather than as reimbursements, so long as the recipients meet federal standards for financial administration and HCD provides ongoing monitoring. Moreover, HCD may furnish technical assistance to applicants in meeting program requirements. [See Health & Saf.C. § 50406.9]

2) [6:22.6] **Online tracking:** HCD's website (*hcd.ca.gov*) is required to feature a tracking system for all programs it administers that shows the deadlines for each step of a program application. [Health & Saf.C. § 50461; see also Gov.C. §§ 7061.1-7061.2 (1/1/33 "sunset" date)]

3) [6:22.7] **Encouraging "adaptive reuse" of property:** Retrofitting and repurposing existing buildings to create new residential units (so-called "adaptive reuse") is an activity eligible for state loan programs that fund development of affordable multi-family homes for rent or ownership. [Health & Saf.C. § 50467]

4) [6:22.8] **CalHome Program:** First introduced in 2000, the CalHome Program supports existing programs aimed at lower and very low income households. Its purpose is to increase home ownership, encourage neighborhood revitalization and sustainable development, and maximize use of existing homes (Health & Saf.C. § 50650 et seq.). Under the CalHome Program, HCD makes grants and loans to local public agencies and nonprofit corporations for specified purposes, including the construction of home ownership units. [Health & Saf.C. § 50650.3]

Commencing January 1, 2024, units within home ownership development projects that are receiving CalHome funds must be initially sold to and occupied by lower income households. In addition, the units must be subjected to a recorded covenant with a term of at least 30 years' duration that includes one or more resale restrictions (e.g., recapture of the CalHome funds or equity sharing upon resale). [Health & Saf.C. § 50650.3(c)(3) (amended Stats. 2023, Ch. 746; eff. 1/1/24)]

[6:22.9 - 6:22.15] ***Reserved.***

(d) [6:22.16] **Local Tenant Preferences to Prevent Displacement Act:** The Legislature has articulated a state policy of providing affordable housing opportunities to lower income individuals residing in areas facing displacement pressures and gentrification. This statutory declaration enables recipients of federal low-income housing tax credits and tax-exempt bonds to favor local tenants at risk of displacement, without jeopardizing the recipients' favorable tax treatment. [Gov.C. § 7061 et seq. (2033 "sunset" date)]

The above Act requires disclosure of local tenant preference policies, coordinated through the HCD (¶ 6:22.4). Thus, local governments adopting a tenant preference policy must, no later than 90 days after the ordinance's operational date, post the ordinance and supporting materials on its website. And every year the local government must provide HCD with a current link to that website. In turn, HCD must post a list of jurisdictions with tenant preference policies on its website. [Gov.C. §§ 7061.1, 7061.2 (1/1/33 "sunset" date)]

b. [6:23] **Seller financing:** "Seller financing" occurs when the seller takes a portion (or, conceivably, all) of the purchase price in the form of a loan to the buyer, which is secured by the property being sold. Seller financing is sometimes called "purchase money financing" (*see ¶ 6:564*).

(1) [6:24] **Secured note or land sale contract:** Seller financing typically takes the form of a promissory note secured by a deed of trust encumbering the property sold. But a "land sale contract" is also a form of seller financing (*see ¶ 4:112 ff.*).

c. [6:25] **Existing financing:** The buyer may elect to take over an existing loan encumbering the property by either (1) purchasing the property "subject to" the existing loan; or (2) specifically "assuming" the existing loan.

(1) [6:26] **"Assumption" vs. taking "subject to":** There is a significant distinction between the concepts of taking "subject to" an existing loan and "assuming" an existing loan:

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(a) [6:27] **"Assumption" of existing loan:** Assumption of an existing loan occurs when the buyer executes a specific written agreement with the lender pursuant to which the buyer "assumes" the original borrower's obligation under the loan and becomes *directly and contractually obligated to the lender*.

(b) [6:28] **Taking "subject to" existing loan:** If the buyer does not execute such an assumption agreement but simply acquires title to the property, the buyer is said to have taken the property "subject to" the existing loan. Although the buyer continues to make payments on the loan, the buyer *is not, and does not become, legally obligated to make payments on that loan*.

(2) [6:29] **Different rights and obligations:** The rights and obligations of the lender, the original borrower and the new buyer vary greatly depending upon whether the buyer assumes or takes subject to the existing loan. Indeed, sometimes a buyer's purchase of property without specifically assuming an existing loan constitutes a default under the loan, permitting the lender to accelerate the loan and foreclose. (*See* *¶ 6:388 ff.* regarding "due-on-sale" provisions.)

Cross-refer: The subject of taking over existing financing is addressed in detail at *¶ 6:310 ff.*

d. [6:30] **Combination financing:** Some financing transactions are a combination of the alternatives set forth at ¶ 6:20 ff.; e.g., a portion of the purchase price comes from a third party loan and another portion is supplied by seller financing.

➪ [6:31] ***PRACTICE POINTER:*** Given the cost of California real estate, home buyers often rely on family assistance when purchasing property. As a result, the potential tax consequences of such arrangements should be taken into account. For example, if a family lender accepts below-market interest on a loan, there may be gift or imputed interest implications. In fact, when a related-party loan is part of the transaction, prudence dictates obtaining tax advice from an expert, documenting the loan and setting an "arms-length" interest rate.

[6:32 - 6:34] ***Reserved.***

2. [6:35] **Types of Real Property Secured Loans:** Buyers can choose from many kinds of secured real property loans. (Indeed, creativity in real property financing is virtually unlimited.) The structure of financing varies dramatically from lender to lender. The process is further complicated by the fact that a variety of names are used in the industry to describe similar, if not identical, loans.

The sections set forth at ¶ 6:36 ff. discuss the general features of standard real property loans, reflecting the popular terminology and salient terms.

a. [6:36] **Short-term vs. long-term loans:** Real property secured loans generally are said to be either "short-term" or "long-term," depending on the duration of the term. However, "short-term" and "long-term" are not legal words of art (such terminology is almost never used in loan documentation) and lenders often disagree as to whether a particular term is considered "short-term" or "long-term."

(1) [6:37] **Short-term loans:** Short-term loans generally mature and become due within approximately three years. They are usually for a specified purpose, such as a construction loan.

Short-term loans *made for a specific purpose* preclude the borrower from using the loan proceeds for anything other than the stated purpose. The lender usually retains control over when, and for what purpose, the loan proceeds are to be disbursed.

(2) [6:38] **Long-term loans:** A long-term loan (sometimes called a "permanent loan") usually involves a term of 15 years or longer. Nevertheless, some lenders refer to a seven-year term as a long-term (permanent) loan.

(3) [6:39] **Mini-perm loans:** Loans having a term somewhere between a short term and long term are sometimes called "mini-permanent" (or "mini-perm") loans. Mini-perm loans are often construction loans combined with fairly short-term "permanent" financing. Under this arrangement, once the construction phase of the loan is completed, the interest rate might be adjusted and the borrower might then be required to make periodic payments of principal and interest. The loan would then mature somewhere in the range of, perhaps, five years later.

b. [6:40] **"Take-out" financing:** "Take-out" financing is a colloquial term used to refer to a loan that pays off and, to that extent, *replaces* an existing loan. The second loan is thus said to "take-out" the prior loan. Short-term loans are therefore taken out (and replaced by) longer-term loans.

Sometimes, take-out financing is arranged concurrent with a short-term loan. This most often occurs in connection with construction loans. Under this arrangement, a lender makes a short-term construction loan and either the same or a different

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lender concurrently agrees to provide a longer-term take-out loan that will pay off the construction loan after completion of construction.

(1) [6:41] **Excess amount:** Take-out financing is sometimes in an amount in excess of the prior loan, so that the owner is both able to pay off the existing loan and to pull out some of its equity in the property.

c. [6:42] **"Gap" and "bridge" loans:** These are popular (nonlegal) terms commonly used to describe certain kinds of short-term loans. The purpose of a "bridge" or "gap" loan is to provide financing in the interim period during which one loan becomes due and long-term, permanent financing becomes available. Thus, bridge or gap loans might be used to take-out a construction loan during the time the borrower seeks permanent financing.

d. [6:43] **Development and construction loans:** Development and construction loans are typically obtained by developers at the time (or shortly after) they acquire title to property. The purpose of the loan is to finance the cost of developing the property and constructing improvements.

(1) [6:44] **"Development" vs. "construction" loan:** Although development and construction loans are discussed at ¶ 6:44.1 ff. as if they were one loan, they are sometimes broken into two entirely different loans.

• [6:44.1] A "development loan" (or that portion of a "development and construction loan" allocated to development costs, but not construction costs) funds the cost of such things as subdivision of the property and obtaining various other zoning permits and so-called "entitlements." A developer who does not intend to construct improvements, but merely plans to sell the property after obtaining such development permits and entitlements, would only obtain a development loan.

• [6:44.2] On the other hand, a developer who wants to improve the property will obtain a construction loan (sometimes called a "building loan") to fund the actual cost of constructing improvements. Developers sometimes purchase property with permits and entitlements already in place (or which requires little in the way of permits and entitlements), in which case only a pure construction loan is necessary.

• [6:44.3] If both development and construction is intended, the loan is usually a combination development and construction loan.

FORM: Construction Loan Agreement, *see Form 6:A*.

(2) [6:45] **Acquisition portion of development and construction loan:** A developer sometimes combines its development and construction loan with an "acquisition" loan at the time it purchases the property. The "acquisition" portion of the loan funds a portion of the purchase price and the balance of the loan funds development and construction costs.

(3) [6:46] **Take-out financing:** A development and construction loan sometimes is tied to take-out financing (either from the same or a different lender). Under this arrangement, a lender agrees to provide long-term financing that pays off and "takes out" the development and construction loan (*see ¶ 6:40 ff.*).

➪ [6:47] ***PRACTICE POINTER:*** Many lenders require, as a condition to making a development and construction loan, that the borrower obtain a commitment for take-out financing. The reason is that the borrower will not necessarily have any income from the property upon completion of construction and the lender wants to make certain a source of financing is in place to pay off the construction loan.

(4) [6:48] **Term:** The term of a development and construction loan is tied to the amount of time anticipated to complete the development and construction work. The loan term is thus determined by the magnitude of the project.

(5) [6:49] **Development costs:** A development loan (or the development portion of a development and construction loan) finances the cost of subdividing the property and obtaining zoning permits and other "entitlements" for property development. It therefore funds such things as engineering and other professional fees, governmental permit application fees, and the cost of certain physical development of the property.

(For example, as a condition to obtaining entitlements and permits, governmental entities may require that the developer perform certain on-site (and sometimes off-site) work on the property. Such work might include grading of the property, construction of sewers, sidewalks and streets, making various utility services available to the property, installing street lights and landscaping, etc.)

(6) [6:50] **Construction costs:** A construction loan (or the construction portion of a development and construction loan) funds the costs of actually completing the improvements. However, there are two different kinds of construction costs: so-called "soft costs" and "hard costs." (Neither of these is a legal term because their definitions vary somewhat among members of the lending community.)

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(a) [6:51] **“Hard costs”:** “Hard costs” generally refer to that portion of construction costs involving the physical building of the structures—i.e., labor and materials (such as lumber, bricks, windows, etc.).

(b) [6:52] **“Soft costs”:** “Soft costs” generally refer to the cost of such things as building permit fees, architect fees, designer fees, legal fees, loan fees, interest, certain overhead and administration costs allocable to the project, etc.

(7) [6:53] **Borrower's budget:** One of the prerequisites to obtaining a development and construction loan is the lender's approval of the borrower's budget for development and construction costs. On the approved budget, each portion of the development and construction work is assigned a specific amount (e.g., so many dollars for grading, so much for permit fees, so much for drywalling, carpeting, etc.).

Each so-called “line item” of work has a corresponding maximum amount allocable to it and the lender generally will not fund any one line item in excess of its stated maximum amount. (Sometimes, a lender will permit the borrower to apply a savings in one line item to a cost overrun in another line item. Additionally, there is typically a line item amount allocable to a “contingency,” which may be applied toward unanticipated expenses and cost overruns.)

Budgets frequently contain a line item allocable to the borrower's own overhead and so-called project supervision costs. The developer is thereby able to borrow money to pay itself (or perhaps a related entity) a fee for development and construction of the project.

(8) [6:54] **Periodic disbursements:** A development and construction loan is disbursed by the lender periodically in varying amounts as and when the borrower needs the funds (but in accordance with the preapproved budget, ¶ 6:53).

(a) [6:55] **Conditions:** Various conditions must be satisfied before the lender makes each disbursement of loan proceeds. For example:

- The lender must be satisfied that the work to which the disbursement applies has actually been completed;
- Development of the project must be proceeding on schedule;
- The lender must receive mechanic's lien releases and appropriate endorsements to its lender's title insurance policy (insuring that the lien of its deed of trust remains senior to any mechanic's lien claimants); and
- The borrower must not be in default under the loan.

Typically, lenders require borrowers to submit a borrowing certificate attesting to the satisfaction of these conditions as a prerequisite to disbursement.

(9) [6:56] **Interest reserve:** Development and construction loan borrowers have no income from the property until after improvements have been constructed and the property is leased or sold; consequently, during the term of the loan, the borrower has no source of income from the property with which to make periodic interest payments. Development and construction loans are therefore structured to create an “interest reserve.” From this interest reserve, the lender pays itself interest by disbursing loan funds for the borrower's account.

(a) [6:57] **Example:** Assume a borrower's intended actual construction cost—for both hard and soft costs, but exclusive of interest—is $1,000,000. The loan will have a term of one year at a fixed 10% interest rate. Because interest will accrue on the loan during its term, the borrower (unless it is willing to make interest payments out of its own pocket) will need to borrow a loan amount in excess of the $1,000,000 in construction costs. However, determining the precise amount of interest that will actually accrue during the term of the construction loan is not easy, because the loan will be disbursed in periodic installments (usually monthly) in varying amounts.

Some lenders determine the amount of interest reserve simply by assuming an average outstanding balance during the loan term equal to a certain percentage (such as 60%) of the total estimated construction costs. Therefore, under the foregoing example, the interest reserve would be based upon 10% (the interest rate) multiplied by $600,000 (60% of the $1,000,000 construction costs), for a total interest reserve of $60,000. (That $60,000 would be added to the $1,000,000 construction costs, for a total loan amount of $1,060,000.)

However, remember that an interest reserve is simply an estimate of the interest charges; the actual amount of accrued interest will almost certainly be different from the estimate.

(10) [6:58] **Land draws:** If the developer already owns the land and has equity in it, a lender may be willing to lend an amount in excess of the development and construction costs. In those situations, the loan includes a line item for a so-called

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"land draw." (Conceptually, this is no different than if the borrower obtains an acquisition, development and construction loan at the time it purchases the property. Under those circumstances, the acquisition portion of the loan is, in essence, the land draw.)

(11) [6:59] **Lender's security for development and construction loans:** In addition to the usual real property security that a lender requires for a long-term loan, a construction lender will also require a security interest in such things as the borrower's construction contract with the general contractor, the architect's agreement, any contracts with engineers, and all drawings, plans and specifications for the project. Therefore, if the lender is compelled to foreclose on the real property, it can also foreclose on the borrower's rights under the other secured instruments (which constitute personal property). (*See* *¶ 6:490 ff.* re personal property security agreements.)

e. [6:60] **Participation/contingent interest loans:** In certain financing transactions, a lender might require (in addition to interest on the principal amount of the loan) a participating (or "contingent") interest in the property or its income. Such loans go by a variety of names, including "participation loans," "contingent interest loans," "shared appreciation loans" or "additional interest loans." The "additional" interest to be paid to the lender (above and beyond a per annum percentage interest rate due on the principal amount of the loan) is contingent because there may or may not be profits from the property in which the lender can share. [See *River Bank America v. Diller* (1995) 38 CA4th 1400, 1407, 45 CR2d 790, 792, fn. 3]

Under these loans, the lender is typically entitled to interest on the principal amount at a given percentage rate irrespective of the borrower's profits from the property. Thus, the lender does not share in any losses concerning the property.

(1) [6:61] **Generally, two forms:** The lender's so-called participating/additional/contingent interest usually takes one or both of the following forms:

(a) [6:62] **Interest in income stream:** Under this form of contingent interest loan, the lender is entitled to a percentage of the income generated from the property (calculated on either a net or gross income basis). Sometimes, this is a percentage of the rental income and sometimes it is a percentage of the profits generated from the business conducted by the borrower on the property (e.g., the operation of a hotel, a nursing home, etc.).

Under some contingent interest loans, the borrower must reach a threshold level of profitability and the lender can only participate in a portion of the profits above that threshold amount. For example, the lender might only be entitled to share in a percentage of the income that exceeds a specific designated amount; or the lender might only be entitled to share in a percentage of annual profits that exceed the amount of annual profits the borrower generated for a base (comparison) year. (Under the latter arrangement, the year prior to the making of the loan is usually the comparison year.)

(b) [6:63] **Interest in profits upon sale of property:** Under this arrangement, the lender is entitled to a portion of the profits the borrower receives upon a sale (or leasing) of the property. This is sometimes called an "equity participation loan" because the lender participates in the borrower's *equity* in the project (as distinguished from an interest in the *income stream* from the property). [See *River Bank America v. Diller* (1995) 38 CA4th 1400, 1407, 45 CR2d 790, 792, fn. 3 ("participating construction loans")]

Here again, there might be a threshold level of profitability that the borrower must reach before the lender is entitled to participate in anything above the stipulated threshold amount. For example, if a borrower purchases the property for $1,000,000, the lender might be entitled to 20% of the net sale proceeds which exceed $1,100,000. (The formula might change periodically during the term of the loan so that, e.g., the lender is entitled to receive a different percentage the later in time the property is sold; or, the lender's percentage of the profits might vary as the amount of net proceeds increases.)

Also, the borrower is sometimes required to obtain the lender's approval of any proposed sale of the property.

1) [6:63.1] **Effect of property rapidly appreciating in value:** Arguably, a "shared appreciation loan" made to finance the purchase of property that rapidly appreciates in value immediately after the loan is made is a "sham" because the lender's receipt of the "contingent interest" is in effect guaranteed. However, because such a loan typically does not allow the lender to force an immediate sale in order to lock in the contingent interest before the property value declines, the lender's contingent interest is always at risk. [See *Jones v. Wells Fargo Bank* (2003) 112 CA4th 1527, 1538-1539, 5 CR3d 835, 843-844]

(2) Statutory provisions regarding "shared appreciation loans"

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(a) [6:64] **Defined:** Contingent interest loans discussed at ¶ 6:60 ff. fall within the statutory definition of "shared appreciation loans" (Civ.C. § 1917(b)). However, a "shared appreciation loan" does *not include* a loan secured by property containing *one to four residential units* (at least one of which is, or is to be, occupied by the borrower at the time the loan is made). [Civ.C. § 1917(b)]

(b) [6:65] **Special rules:** "Shared appreciation loans" are subject to special rules contained in Civ.C. § 1917 et seq. … including:

1) [6:66] **Variable interest rate exemption:** Shared appreciation loans are exempt from variable interest rate rules and limitations. [Civ.C. § 1917.002]

2) [6:67] **Usury exemption:** Such loans are also exempt from California usury laws. [Civ.C. § 1917.005; *see ¶ 6:280 ff.* for detailed discussion of California usury laws]

3) [6:68] **Debtor-creditor relationship:** The relationship of borrower and lender under a shared appreciation loan is that of debtor and creditor—not that of a joint venture partner (or any other kind of partner) or any other type of relationship. [Civ.C. § 1917.001]

4) [6:69] **Notation on deed of trust:** Any deed of trust securing a shared appreciation loan must expressly state it secures a shared appreciation loan. [Civ.C. § 1917.004(b)]

(3) [6:70] **"Loan participation agreements" distinguished:** Participation loans (¶ 6:60 ff.) are different from "*loan participation agreements*." A loan participation agreement is entirely unrelated to a contingent (or "participating") interest loan and, indeed, is not a loan.

(a) [6:71] **Contractual funding relationship among several lenders ("syndicated lending"):** Loan participation agreements are contracts between two or more lenders pursuant to which the "participant" purchases an interest in a loan from another lender. The selling lender is often a member of a group of financial institutions that originally funded the loan in what is commonly referred to as "syndicated lending" or a "syndication."

Syndicate members frequently engage in secondary sales of their loan interests (¶ 6:71.1).

1) [6:71.1] **Participations/assignments:** Participation and assignment are the usual forms employed by syndicate members to sell their loan interests. In a participation, the selling lender remains the official holder of the loan commitment. The participant is *not* in direct contractual privity with the borrower and does *not* have a direct claim on the loan. Participations usually do not require the consent of the borrower or the "lead lender" or "agent" (*¶ 6:72*).

In an assignment, the purchasing lender takes over the selling lender's position and obtains ownership of the loan commitment. Assignments usually require the consent of the "lead lender" or "agent" (*¶ 6:72*).

(b) [6:72] **"Lead lender" or "agent" and "administrative agent":** A syndication (¶ 6:71) usually is structured so that all members hold partial interests in the loan and are in direct contractual privity with the borrower, while only one of the committed lenders (the "lead lender" or "agent") represents the syndicate when dealing with the borrower. All members, however, have consent rights as to material changes in the loan documentation or material actions (e.g., exercising remedies). The lender who services the loan, by monitoring its performance and collecting payments, is referred to as the "administrative agent."

f. [6:73] **All-inclusive ("wrap-around") loans:** An all-inclusive (or "wrap-around") loan includes within it (and therefore "wraps around") existing financing encumbering the property. This kind of loan is usually (but not always) seller financed; it is used when the buyer desires to purchase the property subject to existing financing *and* the seller is going to take back part of the purchase price in the form of a loan secured by a junior deed of trust.

FORMS

- All-Inclusive Promissory Note, *see Form 6:B*.

- All-Inclusive Deed of Trust, *see Form 6:C*.

(1) [6:74] **Not an "assumption" of existing financing:** Under such an arrangement, the buyer does not actually assume the existing ("underlying") loan. Instead, the all-inclusive/wrap-around loan is drafted to reflect the total amount due on the underlying loan as well as the total amount due in respect of seller financing. The buyer makes periodic payments to the seller, who thereupon retains a portion of each such payment for the seller's own account and disburses the balance of the payment in respect of the underlying loan.

(2) [6:75] **Example:** Assume Seller owns property encumbered by a first trust deed loan with an outstanding principal balance of $200,000. The purchase price is $400,000, of which Buyer is willing to pay $100,000 in cash at the closing, but wishes to finance the remaining $300,000. Buyer finances the remaining $300,000 by having Seller take back an "all-inclusive promissory note" in the face amount of $300,000, secured by an "all-inclusive deed of trust" (encumbering the property sold).

The $300,000 "loan" is comprised of (a) the existing first trust deed loan in the amount of $200,000 (the "underlying loan"); *plus* (b) the principal amount of the new $100,000 loan actually provided by Seller. After the closing, Buyer makes periodic installment payments to Seller on the $300,000 all-inclusive promissory note and Seller in turn makes payments due on the underlying $200,000 loan.

➪ [6:76] ***PRACTICE POINTER:*** The following are significant features of all-inclusive financing:

• An all-inclusive loan can be made by anyone, not just the seller. (However, it is unusual to find a third party lender interested in making an all-inclusive loan.)

• Because the buyer does not "assume" the existing underlying loan encumbering the property (but, rather, takes the property "subject to" the underlying loan), the buyer has no contractual privity with the underlying lender.

• An all-inclusive loan can include (or "wrap") within it more than one underlying loan.

• An all-inclusive loan can include within it a *prior, junior all-inclusive loan* (i.e., an all-inclusive loan is sometimes put on top of another existing all-inclusive loan).

(3) [6:77] **Pros and cons of all-inclusive financing:** Buyers and sellers considering all-inclusive financing should evaluate the relative advantages and disadvantages:

(a) Advantages

1) [6:78] **Interest rate spread:** From the lender's perspective, the chief advantage of an all-inclusive loan is that the lender typically charges an interest rate *in excess* of the rate on the underlying loan.

[6:79] **Example:** Continuing the example at *¶ 6:75*, if the underlying first trust deed loan (in the amount of $200,000) is at a 10% interest rate, the all-inclusive lender might charge interest at a rate of 12% *on the entire face amount of the $300,000 all-inclusive loan*. Therefore, the all-inclusive lender will receive 12% interest on the amount actually loaned by it ($100,000), *plus* an extra 2% on the underlying financing (principal amount of $200,000) (i.e., a 2% "override" or "spread" on the underlying loan rate of 10%).

During the first year of the loan, the all-inclusive lender will thus receive a total of $36,000 in interest payments on the $300,000, of which $20,000 will be paid to the underlying lender (in respect of the $200,000 underlying loan that accrues interest at 10%). The total net interest payment to the lender will be $16,000 (in respect of the lender's $100,000 loan).

Compare: If the all-inclusive lender had structured its $100,000 loan (at its 12% interest rate) as a standard second trust deed loan and allowed the buyer to pay the underlying loan directly (at an interest rate of 10% per annum), the same lender would have received only $12,000 in interest payments. However, by structuring the loan as all-inclusive financing, the lender obtains a $4,000 override/spread in the first year alone.

2) [6:80] **Assurance of timely payment on underlying loan:** A second advantage to the all-inclusive lender is that it can be certain payments on the underlying loan will be timely and properly made (since it makes the payment out of the buyer's payment).

a) [6:81] **Compare—recorded request for notice of default or notice of delinquencies:** If the all-inclusive lender simply made a standard junior trust deed loan, it could conceivably keep track of whether the borrower is current on the senior loan by recording a "request for notice of default," which requires that a senior lender notify a junior lender upon recordation of a notice of default by the senior lender. [Civ.C. § 2924b; *see* ¶ *6:527*]

However, a lender is not required to record a notice of default at any particular time following a borrower's default. Therefore, a senior loan could be in default for several months—conceivably even years—before the senior lender actually records a notice of default. By then, the defaulted amount could be substantial.

(Some junior lenders may have a more effective remedy pursuant to Civ.C. § 2924e. That statute provides a mechanism whereby a junior lienholder can compel a senior lienholder to provide written notice of delinquencies of four months or more in connection with certain kinds of residential real estate loans.)

3) [6:82] **Avoiding prepayment charges:** A third (ostensible) advantage to all-inclusive financing is the avoidance of a prepayment charge on the underlying loan (or circumvention of any prohibition against prepayment of an underlying loan). (*See ¶ 6:250 ff.*)

However, this same goal can be reached by having the buyer purchase the property subject to the existing financing and having the seller take back a note secured by a junior deed of trust.

4) [6:83] **Camouflaging violation of "due-on-sale clause":** Because the seller (who is usually the original borrower on the underlying loan) continues to make the payments due on the underlying loan, an all-inclusive loan may be viewed as advantageous because it prevents the underlying lender from becoming aware the property has been sold in violation of a due-on-sale clause in the senior lender's trust deed. Under a due-on-sale clause, the underlying lender can call the loan due upon a sale of the property (*see ¶ 6:388 ff.*).

➪ [6:84] ***PRACTICE POINTER:*** Although the theory that all-inclusive financing disguises an impermissible sale may hold true with respect to private lenders, institutional lenders typically do not keep track of (or care) who actually makes the loan payments. Indeed, lenders typically discover property has been sold upon issuance of the new owner's hazard insurance certificate (which names the lender as a beneficiary under the policy). That insurance certificate will identify the new owner of the property. Providers of tax service contracts will also pick up a change in ownership by reason of the new owner's name appearing on a property tax bill. (A tax service contract provides the lender with notice if the borrower fails to pay real property taxes for the encumbered property.)

Thus, it is risky to assume an all-inclusive loan will effectively camouflage violation of a due-on-sale clause.

(b) Disadvantages

1) [6:85] **Default on underlying loans:** From the borrower's perspective, the major disadvantage of an all-inclusive loan is that the borrower bears the risk the all-inclusive lender will fail to make payments on the underlying loan. Just as a junior lender may not be aware of a default under a senior loan (*¶ 6:81*), a borrower will not necessarily know if the all-inclusive lender has actually made payments on the underlying loan.

If the all-inclusive lender defaults on the underlying loan and the underlying lender does not commence a foreclosure until the underlying loan has been in default for quite some time, the borrower may discover at a late date (and to its great surprise and even greater economic loss), that the underlying loan is substantially in arrears.

2) [6:86] **Complications:** Unless the loan documents are very carefully drafted (and, sometimes, notwithstanding careful drafting), an all-inclusive loan can be complicated for the lender, the borrower, the trustee under the all-inclusive deed of trust (who has to handle any foreclosure of the all-inclusive trust deed) and a judge. Thus, the following issues should be considered and addressed:

• [6:87] The nature and extent of the all-inclusive lender's interest in an all-inclusive loan once its equity in the loan has been paid off, which is frequently difficult to determine.

(For instance, in the example at *¶ 6:75*, the loan documents should specify whether the all-inclusive lender would still be entitled to the interest spread after its $100,000 loan has been paid off.)

• [6:88] Which party is obligated to pay any prepayment penalty on the underlying loan.

• [6:89] What happens if the underlying loan is accelerated on account of violation of a due-on-sale clause.

• [6:90] What the all-inclusive lender is entitled to credit bid at a foreclosure sale.

• [6:91] How the borrower can be certain the all-inclusive lender will make payments on the underlying loan.

a) [6:92] **Comment:** The problems posed by these issues are intensified when all-inclusive financing is added on top of junior all-inclusive financing. In sum, straightforward junior financing (which is not all-inclusive financing) offers the tremendous advantage of simplicity in both accounting, allocation of payments and the foreclosure process. *See ¶ 6:95*.

(4) [6:93] **Collection accounts:** A collection account can be established by the all-inclusive lender and borrower so that the borrower's payments are made to an independent collection agent who thereupon disburses payments to various lenders

(i.e., the senior lender and the all-inclusive lender). In this fashion, the parties can be assured an independent party will remit the loan payments to all lenders in the respective amounts to which they are entitled.

➪ [6:94] ***PRACTICE POINTER:*** Although banks and title insurance companies historically provided this service, they have become increasingly reluctant to serve as collection agents. *Attorneys should avoid providing this service* since it requires continuing attention to receipt and allocation of payments, and such a role is fraught with potential liability as well as conflicts of interest. (Conflict of interest issues arise because the collection agent is agent of both parties to the collection account agreement.)

(5) [6:95] **Comment—junior trust deed loan preferable:** Because of the disadvantages set forth at ¶ 6:85 ff., it is the author's view that all-inclusive financing is generally not advisable and it is almost always easier and better simply to create a junior trust deed loan.

To the extent the junior lender wants to obtain the benefit of the interest spread/override, it can simply adjust the interest rate on its junior loan to a rate that will give it the same effective return as if it had provided all-inclusive financing and received an override. To the extent the junior lender is concerned the borrower will not make payments on the senior loan, it could make some arrangement to receive verification that the borrower is promptly making payments (such as receiving copies of the borrower's cancelled checks; or periodically requesting a beneficiary statement from the senior lender, *see ¶ 6:418*).

[6:96] ***Reserved.***

g. [6:97] **Reverse mortgage loan; statutory regulation:** "Reverse mortgage loans" are not commonly used in purchase and sale transactions. Rather, this type of financing is most often extended to residential property owners (typically, elderly homeowners) looking for a way to obtain an income stream out of the equity or built-up value of their homes. A reverse mortgage loan relies principally on the value of the borrower's home (the secured property) for repayment (the borrower does not make monthly payments but instead receives monthly payments from the lender). Thus, at some point down the line (usually when the home is sold, the borrower moves away or the borrower dies), the "payoff" on the loan is likely to be a transfer of title to the lender. [See *Black v. Financial Freedom Senior Funding Corp.* (2001) 92 CA4th 917, 921-922, 112 CR2d 445, 449]

Reverse mortgage loans on a *borrower-occupied principal residence*, executed on or after January 1, 1998, are subject to California statutory regulation. [Civ.C. § 1923 et seq.; see Civ.C. § 1923.10 (statutory scheme inapplicable to pre-1998 loans)]

(Reverse mortgage loans are also regulated by federal law, mandating various disclosures to assist consumers in evaluating the cost of this type of financing. The federal regulations, not addressed at ¶ 6:97.1 ff., are part of the Truth in Lending Act (15 USC § 1601 et seq.), as implemented by Regulation Z (12 CFR Part 226). The disclosure requirements can be found at 15 USC § 1648 and 12 CFR § 226.33.)

(1) [6:97.1] **"Reverse mortgages" subject to statutory regulation:** For purposes of Civ.C. § 1923 et seq., a "reverse mortgage" is a *nonrecourse loan* secured by real property (*¶ 6:402*) that meets all of the following criteria (Civ.C. § 1923):

- The loan provides *cash advances* to the borrower based on the *equity* or *value* in the borrower's *owner-occupied principal residence* (Civ.C. § 1923(a));

- The loan requires *no payment of principal or interest until the entire loan becomes due and payable* (Civ.C. § 1923(b)); and

- The loan is made by a lender "licensed or chartered" pursuant to California or federal law (Civ.C. § 1923(c)).

(a) [6:97.2] **"Owner-occupied" where title held in trust:** A property is deemed "owner-occupied" within the meaning of Civ.C. § 1923 et seq. even though title is held in trust, so long as the occupant is a beneficiary of the trust. [Civ.C. § 1923.4]

(2) [6:98] **Statutory requirements concerning reverse mortgage loans:** A reverse mortgage loan (as defined at ¶ 6:97 ff.) must comply with all of the following requirements (Civ.C. § 1923.2):

(a) [6:98.1] **No prepayment penalty:** The borrower must be allowed to prepay the loan, in whole or in part, *without penalty* any time during the term of the loan. [Civ.C. § 1923.2(a)]

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But the borrower remains liable for fees, payments or other charges that otherwise would have been due upon the reverse mortgage being due and payable; i.e., these amounts are *not a* "prepayment penalty" within the meaning of § 1923.2(a). [Civ.C. § 1923.2(a)]

(b) [6:98.2] **Fixed or adjustable interest:** A reverse mortgage loan may provide for a fixed or adjustable interest rate, or combination thereof, including compound interest; and may also provide for interest contingent on the value of the property upon execution of the loan or at maturity, or on changes in value between closing and maturity. [Civ.C. § 1923.2(b)]

(c) [6:98.3] **Lender's fees/costs:** A reverse mortgage loan may include costs and fees charged by the lender (or lender's "designee, originator, or servicer"), including costs and fees charged upon execution of the loan, on a periodic basis, or upon maturity. [Civ.C. § 1923.2(c)]

(d) [6:98.4] **Periodic advances not affected by interest adjustments:** Periodic advances to the borrower under the loan cannot be reduced in amount or number based on interest rate adjustments. [Civ.C. § 1923.2(d)]

(e) [6:98.5] **Lender's treble damages liability:** A lender who fails to make loan advances as required by the loan documents, and fails to cure an actual default after notice as specified in the loan documents, "shall forfeit to the borrower treble the amount wrongfully withheld plus interest at the legal rate." [Civ.C. § 1923.2(e)]

(f) [6:98.6] **Events triggering maturity:** A reverse mortgage loan may become due and payable upon the occurrence of any of the following events (Civ.C. § 1923.2(f)):

- A *sale* of or other *transfer of title* to the home securing the loan (Civ.C. § 1923.2(f)(1));
- All borrowers *cease occupying the home* as a principal residence, except as provided in Civ.C. § 1923.2(g) (¶ *6:98.8*) (Civ.C. § 1923.2(f)(2));
- The occurrence of any *fixed maturity date* agreed to by lender and borrower (Civ.C. § 1923.2(f)(3)); or
- The occurrence of any event specified in the loan documents that *jeopardizes the lender's security* (Civ.C. § 1923.2(f)(4)).

(g) [6:98.7] **Repayment—additional conditions:** Repayment of a reverse mortgage loan is subject to the following additional conditions (Civ.C. § 1923.2(g)):

1) [6:98.8] **Maturity not triggered by certain borrower temporary absences:** The borrower's *temporary absences* from the home *not exceeding 60 consecutive days* "shall not cause the mortgage to become due and payable." [Civ.C. § 1923.2(g)(1)]

Nor may the mortgage become due and payable on account of the borrower's extended absences from the home exceeding 60 consecutive days *but less than one year*, if the borrower has taken prior action that "secures and protects the home in a manner satisfactory to the lender" as specified in the loan documents. [Civ.C. § 1923.2(g)(2)]

2) [6:98.9] **Statute of limitations on collection of loan proceeds:** The statute of limitations for *written loan contracts* governs the lender's right to collect reverse mortgage loan proceeds. The limitations period commences to run on the date the loan becomes due and payable as provided in the loan agreement. [Civ.C. § 1923.2(g)(3)]

3) [6:98.10] **Disclosure of interest and fees payable at maturity:** The lender must "prominently disclose" in the loan agreement any interest rate or other fees that will be charged during the period commencing on the date the reverse mortgage loan becomes due and payable and ending when full repayment is made. [Civ.C. § 1923.2(g)(4)]

(h) [6:98.11] **Notice of nature of loan in deed of trust:** The first page of the deed of trust securing a reverse mortgage loan must state in 10-point bold type: "This deed of trust secures a reverse mortgage loan." [Civ.C. § 1923.2(h)]

(i) [6:98.12] **Borrower may not be required to purchase annuity or other financial/insurance products:** A reverse mortgage lender and any other person participating in the origination of a reverse mortgage may not require the borrower to purchase an annuity as a condition for obtaining the mortgage. [Civ.C. § 1923.2(i)]

Moreover, neither the lender nor any other person participating in the origination of a reverse mortgage may:

— participate in, associate with or employ any party that participates in or is associated with any other financial or insurance activity, except as statutorily specified; or

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— refer the borrower to anyone for the purchase of an annuity or other financial or insurance product prior to the closing of the reverse mortgage or before expiration of the borrower's right to rescind the mortgage agreement. [See Civ.C. § 1923.2(i)(1)]

1) [6:98.13] **Title and peril insurance offers/referrals distinguished:** Reverse mortgage lenders may offer or refer borrowers for title insurance, hazard, flood or other peril insurance, and any similar products that are "customary and normal" under a reverse mortgage loan. [Civ.C. § 1923.2(i)(2)]

[6:98.14] ***Reserved.***

(3) [6:98.15] **Extent and priority of lien:** A reverse mortgage constitutes a lien against the secured property to the extent of all advances made pursuant to the mortgage and all interest accrued thereon. [Civ.C. § 1923.3; *Black v. Financial Freedom Senior Funding Corp.* (2001) 92 CA4th 917, 922, 112 CR2d 445, 449]

The lien has priority over any lien filed or recorded after recordation of the reverse mortgage loan. [Civ.C. § 1923.3]

(4) [6:98.16] **Mandatory referral to professional counseling:** No reverse mortgage loan application may be taken by a lender unless the loan applicant, *prior to receiving counseling*, obtains from the lender a statutorily-prescribed "plain language statement in conspicuous 16-point type or larger" advising the applicant that (a) they are *required* to obtain reverse mortgage counseling from a HUD-approved agency and will be provided a list of approved counselors by the lender (below); and (b) senior citizen advocacy groups advise against using the proceeds of a reverse mortgage to purchase an annuity or related financial products. [Civ.C. § 1923.5(a)]

The counselor list provided by the lender must contain at least 10 HUD-approved nonprofit counseling agencies, none of which may receive any compensation, directly or indirectly, from the lender or any other party involved in originating or servicing the reverse mortgage or the sale of annuities, investments, long-term care insurance, etc., except as specified. [See Civ.C. § 1923.2(j)]

In addition, the lender may not accept the application or assess fees until *seven days after* the applicant receives *in person* counseling, as evidenced by the counseling certification. This is so unless the certification indicates the applicant elected to receive counseling in another manner. Moreover, the certification must be signed by the applicant and the counselor, and it must include the date(s) of counseling and the name, address and telephone number of both the applicant and counselor. [Civ.C. § 1923.2(k)]

A reverse mortgage lender "shall be presumed to have satisfied any disclosure duty imposed by [Civ.C. § 1923 et seq.] if the lender provides a disclosure statement in the same form as provided in [Civ.C. § 1923 et seq.]." [Civ.C. § 1923.6]

(a) [6:98.17] **Mandatory worksheet guide:** In addition to providing the loan applicant with a statutorily-prescribed "plain language" statement (¶ 6:98.16), a reverse mortgage lender must give the applicant a "reverse mortgage worksheet guide" that details "five essential questions" to consider before purchasing the mortgage. The worksheet guide is given to the applicant *before* they meet with a reverse mortgage counselor. If, however, the applicant seeks counseling *before* applying for the mortgage, a worksheet guide in minimum 14-point type must be provided to them by the counseling agency. [See Civ.C. § 1923.5(b)(1)]

Approval of a reverse mortgage loan is contingent upon the worksheet guide first being signed by the counselor (if the counseling is done in person) and by the loan applicant, with a copy provided to the applicant. The loan application may not be approved until the signed worksheet guide is provided to the lender, along with the counseling certificate. [Civ.C. § 1923.5(b)(2)]

(5) [6:98.18] **Effect of lender's noncompliance:** No "arrangement, transfer, or lien" subject to Civ.C. § 1923 et seq. will be invalidated solely because of the lender's failure to comply with any provision of § 1923 et seq. By the same token, the statutory scheme does not preclude the application of other civil remedies provided by law. [Civ.C. § 1923.7]

3. Legislative Protection for Homeowners

a. [6:99] **Regulation of nontraditional and subprime mortgage products:** In 2006-07, various federal financial regulatory agencies and other related entities issued guidance documents and statements containing important risk management and consumer protection principles in response to the rise in nontraditional and subprime residential mortgage products (e.g.,

mortgage loans allowing homeowners to defer repayment of principal or interest; adjustable-rate mortgage products typically offered to subprime borrowers and having the potential for "payment shock"). [See Stats. 2007, Ch. 301, § 1 (legislative findings)]

The Commissioner of Real Estate is (1) charged with applying these guidance documents and statements to real estate brokers; and (2) authorized to adopt emergency and final regulations for clarification purposes as soon as possible. In turn, real estate brokers must "adopt and adhere" to any "policies and procedures that are reasonably intended to achieve the objectives" outlined in the guidance documents and statements. [See Bus. & Prof.C. § 10240.3]

b. Truth in lending laws and regulations

(1) [6:99.1] **Housing and Economic Recovery Act of 2008 (HERA):** HERA revised the truth in lending laws affecting extensions of credit secured by a consumer's "dwelling." Among other changes, covered loans may not close until *seven* business days after the borrower's application; early disclosures must be given at the time of application; and final disclosures, if different from early disclosures, must be provided at least three business days before the loan closing (absent a bona fide, documented personal emergency). [15 USC § 1638(b)(2); see also *Holbert v. Fremont Investment & Loan* (2009) 179 CA4th 1067, 1074-1075, 102 CR3d 370, 374-375 (discussing various required disclosures under TILA)]

The borrower may seek damages for the lender's violation of TILA's disclosure requirements by filing an action within one year of the transaction (or within three years for disclosures generally required for residential mortgages; *see* 15 USC §§ 1639, 1639b & 1639c). [15 USC § 1640(e); *Ivanoff v. Bank of America, N.A.* (2017) 9 CA5th 719, 730, 215 CR3d 442, 451—equitable tolling may extend three-year period within which borrower seeking damages for § 1639 violation must bring action; see also *Struiksma v. Ocwen Loan Servicing, LLC* (2021) 66 CA5th 546, 558, 280 CR3d 881, 889-890 (citing 15 USC §§ 1602(g), 1641(a))—TILA's disclosure obligations apply only to loan transaction's original creditor or, if violation is apparent on face of loan documents, to original creditor's assignee]

In addition, the borrower may notify the lender of the borrower's intention to rescind the loan transaction within *three* business days following its consummation or delivery of the required disclosures and rescission forms, whichever is later. Should the lender completely fail to deliver the required disclosures and rescission forms, the borrower's right to rescind expires three years after the transaction is consummated or the property is sold, whichever occurs first. [15 USC § 1635(a) & (f); *Jesinoski v. Countrywide Home Loans, Inc.* (2015) 574 US 259, 261-262, 135 S.Ct. 790, 792—borrowers have *unconditional* right to rescind for *3 days*, after which they may rescind only if lender fails to satisfy TILA's disclosure requirements; see also *U.S. Bank Nat'l Ass'n v. Naifeh* (2016) 1 CA5th 767, 775-776, 205 CR3d 120, 128-129 (discussing TILA's purpose and provisions)]

TILA sets forth a three-step process for pursuing rescission (notice of intent to rescind, return of security interest, and tender of loan's value) that must be followed unless otherwise ordered by a court. [15 USC § 1635(a) & (b); see also *Vien-Phuong Thi Ho v. ReconTrust Co., N.A.* (9th Cir. 2016) 858 F3d 568, 577—obligors may state rescission claims without pleading ability to tender loan's value; *Merritt v. Countrywide Fin'l Corp.* (9th Cir. 2014) 759 F3d 1023, 1030-1033 (discussing TILA's three-step rescission process and court's equitable power to modify same)]

(a) [6:99.1a] **Timely notice rather than filing lawsuit effects rescission:** So long as the borrower notifies the creditor of the borrower's intention to rescind within three years after the loan transaction is consummated, the borrower's rescission is timely. The borrower does *not* also have to file a lawsuit before the three-year period elapses. [15 USC § 1635(f); see *Jesinoski v. Countrywide Home Loans, Inc.* (2015) 574 US 259, 264, 135 S.Ct. 790, 793—error to dismiss complaint filed 4 years and 1 day after loan's consummation where borrower sent lender written notice of rescission exactly 3 years after refinancing home mortgage; see also *U.S. Bank Nat'l Ass'n v. Naifeh* (2016) 1 CA5th 767, 780, 205 CR3d 120, 132—timely rescission notice automatically voids lender's security interest unless lender contests notice; *Beach v. Ocwen Fed. Bank* (1998) 523 US 410, 419, 118 S.Ct. 1408, 1413—no federal right to rescind after 3-year period runs]

(b) [6:99.1b] **Rescission lawsuit; statute of limitations:** Congress has established a one-year statute of limitations for seeking *legal* damages based on TILA violations (see 15 USC § 1640(e)). Nothing in 15 USC § 1635, however, explicitly establishes a time limit for bringing an action for *equitable* relief in the event the lender fails to comply with a rescission request. Moreover, the Supreme Court was silent on the subject in *Jesinoski,* supra. Nonetheless, if a federal law contains no express statute of limitations, "the general rule is that a state limitations period for an analogous cause of action is borrowed and applied to the federal claim." [See *Hoang v. Bank of America, N.A.* (9th. Cir. 2018) 910 F3d

1096, 1101 (citations omitted)—Washington state's six-year statute of limitations under general contract law applied to borrower's TILA rescission action]

➪ [6:99.1c] ***PRACTICE POINTER:*** Notwithstanding *Hoang*, supra, until Congress and/or the Federal Reserve Board provides further statutory and/or regulatory guidance, consider filing suit no later than four years and one day after the loan transaction is consummated (¶ 6:99.1a).

(2) [6:99.1d] **Helping Families Save Their Homes Act of 2009:** In 2009, Congress again revised the truth in lending laws affecting extensions of credit secured by a consumer's "dwelling." Among other changes, a loan servicer who acquires actual ownership of a loan obligation by assignment or purchase must, within 30 days, furnish the borrower with the servicer's name, address, date of transfer and other relevant information. [See 15 USC § 1641(g); *Logan v. U.S. Bank Nat'l Ass'n* (9th Cir. 2013) 722 F3d 1163, 1172; see also *Gale v. First Franklin Loan Services* (9th Cir. 2012) 701 F3d 1240, 1241-1242, 1245-1246 (noting servicer who assigned ownership of loan solely for "administrative convenience" escapes liability but must still respond to borrower's inquiries re loan's true owner); *Jenkins v. JP Morgan Chase Bank, N.A.* (2013) 216 CA4th 497, 516-517, 156 CR3d 912, 928-929 (disapproved on other grounds by *Yvanova v. New Century Mortg. Corp.* (2016) 62 C4th 919, 939, 199 CR3d 66, 82, fn. 13)—statutory obligation to notify borrowers only applies to creditors who are "*new owners or assignees*" of loans, *not* transferors (emphasis added)]

Cross-refer: The Helping Families Save Their Homes Act of 2009 is discussed further at ¶ *6:511.11*.

(3) [6:99.2] **Home Ownership and Equity Protection Act (HOEPA):** HOEPA was enacted in 1994 as an amendment to the truth in lending laws. It applies to a special class of regulated loans that are made at higher interest rates or with excessive costs and fees. In addition to requiring specific disclosures that must be made at least three days before consummating a transaction, HOEPA generally precludes any prepayment penalty provisions in a loan, prohibits increases in the interest rate charged following any default, and bars negative amortization and prepaid monthly payments. A creditor's failure to comply with any of the foregoing requirements is treated as a failure to deliver material disclosures, thereby triggering the debtor's right to rescind. [See 15 USC § 1639(b), (c), (d), (f), (g), (j); *Holbert v. Fremont Investment & Loan* (2009) 179 CA4th 1067, 1076, 102 CR3d 370, 375]

(4) [6:99.3] **Regulation Z:** Regulation Z implements the federal Truth in Lending Act via parallel provisions promulgated by the Bureau of Consumer Financial Protection (12 CFR § 1026.1 et seq.) and the Board of Governors of the Federal Reserve System (12 CFR § 226.1 et seq.). Both sets of regulations require disclosures in connection with consumer credit and protect against abusive practices in the general mortgage market.

A comprehensive treatment of Regulation Z is beyond the scope of this Practice Guide.

c. [6:99.4] **Loan modification/refinance programs:** *See discussion at ¶ 6:511.1 ff.*

d. California residential mortgage loan modification laws

(1) [6:99.5] **Preperformance compensation, etc. (Bus. & Prof.C. § 10085.6):** It is illegal for *any licensee* (e.g., real estate broker, finance lender, residential mortgage lender or servicer, etc.) to (a) demand or receive advance fees or any other type of preperformance compensation; (b) require security as collateral for compensation; or (c) take a power of attorney from the borrower for any purpose in connection with a residential mortgage loan modification or other form of residential mortgage loan forbearance. A licensee who violates these prohibitions can be fined and, if a natural person, imprisoned for up to one year. [Bus. & Prof.C. § 10085.6; see also Civ.C. §§ 2944.7 & 2944.8 (authorizing state and local government officials to commence civil actions to recover up to $20,000 for each such violation, as well as additional penalties up to $2,500 for every violation perpetrated against a senior citizen or disabled person); *Matter of Taylor* (Rev.Dept. 2012) 5 Cal. State Bar Ct.Rptr. 221, 226]

(2) [6:99.6] **Preliminary written disclosure requirement (Bus. & Prof.C. § 10147.6):** *Before entering into any fee agreement with a borrower*, *any licensee* who renders compensable services in connection with a residential mortgage loan modification or other form of residential mortgage loan forbearance must provide their client with a statutorily-prescribed written disclosure in *minimum 14-point boldface type,* as follows (Bus. & Prof.C. § 10147.6(a) & Civ.C. § 2944.6(a)):

> "It is not necessary to pay a third party to arrange for a loan modification or other form of forbearance from your mortgage lender or servicer. You may call your lender directly to ask for a change in your loan terms. Nonprofit housing counseling agencies also offer these and other

forms of borrower assistance free of charge. A list of nonprofit housing counseling agencies approved by the United States Department of Housing and Urban Development (HUD) is available from your local HUD office or by visiting www.hud.gov."

A licensee who violates the above written disclosure requirement can be fined and, if a natural person, can be imprisoned for up to one year. [See Bus. & Prof.C. § 10147.6(c); Civ.C. § 2944.6(c); see also *Matter of Taylor* (Rev.Dept. 2012) 5 Cal. State Bar Ct.Rptr. 221, 226]

(a) [6:99.7] **Translated copies:** If loan modification services are offered or negotiated in one of the languages specified in Civ.C. § 1632 (i.e., Spanish, Chinese, Tagalog, Vietnamese or Korean), a translated copy of the requisite written disclosure must be provided to the client in that language. A licensee that violates this requirement can be fined and, if a natural person, can be imprisoned for up to one year. [Bus. & Prof.C. § 10147.6(b), (c) & Civ.C. § 2944.6(b), (c)]

(3) [6:99.8] **Attorney violators:** Attorneys who violate the Civ.C. § 2944.6 preliminary written disclosure requirement (¶ 6:99.6 ff.) in connection with residential loan modifications or forbearances are subject to discipline. [See Bus. & Prof.C. § 6106.3; see also *Matter of Taylor* (Rev.Dept. 2012) 5 Cal. State Bar Ct.Rptr. 221, 225, 231—attorney suspended and thereafter placed on probation for violating statutory written disclosure requirement and collecting illegal preperformance fees]

(4) [6:99.9] **Compare—federal law:** Under the Federal Trade Commission's Mortgage Assistance Relief Services Rule, mortgage modification and foreclosure relief services generally are prohibited from charging or collecting any advance fees. [See 12 CFR § 1015.1 et seq. ("Regulation O")]

Indeed, these services cannot receive payment until they secure a modification—i.e., until the homeowner has a written offer from their lender or servicer that the homeowner decides is acceptable. [12 CFR § 1015.5(a); see also *Consumer Fin'l Protection Bureau v. Gordon* (9th Cir. 2016) 819 F3d 1179, 1194-1195—attorney violated Regulation O by falsely claiming upfront fees charged for loan modification services were payments for "custom legal products" and that mortgage relief assistance was provided "free" as part of "pro bono program"]

(a) [6:99.10] **Attorney exemption:** Attorneys who provide mortgage assistance relief services as part of their practice to consumers who reside (or whose dwellings are located) in states where the attorneys are licensed are completely exempt from the federal ban on advance fees provided they (i) comply with state laws and regulations covering the same type of conduct; (ii) keep the fees in client trust accounts; and (iii) comply with all state laws and regulations applicable to client trust accounts. [See 12 CFR § 1015.7]

However, *California* lawyers apparently cannot take advantage of this exemption because of the federal provision requiring them to comply "with state laws and regulations that cover the same type of conduct." [See Civ.C. § 2944.7 (prohibiting *any licensee* from collecting advance fees until the licensee has "fully performed each and every service … contracted to perform," ¶ 6:99.5); see also *Consumer Fin'l Protection Bureau v. Gordon* (9th Cir. 2016) 819 F3d 1179, 1194-1195 (¶ 6:99.9)]

[6:99.11 - 6:99.14] ***Reserved.***

4. [6:99.15] **Criminal Prosecution for Mortgage Fraud:** In response to the rising tide of mortgage fraud in California, the Legislature enacted Pen.C. § 532f. Under this statute, any "person" (i.e., individual, partnership, firm, association, corporation, limited liability company or other legal entity) who, among other things, deliberately makes any misstatement, misrepresentation or omission during the mortgage lending process, with the intention that it be relied on by a "mortgage lender, borrower or any other party to the mortgage lending process," is guilty of *mortgage fraud*. [See Pen.C. § 532f(a), (i) & (j)—mortgage fraud may only be prosecuted when the alleged fraud's value meets the Pen.C. § 487 threshold for grand theft (generally, $950)]

A peace officer having reasonable grounds to believe records are "relevant and material to an ongoing investigation of a felony fraud violation" may apply ex parte for an order to produce any and all such records, regardless of their form or method of storage, that are in the possession of a "real estate recordholder" (i.e., title insurer, broker, salesperson, etc.). [See Pen.C. § 532f(c)]

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An offense involving mortgage fraud is a felony, punishable by up to one year imprisonment. [Pen.C. § 532f(h)]

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Chapter 6. Financing and Appraisals

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4. [6:150] Loan Escrow

1. [6:100] **General Nature of Process:** The process of applying for a loan and bringing it to actual funding (i.e., "closing" the loan) varies considerably depending on the kind and complexity of the loan and the particular lender's practice and policy. Generally, the process breaks down into four fundamental stages:

• loan application (¶ *6:105 ff.*);

• lender's acceptance of the application and offer to make the loan (the "loan commitment," ¶ *6:130 ff.*);

• preparation and finalization of the loan documentation (promissory note, deed of trust and various other security instruments, ¶ *6:190 ff.*); and

• loan closing (funding).

a. [6:101] **Variations:** Not all of the foregoing phases of loan processing apply to all kinds of loans; for example:

(1) [6:102] **Seller financing:** No loan application or commitment occurs in connection with seller financing. Instead, the loan approval process is contained within the purchase and sale agreement. (The purchase contract usually states that the seller's obligation to provide seller financing is conditioned upon its review and approval of the buyer's financial statement.)

(2) [6:102.1] **Private third party lenders:** When the lender is a private third party (rather than an institutional lender), the loan application, commitment and funding process is much less formal.

(3) [6:103] **Single family residence transactions:** The process for obtaining a single family residential loan from an institutional lender tends to be much more streamlined than for multifamily or commercial loans.

b. [6:104] **Commitment bypass:** In certain instances, there is no commitment stage and the parties simply move from loan application to documenting the loan and immediate funding. Often, even when there is a commitment phase, the commitment may be abbreviated and informal.

2. [6:105] **Loan Applications:** Institutional lenders almost always require some form of formal written loan application. The application is designed to elicit information about the borrower and the property.

a. [6:106] **Application for single family residential loans:** Single family residential loan applications are relatively simple; they generally consist of the following parts:

(1) [6:107] **Application form and financial statements:** Institutional lenders provide the borrower with a fairly simple loan application form that requires information concerning the applicant's financial condition and work history. (Several other documents and additional information are typically required as well, including tax returns, verification of the source of the down payment, authorizations for the lender to verify the applicant's salary and bank account balances, etc.)

The lender's efforts to determine the borrower's creditworthiness and ability to repay are for the lender's protection, *not* the borrower's. Indeed, "absent special circumstances … a loan transaction is at arm's length and there is no fiduciary relationship between the borrower and lender." [See *Perlas v. GMAC Mortg., LLC* (2010) 187 CA4th 429, 436, 113

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CR3d 790, 796 (brackets omitted)—borrowers not entitled to rely on lender's "loan qualification" determination in deciding whether they could *afford* loans]

(2) [6:108] **Appraisal:** Although it need not be submitted at the time of the loan application, the lender will require an appraisal by one of its in-house appraisal staff or an outside appraiser. The borrower is required to pay for the appraisal. Upon the borrower's request to the lender, the borrower is entitled to receive a copy of the appraisal report. [Bus. & Prof.C. § 11423]

The appraised value of the property must be sufficient to satisfy the lender's minimum "loan to value ratio."

Cross-refer: Appraisals are discussed in detail at *¶ 6:650 ff.*

(a) [6:109] **"Loan to value ratio":** A "loan to value ratio" is a comparison between the amount to be loaned and the appraised value of the property. This ratio is expressed as a percentage.

For example, if the amount to be loaned is $400,000 and the property is appraised at $500,000, the loan to value ratio is 80% ($400,000 divided by $500,000).

The purchase price is disregarded in determining loan to value ratio. Indeed, the purchase price is germane only if less than the property's appraised value. This is because the lender will generally only loan the *lesser* of (i) the loan to value ratio, or (ii) that same percentage of the purchase price.

(b) [6:110] **Significance:** Lenders are concerned about loan to value ratios because they want to loan only a portion of the total value of the property. The difference between the amount of the loan and the appraised value provides the lender with an equity cushion so that, in the event the lender forecloses and takes back the property, there is sufficient equity to cover expenses—such as costs of foreclosure, lost interest on the loan, the lender's carrying charges while the property is being marketed (taxes, maintenance and insurance, etc.), and the cost of reselling the property (broker commissions and escrow charges).

This equity cushion also provides the lender with some comfort that, even if the property should decrease in value, the loan amount will not exceed the value of the property.

(3) [6:111] **Escrow instructions:** Lenders do not want to bother processing loan applications unless the borrower can demonstrate it already has a binding purchase and sale agreement. Therefore, a copy of the escrow instructions for the purchase (or other form of purchase agreement) must be submitted to the lender as part of the loan application.

(4) [6:112] **Title report:** The lender will require a current preliminary title report on the property in order to determine whether the condition of title to be acquired by the buyer is acceptable to the lender or whether exceptions to title will have to be removed prior to funding of the loan. (*See ¶ 3:200 ff.* for detailed discussion of preliminary title reports.)

(5) [6:113] **Fee:** A relatively minimal application fee (usually only a few hundred dollars) is also required. Typically, this fee is nonrefundable and is not applied to loan fees or any other loan closing costs.

b. [6:114] **Applications for multifamily and commercial property loans:** Applications for multifamily and commercial property loans are more complex. This is partly because the borrower's ability to repay such loans is often dependent upon the property's income stream. Therefore, lenders more carefully scrutinize the property.

In addition to the items required upon application for a single family residential loan (*¶ 6:107 ff.*), an application for a multifamily or commercial property loan will require the applicant's delivery of some or all of the items noted at ¶ 6:115 ff.

• [6:114.1] **Comment:** Some of these items might be procured by the buyer/borrower from the seller as part of the purchase and sale transaction—e.g., estoppel certificates, copies of leases, surveys, soil and environmental reports, etc.

Also, bear in mind that some of the following items are not necessarily required at the time the loan application is made, but may be submitted at a later date. Finally, the documents listed at ¶ 6:115 ff. must be approved by the lender as a condition to making the loan.

(1) [6:115] **Rent roll/income and expense report:** The lender will require a schedule of current rents for the property (and perhaps a schedule of future increases in rents), together with a summary of expenses for operation of the property.

(2) [6:116] **Copies of leases:** The applicant will also have to submit a copy of each lease of the property.

(3) [6:117] **Management contract:** If the borrower intends to engage an outside property manager, the lender may want to see a copy of the property management contract. (*See Ch. 10* re real property management and management agreements.)

(4) [6:118] **Real property tax bills:** Copies of recent tax bills for the property are sometimes required (even though current real property taxes due will be reflected on the title report).

(5) [6:119] **Survey:** A lender usually requires a survey of the property.

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(6) [6:120] **Tenant estoppel certificates:** For commercial properties (but not residential projects), the lender often requires an estoppel certificate from each tenant (*see ¶ 4:418 ff.; and Form 4:J*).

(7) [6:121] **Subordination agreement:** If the leases do not specifically provide they are subordinate to future deeds of trust, the lender may require that the tenants execute a subordination, nondisturbance and attornment agreement (*see* ¶ *6:472 and 7:273 ff.* in connection with ground leaseholds).

(8) [6:122] **Soils reports/environmental audits:** Depending on the kind of property involved, the lender will require certain reports concerning geological and environmental conditions. Soils reports and Phase I environmental audits (*¶ 5:238 ff.*) are commonly required.

(9) [6:123] **Evidence of compliance with zoning and other laws:** The lender might require evidence that improvements built on the property, and operation of the business on the property, are all in compliance with building codes, and zoning, land use and other applicable laws.

(10) [6:124] **Evidence of insurance:** As part of the loan closing, the borrower must provide the lender with evidence the borrower holds hazard and liability insurance, with liability limits in amounts required by the lender and under a policy that designates the lender as either a named or additional insured.

(11) [6:125] **Additional requirements for construction loan:** Application for a construction loan requires additional documents and information, including:

• copies of construction contracts;

• copies of all plans and specifications;

• copy of the agreement with the architect;

• in certain circumstances, a construction performance and payment bond;

• a list of all major subcontractors who will be performing work for a fee exceeding a specified amount;

• copies of certain building, zoning and other permits;

• letters from utility companies confirming that utility services will be available to the project;

• a construction budget; and

• perhaps a take-out commitment for a permanent loan (¶ 6:40 ff., 6:46 ff.).

c. [6:126] **Letter of lender's preliminary interest:** In certain kinds of multifamily and commercial property loan transactions, the lender might have preliminary communications with a prospective borrower before the borrower makes a formal and complete loan application. Those communications might include the borrower's submission of certain information about the property and the contemplated loan.

Unlike single family residential loan transactions (where borrowers generally can predict with relative accuracy the likelihood of their qualifying for a loan, as well as the interest rate and terms), the ability to obtain multifamily and commercial loans is not so predictable. Therefore, the applicant may want to learn whether the lender is predisposed to make the contemplated loan.

In these instances, either as part of the initial application process or shortly thereafter (but before a commitment is issued), the lender might issue a *preliminary letter of interest*. Such a letter does not obligate the lender to make the loan or otherwise issue a loan commitment, but it nonetheless serves a practical purpose for both parties:

• [6:126.1] The borrower gains some degree of assurance the lender is willing to make loans of the kind being contemplated and that the lender has at least some preliminary interest in making the loan to the borrower.

• [6:126.2] The lender (who usually requires an application fee for issuance of the letter of preliminary interest) also gains something by making the borrower more committed to borrowing money from it than a competing lender. Although the borrower's “commitment” may only be psychological and financially minimal (in the amount of the application fee), that is usually sufficient to dissuade the borrower from submitting loan applications to competing lenders.

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[6:127 - 6:129] ***Reserved.***

3. Loan Commitments

a. [6:130] **Nature of loan commitment:** Once the lender approves the borrower's application, it will typically (but not necessarily) send the borrower some form of written “commitment” to make the loan. A written commitment sets forth the fundamental terms and conditions upon which the lender will make the loan and provides that the lender will hold its commitment open for a certain period of time.

So long as it contains the minimum essential terms (identity of lender and borrower, amount of the loan and repayment terms, *see ¶ 6:136*), a written loan commitment is binding on the lender, subject to any conditions precedent stated in the commitment. [*Fischer v. First Int'l Bank* (2003) 109 CA4th 1433, 1447-1448, 1 CR3d 162, 172]

• ***FORM:*** Loan Commitment, *see Form 6:D*.

(1) [6:131] **Fee:** Sometimes the commitment is free and sometimes it must be purchased by the borrower. In the latter instance, the lender sends a commitment letter stating if the borrower accepts the commitment and pays a “commitment fee,” the lender's commitment becomes valid and binding (*see ¶ 6:139 ff.*).

In single family residential loan transactions, the commitment is abbreviated and informal, and there is no commitment fee.

(2) [6:132] **Documents:** The loan commitment does not typically include a draft of the form loan documents. Instead, the lender's commitment simply states the loan documents will be those that are acceptable to the lender.

This obviously is risky for a prospective borrower because, although the interest rate and other economic terms are set forth in the commitment letter, other material, substantive terms will be set forth in loan documents that the borrower has not yet seen (but which the borrower arguably is consenting to when it accepts the commitment). *See further discussion at* ¶ 6:147 ff.

(3) [6:133] **Conditions:** Loan commitments describe various conditions which must be satisfied by the borrower before the lender is obligated to make the loan. Thus, even after issuance of a commitment, the borrower still needs to submit (and the lender still needs to approve) various information and documents. The commitment typically provides that the lender's approval of such information and documents may be given or withheld in the lender's sole and absolute discretion. *See further discussion at ¶ 6:142 ff.*

b. [6:134] **Contents of commitments:** Loan commitments range from simple to complex. In single family residential transactions, the commitment is often in the form of an abbreviated letter that simply advises the borrower of approval of the loan (including the loan amount, term of the loan, interest rate, loan fees, etc.), the duration of the commitment, and perhaps a few other matters.

More complex loans require greater thoroughness in the commitment (*see Form 6:D*). Therefore, the following items are usually included in multifamily and commercial loan commitments:

• Borrower's name;

• Loan amount;

• Interest rate and basis of computation (generally using a 360-day year for *commercial* loans);

• Term of loan;

• Loan fee;

• Term of the commitment;

• Loan prepayment charges;

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• Commitment fee (if any, and whether the commitment fee will apply to the loan fee);

• Guarantors (if any);

• Whether tax and insurance impound payments will be required (*see ¶ 6:373 ff.*);

• Identification of security for the loan;

• Description of the title insurance policy the lender will require (including any special endorsements);

• Specification of hazard and liability insurance that will be required;

• Inspections and reports required by the lender (structural, environmental, etc.);

• Conditions regarding borrower's financial condition on the day of closing;

• Requirement that there be no material, adverse change in the property's use, operation or income prior to the loan closing;

• In certain instances, the requirement of an opinion of borrower's counsel (*see Ch. 9*);

• Requirement that the property be in compliance with law as of the closing;

• Requirement that the borrower pay the lender's attorney fees, loan escrow and other closing fees and charges; and

• Any other matters idiosyncratic to the particular loan involved (e.g., construction loan commitments require a host of additional lender approvals—including approval of the construction contract, the general contractor, the architect, etc.).

c. [6:135] **Writing requirement—statute of frauds:** In certain instances, an enforceable loan commitment must be in writing:

A "commitment to loan money or to grant or extend credit in an *amount greater than … $100,000, not primarily for personal, family, or household purposes*, made by a person engaged in the business of funding or arranging for the business of lending of money or extending of credit" must be in writing. [Civ.C. § 1624(a)(7) (emphasis added)]

For this purpose, a loan "secured solely by residential property consisting of one to four dwellings shall be deemed to be for personal, family, or household purposes" (i.e., such a loan commitment need not be in writing). [Civ.C. § 1624(a)(7)]

Cross-refer: For a detailed discussion of the statute of frauds in connection with real property purchase and sale transactions, *see ¶ 4:263 ff.*

(1) [6:136] **Sufficiency of writing:** A commitment subject to the statute of frauds must sufficiently state the material terms of the loan. At a minimum, the following must be clearly stated in writing: borrower, loan amount, interest rate, maturity date, security for the loan, payment schedule, and lender's remedies for default. [See *Grimes v. New Century Mortg. Corp.* (9th Cir. 2003) 340 F3d 1007, 1010 (interest rate not determinable); *Peterson Develop. Co., Inc. v. Torrey Pines Bank* (1991) 233 CA3d 103, 115, 284 CR 367, 374 (commitment letter did not sufficiently name borrower, amount to be loaned or specific terms of repayment); *Laks v. Coast Fed. Sav. & Loan Ass'n* (1976) 60 CA3d 885, 891, 131 CR 836, 839 (commitment letter did not contain payment schedule, clear identity of borrower, security, prepayment conditions, terms for interest calculations, method for loan disbursements, lenders' rights and remedies upon default)]

(2) [6:137] **Estoppel, etc. exceptions:** Prospective borrowers attempting to enforce a loan commitment that does not satisfy the statute of frauds have sometimes resorted to claims of estoppel, misrepresentation, detrimental reliance, duress, breach of fiduciary duty, negligence and fraud against the lender. However, these theories generally have been unsuccessful. [See *Kruse v. Bank of America* (1988) 202 CA3d 38, 52-57, 248 CR 217, 225-228; *Mitsui Manufacturers Bank v. Sup.Ct. (Squidco Corp. of America, Inc.)* (1989) 212 CA3d 726, 732-733, 260 CR 793, 797 (unsuccessful breach of covenant of good faith and fair dealing claim)]

d. Commitment acceptance and fees

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(1) [6:138] **Acceptance of commitment:** Some (but not all) commitments are conditioned on the borrower's "acceptance." The borrower accepts the commitment by executing the commitment agreement and the commitment is then held open for its stated term.

(2) [6:139] **Commitment fees:** In multifamily and commercial loan transactions, the lender often requires that a fee be paid as a condition to the borrower's acceptance of the commitment. The commitment fee is distinct from the loan fee; but the lender often permits the commitment fee to be applied to various loan fees and costs when the loan is closed. In any event, the commitment fee is nonrefundable—i.e., if the loan does not close, the lender retains the fee.

(a) [6:140] **Purpose:** A commitment fee serves a three-fold purpose:

• It covers the lender's administrative and processing costs incurred in connection with the loan.

• It compensates the lender for reserving the loan amount (and refraining from loaning that amount to other prospective borrowers) during the term of the loan commitment.

• It motivates the borrower to close the loan as and when required by the commitment.

(b) [6:141] **Akin to liquidated damages:** Conceptually, a commitment fee is similar to liquidated damages, compensating the lender for the loss it will incur should the borrower elect not to close the loan. The forfeiture of commitment fees (in the event the borrower backs out of the loan commitment) has been upheld. [*Lowe v. Massachusetts Mut. Life Ins. Co.* (1976) 54 CA3d 718, 738, 127 CR 23, 35; *Regional Enterprises, Inc. v. Teachers Ins. & Annuity Ass'n of America* (9th Cir. 1965) 352 F2d 768, 775]

e. [6:142] **Satisfaction of conditions to closing:** Loan commitments require that certain conditions be satisfied before expiration of the term of the commitment.

(1) [6:143] **Typical conditions:** For example, some of the conditions to the lender's obligation to fund the loan might be the lender's approval of an environmental assessment of the property, tenant estoppel certificates, and the condition of title to the property; the lender's satisfaction there have been no material, adverse changes in the borrower's financial condition between the time of the borrower's loan application and the loan closing; and the lender's satisfaction there have been no material, adverse changes in the property's income stream between the time of the borrower's application and the loan closing.

(2) [6:144] **"Satisfaction clauses":** Standards for determining whether the conditions have been satisfied are often not stated with specificity.

Notably, commitment letters frequently provide that the specified conditions are subject to the "lender's satisfaction, in the lender's sole and absolute discretion." These so-called "satisfaction clauses" are fraught with the potential for dispute. Nonetheless, they are not necessarily illusory. Courts have enunciated two general theories to protect prospective borrowers:

(a) [6:145] **Implied covenant of good faith and fair dealing:** As discussed in *Ch. 4*, every contract carries with it an implied covenant of good faith and fair dealing. [*Seaman's Direct Buying Service, Inc. v. Standard Oil Co. of Calif.* (1984) 36 C3d 752, 768, 206 CR 354, 362 (overruled on other grounds by *Freeman & Mills, Inc. v. Belcher Oil Co.* (1995) 11 C4th 85, 88, 44 CR2d 420, 421; and disapproved on other grounds by *Della Penna v. Toyota Motor Sales, U.S.A., Inc.* (1995) 11 C4th 376, 393, 45 CR2d 436, 447, fn. 5); *see* ¶ *4:275.5*]

Consequently, a lender's "satisfaction clause," though stated as being subject to the lender's absolute discretion, will be interpreted consistent with the lender's obligation not to do anything that will defeat the borrower's right to receive the benefits of its "bargain." In other words, the lender must act in "good faith" when it determines the borrower's performance of a specified condition is not "satisfactory" (¶ 6:148). [See *Grimes v. New Century Mortg. Corp.* (9th Cir. 2003) 340 F3d 1007, 1012-1013 (J. McKeown dissent. opn.)]

(b) [6:146] **Objectively reasonable standard:** The lender's "dissatisfaction must be genuine and not arbitrary, and … an objective criterion, good faith controls the exercise of the right to determine satisfaction." [*Rodriguez v. Barnett* (1959) 52 C2d 154, 160, 338 P2d 907, 911; see also *Mattei v. Hopper* (1958) 51 C2d 119, 123, 330 P2d 625, 626-627]

(3) [6:147] **Documentation conditions:** The requisite loan documentation (promissory note, deed of trust, etc.) may also be an area of potential dispute. Although the commitment letter may set forth the material economic and substantive terms

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of the loan, commitments ordinarily make only a general reference to the loan documentation. However, loan documents are extensive and often require negotiation.

(a) [6:148] **Subject to duty of good faith and fair dealing:** As with the exercise of lender "satisfaction clauses," lenders are subject to a duty of good faith and fair dealing in negotiating the loan documents. [See *999 v. C.I.T. Corp.* (9th Cir. 1985) 776 F2d 866, 868-871—lender breached duty of good faith and fair dealing in requiring prepayment penalty provision in loan documents where commitment letter was silent on subject]

➪ [6:149] ***PRACTICE POINTER:*** Because borrowers do not want to be surprised by loan documents containing terms and conditions they did not contemplate, borrower's counsel should, if possible, obtain and review the lender's proposed form loan documents before the borrower executes the commitment letter. This step will position the borrower either to negotiate the loan documents before executing the commitment or at least to determine whether there will be substantial issues over the terms of the loan documentation.

4. [6:150] **Loan Escrow:** A separate escrow (requiring loan escrow instructions to be signed by the lender and borrower) is usually set up to close (fund) the loan. Typically, this escrow takes place at the same escrow that will be consummating the purchase and sale (*see ¶ 4:560 ff.*).

Only the lender and borrower are parties to the loan escrow. The loan escrow instructions direct the escrow holder as to disbursement of the loan funds, recordation of the deed of trust, issuance of the lender's title insurance policy and a variety of issues pertaining to the mechanics of closing the loan.

[6:151 - 6:159] ***Reserved.***

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Chapter 6. Financing and Appraisals

D. Mortgage Loan Brokers and Mortgage Loan Broker Agreements

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1. [6:160] **Function of Loan Broker:** A loan broker (or "mortgage loan broker") is sometimes used by borrowers to procure a loan. A loan broker can be an agent of the lender, the borrower, or both. When acting as the borrower's agent, a loan broker's services involve such things as:

• Counseling the borrower on the most beneficial method of financing;

• Shopping among various lenders to determine what loans are available and identifying prospective lenders;

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• Helping the borrower prepare the loan application (including procurement of requisite appraisal, tenant estoppel certificates, etc.);

• Negotiating the loan terms and helping obtain the loan commitment; and

• Assisting in closing the loan (finalizing the transaction and funding the loan).

a. [6:161] **Akin to real estate broker:** For these services, the loan broker is paid a fee that is almost always based on a percentage of the loan amount. A loan broker therefore functions much like a real estate broker (*Ch. 2*), but on the financing side of the transaction.

[6:162] ***Reserved.***

b. [6:163] **"Mortgage bankers" distinguished:** Mortgage loan brokers are different from "mortgage bankers."

A mortgage banker is a party who actually makes or holds loans. Unlike a mortgage loan broker, a mortgage banker does not act as an intermediary who procures loans for borrowers. Instead, a mortgage banker acts as a lender itself. A mortgage banker sometimes "pools" groups of loans and holds them for a period of time ("warehousing" of loans) and then sells them off. After the sale, the mortgage banker might continue to "service" the loan for a fee. Servicing the loan involves collecting payments from the borrower and disbursing them to the owner of the loan; monitoring the borrower's performance under the loan (including verifying that the borrower timely pays real property taxes and maintains required insurance); and handling a foreclosure or the enforcement of certain other rights of the lender.

2. Loan Broker Fees

a. [6:164] **Timing of payment:** The loan broker's commission is usually paid at the loan closing, when the loan is funded (although it occasionally is paid, in whole or in part, at the time the loan commitment is issued).

b. [6:165] **How paid:** Where the borrower is responsible for the loan broker's commission, it is usually paid out of the loan proceeds.

Where the lender is responsible for the loan broker's commission, it is usually paid out of the lender's loan fees ("points") charged to the borrower. Thus, regardless of whether the broker is the borrower's or lender's agent, the *borrower* effectively pays the broker's entire fee. (When a lender is compelled to pay a loan brokerage fee, the points charged to the borrower for the loan might be correspondingly higher than if no loan broker had been involved.)

c. [6:165.1] **Rebates paid by lender ("yield spread premiums") related to services rendered permissible:** A "yield spread premium" (YSP) is a bonus paid by a lender to a mortgage broker when they originate a loan at an interest rate higher than the minimum interest rate approved by the lender for the loan. The YSP is paid to the broker at closing, and the borrower pays a higher interest rate over the life of the loan to compensate for the payment. [*Wolski v. Fremont Invest. & Loan* (2005) 127 CA4th 347, 351, 25 CR3d 500, 503]

YSPs paid in connection with certain federally-insured residential property loans do *not* violate RESPA (¶ *4:639 ff.*) so long as they represent payment for *services actually performed* by the brokers. [*Geraci v. Homestreet Bank* (9th Cir. 2003) 347 F3d 749, 751; and see *Maganellez v. Hilltop Lending Corp.* (ND CA 2007) 505 F.Supp.2d 594, 603—YSP's legality also depends on whether bonus received is reasonably related to value of services performed (¶ *4:642.6*); *Byars v. SCME Mortg. Bankers, Inc.* (2003) 109 CA4th 1134, 1144-1145, 135 CR2d 796, 803—broker's statement may describe YSP in lump-sum terms in lieu of setting forth itemized list of services and fees]

3. [6:166] **Licensing and Regulation of Loan Brokers:** Anyone who "[s]olicits borrowers or lenders for or negotiates loans or collects payments or performs services for borrowers or lenders or note owners in connection with loans secured directly or collaterally by liens on real property" *must hold a real estate broker's license.* [Bus. & Prof.C. § 10131(d); see also *Onofrio v. Rice* (1997) 55 CA4th 413, 420, 64 CR2d 74, 77 (citing text); *Smith v. Home Loan Funding, Inc.* (2011) 192 CA4th 1331, 1335, 121 CR3d 857, 860—broker acts as borrower's agent; *Salazar v. Interland, Inc.* (2007) 152 CA4th 1031, 1036, 62 CR3d 24, 27—licensing requirement helps protect public from incompetent and untrustworthy practitioners]

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Therefore, like real estate brokers who earn commissions on the sale of real property, loan brokers ordinarily must hold a license as a condition to earning a loan brokerage fee. (*See detailed discussion of real estate broker licensing requirements at ¶ 2:60 ff.*)

a. [6:167] **Exemptions from licensing requirement:** Various statutory provisions exempt certain parties and certain kinds of transactions from the Bus. & Prof.C. § 10131(d) licensing requirement. [See Bus. & Prof.C. §§ 10133 & 10133.1]

For example, exemptions are granted to:

- Attorneys when "rendering legal services to a client." [Bus. & Prof.C. § 10133(a)(3); ¶ *2:91*]

- "Any person licensed to practice law in this state, not actively and principally engaged in the business of negotiating loans secured by real property, when that person renders services in the course of their practice as an attorney at law …" [Bus. & Prof.C. § 10133.1(a)(5); ¶ *2:101*]

- Employees of a real estate broker who, on the broker's behalf, assist the broker in meeting the broker's obligations to customers in residential mortgage loan transactions (as defined in Fin.C. § 50003), where the lender is an institutional lender (as defined in Fin.C. § 50003), provided those employees do not participate in negotiations between the principals. [Bus. & Prof.C. § 10133.1(c)(1); *see* ¶ *2:103.1*]

Cross-refer: For a detailed discussion of the statutory exemptions, *see* ¶ *2:86 ff.*

[6:167.1 - 6:167.4] ***Reserved.***

b. [6:167.5] **Authority to provide loan brokerage services under residential mortgage lender license:** Notwithstanding Bus. & Prof.C. § 10131(d), a *residential mortgage lender* (licensed under the California Residential Mortgage Lending Act, Fin.C. § 50000 et seq.), or a *mortgage loan originator* (¶ 6:167.8 ff.) employed by a residential mortgage lender, may provide brokerage services under the authority of the lender's license, provided the lender first enters into a written brokerage agreement with the borrower pursuant to Fin.C. § 50701 (¶ 6:167.7). [Fin.C. § 50700(c)]

However, when a residential mortgage lender is acting *solely* under the authority of its residential mortgage lender's license, it is empowered to render *only* those brokerage services authorized by Fin.C. § 50700 et seq., and cannot engage in other activities that are subject to the Bus. & Prof.C. § 10131 real estate broker licensing requirement. [Fin.C. § 50700(d)(5); see also *Smith v. Home Loan Funding, Inc.* (2011) 192 CA4th 1331, 1335, 121 CR3d 857, 860 (explaining distinction between mortgage lenders and brokers)]

(1) [6:167.6] **Residential mortgage loans only:** Brokerage services within the scope of a residential mortgage lender's license are limited to obtaining (or attempting to obtain), on behalf of a borrower, a *residential mortgage loan* (as defined in Fin.C. § 50003(p)) *secured by residential real estate* (as defined in Fin.C. § 50003(v)), made with the funds of another institutional lender (as defined in Fin.C. 50003(k)(1), (2) and (4)) and closed in that lender's name or the name of the licensee, for a fee paid by the borrower or institutional lender. [See Fin.C. § 50700(b)(1) & (2)]

(2) [6:167.7] **Written brokerage agreement required:** Before performing brokerage services for the borrower, the residential mortgage lender-licensee and borrower must enter into a written loan brokerage agreement that satisfies all of the requirements of Fin.C. § 50701. [Fin.C. § 50701(a)]

Among other things, the agreement must:

- Be signed and dated by the borrower and licensee's authorized representative, who must be a *licensed mortgage loan originator* (¶ *6:167.8 ff.*);

- Include the mortgage loan originator's unique identifier (¶ *6:167.12*);

- Contain an explicit statement that the licensee (i) is acting as the borrower's agent in providing the brokerage services; and (ii) in that capacity, owes the borrower a *fiduciary duty* of "utmost care, honesty, and loyalty in the transaction, including the duty of *full disclosure of all material facts*" (emphasis added);

- If applicable, disclose the licensee's authority to act as agent for any other person in the transaction, and identify that person;

• Describe in detail the services to be performed for the borrower and provide a good faith estimate of the licensee's fees for those services;

• Contain a "clear and conspicuous statement" of the conditions under which the borrower is obligated to pay the licensee for the agreed-upon brokerage services; and

• Set forth statutorily-prescribed remedies available to the borrower in the event the licensee makes a "materially false or misleading statement or omission" in inducing or implementing the loan brokerage agreement. [See Fin.C. § 50701(b)-(k)]

(3) [6:167.8] **Mortgage loan originators:** A "mortgage loan originator" means an individual who, for compensation or gain, or in the expectation of compensation or gain, takes a residential mortgage loan application or offers or negotiates terms of a residential mortgage loan. [Fin.C. § 50003.5]

A mortgage loan originator may only provide brokerage services as an employee of a licensed residential mortgage lender (¶ *6:167.5*). [See Fin.C. § 50700(e)]

(a) [6:167.9] **License and registration requirement:** Mortgage loan originators must be licensed and registered through the Nationwide Mortgage Licensing System and Registry. [See Fin.C. §§ 50002.5 & 50140]

(b) [6:167.10] **Background information; educational requirements; written examination:** Applicants for a mortgage loan originator license must, at a minimum, furnish the Nationwide Mortgage Licensing System and Registry with prescribed information concerning their identity (e.g., fingerprints, personal history, experience, etc.). [Fin.C. § 50140(e); see also Fin.C. § 50146 (Commissioner's authority to establish requirements for furnishing identity information)]

Applicants also must complete at least 20 hours of education courses, as specified, and pass a qualified written test. Once licensed, they must complete annually at least eight hours of continuing education requirements. [See Fin.C. §§ 50142, 50143, 50145]

(c) [6:167.11] **Lender's minimum net worth; condition reports:** Residential mortgage lenders that employ mortgage loan originators must maintain a minimum net worth of $250,000. In addition, the Commissioner may require these lenders to submit "condition reports" to the Nationwide Mortgage Licensing System and Registry. [See Fin.C. §§ 50201(a) & 50307.2]

The Commissioner also may require a lender who engages in Fin.C. § 50003(m)(2) activities (processing or underwriting residential mortgage loans) to continuously maintain a minimum tangible net worth in excess of $250,000.00, but that does not exceed the net worth required of an approved lender under the Federal Housing Administration. [See Fin.C. § 50201(a)]

(d) [6:167.12] **Disclosure of unique identifier on loan applications, advertisements and solicitations:** The "unique identifier" of any licensed mortgage loan originator, provided by the Nationwide Mortgage Licensing System and Registry, must be clearly disclosed on all residential mortgage loan applications, advertisements and solicitations. [Fin.C. § 50209]

(e) [6:167.13] **Compare—government employees, etc.:** Under certain statutorily specified conditions, government and nonprofit organization employees who originate loans exclusively in their capacity as employees are not considered *mortgage loan originators* under the California Finance Lenders Law or Residential Mortgage Lending Act. [See Fin.C. § 50003.5(b)(5), (6)]

Also generally excluded are (i) individuals who perform purely administrative/clerical tasks on behalf of mortgage loan originators; (ii) individuals who solely renegotiate terms for existing mortgage loans held/serviced by their employer; (iii) individuals solely involved in credit extensions relating to time share plans; and (iv) individuals licensed as mortgage loan originators pursuant to the Business and Professions Code and the SAFE Act. [Fin.C. § 50003.5(b)(1)-(4)]

c. [6:168] **Disclosure requirements:** Every broker performing services subject to the Bus. & Prof.C. § 10131(d) licensing requirement "who negotiates a loan to be secured directly or collaterally by a lien on real property shall, within three business days after receipt of a completed written loan application or before the borrower becomes obligated on the note, whichever

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is earlier …" deliver a *written disclosure statement to the borrower* as prescribed by Bus. & Prof.C. § 10241. [Bus. & Prof.C. § 10240(a)]

For purposes of the disclosure requirement, brokers are deemed to perform services subject to Bus. & Prof.C. § 10131(d) if they solicit borrowers, or cause borrowers to be solicited, "through express or implied representations that the broker will act as an agent in arranging a loan, but in fact [make] the loan to the borrower from funds belonging to the broker." [Bus. & Prof.C. § 10240(b); see *Engstrom v. Kallins* (1996) 49 CA4th 773, 780, 56 CR2d 842, 847—§ 10240(b) *broadens* coverage of Bus. & Prof.C. § 10240 "to include not only situations where a real estate broker acts as mortgage broker … but also where a real estate broker initially offers himself as a mortgage broker but in fact ends up the lender …"]

(These disclosure requirements generally also apply to a residential mortgage loan arranged by a licensed residential mortgage lender; see Fin.C. § 50703.)

(1) [6:169] **Contents of disclosure statement:** The contents of the requisite disclosure statement are prescribed by Bus. & Prof.C. § 10241.

The required items include the estimated maximum costs to be paid by the borrower (including, but not limited to, appraisal fee, escrow fee, title charges, notary fee, recording fee, credit investigation fees), the loan brokerage commission, terms of the loan and maturity date of the loan. [See Bus. & Prof.C. § 10241]

(a) [6:170] **Mandatory:** The items prescribed by Bus. & Prof.C. § 10241 are *mandatory:* "No real estate licensee shall permit the statement to be signed by a borrower if any information required by Section 10241 is omitted." [Bus. & Prof.C. § 10240(a)]

(2) [6:171] **Official disclosure form:** The broker's disclosure statement must be made on a form approved by the Real Estate Commissioner. [Bus. & Prof.C. § 10241] The approved "Mortgage Loan Disclosure Statement" is published by the California Department of Real Estate. [See 10 CCR § 2840 et seq. (also containing other restrictions and requirements concerning disclosures and loan brokerage matters)]

(3) [6:171.1] **Copy to be retained:** A "true and correct copy" of the Bus. & Prof.C. § 10241 disclosure statement signed by the borrower must be retained by the broker for three years. [Bus. & Prof.C. § 10240(a)]

(4) [6:171.2] **Alternative form of compliance in federally-regulated residential mortgage loan transactions:** Real estate brokers negotiating a federally-regulated residential mortgage loan may satisfy the Bus. & Prof.C. § 10240 disclosure requirements (¶ 6:168 ff.) by providing the borrower with (a) a "good faith estimate" that satisfies the Real Estate Settlement Procedures Act (12 USC § 2601 et seq., *¶ 4:639 ff.*), (b) all applicable disclosures required by the federal Truth in Lending Act (15 USC § 1601 et seq.), and (c) an additional statutorily-specified disclosure if the loan contains a balloon payment provision. [Bus. & Prof.C. § 10240(c); *see further discussion at ¶ 2:215.3*]

Before becoming obligated on the loan, the borrower must acknowledge in writing receipt of the "good faith estimate" and all applicable Truth in Lending disclosures. The broker must retain for three years a copy of the signed acknowledgment along with the acknowledged "good faith estimate" and disclosures. [Bus. & Prof.C. § 10240(c)]

[6:171.3 - 6:171.4] ***Reserved.***

(5) [6:171.5] **Additional cosigner disclosure—consumer credit contracts:** If the loan constitutes a "consumer credit contract" (i.e., loan made primarily for personal, family or household purposes, see Civ.C. § 1799.90(a)(5)), cosigners who do not in fact receive any of the loan proceeds or services that are the subject matter of the contract must be given notice as prescribed by Civ.C. § 1799.91 *before* the cosigners become obligated on the contract. The notice essentially explains a cosigner's liability as guarantor on the obligation. [See Civ.C. § 1799.91; *Engstrom v. Kallins* (1996) 49 CA4th 773, 778-781, 56 CR2d 842, 845-847]

No action may be brought or security interest enforced against the cosigner if the requisite notice is not given. [Civ.C. § 1799.95]

(6) [6:172] **Other statutory disclosures:** The Civil Code requires additional statutory disclosures by an "arranger of credit" of a purchase money lien on residential property. [See Civ.C. §§ 2956-2967]

d. [6:173] **Loan broker's duties and standards of conduct:** A loan broker is generally held to the same duties and standards of conduct as a real estate broker (*see ¶ 2:155 ff.*).

General agency principles, combined with the statutory duties created by the real estate law, impose on mortgage loan brokers an obligation to make full and accurate disclosures of the terms of a loan and to always act in utmost good faith

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as a fiduciary toward their principals. [*Wyatt v. Union Mortgage Co.* (1979) 24 C3d 773, 782, 157 CR 392, 397; see also *Montoya v. McLeod* (1985) 176 CA3d 57, 63, 221 CR 353, 357-358; *UMET Trust v. Santa Monica Med. Inv. Co.* (1983) 140 CA3d 864, 866, 189 CR 922, 927-928; see also Bus. & Prof.C. § 10232.5(a)(2); Fin.C. § 50701(d) (same fiduciary duty owed by residential mortgage lender providing brokerage services, ¶ *6:167.7*); *and* ¶ *6:706* re mortgage loan broker's liability for appraiser's negligent valuation]

e. [6:174] **Form of mortgage loan broker agreements:** Unlike real estate brokerage agreements for the payment of a commission upon the sale of real property (¶ *2:281 ff.*), a mortgage loan brokerage agreement need *not* satisfy the statute of frauds. (Nonetheless, a writing setting forth all material terms of the agreement is *always* prudent.)

• ***FORM:*** Mortgage Loan Broker Agreement, *see Form 6:E*.
(Loan brokerage agreements between *residential mortgage lenders* and borrowers are subject to special statutory requirements. See Fin.C. § 50701; *and* ¶ *6:167.7*.)

[6:175 - 6:179] ***Reserved.***

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California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 6. Financing and Appraisals

E. Loan Agreements

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1. [6:180] **Nature and Utilization of Loan Agreement:** Borrowers and lenders sometimes enter into a loan agreement as part of the loan documentation. A loan agreement is usually executed just prior to or at the loan closing (at the same time the promissory note, deed of trust and other loan documents are executed and delivered to the lender).

Loan agreements vary in scope and purpose, depending on the kind of loan involved. They typically are not used in simple loan transactions (such as single family residential loans). However, in larger, more complex loan transactions, the lender may require a loan agreement in addition to its other standard loan documentation. (For example, construction loans almost always involve a separate loan agreement.) The loan agreement typically defines and explains the terms of the contemplated loans; and, in some cases, may operate as a binding "loan commitment" (¶ *6:130 ff.*). [See *Fischer v. First Int'l Bank* (2003) 109 CA4th 1433, 1447-1448, 1 CR3d 162, 172]

Many provisions of a loan agreement commonly are duplicated in other loan documents, making the agreement appear in some cases redundant and perhaps even unnecessary. On the other hand, a loan agreement can occasionally have a profound effect in defining the operative and controlling terms of an overall loan transaction, as where it is incorporated by reference into the deed of trust. [See *Fischer v. First Int'l Bank*, supra, 109 CA4th at 1447-1448, 1 CR3d at 172—loan agreement incorporated as "related document" into deed of trust was critical to dispute over enforceability of "dragnet clause" permitting cross-collateralization of two loans]

• ***FORM:*** Construction Loan Agreement, *see Form 6:A*.

2. [6:181] **Terms:** Loan agreements generally cover the following subjects:

a. [6:182] **Loan terms:** The interest rate, maturity date and other economic terms of the loan.

b. [6:183] **Loan fees:** The various loan fees and expenses to be paid by the borrower.

c. [6:184] **Borrower's representations, warranties and ongoing covenants:** Various representations by, and covenants of, the borrower.

These typically include certain ongoing covenants concerning the borrower's operation of the property; the borrower's required continued minimum net worth; the borrower's obligation to maintain capital reserves, etc.

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d. [6:185] **Conditions to funding:** Conditions precedent to funding of the loan (e.g., receipt of lender's title insurance policy, borrower's counsel's opinion letter, hazard insurance certificates, etc.).

e. [6:186] **Disbursements and use of loan proceeds:** In certain kinds of special purpose loans (such as construction loans), loan funds will only be disbursed for specific purposes in accordance with a disbursement schedule. The terms and conditions of disbursement are covered in the loan agreement. [See *Storek & Storek, Inc. v. Citicorp Real Estate, Inc.* (2002) 100 CA4th 44, 48-50, 122 CR2d 267, 271-272]

f. [6:187] **Loan closing mechanics:** Loan agreements also often describe the mechanics of closing and funding of the loan —e.g., whether a loan escrow will be used, to whom funds will be disbursed at closing, etc.

3. [6:188] **Default Under Trust Deed by Breach of Loan Agreement:** Because loan agreements include ongoing obligations of the borrower during the loan term (which obligations might not be stated in the deed of trust), the deed of trust will usually provide that a default under the loan agreement constitutes a default under the deed of trust.

[6:189] ***Reserved.***

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California Practice Guide: Real Property Transactions | September 2024 Update
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Chapter 6. Financing and Appraisals

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1. [6:190] **Significance in Loan Transactions:** Although a borrower might execute several documents that together embody the terms of the loan, the *promissory note* evidences the borrower's basic monetary obligation to the lender. [See *State of Calif. ex rel. Bowen v. Bank of America Corp.* (2005) 126 CA4th 225, 231, 23 CR3d 746, 750]

Promissory notes range from simple to complex. The sections at ¶ 6:192 ff. analyze those provisions typically found in more complex promissory notes.

FORMS

- Promissory Note Secured by Deed of Trust (Simple), *see Form 6:F*.
- Promissory Note Secured by Deed of Trust (Complex), *see Form 6:G*.

➪ [6:191] ***PRACTICE POINTER:*** Be aware that the titles placed at the top of various form promissory notes published by title insurance companies (e.g., "straight note" or "installment—interest included") can be *misleading*.

It is the author's opinion, and the apparent consensus of the real estate bar, that such titles serve no useful purpose and, indeed, only create confusion. Promissory note titles used by title insurance companies have no legal definition; consequently, the better practice is to avoid incomplete or misleading titles and let the body of the note itself describe how interest and principal are to be paid.

By the same token, also keep in mind that certain capitalized headings are statutorily required for variable interest rate loans (*see ¶ 6:205*).

2. [6:192] **Principal Amount:** The "face" (i.e., "principal") amount of the loan is stated on the note.

Even if only a portion of the principal is initially disbursed at the time the note is executed (as under a construction loan), the note nevertheless should reflect a face amount equal to the total amount of principal the lender *can* be required to disburse under the loan. (*See ¶ 6:54 ff.* re periodic disbursement of construction loans.)

3. [6:193] **Payor ("Maker" or "Obligor"):** If there is more than one payor ("maker" or "obligor") of the note, the note should state the obligations of the makers or obligors are joint and several.

4. [6:194] **Payee ("Holder"):** The payee ("holder" of the note) should be identified by name, followed by the words "or order" (or other words indicating the payee's assignee will be entitled to payment). (*See ¶ 6:196 ff.* re negotiability of notes.)

In addition, the payee's address (or any other address at which payments are to be made) should be stated with specificity.

a. [6:195] **Multiple payees:** Borrowers typically are not concerned with how the payment proceeds will be allocated among multiple payees. Multiple payees, however, may wish to set up a collection account or otherwise create a mechanism for allocating the borrower's payments (*see ¶ 6:93 ff.*).

5. [6:196] **Negotiability:** Every payee under a note wants the note to be "negotiable" so that, in the event the payee assigns its interest in the note, the assignee will be a "holder in due course." [See *Creative Ventures, LLC v. Jim Ward & Assocs.* (2011) 195 CA4th 1430, 1447, 126 CR3d 564, 577—negotiation transfers instrument itself, allowing it to function as money substitute (transfer absent negotiation merely vests in transferee any rights transferor may have had to enforce instrument)]

a. [6:197] **"Holder in due course" protections:** A "holder in due course" is one who takes a negotiable instrument for value, in good faith and without notice it is overdue, has been dishonored or that there is any defense against the note. [Comm'l C. § 3302(a)(2); see also *Creative Ventures, LLC v. Jim Ward & Assocs.* (2011) 195 CA4th 1430, 1446, 126 CR3d 564, 576—"holder" is person in possession of negotiable instrument that is "payable either to bearer or, to an identified person that is the person in possession"; *¶ 6:198*]

Thus, an assignee who is a holder in due course takes the note free of most defenses that could be raised by the borrower (except for defenses of illegality of the transaction, minority of the obligor, discharge in bankruptcy, and certain other limited defenses recognized by Comm'l C. § 3305(b)). [See *Creative Ventures, LLC v. Jim Ward & Assocs.*, supra, 195 CA4th at 1445, 126 CR3d at 575—"holder in due course" takes their interest free of many defenses, including usury defense]

The defenses of a borrower which a holder in due course takes subject to are sometimes called "real" defenses. [Comm'l C. § 3305(a)(1)] Those defenses of a borrower which are cut off by a holder in due course (but which would otherwise be available to the borrower against the original payee) are sometimes called "personal" defenses.

b. [6:198] **Mechanics:** The specific requirements for making a note negotiable are set forth in Comm'l C. § 3104. In particular, the instrument must be "payable to bearer or to order at the time it is issued or first comes into possession of a holder." [Comm'l C. § 3104(a)(1); see also *Creative Ventures, LLC v. Jim Ward & Assocs.* (2011) 195 CA4th 1430, 1446-1447, 126 CR3d 564, 576-577—investors to whom corporation merely assigned fractional interests in various promissory notes were not "holders in due course" (negotiation does not occur, and transferee does not acquire holder's rights, unless *entire* instrument is endorsed and transferred)]

Generally, therefore, the note will be negotiable if made payable to a payee "or order" (or "other holder").

6. [6:199] **Date of Accrual of Interest:** The date of the note (and/or the date of borrower's execution of the note) may not coincide with actual funding of the loan; in that event, the date of the note (and/or date of borrower's execution) may be immaterial and will simply operate to identify the note. Therefore, if the date of funding is different from the actual date of the note, the note should state interest accrues from the date of funding.

➪ [6:200] ***PRACTICE POINTER:*** In many transactions, the buyer executes the note and other loan documents prior to the closing date of the loan. In those instances, it may be necessary for the buyer to authorize the escrow officer to fill in the date of the note (or the date for commencement of interest accrual).

7. [6:201] **Interest Rate and Calculation:** The interest rate must be clearly stated. Interest on a loan can accrue and be computed in an infinite number of ways. The most commonly used methods of calculating interest are as follows:

a. [6:202] **Fixed rate:** Under a fixed rate loan, the predetermined interest rate applies over the term of the loan (although there might be periodic fixed increases (or decreases) during the term).

(1) [6:203] **May be nonassumable:** Fixed rate loans (particularly those for single family residential transactions) are often *not "assumable"* (*see ¶ 6:313 ff.*). This is because lenders want to ensure new buyers will not be able to take advantage of an outdated fixed interest rate that might be lower than current rates.

b. [6:204] **Variable rate:** Under a variable rate loan (as its name implies), the interest rate may fluctuate over time. It might be fixed for an initial specified period, or it may have a minimum "floor" and maximum "ceiling," but the interest rate is tied to some index.

For example, the interest rate might be a certain number of percentage points above the so-called "prime" (or "reference") rate charged by the lender; or it might be tied to some other index, such as the weekly average yield on U.S. Treasury securities.

(1) [6:205] **Statutory limitations on validity:** Variable interest rate loans are subject to several statutory requirements (see Civ.C. § 1916.5).

In particular, a seller-financed loan must contain the following statement on the note in at least 10-point bold type (Civ.C. § 1916.5(a)(6)):

> "NOTICE TO BORROWER: THIS DOCUMENT CONTAINS PROVISIONS FOR A VARIABLE INTEREST RATE."

(2) [6:205.1] **Adjustment date:** The note should clearly specify the date upon which the initial rate may be adjusted and, thereafter, each date upon which the rate may again be adjusted.

When the adjustment date on a variable rate note is *ambiguously* drafted, general rules of contract interpretation apply. Where both parties offer "reasonable interpretations" and there is no evidence they specifically agreed one way or the other, the parties' conduct in performance under the note will be considered in determining the appropriate adjustment date. [See *Oceanside 84, Ltd. v. Fidelity Fed. Bank* (1997) 56 CA4th 1441, 1449-1451, 66 CR2d 487, 492-494 (dispute over what was meant by term "applicable month" in note providing that "all adjusted interest rates shall be established on the 26th day of the applicable month …")—borrower acquiesced to lender's determination of adjustment date for at least 5 years]

c. [6:206] **Contingent interest:** Lenders are sometimes entitled to additional or "contingent" interest (¶ *6:60 ff.*). In such cases, the amount of the additional interest (or the specific method for calculating same) should be clearly stated in the note.

(Although such promissory notes need not contain any special title, the *deed of trust* for a *shared appreciation loan* must state on its face that it secures a shared appreciation loan. See Civ.C. § 1917.004(b), ¶ *6:69*.)

d. [6:207] **Pay rate vs. accrual rate:** Sometimes, the interest rate on a loan ("accrual rate") is greater than the so-called "pay rate" (rate borrower actually pays on an ongoing basis).

For example, assume the interest rate on the principal amount accrues at 11% per annum ("accrual rate"), although the borrower is only required to pay installments of interest at the rate of 9% per annum ("pay rate"). The 2% differential between the pay rate and accrual rate would be paid by the borrower at a later date—usually at loan maturity.

➪ [6:208] ***PRACTICE POINTER:*** A note containing a pay rate different than the accrual rates can generate problems if it fails to state whether the deferred interest is to be added to principal (with interest to accrue thereon). The note should specifically state how the deferred interest is to be treated and, therefore, whether accrued but unpaid interest is also to accrue interest.

e. [6:209] **Interest in arrears:** Interest is paid in arrears and, therefore, the first installment of interest due on a loan is due after the loan is funded. However, because many lenders want payments made on the first or 15th day of each month (and because the loan might not close on the first or 15th day of the month), the first payment for a partial month must often be adjusted. In those situations, at the loan closing, either (1) the first partial month payment is paid in advance; or (2) the first partial month payment is added to the first full monthly payment.

f. [6:209.1] **Simple vs. compound interest:** Interest is said to be "compound" when it is added to principal and accrues interest itself (essentially, "interest on interest"). By statute, interest "shall not be compounded" and interest may not be construed to bear interest "*unless an agreement to that effect is clearly expressed* in writing and signed by the party to be charged therewith" (the borrower). [Civ.C. § 1916-2 (emphasis added); *Curry v. Moody* (1995) 40 CA4th 1547, 1553, 48 CR2d 627, 630-631]

Extrinsic evidence of the parties' intent is *not admissible* to show that a loan bears compound interest. Absent a written agreement *expressly providing* for compound interest, the principal obligation accrues only *simple interest* (meaning the

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interest rate is applied to the principal unpaid balance without regard to interest that has already accrued). [*McConnell v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* (1983) 33 C3d 816, 822-823, 191 CR 458, 462-463; see *Curry v. Moody*, supra, 40 CA4th at 1555-1556, 48 CR2d at 632—note providing for 13% per annum interest "payable at time of sale of the house" and stating "should interest not be so paid it shall thereafter bear like interest as the principal" authorized compound interest *only* from date of sale (not from inception of note)]

Cross-refer: For the effect of compound interest on usury limits, *see ¶ 6:289*.

[6:209.2 - 6:209.4] ***Reserved.***

g. [6:209.5] **Commencement of interest accrual—"one day rule" in secured residential property transactions:** When the security is a mortgage or deed of trust on real property improved with one-to-four dwelling units, the borrower "shall not" be required to pay interest …

— for a period of *more than one day before the loan proceeds are disbursed* from escrow (Civ.C. § 2948.5(a)(1));

— if there is *no escrow and a request for recordation of the mortgage or deed of trust is made*, for a period of more *than one day before the loan proceeds are disbursed* to the borrower, a third party on the borrower's behalf, or the lender to satisfy an existing obligation of the borrower (Civ.C. § 2948.5(a)(2)); *or*

— in *all other circumstances* where there is *no escrow and no request for recordation* is made, for *any period before the loan proceeds are disbursed* to the borrower, a third party on the borrower's behalf, or the lender to satisfy an existing obligation of the borrower (Civ.C. § 2948.5(a)(3)). [Civ.C. § 2948.5(a); see also Fin.C. § 50204(o); *Wells Fargo Bank N.A. v. Boutris* (9th Cir. 2005) 419 F3d 949, 969—Civ.C. § 2948.5(a) not preempted by § 501(a)(1) of Depository Institutions Deregulation & Monetary Control Act (12 USC § 1735f-7a); and *Quicken Loans, Inc. v. Wood* (9th Cir. 2006) 449 F3d 944, 950-951—also holding Civ.C. § 2948.5(a) not preempted by Alternative Mortgage Transaction Parity Act (12 USC § 3801 et seq.) as applied to alternative mortgage transactions]

Interest on loans described in Civ.C. § 2948.5(a)(1) and (2) (¶ 6:209.5) may begin accruing on the *business day immediately preceding the day of disbursement* if *both:*

— the borrower requests and the lender agrees the recording will occur on Monday or a day immediately following a bank holiday; *and*

— the lender discloses to the borrower in writing the amount of the additional per diem interest that will accrue and that the borrower may be able to avoid the additional interest by recording on a day immediately following a business day (the borrower must sign a copy of the disclosure document before the funds are placed in escrow). [See Civ.C. § 2948.5(b); see also Fin.C. § 50204(o)]

Exception: Civ.C. § 2948.5 does not apply to loans subject to Bus. & Prof.C. § 10242(c) (loans secured by a dwelling), which states "No interest may be charged with respect to any period prior to the date that the proceeds of the loan are made available to the borrower or are deposited in escrow." [Civ.C. § 2948.5(c)]

8. [6:210] **Principal Payments:** Like interest, principal may be required to be paid in an infinite variety of ways. Principal is usually paid either on an amortized basis (*¶ 6:215 ff.*); on fixed, periodic dates (e.g., so many dollars every so many months, etc.); or in a so-called "balloon payment" at maturity (¶ 6:211 ff.).

a. [6:211] **Statutory limitations on residential balloon payment loans:** Certain statutory requirements apply to "balloon payment loans" with terms in excess of one year that are secured by a deed of trust on real property *containing one to four residential units*, at least one of which at the time the loan is made is (or is to be) occupied by the borrower. [Civ.C. § 2924i]

(1) [6:212] **"Balloon payment loans":** A Civ.C. § 2924i loan is a "balloon payment loan" if it *either:*

- provides for a final payment, as originally scheduled, that is more than twice the amount of the immediately preceding six regularly scheduled payments; *or*

- contains a "call provision." [Civ.C. § 2924i(d)(1)]

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A "call provision" permits the holder to call the loan due and payable at any time after a specified period has elapsed. [Civ.C. § 2924i(d)(2)]

(2) [6:213] **Required notice to borrower before final balloon payment:** Among other requirements imposed by Civ.C. § 2924i, at least 90 days (but not more than 150 days) prior to the due date of the final balloon payment, the holder of the loan must deliver to the borrower (or borrower's successor) a written notice (via first class mail) stating:

• the name and address of the person to whom final payment is required to be made;

• the date on or before which the final payment is to be made; and

• the amount of the final payment (or if the exact amount is unknown, a good faith estimate of the amount). [Civ.C. § 2924i(c)(1), (2) & (3)]

(a) [6:214] **Effect of noncompliance:** Failure to provide the notice set forth at ¶ 6:213 does not exonerate the borrower from its obligation to pay the loan, but the *maturity date will be extended* until such time as proper notice has been given. [Civ.C. § 2924i(e)]

b. Amortization

(1) [6:215] **Self-amortization:** A "self-amortizing" loan is payable in equal installments during the term of the loan. Each installment represents an aggregate of principal and interest, although that portion of the payment allocable to principal and that portion allocable to interest varies over time.

(a) [6:216] **Amortization schedule:** The amortization period might be longer than the term of the loan. For example, a loan with a seven-year maturity date might have an amortization schedule based on a 25-year loan. The installment payments would thus be based on a 25-year amortized loan, but a large balloon payment would be due in the seventh year.

(2) [6:217] **Negative amortization:** A "negative amortization" loan requires monthly (or other periodic installment) payments which do not cover the interest due. As a result, the principal balance due on a negative amortization loan increases over time.

9. [6:218] **Maturity Date:** A clear and specific maturity date, "at which time all accrued, but unpaid interest and all outstanding principal shall become due and payable," should be stated in the note.

10. [6:219] **Application of Payments:** Generally, where the parties fail to designate the order of application of the borrower's payments, payments are to be applied first to "interest due at the time of the performance" and then to the "principal due at that time." [See Civ.C. § 1479]

a. [6:219.1] **Comment:** Customarily, the note (or deed of trust) specifies how payments are to be applied. From the lender's perspective, it is beneficial to provide that each payment shall be applied first to costs and attorney fees on account of collection (if any); second, to the borrower's fees, expenses and obligations advanced by the lender pursuant to the security documents; third, to late charges (if any); fourth, to interest then accrued and due; and lastly, to principal.

11. [6:220] **Form of Payment:** Many notes state all sums due are payable "in lawful money of the United States of America."

12. [6:221] **Reference to Security:** In secured financing transactions, it is advisable that the note state it is secured by a deed of trust from the borrower, as trustor, in favor of lender, as beneficiary; and it should identify the real property pledged as security.

13. [6:222] **Events of Default:** Events of default under the note should be defined, identifying any cure (or so-called "grace") periods.

14. [6:223] **Acceleration Upon Default:** An "acceleration provision" is essential for lenders. It permits the lender to accelerate all sums due under the loan upon a default by the borrower. Without a right of acceleration, the lender would have to sue on each defaulted installment as and when it became due—an unacceptably cumbersome procedure.

15. [6:224] **Late Payment Charges:** Any late payment charges which can be imposed by the lender should be clearly identified, including whether the borrower must be given prior notice before the late charge is incurred.

Limitations: Late charges are subject to several statutory restrictions:

a. [6:224.1] **Prior notice requirement:** As a condition to the collection of a late payment charge, the borrower must be *given prior written notice* of the payment due date and of the amount of the late charge. Such notification can be included with the billing. [See Civ.C. § 2954.5]

If notification is given *after* the payment becomes due, the borrower must be given at least 10 days from mailing of the notice in which to cure the delinquency before a late charge may be imposed. [See Civ.C. § 2954.5]

b. [6:225] **Additional requirements re single family residence loans:** Late charges in connection with loans secured by real property containing a single-family, owner-occupied dwelling are subject to the following restrictions (Civ.C. §§ 2954.4 & 2954.5):

• [6:226] The charge for a late payment may not exceed the *greater of* (i) 6% of the installment due, or (ii) $5. [Civ.C. § 2954.4(a)]

• [6:227] No charge may be imposed more than once for late payment of the same installment. [Civ.C. § 2954.4(a)]

• [6:228] A payment may not be deemed late for purposes of incurring late payment charges until at least 10 days after the due date has passed. [Civ.C. § 2954.4(a)]

(1) [6:229] **"Property inspection fees" distinguished:** Deeds of trust commonly give the lender the right to take reasonably necessary steps to protect the value of the security should the borrower default; this may include the right to conduct and charge the defaulted borrower for a property inspection and repairs. [See *Walker v. Countrywide Home Loans, Inc.* (2002) 98 CA4th 1158, 1165, 121 CR2d 79, 83]

Such "property inspection fees" are *not* "late charges" subject to the limitations of Civ.C. § 2954.4. Unlike a "late charge," which is designed to encourage timely payment or to compensate the lender for loss of interest on late payments, the "property inspection fee" reflects the actual cost the lender incurs to protect its security. [*Walker v. Countrywide Home Loans, Inc.*, supra, 98 CA4th at 1171-1172, 121 CR2d at 88-89]

c. [6:230] **Liquidated damages limitations:** A late payment charge is essentially a form of *liquidated damages*. Therefore, even when a late charge is not otherwise regulated by specific statute (see Civ.C. § 2954.4, ¶ 6:225, re single family residence loans), its validity is subject to the restrictions on liquidated damages (Civ.C. § 1671). [Civ.C. § 1671; *Ridgley v. Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 978, 73 CR2d 378, 382]

(1) [6:231] **"Reasonableness" issue:** Broadly, the validity of a liquidated damages clause is tested by its "reasonableness": "[A] provision in a contract liquidating the damages for the breach of the contract is valid *unless* the party seeking to invalidate the provision establishes that the provision was *unreasonable* under the circumstances existing at the time the contract was made." [Civ.C. § 1671(b) (emphasis added); *Ridgley v. Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 977, 73 CR2d 378, 381; *Purcell v. Schweitzer* (2014) 224 CA4th 969, 974, 169 CR3d 90, 94 (¶ 6:233.3); see also *Krechuniak v. Noorzoy* (2017) 11 CA5th 713, 722, 217 CR3d 740, 748—liquidated damages provision may be invalid if estimate of damages resulting from breach is outside range of reasonableness known to parties at time of estimate; ¶ 4:315 ff.]

Compare: While liquidated damages clauses in non-consumer contracts such as mortgages are presumed valid, liquidated damages clauses are presumed void in consumer contracts involving the "retail purchase, or rental … of personal property or services, primarily for … personal, family or household purposes," or "a lease of real property for use as a dwelling." [See Civ.C. § 1671(b), (c); *Honchariw v. FJM Private Mortgage Fund, LLC* (2022) 83 CA5th 893, 905, 299 CR3d 819, 828—validity presumption re non-consumer mortgage contracts did not preclude finding liquidated damages provision violated public policy (¶ 6:233)]

[6:232] **Application:** Case law provides some guidance for counsel in determining standards of "reasonableness" for this purpose.

• [6:233] A late charge will be deemed invalid as "unreasonable" (an invalid "penalty") if assessed against the *entire* unpaid principal balance of an unmatured loan. [*Garrett v. Coast & Southern Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 740, 108 CR 845, 851—"It is an attempt to coerce timely payment by a forfeiture which is not reasonably calculated to merely compensate the injured lender"; see also *Honchariw v. FJM Private Mortgage Fund, LLC* (2022) 83 CA5th

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893, 904-905, 299 CR3d 819, 827-828—"liquidated damages in the form of a penalty assessed during the lifetime of a partially matured note against the entire outstanding loan amount are unlawful penalties"]

• [6:233.1] A "prepayment charge" (despite its label as such) will be invalidated as an unenforceable penalty where it is triggered only by a late monthly payment entirely unrelated to the borrower's subsequent election to prepay the loan. [*Ridgley v. Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 981-982, 73 CR2d 378, 384-385—"prepayment charge" of 6 months' interest on principal unenforceable as invalid liquidated damages; *see further discussion at ¶ 6:259.5 ff.*]

• [6:233.2] A promissory note's clause requiring the obligor to pay 10% of any installment tendered late is an unenforceable penalty provision if applied to the final balloon payment. "[W]e can state as a matter of law a late charge provision covering administrative expenses that amounts to $614.67 for one late payment and $77,614.67 for another is not a reasonable attempt to estimate actual administrative costs incurred …" [*Poseidon Develop., Inc. v. Woodland Lane Estates, LLC* (2007) 152 CA4th 1106, 1115-1116, 62 CR3d 59, 65-66 (noting provision expressly indicated late charge was to compensate for administrative expenses)]

• [6:233.3] A provision in a settlement agreement reinstating the *full, original* amount owed if the borrower makes one late payment constitutes an unenforceable penalty because the provision bears no reasonable relationship to the damages the lender may be expected to actually suffer as a result of the borrower's breach. [See *Purcell v. Schweitzer* (2014) 224 CA4th 969, 975-976, 169 CR3d 90, 95—stipulation allowing entry of judgment for almost $60,000 deemed unenforceable penalty because underlying settlement was for $38,000]

• [6:234] On the other hand, late charges on a monthly (or other periodic) installment are *not* per se unreasonable; indeed, if the late charge is deemed to be an *alternative method for performance*, it will *not* be considered an invalid penalty. (In other words, if the borrower has the choice of making a timely payment or making a late payment with an additional charge, the note will be deemed to provide for an alternative method of performance.) [*Garrett v. Coast & Southern Fed. Sav. & Loan Ass'n* (1973) 9 C3d 731, 735-738, 108 CR 845, 847-849]

Nonetheless, a late charge must *bear some reasonable relation* to the *actual damages* suffered by the lender for the delay in payment. [*Garrett v. Coast & Southern Fed. Sav. & Loan Ass'n*, supra, 9 C3d at 739-740, 108 CR at 850-851; *Ridgley v. Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 978, 73 CR2d 378, 382; see also *Greentree Fin'l Group, Inc. v. Execute Sports, Inc.* (2008) 163 CA4th 495, 500, 78 CR3d 24, 28—late charges encourage borrowers to make timely payments and compensate lenders for lost use of money and reasonable costs in pursuing payment; compare *Honchariw v. FJM Private Mortgage Fund, LLC* (2022) 83 CA5th 893, 904, 299 CR3d 819, 826-827—loan agreement indicating default would impose specified loan servicing expenses, lost use of money and frustration to lender in meeting other financial commitments, coupled with one-word testimony averring late charges were fair and reasonable cost estimate, was insufficient to demonstrate reasonable relationship between actual and anticipated damages from breach]

➪ [6:235] ***PRACTICE POINTER:*** Following the guidelines noted at ¶ 6:232 ff., it may help to include language in a late payment charge provision indicating that, in fixing the specified charge, the parties considered the actual damages that would likely be suffered by the lender should the borrower default on timely payment of an installment. Some lenders specifically identify in the note various items of damage they will suffer—e.g., loss of use of the funds, cost of administering a default, etc. However, in view of *Honchariw* (¶ 6:234), lender's counsel should be prepared to buttress any language in the late payment charge provision with specific evidence should the provision be challenged.

d. [6:236] **Risk of violating usury laws:** Provisions for late charges must also be worded so as not to be the equivalent of additional *interest* that might run afoul of *usury laws*. *See ¶ 6:286*.

16. [6:237] **Default Interest Rates:** Some promissory notes provide that, upon the borrower's default, the interest rate on the overdue amount will automatically increase by a specified percentage. This increased charge might be in addition to, or in lieu of, a late payment charge.

➪ [6:238] ***PRACTICE POINTERS:*** Viewed as a charge in respect of a borrower's default, default interest rates undoubtedly should be subject to the limitations on enforceability of late payment charges (including restrictions on the validity of liquidated damages). Therefore, when drafting a default interest rate provision, it is advisable to include the same recitations utilized in connection with late payment charges (*see ¶ 6:235; see also ¶ 6:286* re usury issues).

In addition, if the lender's intent is to charge default interest following *any* monetary default, lender's counsel should ensure the promissory note's default interest rate provision applies not only after acceleration, but also when the loan matures and no payment is made. [See *JCC Develop. Corp. v. Levy* (2012) 208 CA4th 1522, 1524, 1535, 146 CR3d 635, 636, 645—borrower's failure to make payment upon loan's maturity did not trigger promissory note's default interest rate provision made expressly applicable to "circumstances of acceleration" only]

17. [6:239] **Due-On-Sale/Due-On-Encumbrance Clause:** A "due-on-sale" clause permits the lender to accelerate all sums due under the loan upon sale of the property by the original borrower. Similarly, a "due-on-encumbrance" clause permits the lender to accelerate all sums due under the loan if the borrower pledges the property as security for another obligation.

Cross-refer: Both types of acceleration clauses are discussed in detail at *¶ 6:388 ff.* in connection with deeds of trust.

a. [6:240] **Parallel deed of trust/promissory note provisions required for certain residential secured financing transactions:** Such acceleration provisions are commonly incorporated into a deed of trust. However, if a due-on-sale clause is set forth in a deed of trust encumbering property containing *four or fewer residential units* (or on which four or fewer residential units are to be constructed), *it must also be set forth in the promissory note* (or other document evidencing the secured obligation). Noncompliance renders the due-on-sale clause *invalid*. [Civ.C. § 2924.5; *see ¶ 6:396*]

18. [6:241] **Attorney Fees and Costs of Collection:** Most promissory notes contain a provision requiring the borrower to pay the lender's attorney fees and other costs of collection upon the borrower's default. (A similar attorney fees provision may be included in the deed of trust, or other security instrument. See *Chase Manhattan Mortg. Corp. v. Lessel* (1997) 55 CA4th 10, 11-12, 64 CR2d 113, 114; *and ¶ 6:417.5*.)

Limitations: Such fees and costs provisions are subject to two important statutory restrictions:

a. [6:242] **Reciprocal "prevailing party" entitlement:** By law, contracts (including promissory notes) expressly providing that attorney fees and costs incurred in an action to enforce the contract shall be awarded either to one of the parties or to the prevailing party, will be interpreted as authorizing a fees and costs recovery in favor of *whichever party* is determined to be the party prevailing on the contract—*whether or not* they are the party specified in the contract. [Civ.C. § 1717(a); *see ¶ 11:136 ff.*]

Moreover, a contractual fee provision in one section of the contract applies to the *entire* contract unless the agreement specifies each party was represented by counsel in the agreement's negotiation and execution and that fact is stated in the contract. [Civ.C. § 1717(a); see *Andrade v. Western Riverside Council of Governments* (2024) 99 CA5th 1020, 1026-1027, 318 CR3d 396, 401-402 (finding Civ.C. § 1717's goal is to avoid "lopsided arrangements" where one party can limit the other's attorney fee recovery to particular types of claims)—error to deny § 1717 fees to homeowner seeking rescission of loan agreements that impermissibly limited fee provisions to judicial foreclosure actions]

In fact, the right to § 1717 reciprocal recovery of fees and costs is available even if the party seeking reimbursement "prevails on grounds the contract is inapplicable, invalid, unenforceable or nonexistent, if the other party would have been entitled to attorney's fees had it prevailed." [See *Andrade v. Western Riverside Council of Governments,* supra, 99 CA5th at 1025-1026, 318 CR3d at 400 (internal quotes and citation omitted)—homeowner fraudulently enrolled in a Property Assessed Clean Energy (PACE) program could recover attorney fees in action to rescind PACE loan documents because they provided for lender's recovery of fees and enforcement costs (above)]

(1) [6:242.1] **Recovery by or against nonsignatories:** Civ.C. § 1717 provides a reciprocal "prevailing party" right to attorney fees in favor of a *nonsignatory* defendant sued on the note if the plaintiff would have been entitled to Civ.C. § 1717 fees in the event they prevailed in enforcing the note against the defendant nonsignatory. [*Reynolds Metals Co. v. Alperson* (1979) 25 C3d 124, 128, 158 CR 1, 3; compare *Curry v. Moody* (1995) 40 CA4th 1547, 1557, 48 CR2d 627, 633—nonsignatories not entitled to § 1717 fees where opposing party ineligible for § 1717 fees against nonsignatories]

Similarly, a defendant who has signed the note providing for attorney fees generally is entitled to fees if it prevails against a nonsignatory plaintiff in an action on the note, so long as the nonsignatory plaintiff would have been entitled to recover their fees had they prevailed in the action. [*Real Property Services Corp. v. City of Pasadena* (1994) 25 CA4th 375, 380-382, 30 CR2d 536, 539-541; *Abdallah v. United Sav. Bank* (1996) 43 CA4th 1101, 1111, 51 CR2d 286, 293; see also *Cargill, Inc. v. Souza* (2011) 201 CA4th 962, 964-965, 134 CR3d 39, 40-41—nonsignatory plaintiff liable for

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attorney fees in action it commenced on contract previously entered into between signatory defendants and nonsignatory plaintiff's debtors (*¶ 11:139.28d*)]

(2) [6:242.2] **Limited to actions on note:** There is an entitlement to Civ.C. § 1717 attorney fees only in litigation *on the contract* providing for a prevailing party's attorney fees recovery (Civ.C. § 1717(a)). Thus, despite a fee recovery provision in the promissory note, § 1717 fees are not awardable where the cause of action pleaded, and on which either party prevails, is *not an action on the note.* [*Curry v. Moody* (1995) 40 CA4th 1547, 1557, 48 CR2d 627, 633—no entitlement to § 1717 fees pursuant to attorney fees provision in promissory note where complaint pled only causes of action for declaratory relief and to quiet title based on forged reconveyance; *Walker v. Countrywide Home Loans, Inc.* (2002) 98 CA4th 1158, 1180-1181, 121 CR2d 79, 95—no entitlement to § 1717 fees pursuant to attorney fees provision in promissory note where action was "principally one to enjoin an unfair business practice"; compare *Andrade v. Western Riverside Council of Governments* (2024) 99 CA5th 1020, 1025-1026, 318 CR3d 396, 400-401—suit to rescind fraudulent loan documents deemed "action on the contract" justifying § 1717 fee award (¶ 6:241); *Yoon v. Cam IX Trust* (2021) 60 CA5th 388, 392-393, 274 CR3d 506, 510-511 (affirming § 1717 fee award against borrower who unsuccessfully challenged foreclosure sale based on tort theories)—suit's gravamen was to avoid enforcement of note and deed of trust and therefore was "based on a contract" regardless of relief sought; see also *Kachlon v. Markowitz* (2008) 168 CA4th 316, 347-348, 85 CR3d 532, 556-557 (concluding § 1717 fees warranted even though remedies sought were equitable)—action for declaratory relief, to enjoin nonjudicial foreclosure sale, and to quiet title that arose out of promissory note and trust deed containing attorney fee clauses deemed "on the contract" because said action essentially sought to enforce note and trust deed's terms]

By the same token, mere joinder of noncontract causes of action does not dilute the right to attorney fees incurred in a successful action on the note (the contract cause of action). Moreover, attorney fees need not be apportioned between the various causes of action to the extent incurred on issues common to *both* the contract and noncontract causes of action. [*Reynolds Metals Co. v. Alperson* (1979) 25 C3d 124, 129-130, 158 CR 1, 4; see *Webber v. Inland Empire Investments, Inc.* (1999) 74 CA4th 884, 919, 88 CR2d 594, 617-618]

(a) [6:242.3] **Interim attorney fee awards distinguished:** Absent specific statutory authorization, attorney fee awards on contract claims are *not* available until final disposition of an entire case. [*Chen v. Valstock Ventures, LLC* (2022) 81 CA5th 957, 983, 295 CR3d 666, 685 (reversing interim attorney fee award to party who won summary adjudication of all contractual claims under lease while non-contractual claims had yet to be tried); compare Civ.C. § 2924.12(h) (special, HBOR provision permitting interim fee awards (¶ 6:524.20))]

Cross-refer: Civ.C. § 1717 contractual attorney fee awards are discussed in greater detail at *¶ 11:136 ff.*

b. [6:243] **Ceiling on trustee's/attorney's fees chargeable on secured loan reinstatement:** Also, there is a statutory limit on the maximum amount of trustee's fees *or attorney's fees* that may be charged in connection with reinstating a loan secured by real property (upon the borrower's default). [Civ.C. § 2924c(d)]

The statutory formula for calculating the maximum fee amount is based on the unpaid principal obligation secured by the real property. The fee is a flat $350 for obligations of $50,000 or less. If the principal balance is greater than $50,000 but no more than $150,000, the $350 fee is increased by 1/2% of the difference between the unpaid principal and $50,000. If the unpaid principal exceeds $150,000 but is no more than $500,000, the base drops to $300, and is increased by 1/2% of the difference between $50,000 and $150,000, plus 1/4% of the difference between the unpaid principal and $150,000. If the obligation exceeds $500,000, the base is $300, and is increased by 1/2% of the difference between $50,000 and $150,000, plus 1/4% of the difference between the unpaid principal and $500,000, plus 1/8% of the difference between the unpaid principal and $500,000. [See Civ.C. § 2924c(d)—"unpaid principal sum secured" is determined as of notice of default's recordation date]

Example 1: Assume the unpaid principal on a note secured by real property is $140,000 on the date a notice of default is recorded. The maximum allowable fee would be the $350 base amount plus 1/2% of the unpaid principal in excess of $50,000, or ($140,000 − $50,000 = $90,000 x 1/2% = $450), for a total fee of $800 ($350 + 450).

Example 2: Assume the unpaid principal on a note secured by real property is $750,000 on the date a notice of default is recorded. The maximum allowable fee would be the $300 base amount, plus 1/2% of the amount between $50,000 and $150,000 ($150,000 − $50,000 = $100,000 x 1/2% = $500), plus 1/4% of the amount between $150,000 and $500,000 ($500,000 − $150,000 = $350,000 x 1/4% = $875), plus 1/8% of the excess of the unpaid principal over $500,000 ($750,000 − $500,000 = $250,000 x 1/8% = $312.50) for a total fee of $1,987.50 ($300 + $500 + $875 + $312.50).

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(1) [6:244] **Application to lender's litigation attorney fees:** Civ.C. § 2924c(d) is itself ambiguous regarding the extent to which the specified limit applies when a lender seeks to obtain its attorney fees for litigation in addition to the trustee's fees incurred in connection with a foreclosure. Although the law is not entirely settled, some general guidelines are apparent from two leading cases in this area:

(a) [6:245] **Statutory limit inapplicable to fees "collateral" to foreclosure:** One case holds the lender's litigation attorney fees may exceed the Civ.C. § 2924c(d) limit where the deed of trust expressly authorizes the lender (beneficiary) to protect its security and, in doing so, to employ counsel and pay counsel's reasonable fees. Here, the claimed attorney fees are essentially in the nature of a "collateral advance" recoverable because the deed of trust permits that sum to be added to the secured debt. [*Buck v. Barb* (1983) 147 CA3d 920, 925, 195 CR 461, 463-464—creditor can add attorney fees incurred in protecting security as authorized by deed of trust]

(b) [6:246] **Statutory limit applies to fees incurred to commence and prosecute foreclosure action:** However, case law also makes clear that, at least as to attorney fees incurred with respect to a *judicial foreclosure* action, the Civ.C. § 2924c(d) limitation will apply where the debtor seeks to cure the default and reinstate the loan prior to the issuance of a decree of foreclosure. [*Bruntz v. Alfaro* (1989) 212 CA3d 411, 419-422, 260 CR 488, 492-494]

(c) [6:247] **Comment:** In reading *Buck* and *Bruntz* together, it seems the lender is not precluded from recovering attorney fees in excess of the statutory limit to the extent those fees are incurred for something *other than* the ordinary prosecution of a judicial foreclosure action prior to the entry of a decree of foreclosure.

Civ.C. § 2924c(d) provides the maximum fees that may be claimed as expenses of *foreclosing* on the property. "But aside from the expenses of foreclosure, there are other costs, including legal fees, which may be incurred by a creditor in protecting the security. Under appropriate contract provisions, such expenses may be treated as collateral advances and added to the amount of the debt. Whether a particular expense may be treated as an advance, or is subject to the limitations in Civil Code section 2924c, will depend upon the purpose for which the expense was incurred and the particular contractual terms involved." [*Bruntz v. Alfaro* (1989) 212 CA3d 411, 421, 260 CR 488, 494; see also *Passanisi v. Merit-McBride Realtors, Inc.* (1987) 190 CA3d 1496, 1512, 236 CR 59, 69, fn. 10]

(2) [6:248] **Compare—recoverable fees in connection with judicial decree of foreclosure:** Civ.C. § 2924c(d) does not apply where the debtor does *not* seek to cure the default and a lender's foreclosure action proceeds to a *decree of judicial foreclosure*. Upon issuing a *judgment of foreclosure*, the court has discretion to award "reasonable" attorney fees, costs and expenses if provided for in the note, deed of trust or mortgage, pursuant to CCP § 580c. [See Civ.C. § 2924d(e); *Bruntz v. Alfaro* (1989) 212 CA3d 411, 420, 260 CR 488, 493]

Similarly, CCP § 730 empowers the court in a judicial foreclosure proceeding to fix awardable attorney fees. But the statute does not create an entitlement to fees nor independently authorize the court to award fees. Rather, the power to determine awardable fees under CCP § 730 is triggered only if either party is entitled to fees pursuant to an attorney fees clause in the security instrument (or, presumably, the promissory note) and thus only if there is a prevailing party entitled to fees under Civ.C. § 1717. [See *Chase Manhattan Mortg. Corp. v. Lessel* (1997) 55 CA4th 10, 13-14, 64 CR2d 113, 115—per Civ.C. § 1717(b)(2), voluntary dismissal of judicial foreclosure action precluded borrower's claim to prevailing party fees under clause in deed of trust]

c. [6:249] **Attorney fees recovery under nonrecourse loan:** Under a nonrecourse loan, the borrower ordinarily has no personal liability for defaults and the lender's sole recourse is against the security for the loan (*see ¶ 6:402*). The lender must likewise look solely to the security for payment of its attorney fees in pursuing its default remedies. [See *Aozora Bank, Ltd. v. 1333 North Calif. Blvd.* (2004) 119 CA4th 1291, 1294-1295, 15 CR3d 340, 341-342]

A nonrecourse loan may provide for certain *exceptions* (or "carve-outs") to the personal liability limitation (*see ¶ 6:403*). Even so, the lender may recover from the borrower its attorney fees incurred to enforce such an exception *only* if the language of the exception so provides. [*Aozora Bank, Ltd. v. 1333 North Calif. Blvd.*, supra, 119 CA4th at 1295-1297, 15 CR3d at 342-343 (observing it would rarely, if ever, be appropriate to *imply* carve-out for attorney fee liability)]

19. Prepayment Charges

a. [6:250] **Types of prepayment charges:** There are two basic types of prepayment charges:

(1) [6:251] **"Nonoption" payment under lock-in loan:** Some lenders do not want certain kinds of loans prepaid prior to the scheduled maturity date. Provided they are clearly stated, such "lock-in" provisions prohibiting prepayment generally are enforceable. [*Gutzi Associates v. Switzer* (1989) 215 CA3d 1636, 1645, 264 CR 538, 542-543—not a per se "unreasonable" restraint on alienation]

Under a lock-in loan, if the borrower requests prepayment permission, the lender can negotiate the charge it will accept in return for consenting to the prepayment; "[i]nasmuch as prepayment of the loan is a privilege, the lender may extract a payment or 'penalty' for exercise of the privilege." [*Williams v. Fassler* (1980) 110 CA3d 7, 10, 167 CR 545, 547]

(a) [6:251.1] **Exception—certain residential property loans:** Except as otherwise provided by statute, borrowers under a loan secured by *residential property of four units or less* "*shall be entitled*" to prepay the loan (or any part of it) at any time; in effect, the lender cannot lock in these loans. [Civ.C. §§ 2954.9(a)(1), 2954.11(b)(1)]

However, a prepayment charge generally may be imposed pursuant to written agreement with the borrower. But there are limits on the amount that can be charged and circumstances under which no charge may be imposed (*see ¶ 6:254 ff.*). [Civ.C. §§ 2954.9(a)(2), (b), 2954.11(b)(2)]

(2) [6:252] **"Option" payment—prepayment conditioned on stipulated fee:** Other lenders may permit prepayment but *conditioned* on the borrower's paying a prepayment charge. This is known as an "option type" of prepayment charge, which effectively allows the borrower an "alternative method of performance" under the loan obligation; i.e., the borrower may either pay the loan off at its maturity date (paying only the principal and interest) *or elect to repay the loan in advance of the maturity date* and pay a prearranged fee for the privilege. (Some lenders, however, may allow prepayment *without* charge or fee; see *Dieckmeyer v. Redevelopment Agency of City of Huntington Beach* (2005) 127 CA4th 248, 253, 24 CR3d 895, 899.)

"Payment before maturity is not a breach of the contract, but simply an additional mode of performance on the borrower's part; the prepayment charge is not a penalty imposed for default, but an agreed form of compensation to the lender for interest lost through prepayment, additional tax liability or other disadvantage." [*Ridgley v. Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 978, 73 CR2d 378, 383; see also *Williams v. Fassler* (1980) 110 CA3d 7, 11, 167 CR 545, 547—"in effect, the borrower is paying a fee for the 'nonuse' of the money"]

Prepayment, alternatively, may be conditioned on payment of something other than a prearranged flat fee, such as an amount representing the borrower's "equity share" in the subject property at the time of prepayment. [See *Dieckmeyer v. Redevelopment Agency of City of Huntington Beach*, supra, 127 CA4th at 253-254, 24 CR3d at 899-900]

(a) [6:252.1] **Application where debt acceleration triggered by default or due-on-sale clause:** A prepayment triggering an agreed-upon charge is not necessarily limited to the obligor's voluntary prepayment. The result turns upon the terms of the note: If the note is properly worded (i.e., not limited to obligor's exercise of prepayment privilege), the lender may become entitled to a stipulated prepayment charge after accelerating the principal obligation upon the buyer's default or pursuant to a due-on-sale clause. [*Ridgley v. Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 979, 73 CR2d 378, 383, fn. 3; *Biancalana v. Fleming* (1996) 45 CA4th 698, 702-704, 53 CR2d 47, 49-50; compare *Tan v. California Fed'l Sav. & Loan Ass'n* (1983) 140 CA3d 800, 809-810, 189 CR 775, 782—under terms of note, prepayment charge applied only when obligor voluntarily exercised prepayment option and thus was not triggered by lender's exercise of due-on-sale clause]

(But there are statutory limits on prepayment assessments triggered by due-on-sale loan accelerations; see Civ.C. § 2954.10, *¶ 6:258 & 6:259.4*.)

(b) [6:252.2] **Repayment distinguished:** Prepayment of a loan and repayment of a loan on the maturity date stated in the loan agreement (which necessarily includes all unpaid interest and principal, *see ¶ 6:218*) are *not* the same, and invoke different consequences. For instance, prepayment does not extinguish all of the parties' rights and obligations under the loan (¶ 6:253 ff.), while repayment does. [See *Dieckmeyer v. Redevelopment Agency of City of Huntington Beach* (2005) 127 CA4th 248, 255-257, 24 CR3d 895, 900-902—prepayment did not trigger borrower's obligation to pay lender equity share in secured property due upon repayment of loan]

b. [6:253] **Limits on amount of prepayment charge:** Prepayment charges are *not* inherently invalid; they are neither open to challenge as usurious, susceptible to attack as an invalid liquidated damage (because they do not penalize for the "breach of an obligation," *see ¶ 6:252*), nor per se unenforceable as a "forfeiture" or "unreasonable restraint on alienation." [*Ridgley v. Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 978, 73 CR2d 378, 382-383; see *Williams v. Fassler* (1980) 110 CA3d

7, 11, 167 CR 545, 547, and cases cited therein; see also *Sacramento Sav. & Loan Ass'n v. Sup.Ct. (MacLaughlin)* (1982) 137 CA3d 142, 147, 186 CR 823, 826—prepayment charge not unlawful restraint on alienation where reasonably related to protecting lender's legitimate interests]

Nonetheless, there are certain restrictions on the assessment or collection of a prepayment charge:

(1) [6:254] **Certain residential loan transactions:** With regard to a loan secured by *residential property of four units or less*, the borrower's obligation under a written agreement to pay a prepayment charge is limited as discussed at ¶ 6:254.1 ff. [Civ.C. § 2954.9 (residential loans generally), Civ.C. § 2954.11 (applicable to "installment loans" as defined by Civ.C. § 2954.11(a), ¶ *6:260.6*); see *Garver v. Brace* (1996) 47 CA4th 995, 1001-1002, 55 CR2d 220, 224-225—§ 2954.9 limitations apply to agricultural property which, by prior agreement with lender, becomes owner-occupied residence after loan is executed and before prepayment fee is due; compare *Scalese v. Wong* (2000) 84 CA4th 863, 867, 101 CR2d 40, 42—§ 2954.9 *inapplicable* where *five-unit* apartment building at inception of loan subsequently *converted* to *single-family* residence]

(a) [6:254.1] **No prepayment charge after five years:** No prepayment charge may be imposed on prepayments made after five years from the date of execution of the mortgage or deed of trust; or, with regard to "installment loans" (¶ *6:260.6*), after five years from the date the installment loan is made. [Civ.C. §§ 2954.9(b) (owner-occupied residential property), 2954.11(b)(2) (installment loans)]

When the deed of trust secures more than one "installment loan," each is deemed to have been separately made on the date the proceeds of the loan are advanced. [Civ.C. § 2954.11(c)]

(b) [6:255] **Up to 20%/year free of prepayment charge:** Within the first five years, up to 20% of the original principal amount may be prepaid in any 12-month period without incurring a prepayment charge. [Civ.C. §§ 2954.9(b) (owner-occupied residential property), 2954.11(b)(2) (installment loans)]

(c) [6:256] **Cap on charge for prepayments exceeding 20%/year:** The maximum charge on prepayments in excess of 20% of the original principal amount in any 12-month period is an amount equal to six months' advance interest on that amount. [Civ.C. §§ 2954.9(b) (owner-occupied residential property), 2954.11(b)(2) (installment loans)]

(d) [6:257] **Circumstances precluding prepayment charge:** Notwithstanding the prepayment charge limits (¶ 6:253 ff.), *no* prepayment charge may be imposed in the following circumstances:

• [6:257.1] When the residential structure securing the loan has been damaged to such an extent by a natural disaster for which a state of emergency has been declared by the Governor (pursuant to Gov.C. § 8550 et seq.) that the structure "cannot be occupied and the prepayment is causally related thereto." [Civ.C. §§ 2954.9(c), 2954.11(d)(1)]

• [6:258] When the residential property loan is accelerated under a due-on-sale or due-on-encumbrance clause. [Civ.C. § 2954.10; *see also* ¶ *6:259.4*]

• [6:258.1] With regard to an "installment loan" (¶ *6:260.6*), when the prepayment is made in conjunction with a "bona fide sale" of the residential property securing the loan. [Civ.C. § 2954.11(d)(2)]

• [6:258.2] With regard to an "installment loan" (¶ *6:260.6*), when the lender does not comply with the Civ.C. § 2954.11(e) disclosure requirements (¶ *6:260.5 ff.*). [Civ.C. § 2954.11(d)(3)]

• [6:258.3] With regard to an "installment loan" (¶ *6:260.6*), when the term of the loan does not exceed five years and the original principal amount is less than $5,000. [Civ.C. § 2954.11(e)(4)]

(2) [6:258.4] **High-cost loans secured by borrower's principal dwelling:** In response to abusive practices in the mortgage loan markets, the Federal Reserve Board has expanded existing restrictions on prepayment penalties for *high-cost loans* secured by the borrower's principal dwelling. [See 12 CFR § 226.35 (Reg. Z), *discussed at* ¶ *6:99.3*]

[6:258.5 - 6:258.9] ***Reserved.***

(3) [6:258.10] **Reverse mortgage loans (borrower-occupied homes):** Prepayment charges *cannot* be imposed under a reverse mortgage loan secured by the borrower's owner-occupied principal residence. [Civ.C. § 1923.2(a)—prepayment "shall be permitted without penalty at any time during the term of the reverse mortgage loan"; *see* ¶ *6:98.1*]

(4) Other loan transactions

(a) [6:259] **"Reasonableness"/"unconscionability" limit:** There are no fixed statutory limits on the amount of a prepayment charge in connection with loans on commercial properties or residential properties in excess of four units

(unless a "reverse mortgage loan," ¶ *6:258.10*). Indeed, such charges will generally be upheld so long as "reasonably related" to protection of the lender's legitimate interests. [See *Williams v. Fassler* (1980) 110 CA3d 7, 11-13, 167 CR 545, 547-549—50% option-type prepayment charge valid if "reasonably related to the obligee's anticipated risk of incurring increased tax liability upon the occurrence of the prepayment"; *Sacramento Sav. & Loan Ass'n v. Sup.Ct. (MacLaughlin)* (1982) 137 CA3d 142, 147, 186 CR 823, 826 (¶ *6:253*); *Lazzareschi Invest. Co. v. San Francisco Fed. Sav. & Loan Ass'n* (1971) 22 CA3d 303, 311, 99 CR 417, 422]

Even so, dictum in several cases suggests courts may nonetheless strike down exceptionally high prepayment charges as "unconscionable" (an invalid penalty) if "so exorbitant as to shock the judicial conscience and entirely incompatible with customs of the trade." [See *Williams v. Fassler*, supra, 110 CA3d at 11-12, 167 CR at 547-548; *Lazzareschi Invest. Co. v. San Francisco Fed. Sav. & Loan Ass'n*, supra, 22 CA3d at 308, 99 CR at 420]

➪ [6:259.1] ***PRACTICE POINTER:*** The availability of a prepayment fee upon acceleration must be stated in clear and explicit terms in the loan documentation; otherwise, the creditor may be unable to collect the prepayment fee as of the date of acceleration.

For example, a promissory note provided for a prepayment fee upon *payment after acceleration*, but the trust deed provided for a fee *upon acceleration*. The loan documents stated in the event of a conflict the note governed. As a result, the creditor was required to calculate its fee from the date of payment by credit bid at a foreclosure sale. [*U.S. Bank Nat'l Ass'n v. Yashouafar* (2014) 232 CA4th 639, 648, 181 CR3d 615, 621—under "clear and explicit" terms of note and trust deed no prepayment fee was due until guarantors actually prepaid note's indebtedness]

[6:259.2 - 6:259.3] ***Reserved.***

(b) [6:259.4] **Acceleration upon enforcement of due-on-sale/due-on-encumbrance clause:** By statute, *no* prepayment charge may be assessed or collected upon acceleration of the loan under a due-on-sale or due-on-encumbrance clause … *unless* (i) the obligor has waived in writing the right to prepay without penalty (or has expressly agreed in writing to a specific prepayment charge upon acceleration); *and* (ii) the waiver is separately signed or initialed by the obligor. [Civ.C. § 2954.10]

In addition, enforcement of the obligor's waiver or agreement must "be supported by evidence of a course of conduct by the obligee of individual weight to the consideration in that transaction for the waiver or agreement." [Civ.C. § 2954.10]

Compare: There is an *absolute prohibition* on prepayment charges in connection with acceleration under a loan on residential property containing four units or less (Civ.C. § 2954.10). *See* ¶ *6:258*.

(c) [6:259.5] **Invalid late charge disguised as prepayment charge—substance over form:** A charge contingent on *both* the borrower's prepayment of principal *and* late payment of an interest installment (or other borrower default) is, in effect, *both* a "prepayment charge" and a "late payment charge." Therefore, even though labeled by the contract as a "prepayment charge," it cannot be validated simply as providing the borrower an option to elect an alternative mode of performance; rather, courts must look to the *substance* of the arrangement. [*Ridgley v. Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 979, 73 CR2d 378, 383]

Where the "prepayment charge" is triggered only when the borrower, during the period of the loan, has made a late payment or otherwise was in contractual default, its purpose, from the lender's perspective, is clearly to coerce the borrower's timely payment of interest under the loan, not to compensate the lender for interest payments lost through prepayment of principal or extra administrative expenses associated with relending the money. As such, the validity of the charge must be determined strictly as if it were a *late payment charge:* i.e., it will be invalidated as an unreasonable *penalty* unless the preset charge constitutes a reasonable attempt to estimate the lender's potential losses from late payment (¶ *6:230 ff.*). [*Ridgley v. Topa Thrift & Loan Ass'n*, supra, 17 C4th at 980-981, 73 CR2d at 384-385]

1) [6:259.6] **Notwithstanding validity of unconditional prepayment charge:** The fact the prepayment charge might validly have been imposed *without condition* does not mean it may validly be imposed on the condition of the borrower's late payment of interest. "A forfeiture or unreasonable penalty, imposed only upon the other party's default, is unenforceable even though the same money, property or other consideration might have validly been bargained for as a form of contractual performance." [*Ridgley v. Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 981, 73 CR2d 378, 384-385]

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2) [6:259.7] **Example:** A promissory note on a $2.3 million loan called for monthly interest payments, at a variable rate, on the 21st day of each month. One provision of the note gave Borrowers the option to prepay the outstanding principal balance (in whole or in part), conditioned on Borrowers' paying Lender a "prepayment charge" of six months' interest at the rate in effect at the time of prepayment on the amount prepaid. The note further stated, however, that *no prepayment charge* would be assessed if (i) all scheduled payments have been received by Lender not more than 15 days after their scheduled due date, and (ii) there have been no other defaults under the note.

When Borrowers sold the property, Lender demanded accelerated payment under a due-on-sale clause, which in turn triggered the prepayment charge because Borrowers had been late with a prior interest payment. Looking to the substance of the charge, the court ruled it to be a *penalty* for delinquency in meeting the contractual interest payments; it was an *unenforceable liquidation of damages* because a charge of six months' interest on the entire principal bore no relationship to the potential damages Lender would incur from a late interest payment. [*Ridgley v. Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 982, 73 CR2d 378, 385]

[6:260 - 6:260.4] ***Reserved.***

c. [6:260.5] **Written disclosure required in connection with prepayment charges on residential property "installment loans":** A lender receiving a borrower's written agreement to pay an authorized prepayment charge on an "installment loan" secured by residential real property of four units or less (*¶ 6:254 ff.*) must furnish the borrower with a *written disclosure* describing the existence of the prepayment charge obligation and the method by which the amount of the prepayment charge will be determined. [Civ.C. § 2954.11(e)(1)]

If the borrower has a right to rescind the loan transaction because of the lender's delay in making the disclosure (*¶ 6:260.8*), the disclosure must also advise the borrower of the right to rescind, how and when to exercise the right, and where to mail or deliver a notice of rescission. [Civ.C. § 2954.11(e)(1)]

(1) [6:260.6] **"Installment loan":** Civ.C. § 2954.11 applies to any installment loan secured by a deed of trust, mortgage or other lien on residential property of four units or less (unless the loan is subject to Bus. & Prof.C. § 10242.6) and which is (a) extended under an "installment loan feature" (i.e., a feature of an "open-end credit plan" under Regulation Z of the Federal Reserve System, 12 CFR § 226.2(a)(20)), and (b) to be repaid in substantially equal installments over a specified period without regard to the amount outstanding. [See Civ.C. § 2954.11(a) & (h)]

(2) [6:260.7] **Timing:** The Civ.C. § 2954.11(e)(1) disclosure may be separately furnished or included in the agreement or other loan documentation (provided the borrower is given a copy to retain). [Civ.C. § 2954.11(f)(3)]

In any event, the disclosure must be provided when or up to 30 days before the borrower signs the agreement or other installment loan documents, or no earlier than 30 days before nor later than 10 days after the installment loan is made if it is made without the borrower having to sign an agreement or other loan documentation. [Civ.C. § 2954.11(f)(1)]

If the disclosure is included in the prepayment charge agreement or other loan document signed by the borrower, it "shall be deemed given at that time." In other cases, the disclosure "shall be deemed furnished" when personally delivered to the borrower or three days after it is mailed to the borrower, by postage prepaid first-class mail, at the address to which billing statements for the open-end credit plan (Civ.C. § 2954.11(a)(1)) are being sent. [Civ.C. § 2954.11(f)(2)]

Where there is more than one borrower, a disclosure properly given to any one of them is deemed given to all of them. [Civ.C. § 2954.11(f)(5)]

(3) [6:260.8] **Borrower's right to rescind where disclosure delayed:** If the installment loan is made *before* the required disclosure, the borrower has a right to rescind the loan and the related obligation to pay a prepayment charge. The right of rescission is effected by personally delivering or mailing notice to that effect to the lender, by postage prepaid first-class mail, within 10 days after the disclosure is furnished. [Civ.C. § 2954.11(f)(1)]

Upon rescission, the loan must be repaid according to the terms of the agreement as if the installment loan had never been made. [See Civ.C. § 2954.11(g)]

(4) [6:260.9] **Noncompliance negates prepayment fee obligation:** *See ¶ 6:258.2*.

[6:260.10 - 6:260.14] ***Reserved.***

d. [6:260.15] **Accrual of cause of action challenging prepayment fee:** A cause of action challenging the validity of a prepayment charge does not accrue, and hence the applicable statute of limitations does not commence to run, until either

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the prepayment fee is paid or the creditor (lender) demands its payment. [*Garver v. Brace* (1996) 47 CA4th 995, 1000-1001, 55 CR2d 220, 224 (rejecting argument that limitations period commences when borrower signs note containing prepayment fee clause)]

e. [6:260.16] **Effect of prepayment:** Prepayment of a loan secured by a deed of trust does not trigger a reconveyance clause in the trust deed (i.e., the right to a release of the lender's lien on the real property security, *¶ 6:406 ff.*) *unless all of the obligations under the loan agreement have been satisfied* at the time of prepayment. [See *Dieckmeyer v. Redevelopment Agency of City of Huntington Beach* (2005) 127 CA4th 248, 258-259, 24 CR3d 895, 902-903—where trust deed secured loan, plus borrower's payment to lender of equity share in property upon sale and borrower's obligations under CC&Rs executed with loan documents, prepayment constituted only partial performance of secured obligations and did not entitle borrower to reconveyance]

20. [6:261] **Severability Provisions and Usury Savings Clauses:** "Severability" and "usury savings" provisions in the note are important from the lender's perspective.

a. [6:262] **Severability:** A "severability clause" essentially states that if any provision of the note is unenforceable, the remaining provisions will nevertheless remain enforceable. Thus, it generally ensures the entire note will not be invalidated simply because certain provisions therein are unenforceable.

b. [6:263] **Usury savings:** A companion "usury savings provision" states that any payments deemed to be interest (or which are otherwise paid in respect of the forbearance of money) that would exceed the usury limit, shall only be required to be paid to the extent such payments would not violate the usury laws. Usury savings provisions typically also provide that any such amount in excess of the usury limit will be automatically applied to principal. In effect, such language preserves the validity of payment provisions that might otherwise be stricken as violating the usury laws. (*See ¶ 6:280 ff.* for discussion of usury issues.)

21. [6:264] **Borrower's Waivers:** Many promissory notes contain various waivers by the borrower—e.g., waivers of presentment, notice of dishonor, protest, notice of demand or nonpayment, etc.

a. [6:265] ***Caveat—statute of limitations waiver:*** Arguably, waivers of presentment, notice of dishonor, and the like are not of serious consequences to borrowers. But that is not so with regard to any *statute of limitations* waiver. An agreement to waive an applicable statute of limitations defense significantly impacts the borrower's substantive rights and should be *carefully considered* by the borrower.

b. [6:266] **Jury trial waiver; waiver exclusively pursuant to statute:** The California Constitution vests the Legislature with the exclusive power to prescribe the rules under which parties may waive a jury trial (Cal.Const. Art. 1, § 16); and pursuant thereto, the Legislature has determined that trial by jury in a civil case may be waived *only* in the manner designated by statute. [*Grafton Partners L.P. v. Sup.Ct. (PriceWaterhouseCoopers L.L.P.)* (2005) 36 C4th 944, 956, 32 CR3d 5, 11-12; see CCP § 631]

(1) [6:267] **Strict statutory interpretation; ambiguities resolved against waiver:** Indeed, the constitutional right to a jury trial is considered so fundamental that any ambiguity in the statute permitting a jury waiver (CCP § 631) must be resolved in favor of according litigants a jury trial. [*Grafton Partners L.P. v. Sup.Ct. (PriceWaterhouseCoopers L.L.P.)* (2005) 36 C4th 944, 956, 32 CR3d 5, 12; *DiPirro v. Bondo Corp.* (2007) 153 CA4th 150, 176, 62 CR3d 722, 741]

[6:268 - 6:269] ***Reserved.***

22. [6:270] **Extensions and Acceptance of Partial Payments:** Notes usually provide that the lender's failure to promptly enforce its rights, or its acceptance of a partial or tardy payment, will not constitute a waiver of any of the lender's rights or remedies or an extension of time for payments. (Absent such provision, a defaulting borrower might successfully argue the lender waived the right to insist on timely payments in the future (and its consequent default remedies) by reason of the lender's acceptance of partial or late payments on prior occasions.)

23. [6:271] **Successors and Assigns:** A "successors and assigns provision" effectively makes the note binding on the parties' assignees or successors in interest. Such a provision customarily is (and should be) included in the note.

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24. [6:272] **Governing Law and Venue:** Like any contract, the note should set forth which state's laws will govern interpretation and enforcement of the note. It should also specify the jurisdictional situs in the event of litigation arising under the note (an advance "mutual consent" to jurisdiction at the selected venue is commonplace).

➪ [6:272.1] ***PRACTICE POINTER—CONSIDER HOW OUT-OF-STATE LAW AFFECTS PARTIES' RIGHTS AND OBLIGATIONS*:** Consider carefully the effect on your client's rights and obligations before agreeing to a particular choice of law provision. Complications may arise if the note is to be governed by state law differing from California law normally applicable to the deed of trust or other loan documents. Your client effectively may be waiving important protections extended by California law. [See, e.g., *Guardian Sav. & Loan Ass'n v. MD Assocs.* (1998) 64 CA4th 309, 323, 75 CR2d 151, 160—promissory note's choice of law provision invoked Texas law, under which borrowers had *no antideficiency judgment protection*, thus permitting payee to seek deficiency judgment after foreclosure sale]

a. [6:273] **Enforceability of choice of law provisions:** In determining the enforceability of arm's length contractual choice of law provisions, California courts apply the principles set forth in Rest.2d Conflict of Laws § 187, "which reflect a strong policy favoring enforcement." [*Nedlloyd Lines B.V. v. Sup.Ct.* (*Seawinds Ltd.*) (1992) 3 C4th 459, 464-465, 11 CR2d 330, 333; see also *Washington Mut. Bank, FA v. Sup.Ct.* (*Briseno*) (2001) 24 C4th 906, 916, 103 CR2d 320, 328; *Gramercy Investment Trust v. Lakemont Homes Nevada, Inc.* (2011) 198 CA4th 903, 909, 130 CR3d 496, 501]

(1) [6:273.1] **Restatement approach:** Under the Restatement approach, the court first must determine whether (1) the chosen state has a "substantial relationship" to the parties or their transaction *or* (2) there is any other "reasonable basis" for the parties' choice of law. If neither of these tests is met, the inquiry ends; and the court need not enforce the parties' choice of law. [*Nedlloyd Lines B.V. v. Sup.Ct.* (*Seawinds Ltd.*) (1992) 3 C4th 459, 466, 11 CR2d 330, 334; *Washington Mut. Bank, FA v. Sup.Ct.* (*Briseno*) (2001) 24 C4th 906, 916, 103 CR2d 320, 328]

If, however, either test is met, the court must next determine whether the chosen state's law is contrary to a "fundamental policy" of California. Absent such conflict, the court must enforce the parties' choice of law. Conversely, if there is such a conflict, the court must determine whether California has a "materially greater interest" than the chosen state in determining the particular issues. If California has a materially greater interest, the parties' choice of law will not be enforced; but otherwise, the chosen state's law will be applied. [*Nedlloyd Lines B.V. v. Sup.Ct. (Seawinds Ltd.)*, supra; *Washington Mut. Bank, FA v. Sup.Ct. (Briseno)*, supra, 24 C4th at 916, 103 CR2d at 328; *Brack v. Omni Loan Co., Ltd.* (2008) 164 CA4th 1312, 1321-1322, 80 CR3d 275, 281]

• [6:273.1a] The Restatement approach warranted enforcement of a Texas choice of law provision in a promissory note, effectively eliminating CCP § 580b antideficiency judgment protection "under the peculiar facts … [before the court]: a series of complex security interests on a large commercial property, negotiated between sophisticated Texas domiciliaries." [*Guardian Sav. & Loan Ass'n v. MD Assocs.* (1998) 64 CA4th 309, 323, 75 CR2d 151, 160; compare *Brack v. Omni Loan Co., Ltd.* (2008) 164 CA4th 1312, 1327-1330, 80 CR3d 275, 285-287—Nevada choice of law provision in loan agreements with California consumers not enforceable because application of Nevada law would conflict with fundamental California policy manifested in California Finance Lenders Law and California had greater interest in parties' transaction than did Nevada]

• [6:273.1b] On the other hand, the Restatement approach did not warrant enforcement of a New York choice of law provision in loan agreements and a guaranty contract that would have compelled application of New York's antideficiency law to a foreclosure proceeding involving California property. Although contractual provisions adopting New York law may be applied to foreclosures involving out-of-state property when New York has sufficient contacts, in this case the only contact with New York was the plaintiff's place of business (i.e., the contract was executed, the debt was created and the default occurred in California). Thus, "lacking sufficient contacts," New York's antideficiency statute was deemed inapplicable. [See *Gramercy Investment Trust v. Lakemont Homes Nevada, Inc.* (2011) 198 CA4th 903, 909-912, 130 CR3d 496, 501-503 (also finding guarantor expressly waived California's antideficiency protections and defenses; ¶ *6:601.3*)]

(2) [6:273.2] **Enforcement despite contract of adhesion:** The same analysis applies even though the choice of law clause is contained in a contract of adhesion. The Restatement approach "contains safeguards to protect contracting parties, including consumers, against choice of law agreements that are unreasonable or in contravention of a fundamental

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California policy.” [*Washington Mut. Bank, FA v. Sup.Ct. (Briseno)* (2001) 24 C4th 906, 917, 103 CR2d 320, 329 (provision in institutional lender's standard nonnegotiable deed of trust)]

Cross-refer: See also ¶ 4:544 ff., discussing choice of law and forum-selection clauses in real property purchase agreements.

[6:274] *Reserved.*

25. [6:275] **Nonrecourse:** If the lender is permitted to look only to the secured property to satisfy the loan, the note should state it is “nonrecourse,” that the borrower has no personal liability, and that the lender is limited to its security as its sole recourse for any default under the loan.

• [6:276] **Comment:** Lenders are usually reluctant to limit their recourse solely to the secured property where there is any concern the borrower has committed fraud or waste or permitted environmentally hazardous materials to be placed upon the property. (*See further discussion at ¶ 6:401 ff.*)

[6:277 - 6:279] *Reserved.*

26. [6:280] **Usury Issues:** California law limits the amount of interest that may be charged for any “loan or forbearance of money.” [Cal.Const. Art. XV, § 1; *Stoneridge Parkway Partners v. MW Housing Partners III* (2007) 153 CA4th 1373, 1379, 64 CR3d 61, 65]

Indeed, inclusion of the usury law in the California Constitution, coupled with the fact it cannot be waived, reflects its importance as a fundamental public policy. [*G Companies Management, LLC v. LREP Arizona LLC* (2023) 88 CA5th 342, 352-353, 304 CR3d 651, 658 (declining to enforce contractual provision designating Arizona as forum because it would deprive commercial borrower of California's anti-usury protections); see also *Bisno v. Kahn* (2014) 225 CA4th 1087, 1097, 170 CR3d 709, 715—usury law's purpose is to protect “necessitous, impecunious borrower” who cannot acquire credit from usual sources and is forced to resort to excessively costly funds to meet their financial needs]

Charging usurious interest risks forfeiting the right to collect *any* interest, plus treble damages exposure (¶ *6:296*); and also may draw criminal penalties (¶ *6:297*). [See *Development Acquisition Group, LLC v. EA Consulting, Inc.* (ED CA 2011) 776 F.Supp.2d 1161, 1164-1166—lenders who negotiate loans at usurious rates absent qualified exemptions have no “action at law to recover any interest” and may be liable for treble the interest amount in court's discretion]

a. [6:281] **Usury framework:** “Usury” is the charging of interest for “any loan or forbearance of money” in excess of the statutory maximum. [*Ghirardo v. Antonioli* (1994) 8 C4th 791, 798, 35 CR2d 418, 423; *Hall v. Beneficial Finance Co.* (1981) 118 CA3d 652, 654, 173 CR 450, 451]

The essential elements of usury are:

• the transaction must be a “loan or forbearance” (¶ *6:283*);

• the interest to be paid must exceed the statutory maximum (¶ *6:282*);

• the loan and interest must be absolutely repayable by the borrower (¶ *6:282.4*); and

• the lender must have a “willful intent” to enter into a usurious transaction (¶ *6:282.5*). [*Ghirardo v. Antonioli,* supra, 8 C4th at 798, 35 CR2d at 423; *Jones v. Wells Fargo Bank* (2003) 112 CA4th 1527, 1537, 5 CR3d 835, 843; see also *Creative Ventures, LLC v. Jim Ward & Assocs.* (2011) 195 CA4th 1430, 1449, 126 CR3d 564, 579—in usury, element of intent is “narrow”]

(1) [6:281.1] **Borrower's burden of proof:** The lender has the benefit of a *rebuttable presumption* that a transaction is *not* usurious. Thus, a borrower claiming usury bears the burden of proving all of the essential elements (¶ 6:281). [*Ghirardo v. Antonioli* (1994) 8 C4th 791, 798-799, 35 CR2d 418, 423; *De Guere v. Universal City Studios, Inc.* (1997) 56 CA4th 482, 509, 65 CR2d 438, 456]

b. [6:282] **Maximum nonusurious interest:** For *nonconsumer* loans (i.e., loans *not* made primarily for personal, family or household purposes), the maximum interest rate that can be charged is the *greater of* (1) 10% per annum; or (2) 5% over the

San Francisco Federal Reserve Bank's rate for advances made to member banks under Sections 13 and 13a of the Federal Reserve Act prevailing on the 25th day of the month prior to the earlier of the date of the loan contract or the date the loan was made. [Cal.Const. Art. XV, § 1(2); *Stoneridge Parkway Partners v. MW Housing Partners III* (2007) 153 CA4th 1373, 1379, 64 CR3d 61, 65]

(The maximum interest rate for *consumer* loans is 10% per annum. Cal.Const. Art. XV, § 1(1).)

➪ [6:282.1] ***PRACTICE POINTER:*** The current rate on advances to member banks can be ascertained by phoning the San Francisco Federal Reserve Bank at (415) 974-2000. In addition, if requested, the San Francisco Federal Reserve Bank will put your name on a mailing list for periodic notices of changes in the rate for advances to member banks.

(1) [6:282.2] **Extent of unlawful interest and borrower's sophistication immaterial:** If the transaction is a type subject to the usury laws, the margin by which the maximum interest rate is exceeded is immaterial. "There is no such thing as a little usury." [*Ghirardo v. Antonioli* (1994) 8 C4th 791, 807, 35 CR2d 418, 429]

Likewise, there is no exemption in the usury law for sophisticated borrowers. [*G Companies Management, LLC v. LREP Arizona, LLC* (2023) 88 CA5th 342, 353, 304 CR3d 651, 659]

(2) [6:282.3] **Limitation—federal law preemption re national bank maximum interest:** Federal law *preempts* state usury law concerning interest charged by *national banks:*

The maximum interest rate that can be charged on a loan made by a bank chartered under the National Bank Act is prescribed by § 85 of the Act (see 12 USC § 85); and § 86 of the Act in turn sets forth the exclusive usury cause of action and remedies against a national bank for charging excessive interest (see 12 USC § 86). Together, §§ 85 and 86 of the Act "supersede both the substantive and the remedial provisions of state usury laws and create a federal remedy for overcharges that is exclusive …" [*Beneficial Nat'l Bank v. Anderson* (2003) 539 US 1, 11, 123 S.Ct. 2058, 2064—there is "no such thing as a state-law claim of usury against a national bank"; *see also ¶ 6:297.5*]

(3) [6:282.3a] **Limitation—maximum interest rate during military service:** *See discussion at ¶ 6:512.1 ff.*

c. [6:282.4] **Absolute repayment requirement:** A transaction cannot be usurious under California law unless the loan and interest are "absolutely repayable." Thus, there cannot be a usury violation when the note makes the borrower's repayment obligation subject to a contingency. [See *D-Beam Ltd. Partnership v. Roller Derby Skates, Inc.* (9th Cir. 2004) 366 F3d 972, 975 (applying Calif. law)—loan not absolutely repayable where notes limited repayment to borrower's share of possible royalty payments]

d. [6:282.5] **Lender's "willful intent":** The lender need not have purposely intended to evade the usury laws. The requisite "willful intent" to support a usury judgment simply requires that the lender consciously and voluntarily take more than the maximum allowable rate of interest on a loan or forbearance of money. [*Ghirardo v. Antonioli* (1994) 8 C4th 791, 798, 35 CR2d 418, 423; *Creative Ventures, LLC v. Jim Ward & Assocs.* (2011) 195 CA4th 1430, 1449-1450, 126 CR3d 564, 579]

However, intent becomes relevant on the issue of the true *purpose* of the underlying transaction—i.e., "whether the intent of the contracting parties was that disclosed by the form adopted, or whether such form was a mere sham and subterfuge to cover up a usurious transaction" (i.e., whether the parties actually intended a loan or forbearance rather than a sale). [*Ghirardo v. Antonioli*, supra, 8 C4th at 798, 35 CR2d at 423 (internal quotes omitted); see also *Creative Ventures, LLC v. Jim Ward & Assocs.*, supra, 195 CA4th at 1449-1450, 126 CR3d at 579—intent takes on greater significance when question is whether transaction is one to which usury law applies; compare *Jones v. Wells Fargo Bank* (2003) 112 CA4th 1527, 1538, 5 CR3d 835, 843—intent generally irrelevant when lender admits transaction is a loan; *and see ¶ 6:284* re "substance over form"]

e. [6:283] **What constitutes "loan" or "forbearance of money":** The usury limits apply only with respect to interest on a "loan" or "forbearance of money" (*¶ 6:280*); if neither of these transactions is involved, usury cannot exist. [*Ghirardo v. Antonioli* (1994) 8 C4th 791, 801-802, 35 CR2d 418, 425; *Southwest Concrete Products v. Gosh Const. Corp.* (1990) 51 C3d 701, 705, 274 CR 404, 406; see *De Guere v. Universal City Studios, Inc.* (1997) 56 CA4th 482, 509, 65 CR2d 438, 456]

For usury purposes, a "loan" is the delivery of a sum of money under a contract to return an equivalent amount at some future time; and a "forbearance of money" is the giving of further time for payment of a debt or an agreement not to enforce a claim at its due date. [*Southwest Concrete Products v. Gosh Const. Corp.*, supra, 51 C3d at 705, 274 CR at 406; *Ghirardo v. Antonioli*, supra, 8 C4th at 802, 35 CR2d at 426; see also *In re Moon* (9th Cir. BAP 2023) 648 BR 73, 82-83—settlement agreement providing two-year maturity extension deemed forbearance despite agreement stating otherwise; *DCM Partners*

v. Smith (1991) 228 CA3d 729, 735, 278 CR 778, 781—"forbearance" within meaning of usury law is "an agreement to extend the time for payment of the obligation due either *before or after* the obligation's due date" (emphasis in original)]

(1) [6:284] **Substance over form:** As noted earlier, a borrower often pays the lender various fees and charges that are not denominated as "interest" (e.g., loan fees, commitment fees, prepayment fees and late charges). Nonetheless, after examining the nature of the transaction, those additional charges may sometimes be deemed to constitute interest upon a loan or forbearance of money and thus subject to the usury laws.

On the question whether a transaction constitutes a "loan" or "forbearance of money," trial courts look beyond the form of the transaction to ascertain its *substance*. [*Ghirardo v. Antonioli* (1994) 8 C4th 791, 798, 35 CR2d 418, 423; *Roodenburg v. Pavestone Co., L.P.* (2009) 171 CA4th 185, 193, 89 CR3d 558, 564; see also *In re Moon* (9th Cir. BAP 2023) 648 BR 73, 83 (citing *Ghirardo* with approval)—substance of agreement controls over its form]

"In all such cases the issue is whether or not the bargain of the parties, assessed in light of all the circumstances and with a view to substance rather than form, has as its true object the hire of money at an excessive rate of interest." [*Boerner v. Colwell Co.* (1978) 21 C3d 37, 44, 145 CR 380, 384; see also *Roodenburg v. Pavestone Co., L.P.*, supra]

(2) [6:284.1] **Mixed question of law and fact:** The true nature of the transaction, assessed in light of the parties' intent, presents a question of fact (see *Boerner v. Colwell Co.* (1978) 21 C3d 37, 44, 145 CR 380, 384-385—"existence of the requisite intent [to hire money at an excessive rate of interest] is always a question of fact"). However, once that factual issue is decided, the issue whether the particular transaction is subject to the usury proscription is a question of law. [*Ghirardo v. Antonioli* (1994) 8 C4th 791, 799-801, 35 CR2d 418, 424-425]

(3) Application

(a) [6:285] **Loan fees:** Loan fees generally are not considered "interest" subject to the usury laws so long as the fees relate to the lender's cost in processing the loan application and making or servicing the loan. [*Forte v. Nolfi* (1972) 25 CA3d 656, 681, 102 CR 455, 471]

"A lender is not prohibited from charging an extra and reasonable amount for incidental services, expenses or risk additional to the lawful interest, other than for the loan of money. He may make a reasonable charge for investigating, arranging, negotiating, brokering, making, servicing, collecting and enforcing his obligation. [Par] Such items, however, must be confined to specific service or expense incidental to the loan incurred in such a way as to preclude it being a device through which additional interest or profit on the loan may be exacted." [*Klett v. Security Accept. Co.* (1952) 38 C2d 770, 787-788, 242 P2d 873, 884]

(b) [6:286] **Late charges and default interest rate:** Nor are late payment/default interest rate charges generally considered "interest" within the meaning of the usury laws because it is the *borrower's* conduct that created the additional charge. Late charges do not involve payment for a "loan" or a "forbearance of money"; and "a transaction that was not usurious at its inception cannot become usurious by virtue of the debtor's voluntary default." [*Southwest Concrete Products v. Gosh Const. Corp.* (1990) 51 C3d 701, 706-709, 274 CR 404, 407-409—where excessive interest caused by contingency under debtor's control, transaction will not be deemed usurious; see also *Roodenburg v. Pavestone Co., L.P.* (2009) 171 CA4th 185, 194, 89 CR3d 558, 565—operating agreement's 18% prejudgment interest provision in event of default not a "forbearance" and therefore not subject to usury limits]

(c) [6:287] **Prepayment penalties:** Prepayment penalties do not enter into the usury calculus so long as the option to prepay is within the borrower's discretion. [*French v. Mortgage Guar. Co.* (1940) 16 C2d 26, 31, 104 P2d 655, 657]

(d) [6:288] **Loan broker commissions:** A broker's commission charged to the borrower by the lender's agent can render the transaction usurious if exaction of the commission is *known to and authorized or ratified by the lender*. [*Forte v. Nolfi* (1972) 25 CA3d 656, 681-682, 102 CR 455, 472]

But the mere fact the lender knows a broker's commission is being charged is not fatal if it is paid with the borrower's consent to an agent employed by the borrower to seek a loan or to a broker whose services were rendered to both parties and who does not rebate any part of the commission to the lender. [*Forte v. Nolfi*, supra, 25 CA3d at 682, 102 CR at 472]

(e) [6:289] **Compound interest:** Compounding of interest (adding interest to principal which itself accrues interest—or interest on interest) can be usurious if the compounding occurs on more than an annual basis and results in exceeding the statutory usury limit. [*Heald v. Friis-Hansen* (1959) 52 C2d 834, 839, 345 P2d 457, 461-462]

(f) [6:289.1] **Forbearance fees collected by judgment creditors:** The usury law does not prohibit a judgment creditor from accepting a forbearance fee in addition to the statutory interest automatically applied by a court to a judgment. "Usury liability is wholly a creature of statute. Because the usury law does not expressly prohibit a party from entering into an agreement to forbear collecting on a judgment, usury liability does not extend to judgment creditors who receive remuneration beyond the statutory 10 percent interest rate in exchange for a delay in enforcing a judgment." [*Bisno v. Kahn* (2014) 225 CA4th 1087, 1093, 170 CR3d 709, 712]

Nonetheless, any forbearance fee does not become part of the judgment and is not an amount that must be paid to satisfy the judgment. "Rather, a forbearance agreement is a contract between the judgment creditor and the judgment debtor that is separate from the judgment to which it applies. Consequently, a forbearance agreement must be enforced in a separate contract action and is subject to standard contractual defenses such as duress and unconscionability." [*Bisno v. Kahn*, supra, 225 CA4th at 1093, 170 CR3d at 712]

f. [6:290] **Usury exemptions:** There are several exemptions from the California usury laws, broadly categorized as federal statutory exemptions, California constitutional, statutory and case law exemptions, and a "time-price exemption" (*¶ 6:294*). If any one exemption applies, the loan is not subject to a maximum interest rate.

(1) [6:291] **Federal exemption for "federally-related" secured residential property loans:** Federal law generally *exempts* from state usury laws any "federally-related" loan secured by a *first position lien on residential property*. [See 12 USC § 1735f-7a]

(a) [6:291.1] **"Federally-related" loans:** "Federally-related" loans are those:

- made by any lender whose deposits or accounts are insured by any federal agency (e.g., Federal Deposit Insurance Corp. (FDIC) or the Federal Savings Loan Insurance Corp. (FSLIC));

- made by any lender regulated by any federal agency (e.g., the Federal Reserve System Board of Governors);

- made by any lender approved by the Secretary of Housing and Urban Development (HUD) for participation in any mortgage insurance program under the national Housing Act;

- made in whole or in part by HUD; *or*

- eligible for purchase by the Federal National Mortgage Association, Government National Mortgage Association or Federal Home Loan Mortgage Corp. [12 CFR § 590.2]

(b) [6:291.2] **States may opt out:** The same federal law providing for the exemption also gives states the option of *explicitly opting out* of the exemption; opt-out states may reassert their usury limitations: The exemption does not apply in a state that "adopts a law or certifies" that its voters have voted in favor of any provision that "states explicitly and by its terms that such State does not want" the exemption to apply. [12 USC § 1735f-7a(b)(2); see *Brown v. Investors Mortg. Co.* (9th Cir. 1997) 121 F3d 472, 476 (decided under Wash. law)—no effective opt-out under state's general usury statute which did not state "*explicitly and by its terms*" that state did not want exemption to apply to loans made within its borders]

(2) [6:292] **California constitutional and statutory exemptions:** The California Constitution and various California statutes exempt several classes of lenders as well as certain types of loans from the usury laws. (Certain kinds of lenders and certain kinds of loans are not restricted by any interest rate ceilings, while others are subject to at least some interest rate ceiling.)

These exemptions are scattered throughout Cal.Const. Art. XV, § 1 and various provisions of the Financial Code, Corporations Code, Insurance Code, Government Code and Civil Code. [*Jones v. Wells Fargo Bank* (2003) 112 CA4th 1527, 1531, 5 CR3d 835, 841; see also *Ghirardo v. Antonioli* (1994) 8 C4th 791, 807, 35 CR2d 418, 429—"the usury law … is riddled with so many exceptions that the law's application itself seems to be the exception rather than the rule"]

(a) [6:293] **Broker-arranged loans or forbearances on secured real property:** Significantly, in connection with real property purchase and sale transactions, there is a usury exemption for loans or forbearances "*made or arranged*" *by a licensed real estate broker and secured by a lien on real property.* [Cal.Const. Art. XV, § 1; Civ.C. § 1916.1; *Creative Ventures, LLC v. Jim Ward & Assocs.* (2011) 195 CA4th 1430, 1442, 126 CR3d 564, 573—licensed real estate brokers may be either individuals or corporations through designated officers (*discussed further at ¶ 6:293e*); *Stoneridge*

Parkway Partners v. MW Housing Partners III (2007) 153 CA4th 1373, 1379, 64 CR3d 61, 65—§ 1916.1 implements Constitution's licensed broker exemption and defines when secured loan is "arranged" by licensed broker; see also *In re Moon* (9th Cir. BAP 2023) 648 BR 73, 86-87—broker exemption did not exclude forbearance from usury proscription where licensed real estate broker arranged original loan but not forbearance]

1) [6:293a] **"Arranging" for loan or forbearance:** A broker "arranges" for a loan or forbearance within the meaning of the exemption if the broker "acts for another and receives or expects to receive compensation for it." [*Park Terrace Ltd. v. Teasdale* (2002) 100 CA4th 802, 806, 122 CR2d 797, 799; *Stoneridge Parkway Partners v. MW Housing Partners III* (2007) 153 CA4th 1373, 1379, 64 CR3d 61, 65]

In other words, a loan is exempt under Civ.C. § 1916.1 if it was negotiated for compensation by a licensed real estate broker acting as an *intermediary* for the benefit of another. [*Park Terrace Ltd. v. Teasdale*, supra, 100 CA4th at 806-807, 122 CR2d at 799-800—exemption inapplicable to brokers acting merely for their own benefit]

The usury exemption for a broker arranged loan does not, however, extend to the loan's modification *unless* a broker arranges the modification. [See *In re Moon* (9th Cir. BAP 2023) 648 BR 73, 83, 86—settlement agreement extending mortgage's maturity, made without broker's involvement, deemed forbearance subject to usury laws]

a) Application

• [6:293b] The exemption applied to a loan negotiated by a broker/general partner on behalf of various limited partnerships, where the broker/general partner was compensated with a share of the partnerships' profits. [*Park Terrace Ltd. v. Teasdale* (2002) 100 CA4th 802, 806-807, 122 CR2d 797, 799-800; see also *Stickel v. Harris* (1987) 196 CA3d 575, 582, 585, 242 CR 88, 92, 94—exemption applied to loan negotiated by broker for joint venture and partnerships in which broker was a member (compensation was broker's anticipated profits from property's development)]

• [6:293c] The exemption also applied where a broker, although an employee of the lender's affiliate, acted as a third party intermediary for the benefit of the lender and was compensated for his efforts. "It is of no moment that [the broker] indirectly benefited from the transaction. As long as [he] was not negotiating solely on his own behalf, he fits squarely within the statutory exemption of a licensed broker who negotiated and arranged a loan for another." [*Stoneridge Parkway Partners v. MW Housing Partners III* (2007) 153 CA4th 1373, 1381, 64 CR3d 61, 66-67]

• [6:293d] A secured loan made by a licensed real estate broker's wholly-owned corporation to a third party was a loan "arranged" by the broker and therefore exempt even though the broker did not take a commission. Reason: In arranging the loan for his corporation, the broker did so "for another" and "in expectation of compensation" since he expected to reap the benefits of the interest his corporation was supposed to earn. [See *Bock v. California Capital Loans, Inc.* (2013) 216 CA4th 264, 266-267, 273, 156 CR3d 874, 875, 880 (noting it "makes no difference" whether broker took compensation by drawing corporate dividend or receiving commission)]

• [6:293e] *Compare:* Loans arranged by an *unlicensed* mortgage lender and loan processing corporation were *not* exempt from the usury prohibition even though the corporation's primary officer/director was personally licensed as a real estate broker. Reason: Only a *designated officer* may conduct licensed activities on a corporation's behalf (*¶ 2:108*). [*Creative Ventures, LLC v. Jim Ward & Assocs.* (2011) 195 CA4th 1430, 1442, 126 CR3d 564, 573]

• [6:293f] A loan was *not* exempt from the usury prohibition where the only broker involved in the transaction was the borrower himself, who signed the promissory note and used the money to pay personal expenses. [*Winnett v. Roberts* (1986) 179 CA3d 909, 915, 920, 225 CR 82, 83-84, 87; see also *Green v. Future Two* (1986) 179 CA3d 738, 742-743, 225 CR 3, 4-5—partnership loan negotiated by general partner/broker not exempt (general partner/broker did not expect or receive compensation and was deemed to be acting for herself alone in her capacity as borrower)]

1/ [6:293g] **Comment:** It is somewhat difficult to reconcile the holding in *Green*, supra, with the *Park Terrace* and *Stickel* decisions (*¶ 6:293b*). In fact, the *Stoneridge Parkway* court (*¶ 6:293c*) expressly declined to follow *Green,* noting the "*Green* court reached its conclusion ipse dixit, without analyzing the broker's efforts on behalf of the partnership." [See *Stoneridge Parkway Partners v. MW Housing Partners III* (2007) 153 CA4th 1373, 1380, 64 CR3d 61, 66 (finding *Park Terrace* and *Stickel* holdings "instructive")]

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b) [6:293h] **Includes structuring loan, etc.:** Civ.C. § 1916.1 "arranging" includes "structuring the loan as the agent for the lender, setting the interest rate and points to be paid, setting the terms of the forbearance agreement, reviewing the loan and forbearance documents, conducting title searches, or drafting the terms of the loan." [*Creative Ventures, LLC v. Jim Ward & Assocs.* (2011) 195 CA4th 1430, 1442, 126 CR3d 564, 573; see also *Gibbo v. Berger* (2004) 123 CA4th 396, 402-403, 19 CR3d 829, 833-834 (noting broker who, for fee, acted as escrow officer and merely inserted terms agreed upon by parties in form loan documents, photocopied and collated document pages, ordered title insurance and dispersed funds, *not* an "arranger")]

[6:293i - 6:293j] ***Reserved.***

2) [6:293k] **Acting in licensed capacity *not required:*** The Civ.C. § 1916.1 exemption applies even if the broker, in making or arranging the loan, was not acting within the course and scope of the broker's real estate license. [*Park Terrace Ltd. v. Teasdale* (2002) 100 CA4th 802, 808-809, 122 CR2d 797, 801-802—exemption applied where broker arranged loans in nonlicensed capacity as general partner of limited partnerships]

(b) [6:293.1] **Exemption for ERISA plan loans *preempted:*** Civ.C. § 1917.220 purports to exempt from the California usury law loans made by an ERISA-governed pension plan. However, this statute, and hence the exemption, is *preempted* by ERISA. [See *Varr v. Olimpia* (1996) 45 CA4th 675, 680-681, 53 CR2d 106, 109]

On the other hand, ERISA does *not* preempt California's general usury law—i.e., loans from an ERISA-governed pension plan are subject to the Cal.Const. Art. XV, § 1 interest rate limits. (Unlike the Civ.C. § 1917.220 exemption, which singles out ERISA plans for special treatment, California's usury law is a law of general application which has only a tenuous or peripheral connection with ERISA plans.) [*Varr v. Olimpia*, supra, 45 CA4th at 685-687, 53 CR2d at 112-113]

[6:293.2 - 6:293.4] ***Reserved.***

(c) [6:293.5] **Commercial loans based on "preexisting personal or business relationship":** Certain commercial transactions (¶ 6:293.6 ff.) between a lender and the issuer or guarantor of a debt are exempt from the California usury laws so long as (i) the lender and issuer or guarantor (or any of their respective officers, directors, controlling persons, or managers of limited liability companies) have a "preexisting personal or business relationship" (as defined in Corps.C. § 25118(g)); *or* (ii) the lender and issuer or guarantor, by reason of their own respective business and financial experience or that of their professional advisors, could reasonably be assumed to have the capacity to protect their own interests in connection with the transaction. [Corps.C. § 25118(f); see also *Development Acquisition Group, LLC v. EA Consulting, Inc.* (ED CA 2011) 776 F.Supp.2d 1161, 1164—California law provides usury law exemptions for "sophisticated parties" engaged in commercial transactions, *not* "where there is any evidence" debt was issued/guaranteed by individual]

If *either* of the above criteria are met, the following transactions are exempt from the usury laws:

1) [6:293.6] **Note issued or guaranteed by borrower's "affiliate":** An evidence of indebtedness issued by or guaranteed by the borrower's "affiliate" (as defined in Corps.C. § 150) that on the date the evidence of indebtedness is made or guaranteed has total assets of at least $2,000,000, according to its then most recent financial statements. [See Corps.C. § 25118(a), (c)]

The financial statements must be *both:* (i) made as of a date not more than 90 days before the date the evidence of indebtedness is made or guaranteed; *and* (ii) prepared according to generally accepted accounting principles or Securities and Exchange Commission rules. [Corps.C. § 25118(a)]

2) [6:293.7] **Notes aggregating at least $300,000:** Any one or more evidences of indebtedness that aggregate at least $300,000, *or* are issued pursuant to a bona fide written commitment or line of credit in the amount of at least $300,000. [Corps.C. § 25118(b), (c)]

This exemption is *not* affected by an event beyond the lender's control, including the issuer's default, that relieves the lender from its commitment. [Corps.C. § 25118(b)]

[6:293.8 - 6:293.9] ***Reserved.***

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(d) [6:293.10] **Loans by banks engaged in trust business and acting in fiduciary capacity (Fin.C. § 1504):** The constitutional interest rate restrictions do not apply to loans made by a California bank, or any national or foreign bank with an office in California, "authorized to engage in the trust business" *and* "acting in its fiduciary capacity." [Fin.C. § 1504; *Jones v. Wells Fargo Bank* (2003) 112 CA4th 1527, 1536-1537, 5 CR3d 835, 842-843—application of exemption to national bank not preempted by National Bank Act (*¶ 6:282.3*) or ERISA]

[6:293.11 - 6:293.12] ***Reserved.***

(e) [6:293.13] **"Shared appreciation loans":** *See ¶ 6:67*.

[6:293.14 - 6:293.19] ***Reserved.***

(3) [6:293.20] **California case law exemption (joint ventures and partnerships):** Where the relationship between parties is a *bona fide* joint venture or partnership, the advance by the partners or joint venturers is deemed an investment rather than a loan. As such, the profit or return earned by the investors is not subject to California usury laws. [See *Junkin v. Golden West Foreclosure Service, Inc.* (2010) 180 CA4th 1150, 1155-1158, 103 CR3d 582, 586-588 (delineating factors considered in determining whether bona fide joint venture exists)—usury law inapplicable to foreclosure of office building by one joint venturer under allegedly usurious promissory note and trust deed]

(4) [6:294] **"Time-price exemption":** When a seller finances the purchase of real or personal property by extending payment of the price over time and charging a higher price for carrying the financing, California usury laws do *not* apply (so-called "time-price doctrine"). This type of transaction is considered a *bona fide credit sale*, not a "loan" or "forbearance of money." [*Verbeck v. Clymer* (1927) 202 C 557, 563, 261 P 1017, 1019; see *Ghirardo v. Antonioli* (1994) 8 C4th 791, 802-803, 35 CR2d 418, 426; *Southwest Concrete Products v. Gosh Const. Corp.* (1990) 51 C3d 701, 705, 274 CR 404, 407; *In re Moon* (9th Cir. BAP 2023) 648 BR 73, 77, 85-86]

(a) [6:294.1] **Rationale:** "[T]he owner of property … has a perfect right to name the price on which he is willing to sell, and to refuse to accede to any other. He may offer to sell at a designated price for cash or at a much higher price on credit, and a credit sale will not constitute usury however great the difference between the two prices, unless the buying and selling was a mere pretense …" [*Verbeck v. Clymer* (1927) 202 C 557, 563, 261 P 1017, 1019; see also *Ghirardo v. Antonioli* (1994) 8 C4th 791, 804, 35 CR2d 418, 427; *In re Moon* (9th Cir. 2023) 648 BR 73, 83-84]

(b) [6:294.2] **Applies to subsequent debt restructuring in lieu of foreclosure:** An original seller-financed loan exempt under the "time price doctrine" *remains exempt* when the seller subsequently agrees (at the borrower's request or otherwise to accommodate a borrower in default) to *substitute a new note* that *extends the time for payment* and/or to *modify* the secured obligation at an *increased interest rate*, which transaction, but for the exemption, would be usurious. [*Ghirardo v. Antonioli* (1994) 8 C4th 791, 804, 35 CR2d 418, 426-427; *DCM Partners v. Smith* (1991) 228 CA3d 729, 735, 278 CR 778, 781—usury law inapplicable to seller's modification of secured purchase money note, increasing interest rate in consideration for extending note's maturity date]

1) [6:294.3] **Rationale:** There is no practical reason why the underlying policy of the time-price exemption (*¶ 6:294.1*) should not apply as well when the seller has already transferred title and is about to foreclose on the purchase money note. "Just as he had an initial right to sell the property on any price terms he wished, he has the right to foreclose and to resell the property as he sees fit, at any interest rate, including reselling to the initial buyer. Precluding him from renegotiating with the buyer would elevate form over substance." [*Ghirardo v. Antonioli* (1994) 8 C4th 791, 804, 35 CR2d 418, 427; *DCM Partners v. Smith* (1991) 228 CA3d 729, 736, 278 CR 778, 782]

Applying the original time-price exemption to the modification (or debt restructuring) is also supported by the following theories:

• [6:294.4] Since the note was initially created in an exempt transaction, the trustor (borrower) would be "unjustly enriched" if it had the benefit of an interest-free loan upon its subsequent modification. [*DCM Partners v. Smith* (1991) 228 CA3d 729, 735, 278 CR 778, 781]

• [6:294.5] A modification of the note at the trustor's (borrower's) request triggers the rule that a debtor cannot, by their voluntary act, render an otherwise nonusurious transaction usurious (*see ¶ 6:286*). [*DCM Partners v. Smith* (1991) 228 CA3d 729, 736, 278 CR 778, 782]

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• [6:294.6] The usury laws should not be applied to "remake" privately-negotiated bargains. "To declare a privately negotiated bargain as illegal where the original bargain was not, will only chill the willingness of non-exempt lenders to extend credit in private transactions where there is no apparent unlawfulness in so doing." [*DCM Partners v. Smith* (1991) 228 CA3d 729, 737, 278 CR 778, 782-783]

2) [6:294.7] **Nonusurious despite increased interest:** The original time-price exemption applies to a subsequent extension of the secured loan even though the interest rate for the extension is increased. [*Ghirardo v. Antonioli* (1994) 8 C4th 791, 805, 35 CR2d 418, 428]

It would be *unfair* to both sides of the debt restructuring transaction to require that the interest rate be the same as or lower than the original rate. "The only alternative to foreclosure for a seller who has suffered a default should not be an extension on more favorable terms to the buyer. That is unfair and impractical. Indeed, for that reason, it also prejudices the buyer who wishes to renegotiate because a seller who has two choices—foreclosure or extension on new terms favorable only to the buyer—will plainly be more likely to foreclose." [*Ghirardo v. Antonioli*, supra, 8 C4th at 805-806, 35 CR2d at 428]

g. [6:295] **Usury savings clauses:** A "usury savings clause" in loan documents protects lenders against the consequences of an inadvertent violation of the usury laws. It provides that, in the event the loan exceeds the maximum allowable interest rate, the interest will automatically be reduced to the maximum rate permissible under the law. Such "savings" provisions are enforceable according to their terms. [*In re Dominguez* (9th Cir. 1993) 995 F2d 883, 886-887—unambiguous "savings clause" may preclude finding that loan agreement is usurious "on its face"; see also *Arneill Ranch v. Petit* (1976) 64 CA3d 277, 293-296, 134 CR 456, 466-468—extrinsic evidence admissible to resolve ambiguity over scope and effect of savings clause]

h. Penalties for violation of usury laws

(1) [6:296] **Civil penalties:** If a loan is found to be usurious, the lender may be precluded from recovering *any* interest. [*Gibbo v. Berger* (2004) 123 CA4th 396, 403, 19 CR3d 829, 834; see also *Hardwick v. Wilcox* (2017) 11 CA5th 975, 978-979, 217 CR3d 883, 885-886—no error in finding usurious interest payments made on series of loans offset principal debt and awarding borrower $227,236 for payments made during two years prior to filing suit; *Development Acquisition Group, LLC v. EA Consulting, Inc.* (ED CA 2011) 776 F.Supp.2d 1161, 1164—lenders who negotiate loans at usurious rates absent qualified exemptions have "no action at law to recover any interest"; *Creative Ventures, LLC v. Jim Ward & Assocs.* (2011) 195 CA4th 1430, 1448, 126 CR3d 564, 578—investors holding fractional interests in various promissory notes had no right to interest in any amount because interest terms were deemed usurious and therefore "null and void"; *but see ¶ 6:295*]

Additionally, the trial court may, in its discretion, assess *treble damages* against the lender (i.e., three times the amount paid in violation of the usury limit). [Civ.C. § 1916-3(a); *Burr v. Capital Reserve Corp.* (1969) 71 C2d 983, 994, 80 CR 345, 352; see also *Development Acquisition Group, LLC v. EA Consulting, Inc.*, supra, 776 F.Supp.2d at 1165-1166—borrower may recover treble the interest amount paid so long as action is brought within one year after payment; *Creative Ventures, LLC v. Jim Ward & Assocs.*, supra, 195 CA4th at 1450, 126 CR3d at 579 (declining to award civil penalties where defendants' misconduct deemed merely "careless" or "mistaken")]

(2) [6:297] **Criminal penalties:** Charging a usurious interest rate is also a criminal offense, punishable by a maximum five years' imprisonment. [Civ.C. § 1916-3(b)]

[6:297.1 - 6:297.4] *Reserved.*

(3) [6:297.5] **Limitation—federal law preemption re usury claims against national banks:** As discussed earlier, federal law *preempts* state law usury claims and remedies against national banks. The usury cause of action and remedies against a bank charted under the National Bank Act are exclusively as prescribed by § 86 of the Act. [12 USC § 86; *Beneficial Nat'l Bank v. Anderson* (2003) 539 US 1, 11, 123 S.Ct. 2058, 2064; *see ¶ 6:282.3*]

i. [6:298] **Standing to challenge limited to borrower or borrower's representative:** Usury protection is for the benefit of, and *personal* to, the borrower. Thus, only the *borrower* or borrower's personal representative has standing to raise a usury challenge. [*Roes v. Wong* (1999) 69 CA4th 375, 378, 81 CR2d 596, 598; see *Matthews v. Ormerd* (1903) 140 C 578, 582, 74 P 136, 138—"one not a party to an usurious contract, may not … invalidate it [on usury grounds]"]

(1) [6:298.1] **Receivers:** A receiver for an insolvent borrower acts as the borrower's legal representative in connection with the borrower's assets and liabilities (including usurious loans) and thus may assert a usury claim on the borrower's behalf. [See *Roes v. Wong* (1999) 69 CA4th 375, 378, 81 CR2d 596, 598]

(2) [6:298.2] **Executors:** The executor of a deceased borrower's estate likewise has standing to assert usury. [See *Roes v. Wong* (1999) 69 CA4th 375, 378-379, 81 CR2d 596, 598]

(3) [6:298.3] **Corporate alter ego:** Similarly, a borrower's corporate alter ego may raise a usury defense in a lender's action on a usurious note. [*Western States Acceptance Corp. v. F.D.Tuttle, Inc.* (1930) 210 C 51, 53, 290 P 574, 575]

(4) [6:298.4] **Compare—"nonassuming" purchasers:** A purchaser who acquires property "subject to" an existing loan but who does *not assume* the loan may *not* raise a claim of usury (i.e., the nonassuming purchaser is bound by whatever interest rates and charges are specified in the loan). [*Ames v. Occidental Life Ins. Co.* (1930) 210 C 271, 273, 291 P 182, 183; *Roes v. Wong* (1999) 69 CA4th 375, 378-379, 81 CR2d 596, 598]

Rationale: Where property is purchased subject to a usurious loan, the law *presumes* that the usurious interest was factored in as part of the purchase price. "In this context, recognizing a claim for usury would give the purchaser a better deal than the one he made." [*Roes v. Wong*, supra, 69 CA4th at 378-379, 81 CR2d at 598]

(5) [6:298.5] **Compare—junior lienholders:** A junior lienholder who pays off the senior lien in order to prevent foreclosure *cannot* assert a usury claim. The junior lienholder is neither directly liable for the senior loan nor acting in a representative capacity on behalf of the borrower. [*Roes v. Wong* (1999) 69 CA4th 375, 380, 81 CR2d 596, 599; *Barnes v. Hartman* (1966) 246 CA2d 215, 223, 54 CR 514, 520; but see *Roesch v. De Mota* (1944) 24 C2d 563, 574, 150 P2d 422—allowing junior lienholder to enjoin foreclosure on basis of usurious senior loan (but issue of junior's standing to assert usury was neither raised nor addressed)]

➪ ***PRACTICE POINTERS***

• [6:299] ***For lenders:*** Except in seller-financed transactions (where the "time-price exemption" insulates the seller from usury claims, *¶ 6:294*), lenders are cautioned to carefully review those charges that might conceivably be considered interest on a "loan" or "forbearance of money" to ensure the amounts do not exceed the applicable maximum rate. Since the consequences of a usurious loan can be significant, a "savings clause" (*¶ 6:295*) should routinely be included in the loan documents.

• [6:300] ***For borrower's counsel:*** As a practical matter, the "time-price exemption" (protecting sellers from usury claims, *¶ 6:294*) will usually make usury issues of little concern for attorneys involved in purchase and sale transactions. However, borrower's counsel is sometimes required to issue a *usury opinion* to the effect that the loan is not usurious. In that event, borrower's counsel must carefully scrutinize the transaction to determine whether any charge or provision might be under the usury umbrella.

Cross-refer: Attorney opinion letters in purchase and sale transactions are discussed in detail in *Ch. 9*.

[6:301 - 6:309] ***Reserved.***

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Chapter 6. Financing and Appraisals

G. Assuming Existing Financing or Purchasing Subject to Existing Financing

- 1. [6:310] General Considerations
  - a. [6:311] Distinctions
  - b. [6:312] Advantages over outright payoff of existing loan
- 2. [6:313] Assumption of Existing Financing
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        - 1) [6:318] Fee
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  - c. [6:324] Compare—assumption/indemnity in favor of seller only
- 3. Purchasing Subject to Existing Financing
  - a. [6:325] Advantages for buyer
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  - c. [6:331] Disadvantages for seller

1. [6:310] **General Considerations:** A buyer looking to acquire property that is encumbered by a loan has three choices—either:

- Pay off the existing loan;
- Specifically *assume* the existing loan pursuant to an agreement with the lender (or seller) (¶ *6:313 ff.*); *or*
- Simply purchase the property "*subject to*" the existing loan, but not assume the loan (such a buyer is said to be a "nonassuming grantee") (¶ *6:325 ff.*).

a. [6:311] **Distinctions:** Whether the buyer takes "subject to" an existing loan or "assumes" the loan has different consequences for the *lender*, the *original borrower* (seller) and the *buyer*.

Fundamentally, an *assuming grantee* becomes *contractually bound* to the lender; by contrast, a *nonassuming grantee* is *not* contractually (or otherwise) bound to pay the existing debt.

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b. [6:312] **Advantages over outright payoff of existing loan:** There are several advantages to buyers who either assume or take subject to existing financing (rather than paying off the existing loan at the outset). Both alternatives obviate the need to obtain a new loan.

Additionally, buyer and seller might benefit by the following:

- Prepayment penalties on existing financing are avoided.
- The interest rate on the existing loan may be more favorable than current market rates.
- New loan fees and charges can be avoided (although lenders typically charge a fee for the buyer's assumption of an existing loan).
- A buyer who takes subject to an existing loan will not have to qualify for the financing.
- A financing condition to closing of the purchase and sale will be unnecessary if the buyer is taking subject to the existing loan. In turn, the parties may be able to more expeditiously consummate the purchase and sale.

2. [6:313] **Assumption of Existing Financing:** An assumption of existing financing is typically effected by the buyer's execution of a written assumption agreement with the existing lender. The assuming buyer is usually required to pay an assumption fee and meet the lender's financial qualification requirements.

a. Practical considerations

(1) From buyer's perspective

(a) [6:314] **Advantages for buyer:** An assumption may offer any or all of the following advantages for the buyer:

1) [6:315] **Avoiding default under due-on-sale clause:** If there is a due-on-sale clause in the deed of trust (¶ *6:388 ff.*), the buyer's assumption of existing financing will prevent the sale from triggering a default under the deed of trust.

2) [6:316] **Preserving antideficiency protection:** If the existing loan originally was purchase money financing, an assumption will enable the buyer to retain the protection of antideficiency laws (CCP § 580b; *see* ¶ *6:563 ff.*).

(b) [6:317] **Disadvantages for buyer:** On the other hand, buyers should also consider these potential disadvantages to an assumption:

1) [6:318] **Fee:** Lenders usually require assuming buyers to pay an assumption fee.

(In single-family residential transactions, this fee is often 1% of the outstanding principal balance due, plus certain administrative and other costs.)

2) [6:319] **Qualification:** The buyer may have to meet the lender's creditworthiness standards.

3) [6:320] **Personal liability exposure under full recourse loan:** If the existing loan was not purchase money, the assuming buyer will not have the benefit of CCP § 580b (purchase money antideficiency protection, ¶ *6:563 ff.*) and may be assuming a full recourse loan. [See *Paramount Sav. & Loan Ass'n v. Barber* (1968) 263 CA2d 166, 169, 69 CR 390, 392]

(2) [6:321] **From seller's perspective:** The buyer's assumption of existing financing *exonerates the seller* from any future liability on the loan. This is most important to sellers when the loan is nonpurchase money or otherwise a recourse loan (for which the seller would not have the benefit of antideficiency law protection).

➪ [6:322] ***PRACTICE POINTER:*** In an assumption transaction, the seller should make certain the lender *specifically releases* the seller pursuant to either the buyer's assumption agreement or a separate instrument. In this manner, there can be no subsequent claim by the lender that the buyer's assumption simply created an additional, second obligor, but that the seller was never exonerated.

b. [6:323] **Formalities—writing requirement:** Assumption agreements in the lender's favor are subject to the statute of frauds: An assumption agreement is ineffective to make the buyer personally liable on the existing loan *unless* it is (1) reduced to a *writing signed by the buyer* or (2) specifically provided for in the conveyance of the property. [Civ.C. § 1624(a)(6); *Cornelison v. Kornbluth* (1975) 15 C3d 590, 597, 125 CR 557, 561]

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c. [6:324] **Compare—assumption/indemnity in favor of seller only:** Sometimes the buyer does not assume the loan pursuant to an agreement with the lender, but simply agrees (in its contract with the seller) to assume the seller's obligations to pay the loan and to indemnify the seller in the event the buyer fails to pay the loan.

Under such circumstances, the *lender* may have a third party claim against the buyer based on the principle of equitable subrogation. [*Birkhofer v. Krumm* (1935) 4 CA2d 43, 48, 40 P2d 553, 556]

3. Purchasing Subject to Existing Financing

a. [6:325] **Advantages for buyer:** A buyer who takes "subject to" existing financing may realize the following benefits:

(1) [6:326] **No fee or qualification:** The buyer avoids payment of any assumption fee and the necessity of meeting the lender's creditworthiness standards.

(2) [6:327] **No personal liability to lender:** The buyer has no contractual obligation to the lender on the preexisting loan. Consequently, the buyer will not be liable to the lender for a default under that loan even if the loan is nonpurchase money (and is otherwise recourse). [See *Cornelison v. Kornbluth* (1975) 15 C3d 590, 597-598, 125 CR 557, 561-562—nonassuming grantee not personally liable]

b. [6:328] **Disadvantages for buyer:** On the other hand, the following considerations may make it less desirable for buyers to take subject to existing financing:

(1) [6:329] **Acceleration under due-on-sale clause:** If there is a due-on-sale provision in the existing loan, the lender will have the right to call a default and *accelerate the loan* by reason of the sale. (*See ¶ 6:388 ff.*)

(2) [6:330] **No usury protection:** A purchaser of property that is subject to an existing usurious loan may not raise a claim of usury because the purchaser has not assumed the loan and is therefore not privy to the usurious transaction. [*Ames v. Occidental Life Ins. Co.* (1930) 210 C 271, 273, 291 P 182, 183; *see ¶ 6:298.4*]

c. [6:331] **Disadvantages for seller:** Sellers may be reluctant to agree to a sale subject to existing financing because, without an assumption, the seller is not exonerated from the debt; and, if the loan is nonpurchase money (and is otherwise recourse), the seller will remain personally liable for the loan obligation notwithstanding the sale.

[6:332 - 6:334] ***Reserved.***

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Cal. Prac. Guide Real Prop. Trans. Ch. 6-H

California Practice Guide: Real Property Transactions | September 2024 Update
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Chapter 6. Financing and Appraisals

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[6:335] The borrower's obligations under the promissory note are almost always secured by the property purchased with the loan proceeds.

(Even if the note is secured by property other than (or in addition to) the purchased real property, legal issues pertaining to the lender's security interest will generally be the same.)

1. [6:336] **Deed of Trust:** In California, the instrument that is used to secure a promissory note given for a real property loan is almost invariably a deed of trust. It effectively gives the creditor (lender) a lien on the secured property (also referred to as the collateral) to satisfy the obligation under the note if it is not paid. [*Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1235, 44 CR2d 352, 357]

FORMS

- Deed of Trust (Simple), *see Form 6:H*.

- Deed of Trust (Complex), *see Form 6:I*.

a. [6:337] **Mortgage compared:** A promissory note also can be secured by a “mortgage” on the property that, like a deed of trust, gives the creditor a lien on the security (the real property collateral) to satisfy the borrower's obligation. [See Civ.C. §§ 2920, 2947—any interest in real property capable of being transferred may be mortgaged; *Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1235, 44 CR2d 352, 357]

Technically, mortgages operate by placing a lien on real property, while deeds of trust operate by passing title from the trustor to the trustee until the debt is paid or the property is sold following default. In practical effect, however, the instruments function the same. [See *Bailey v. Citibank, N.A.* (2021) 66 CA5th 335, 352-353, 280 CR3d 546, 560—title conveyed by trust deed is for security purposes only and confers no possessory interest in property; *Robin v. Crowell* (2020) 55 CA5th 727, 742-744, 270 CR3d 25, 34-36—because trust deeds function as lien on property, Civ.C. § 2911 lien extinguishment (¶ 3:299 ff.) applies and therefore bars beneficiaries from bringing judicial foreclosure action once statute of limitations expires (¶ 6:515.2); *Jenkins v. JP Morgan Chase Bank, N.A.* (2013) 216 CA4th 497, 518, 156 CR3d 912,

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929-930, fn. 2 (disapproved on other grounds by *Yvanova v. New Century Mortg. Corp.* (2016) 62 C4th 919, 939, 199 CR3d 66, 82, fn. 13)—there is "little practical difference" between mortgages and trust deeds since they perform same basic function and trust deeds are "only a mortgage with power of sale"]

(1) [6:337.1] **Remedies:** Deeds of trust traditionally have been the preferred security instrument in real property loan transactions because, among other things, they are thought to provide the lender with broader remedies upon the borrower's default. Under a deed of trust, the lender has the remedy of nonjudicial foreclosure, by way of a "private power of sale" (*see ¶ 6:514 ff.*). According to dictum in at least one case, that remedy is not available under a mortgage (*but see ¶ 6:337.2*). [*Ung v. Koehler* (2005) 135 CA4th 186, 192, 37 CR3d 311, 314—aside from availability of nonjudicial foreclosure remedy, trust deeds have same legal effect as traditional mortgages and thus are often characterized as "mortgages with power of sale"]

(a) [6:337.2] **Comment:** Notwithstanding the *Ung* decision (¶ 6:337.1), it is clear mortgagees as well as trust deed beneficiaries may have at their disposal the remedy of nonjudicial foreclosure by way of a "private power of sale." The main distinction is that a *mortgagee's assignee* must *record* the assignment prior to exercising a power of sale. [See Civ.C. §§ 2932 (power of sale may be conferred by mortgage on mortgagee), 2932.5 (power of sale may be exercised by mortgagee's assignee if assignment is duly acknowledged and recorded) & 2924 (power of sale foreclosure provision explicitly references mortgages); *Rossberg v. Bank of America, N.A.* (2013) 219 CA4th 1481, 1498, 162 CR3d 525, 538 (noting § 2932.5 recordation requirement re assignments applies only to mortgages, not trust deeds); *Orcilla v. Big Sur, Inc.* (2016) 244 CA4th 982, 1003, 198 CR3d 715, 732 (same)]

(2) [6:337.3] **Parties:** One significant difference between the two security devices endures: Because a trustee conducts the private nonjudicial foreclosure sale, there are three parties to a deed of trust (*¶ 6:338 ff.*), whereas a mortgage involves only two parties (the lender and borrower). [See *Robin v. Crowell* (2020) 55 CA5th 727, 742, 270 CR3d 25, 34; *Jenkins v. JP Morgan Chase Bank, N.A.* (2013) 216 CA4th 497, 518, 156 CR3d 912, 930 (disapproved on other grounds by *Yvanova v. New Century Mortg. Corp.* (2016) 62 C4th 919, 939, 199 CR3d 66, 82, fn. 13)]

(3) [6:337.4] **"Cal-Vet" mortgages:** Under the "Cal-Vet" program (Mil. & Vet.C. § 987.50 et seq.), eligible California veterans can purchase a home with a special low-interest loan from the Department of Veterans Affairs. The Department takes title to the home the veteran seeks to buy, and the veteran enters into a long-term installment contract with the Department. [See *Department of Veterans Affairs v. Duerksen* (1982) 138 CA3d 149, 151-152, 187 CR 832, 833-834; *Fountain Valley Chateau Blanc Homeowner's Ass'n v. Department of Veterans Affairs* (1998) 67 CA4th 743, 756-757, 79 CR2d 248, 257-258]

(a) [6:337.5] **Forfeiture upon default:** Cal-Vet loans are enforced by *forfeiture* rather than foreclosure: If the buyer fails to comply with any of the contract terms, the Department may cancel the contract and take possession of the property. The buyer's payments made up to that time are "deemed to be rental paid for occupancy." [See Mil. & Vet.C. § 987.77; *Fountain Valley Chateau Blanc Homeowner's Ass'n v. Department of Veterans Affairs* (1998) 67 CA4th 743, 757, 79 CR2d 248, 257]

(b) [6:337.6] **Department treated as lender:** Although the Department holds title to the home until the purchase price is fully paid, a Cal-Vet sales contract is essentially a *mortgage* (see Civ.C. § 2920—any security device other than a deed of trust that confers a power of sale is a mortgage for purposes of default). The Department "clearly acts as a *lender*, as distinct from owner … The veteran retains control and actual possession of the property; [they have] all the indicia of ownership except legal title." [*Fountain Valley Chateau Blanc Homeowner's Ass'n v. Department of Veterans Affairs* (1998) 67 CA4th 743, 757, 79 CR2d 248, 257 (emphasis added)—as lender (not an owner), Department of Veterans Affairs not bound by CC&Rs nor liable for borrower's CC&R violations]

b. [6:338] **Parties to deed of trust:** A deed of trust creates a triparty relationship between the trustor, trustee and beneficiary. [See *Yvanova v. New Century Mortg. Corp.* (2016) 62 C4th 919, 926, 199 CR3d 66, 72; *Vien-Phuong Thi Ho v. ReconTrust Co., N.A.* (9th Cir. 2016) 858 F3d 568, 570; *Aviel v. Ng* (2008) 161 CA4th 809, 816, 74 CR3d 200, 205]

(1) [6:339] **Trustor:** The "trustor" is the owner of the real property estate that is pledged.

(a) [6:340] **Not necessarily borrower:** The trustor is not necessarily the borrower under the promissory note. If another party pledges property as security for the borrower's obligations, that third party is the trustor.

(b) [6:341] **Transfer of title:** A trustor under a deed of trust technically conveys title to its interest in the secured property to the trustee. But the transfer is for security purposes only; the trustor still retains all the rights and benefits of ownership and, indeed, can convey title to the property *subject to* the lien of the deed of trust. [*Lupertino v. Carbahal*

(1973) 35 CA3d 742, 748, 111 CR 112, 115-116; *Aviel v. Ng* (2008) 161 CA4th 809, 816, 74 CR3d 200, 205; see also *Bailey v. Citibank, N.A.* (2021) 66 CA5th 335, 356, 280 CR3d 546, 563—party claiming adverse possession of property encumbered by pre-existing trust deed could, at most, acquire title subject to prior trust deed]

➪ [6:341.1] ***PRACTICE POINTER:*** Lender's counsel should make sure the trustor holds a fee simple estate in the real property security. Otherwise, holders of competing interests may impede the lender's efforts to realize on its security. For example, a bank that loaned against a widow's life estate had no interest in the underlying property following her death, making it impossible for the bank to foreclose and collect its loan. [See *Peterson v. Wells Fargo Bank, N.A.* (2015) 236 CA4th 844, 186 CR3d 842 (*discussed further at ¶ 4:92.7*)]

(2) Trustee

(a) [6:342] **Limited function and powers:** The trustee holds legal title to the secured real property interest, but only so far as necessary to carry out the trustee's duties—i.e., to the extent necessary to conduct a *nonjudicial foreclosure sale* and convey title to the successful bidder in the event of the borrower's default. [*Lupertino v. Carbahal* (1973) 35 CA3d 742, 748, 111 CR 112, 115; see also *Shuster v. BAC Home Loans Servicing, LP* (2012) 211 CA4th 505, 511, 149 CR3d 749, 753—trustee carries no incidents of property ownership other than right to convey upon default; *Heritage Oaks Partners v. First American Title Ins. Co.* (2007) 155 CA4th 339, 345, 66 CR3d 510, 514-515—trustee's duties do not extend beyond those specified in trust deed and statutes]

The trustee under a deed of trust is not a true "trustee" and owes no fiduciary obligations. The trustee has no functions other than (i) upon a default, to enforce the lender's nonjudicial (private power of sale) foreclosure rights; or (ii) upon satisfaction of the secured obligation, to execute and record a reconveyance (¶ 6:406 ff.). [*Yvanova v. New Century Mortg. Corp.* (2016) 62 C4th 919, 927, 199 CR3d 66, 72; see also *Citrus El Dorado, LLC v. Chicago Title Co.* (2019) 32 CA5th 943, 948, 244 CR3d 372, 376-377—trustee has no fiduciary duty to trustor or beneficiary; *Kalnoki v. First American Trustee Servicing Solutions, LLC* (2017) 8 CA5th 23, 40, 214 CR3d 292, 305 (same); *In re Cedano* (9th Cir. BAP 2012) 470 BR 522, 534-535 (applying Calif. law)—debtor's professional negligence claim against trustee properly dismissed because trustee fully satisfied its duties by taking all steps necessary to foreclose on trust deed]

Thus, the trustee's powers and duties under a deed of trust are far different from those conferred by law upon trustees under an express trust.

(b) [6:343] **Dual agent:** The trustee acts at the direction of the beneficiary when the beneficiary elects to commence a nonjudicial foreclosure. Nonetheless, within the scope of its functions, the trustee is a common agent for *both* the *trustor and beneficiary*. [*Lupertino v. Carbahal* (1973) 35 CA3d 742, 747, 111 CR 112, 115; *Heritage Oaks Partners v. First American Title Ins. Co.* (2007) 155 CA4th 339, 345, 66 CR3d 510, 514; *Vournas v. Fidelity Nat'l Title Ins. Co.* (1999) 73 CA4th 668, 677, 86 CR2d 490, 496-497; see also *Citrus El Dorado, LLC v. Chicago Title Co.* (2019) 32 CA5th 943, 948, 244 CR3d 372, 376—trustee "acts merely" as trustor's/beneficiary's common, passive agent for limited purpose of foreclosing after default or reconveying property upon satisfaction of debt]

(c) [6:344] **Substitution of trustees:** Even though a party to the deed of trust, the trustee is not required to execute or otherwise accept the deed of trust. However, if the trustee refuses to act, or cannot act due to resignation, incapacity, disability, absence or death, the beneficiaries or their authorized agents must appoint a new or successor trustee. [See Civ.C. § 2934a(d)(2)(C); *and ¶ 6:405 ff.*]

(d) [6:344.1] **Failure to initially designate trustee no bar to enforcement of deed of trust:** Because of the trustee's limited role (*¶ 6:342*), it is unnecessary to name any particular entity as trustee when a deed of trust is created. Indeed, the naming of the trustee is irrelevant to the creation of a deed of trust *so long as a trustee is named prior to foreclosure:* "Although an issue of first impression in California, the weight of authority from other jurisdictions supports the … conclusion that the omission of a trustee does not prevent enforcement of the deed of trust." [*Shuster v. BAC Home Loans Servicing, LP* (2012) 211 CA4th 505, 507-508, 510-511, 149 CR3d 749, 751, 753-754—failure to designate trustee does not transform instrument into mortgage; see also Civ.C. § 2934a(d)(2)(C)—if trust deed does not designate trustee, beneficiaries or their agents must appoint one]

(3) [6:345] **Beneficiary:** The beneficiary is the obligee of the obligation secured by the deed of trust—i.e., the lender. (Although the trustor might be different from the obligor of the secured obligation (*¶ 6:340*), the beneficiary is always the obligee of the secured obligation.)

(a) [6:346] **Signature:** The beneficiary typically does not sign the deed of trust. However, if the beneficiary has specific obligations under a deed of trust, the trustor may find it advisable to require the beneficiary's signature (as where, e.g., the beneficiary is obligated to subordinate its lien (*¶ 6:450 ff.*) or to partially reconvey the deed of trust (*¶ 6:409 ff.*), or where the beneficiary has obligations under an all-inclusive deed of trust (*¶ 6:73 ff.*)).

Comment: The beneficiary's *acceptance* of the deed of trust should be sufficient to bind the beneficiary to its obligations thereunder regardless of whether it actually executes the document.

[6:347 - 6:349] ***Reserved.***

c. [6:350] **Required formalities; recordation:** Like any other conveyancing instrument (*see Ch. 4*), the validity of a deed of trust turns on compliance with certain minimum requirements: A deed of trust may be created, renewed or extended only by a *writing* "executed with the formalities required in the case of a grant of real property." [Civ.C. § 2922; see *Granadino v. Wells Fargo Bank, N.A.* (2015) 236 CA4th 411, 416, 186 CR3d 408, 412; *Jones v. Wachovia Bank* (2014) 230 CA4th 935, 943, 179 CR3d 21, 27]

Thus, the *trustor must execute* the trust deed instrument and *deliver it to the beneficiary*. Moreover, the instrument must *adequately describe the parties* and the *encumbered property*. [See *MTC Fin'l Inc. v. California Dept. of Tax & Fee Admin.* (2019) 41 CA5th 742, 745, 747, 751-752, 254 CR3d 485, 488-489, 493—trust deed that excluded property's city and county and contained inaccurate lot and page book numbers did not describe encumbered land sufficiently to enforce lien priority]

The deed of trust also must be *recorded* in order to perfect the priority of the beneficiary's lien, etc. [See *RNT Holdings, LLC v. United Gen. Title Ins. Co.* (2014) 230 CA4th 1289, 1296, 179 CR3d 175, 181—although not usually required for proving trust deed's validity, recordation affects deed's potential efficacy re subsequent BFPs; *Azadozy v. Nikoghosian* (2005) 128 CA4th 1369, 1374-1375, 27 CR3d 811, 815—priority given only to bona fide purchaser or encumbrancer who first duly records instrument creating interest; compare *First Bank v. East West Bank* (2011) 199 CA4th 1309, 1311, 132 CR3d 267, 269 (distinguishing *recordation,* which establishes priority, from *indexing*, which provides constructive notice) —lenders' trust deeds secured by same property, executed on same day and "simultaneously time-stamped for recording" pursuant to standard practice given equal priority even though indexed at different times (¶ 6:408.4a); *MTC Fin'l, Inc. v. Nationstar Mortgage, LLC* (2018) 19 CA5th 811, 815-816, 228 CR3d 238, 240-241—parties' intent, *not* recorder's random act of indexing, controlled lien priority of 2 trust deeds created and submitted for recordation simultaneously, but indexed in reverse order]

d. [6:351] **Title insurance company/commercial trustee form deeds of trust:** Most major title insurance companies, as well as other commercial trustee enterprises, publish form deeds of trust naming the title insurance company/commercial trustee entity (or an affiliated entity) as trustee. (The motivation, of course, is to position the company for additional business through the handling of foreclosures and reconveyances.)

Although necessarily generic, these form deeds of trust are usually more than adequate for simple secured real estate transactions; indeed their use offers two principal advantages:

• [6:352] *Court tested:* The forms are court-tested security instruments which sufficiently cover the most important aspects of simple financing transactions (and many complex transactions as well).

• [6:353] *Cost-saving:* The client will save attorney fees by using an acceptable, preprinted form.

e. Basic provisions of deed of trust

(1) [6:354] **Grant:** The deed of trust must contain a grant to the trustee, in trust, with a power of sale (i.e., right to conduct a nonjudicial foreclosure sale).

(a) [6:355] **Not necessarily fee interest:** A deed of trust can pledge almost any estate in real property. Therefore, the trustor might be granting something other than a fee interest—such as a *leasehold* estate. (*See ¶ 7:390 ff.* re financing of ground leases.)

(b) [6:355.1] **After-acquired property:** The secured interest might be described broadly enough to extend to interests in the underlying property acquired by the trustor *after* execution of the deed of trust. Indeed, "it is well settled that a trust deed creates a valid lien on real property to secure a debt for which it is executed, even though the trustor has no title to the property at the time of the execution of the instrument, provided he subsequently acquires title thereto during the life of the deed of trust. Title to real property acquired after it is mortgaged is deemed to be covered by the lien on

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the theory that the mortgagor is estopped from denying title under such circumstances." [*RNT Holdings, LLC v. United Gen. Title Ins. Co.* (2014) 230 CA4th 1289, 1296, 179 CR3d 175, 181—trustor who executed trust deed before closing estopped from denying lien's validity]

For example, a deed of trust expressly stating that it includes, together with the legal description of the property, "all the improvements now or hereafter erected on the property, and all easements, rights, appurtenances … and all fixtures now or hereafter a part of the property …" operates *automatically* to add easements, fixtures and additions to the secured property obtained after the deed was provided to the lender; it is immaterial whether those additions are recorded. [*Hellweg v. Cassidy* (1998) 61 CA4th 806, 809-810, 71 CR2d 798, 800—trust deed encumbered property subsequently added by lot line adjustment]

(2) [6:356] **Obligations secured:** There must be a clear description of the obligations secured by the deed of trust.

The obligation most often secured in connection with a real property sales transaction is payment of a promissory note. However, the lender may additionally want security for the performance of a contract, such as a loan agreement (*¶ 6:180 ff.*); in that event, the deed of trust usually secures both the promissory note and the borrower's obligations under the contract. [See *Dieckmeyer v. Redevelopment Agency of City of Huntington Beach* (2005) 127 CA4th 248, 258, 24 CR3d 895, 903—deed of trust secured promissory note as well as borrower's performance of CC&Rs recorded against secured property and loan agreement]

(a) [6:357] **Description by reference to secured document(s) suffices:** A detailed description of the terms and conditions of the secured obligations is not required; identification of the nature and character of the debt suffices. [See *W.P. Fuller & Co. v. McClure* (1920) 48 CA 185, 193-194, 191 P 1027, 1031]

Thus, e.g., the deed of trust may simply identify the *document(s)* evidencing the secured obligation—preferably, including the date thereof and the parties thereto. (However, a deed of trust can also secure an oral agreement.)

(b) [6:358] **Future/additional advances:** Many deeds of trust include a provision stating any future, additional loan or advance made to the trustor (or borrower) by the lender will be secured by the deed of trust ("future (or additional) advance" clauses).

1) [6:359] **Validity:** California law permits the granting of security for performance of obligations not then in existence (Civ.C. § 2884); however, such provision may be held unenforceable if overly broad or ambiguous or if the obligor was not made reasonably aware of the provision. An important consideration is whether the future/additional obligations are reasonably related to the primary obligation. [See *Bear Creek Master Ass'n v. Southern California Investors, Inc.* (2018) 28 CA5th 809, 819-821, 239 CR3d 547, 555-557—recorded instrument that created "inchoate claim of lien" to secure future advances for golf course maintenance did not impart constructive notice of actual, immediately effective lien and thus did not relate back to recorded instrument's date; compare *Wong v. Beneficial Sav. & Loan Ass'n* (1976) 56 CA3d 286, 294-296, 128 CR 338, 343-344 (dealing with "dragnet clauses," ¶ 6:360 ff.)]

(c) [6:360] **"Dragnet clauses":** A "dragnet" (or "anaconda") clause is similar in effect to a future/additional advance clause. It purports to include within the secured debt *any and all* obligations of the borrower to the lender, whether then existing or arising in the future, and whether a loan, an advance or a nonmonetary obligation. [*Fischer v. First Int'l Bank* (2003) 109 CA4th 1433, 1444, 1 CR3d 162, 168-169]

1) [6:361] **Narrowly construed:** Dragnet clauses generally are upheld. However, because of the breadth of their apparent coverage and because the trustor (borrower) often is unaware of their implications, courts tend to narrowly construe them against the lender. [See *Fischer v. First Int'l Bank* (2003) 109 CA4th 1433, 1444, 1 CR3d 162, 169; *Wong v. Beneficial Sav. & Loan Ass'n* (1976) 56 CA3d 286, 294-296, 128 CR 338, 343-344]

2) [6:361.1] **Varying approaches to application and validity:** Courts in different jurisdictions have adopted widely divergent approaches in considering the application and validity of broadly-worded dragnet clauses. [See *Fischer v. First Int'l Bank* (2003) 109 CA4th 1433, 1444-1445, 1 CR3d 162, 169 (surveying jurisdictional approaches and collecting cases)]

At one extreme, dragnet clauses will be applied to other debts only if those debts are explicitly described in the security agreement. [See *Wong v. Beneficial Sav. & Loan Ass'n* (1976) 56 CA3d 286, 293-294, 128 CR 338, 342-343 (citing out-of-state cases)]

At the other extreme, generally-worded dragnet clauses are viewed literally as conclusive evidence of the parties' intent that the clause encompass all other debts. These courts reason that the parties could have limited the scope

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of the clause had they truly intended to do so. [See *Fischer v. First Int'l Bank*, supra, 109 CA4th at 1444-1445, 1 CR3d at 169 (citing out-of-state cases)]

3) [6:361.2] **California approach—parties' actual expectations control:** California courts take an intermediate position, looking more to "the *actual expectations of the parties* … than the literal wording of the boilerplate clause." [*Fischer v. First Int'l Bank* (2003) 109 CA4th 1433, 1445, 1 CR3d 162, 170 (emphasis added; internal quotes omitted)]

The parties' actual expectations are tested *objectively*. [*Fischer v. First Int'l Bank*, supra, 109 CA4th at 1445, 1 CR3d at 170]

a) [6:361.3] **Impact of trust deed being contract of adhesion:** Dragnet clauses are commonly contained in preprinted (boilerplate) standard bank form deeds of trust and as such are deemed part of a contract of adhesion. [*Lomanto v. Bank of America* (1972) 22 CA3d 663, 668, 99 CR 442, 444]

The California approach to the application of dragnet clauses (looking to the parties' actual expectations) is consistent with the law regarding the enforceability of adhesion contracts generally: A provision contained in a contract of adhesion is not enforceable if it does not fall within the reasonable expectations of the weaker or "adhering" party (in this case, the borrower). [See *Fischer v. First Int'l Bank* (2003) 109 CA4th 1433, 1445-1446, 1 CR3d 162, 170]

b) [6:361.4] **Proponent's burden:** The proponent of a dragnet clause bears the burden of establishing that the parties intended all of the subject loans to be within its scope. [*Fischer v. First Int'l Bank* (2003) 109 CA4th 1433, 1445, 1 CR3d 162, 170]

c) [6:361.5] **Relevant factors:** California courts have examined several factors in determining whether a broadly-worded dragnet clause was mutually intended to cover preexisting, contemporaneous and/or after-acquired debts. [See *Fischer v. First Int'l Bank* (2003) 109 CA4th 1433, 1446, 1 CR3d 162, 170-171]

Of all the relevant factors, however, two (¶ 6:361.6 ff.) are commonly given the greatest weight when the instrument does not expressly set forth the parties' intent. [See *Wong v. Beneficial Sav. & Loan Ass'n* (1976) 56 CA3d 286, 295-297, 128 CR 338, 343-345]

1/ [6:361.6] **"Relationship of the loans" test:** This approach examines the relationship between the subject loans. If there is little or no connection between the loans, or they are entirely different in nature, it can fairly be concluded that the parties did *not intend* the other loan to be covered by the security (trust deed) given for the primary loan. [*Wong v. Beneficial Sav. & Loan Ass'n* (1976) 56 CA3d 286, 295-296, 128 CR 338, 343-344]

2/ [6:361.7] **"Reliance on the security" test:** This test (or factor) considers whether the lender relied upon the dragnet clause as security for the other loan.

When *different security* is taken for the other loan, it cannot be inferred that the parties relied on the security for the primary loan, creating a strong inference the parties did not mutually intend cross-collateralization. [*Wong v. Beneficial Sav. & Loan Ass'n* (1976) 56 CA3d 286, 296, 128 CR 338, 344; *Fischer v. First Int'l Bank* (2003) 109 CA4th 1433, 1448-1449, 1 CR3d 162, 172-173—triable issue of fact whether dragnet clause brought separately-secured take-out loan within second deed of trust on borrowers' residence securing equipment loan]

d) [6:361.8] **Effect of conflicting provisions in related documents:** At least where the trust deed incorporates by reference related loan documents (promissory note, loan agreement, loan commitment, etc.), courts will also look to those additional documents in determining the scope and application of a dragnet clause. [See *Fischer v. First Int'l Bank* (2003) 109 CA4th 1433, 1447-1448, 1 CR3d 162, 172]

Any ambiguity between the dragnet provision in the trust deed itself and another provision in the related documents covering the same subject matter will be construed *against* application of the dragnet clause absent other evidence of the parties' intent. [*Fischer v. First Int'l Bank*, supra, 109 CA4th at 1448, 1 CR3d at 172—related loan agreement specifically addressed subject of collateral but did not mention cross-collateralization, suggesting trust deed's dragnet clause did not operate to bring separately-secured loan within its scope]

[6:361.9 - 6:361.14] ***Reserved.***

4) [6:361.15] **Compare—dragnet clause expressly conditioned on specified events:** It is not necessary to resort to extrinsic evidence or objective "tests" when the terms of the dragnet clause expressly state how or when it will apply (or become "activated").

For example, a dragnet clause in a 1983 trust deed "simply [had] no application" to cause a merger with a subsequent (1988) trust deed given for a 1988 additional loan where the clause explicitly stated (i) in order for it to apply, a subsequent note must *expressly recite* that it is secured by the 1983 trust deed (which did not occur in this case); and (ii) additional indebtedness would be included under the dragnet clause only at the *lender's (beneficiary's) option* evidenced by a *notice in writing to the borrower (trustor)* (no such notice was ever given in this case). [See *Ostayan v. Serrano Reconveyance Co.* (2000) 77 CA4th 1411, 1421, 92 CR2d 577, 585 (disapproved on other grounds by *Black Sky Capital, LLC v. Cobb* (2019) 7 C5th 156, 165, 246 CR3d 583, 591)—dragnet clause did not cause merger of 1983 and 1988 deeds of trust so as to wipe out bank's senior lien when it foreclosed its junior lien; see also *National Enterprises, Inc. v. Woods* (2001) 94 CA4th 1217, 1228, 115 CR2d 37, 44—no merger of first and second deeds of trust under dragnet clause because contrary to language of loan documents, and lender failed to exercise option to include second debt under first deed of trust]

(d) [6:362] **"Other obligations":** In an effort to buttress the lender's argument that any future obligation of the borrower to the lender is secured by the deed of trust, some deeds of trust include a provision stating the deed of trust will be deemed to secure any "other obligation" of the borrower to the lender *whenever such other obligation specifically provides it is secured by the deed of trust*. [See *Ostayan v. Serrano Reconveyance Co.* (2000) 77 CA4th 1411, 1414, 92 CR2d 577, 579, fn. 2 (disapproved on other grounds by *Black Sky Capital, LLC v. Cobb* (2019) 7 C5th 156, 165, 246 CR3d 583, 591)]

1) [6:363] **Lien priority issues:** Though such a provision might be enforceable as between trustor and beneficiary, the lender may have problems with the priority of its lien (vis-à-vis junior lienholders) in respect to such "other obligations" which are *not specifically described* in the deed of trust.

(e) [6:364] **Nonmonetary obligations—foreclosure problems:** A deed of trust can secure nonmonetary obligations; however, there are several practical problems in foreclosing such a deed of trust:

• [6:365] It is often difficult to convince an institutional trustee (such as a title insurance company) to conduct a nonjudicial foreclosure when the obligation in default is not a definitive monetary amount.

• [6:366] Also, it is difficult to determine the amount the beneficiary may credit bid at the foreclosure sale. (*See ¶ 6:535* re credit bids.)

[6:367 - 6:369] ***Reserved.***

f. Additional provisions

(1) [6:370] **Trustor's standard covenants:** Deeds of trust typically include extensive covenants by the trustor with respect to the encumbered property. The nature and scope of the trustor's covenants are negotiable and will vary with the particular transaction; however, the following covenants are contained in almost every deed of trust (*see Form 6:H*):

(a) [6:371] **Property maintenance:** Trustor must maintain the property in good condition and repair, and neither remove or demolish structures nor commit or suffer waste thereon. [See Civ.C. § 2929]

("Bad faith waste" is actionable following a foreclosure notwithstanding the protections afforded some debtors under the antideficiency statutes; *see ¶ 6:561.5a ff.*)

(b) [6:372] **Compliance with law:** Trustor must at all times keep the property in compliance with the law.

(c) [6:373] **Taxes/assessments:** Trustor must timely pay all property taxes and assessments before delinquency (including any senior encumbrances, charges and other liens).

1) [6:374] **Impounds and limitations:** Lenders sometimes require that the borrower pay the lender a monthly "impound" to cover annual property taxes and insurance premiums (usually paid in equal monthly installments). Impound accounts are, however, subject to statutory limitations:

a) [6:374.1] **No mandatory impounds in residential loan transactions:** Generally, a loan secured by a "single-family, owner-occupied dwelling" (see Civ.C. § 2954(c)) cannot be conditioned on a mandatory impound account for taxes, insurance or other purposes related to the property. Such impounds are strictly *voluntary* absent the borrower's written waiver and, therefore, are also *terminable* by the borrower at any time unless the borrower signed

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a written consent to a mandatory, permanent impound account. [See Civ.C. § 2954(a); *Kirk v. Source One Mortg. Services Corp.* (1996) 46 CA4th 483, 489-490, 54 CR2d 358, 362]

A borrower's consent to impounds is not effective unless the lender first provided the borrower with a written disclosure (in the loan application or otherwise) stating that the establishment of an impound account shall not be required as a condition to execution of the loan agreement and whether interest will be paid on the impounded funds. [Civ.C. § 2954(a)]

1/ [6:374.2] **Exceptions:** Mandatory impounds on a single-family, owner-occupied dwelling secured loan are permitted (i) if required by a state or federal regulatory authority; (ii) if the loan is made, guaranteed or insured by the state or federal government; (iii) upon the borrower's failure to pay two consecutive tax installments before the delinquency date; (iv) where the original principal amount of the loan is 90% or more of the purchase price (or appraised value of the underlying security); (v) whenever the combined principal amount of all loans secured by the property exceeds 80% of the appraised value; (vi) where the loan is made in compliance with Regulation Z requirements for higher priced mortgage loans (regardless of whether it is a higher priced mortgage loan); *or* (vii) where the loan is refinanced or modified under a lender's homeownership preservation program or by the lender's participation in such a program sponsored by a nonprofit organization or the federal, state or local government. [See Civ.C. § 2954(a) (defining “Regulation Z” for purposes of this statute)]

b) [6:374.3] **Investment of impounded funds:** There are statutory restrictions on where a trust deed beneficiary may invest funds held as impounds for taxes, assessments or insurance premiums. [See Civ.C. § 2955]

c) [6:374.4] **Interest credit to borrower (residential loans):** The borrower must be credited for a minimum amount of interest on property taxes, assessments and insurance impounds for residential loans. [See Civ.C. § 2954.8—minimum 2% simple interest per annum]

The credited interest requirement (above) is equally binding on state and federally chartered banks. [See *Lusnak v. Bank of America, N.A.* (9th Cir. 2018) 883 F3d 1185, 1197-1198 (finding National Banking Act does *not* preempt Civ.C. § 2954.8)—borrower could bring state law action against national bank for refusing to pay interest on impound accounts]

1/ [6:374.5] **Hazard insurance proceeds distinguished:** Section 2954.8 (¶ 6:374.4) does not require the lender to pay interest on hazard insurance *proceeds* that are held in escrow (e.g., to allow rebuilding following destruction of the mortgagor's residence). [See *Gray v. Quicken Loans, Inc.* (2021) 61 CA5th 524, 528-529, 275 CR3d 787, 790—Civ.C. § 2954.8 mandates interest payments on impounds collected by mortgage lenders in advance, but not on insurance proceeds paid in arrears for past losses]

(d) [6:375] **Defense of legal proceedings:** Trustor must appear in and defend actions or proceedings purporting to affect the secured property or the deed of trust.

(e) [6:376] **Liens:** Trustor must keep the property free from mechanic's and other liens. (Sometimes the lender will prohibit junior financing; *see ¶ 6:397 ff.* re “due-on-encumbrance” provisions.)

(f) [6:377] **Hazard insurance:** Trustor must provide hazard insurance (with loss payable to beneficiary) in an amount and on coverage and other terms satisfactory to the beneficiary.

1) [6:377.1] **Impounds for insurance premiums:** *See ¶ 6:374 ff.*

2) [6:378] **Replacement value coverage:** Lenders typically require coverage for the full replacement value of the improvements.

a) [6:378.1] **Statutory replacement value limit:** Civ.C. § 2955.5 prohibits lenders from requiring borrowers, as a condition of receiving or maintaining a loan secured by real property, to provide hazard insurance coverage “in an amount exceeding the replacement value of the improvements of the property.” [Civ.C. § 2955.5(a)]

Lenders must disclose this limitation, in writing, to borrowers “as soon as practicable” but, in any event, before execution of any note or security documents. [Civ.C. § 2955.5(b)]

Anyone harmed by a violation of Civ.C. § 2955.5 is entitled to obtain injunctive relief and “may recover” damages and reasonable attorney fees and costs. [Civ.C. § 2955.5(c)] But a violation of the statute does not affect the validity of the secured loan. [Civ.C. § 2955.5(d)]

3) [6:379] **Noncancelable:** The required insurance policies usually must be noncancelable, except upon prior written notice to the lender.

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4) [6:380] **Insurance proceeds:** In addition, the lender will require strict controls over use of insurance proceeds: e.g., how insurance proceeds are to be used to rebuild the property; how insurance claims can be compromised and adjusted; and how insurance proceeds will be impounded during the period of reconstruction.

a) [6:381] **Lender's right to control disbursement of insurance proceeds:** Generally, provisions in a deed of trust authorizing the lender to receive and control disbursement of hazard insurance proceeds are enforceable "whether or not impairment of the security interest in the property has resulted from the event that caused the proceeds of the insurance policy to become payable." [Civ.C. § 2924.7; see *JEM Enterprises v. Washington Mut. Bank* (2002) 99 CA4th 638, 644-646, 121 CR2d 458, 462-474—under assignment provision in deed of trust, lender entitled to use earthquake damage insurance proceeds to repair secured property, apply funds to secured debt, or release funds to owner]

1/ [6:381.1] **Effect of conditional promise to name lender as loss payee:** The same result obtains where the deed of trust (or other loan documents) does not mandate the procurement of hazard insurance for the lender's benefit but simply states that *if* the borrower obtains it the lender will be named as loss payee and have the right to control disbursement of the proceeds. [*Martin v. World Sav. & Loan Ass'n* (2001) 92 CA4th 803, 809, 112 CR2d 225, 229-230—trustor's conditional promise to assign right to earthquake insurance proceeds to lender did not require consideration separate from loan itself]

2/ [6:381.2] **Compare—where loan documents neither require insurance nor give lender rights in proceeds:** On the other hand, the lender has no right to collect or control the insurance proceeds where the loan documents neither require the borrower to obtain the coverage for which the proceeds are paid nor give the lender an interest in or authority over policy proceeds if the borrower elects to obtain that (or any other) coverage. [*Foothill Village Homeowners Ass'n v. Bishop* (1999) 68 CA4th 1364, 1377-1378, 81 CR2d 195, 204; *Ziello v. Sup.Ct. (First Fed'l Bank of Calif.)* (1995) 36 CA4th 321, 324, 42 CR2d 251, 252-253—lender had no interest in earthquake insurance proceeds since deed of trust did not require insurance against earthquake damage as condition for loan, did not assign proceeds to lender and did not give lender right to share, control or direct proceeds]

3/ [6:381.3] **Effect of loss payable endorsement:** As between *lender and borrower*, the lender's rights in and to hazard insurance proceeds are defined by the loan documents (or any assignments thereunder). The lender has no greater rights even if it is *mistakenly named by the insurer as loss payee* on the policy. The policy's loss payable endorsement defines only the *insurer's* obligation; it does not conclusively determine the lender's entitlement to the proceeds. [*Ziello v. Sup.Ct. (First Fed'l Bank of Calif.)* (1995) 36 CA4th 321, 329-330, 42 CR2d 251, 256; compare *Home Sav. of America, F.S.B. v. Continental Ins. Co.* (2001) 87 CA4th 835, 854, 104 CR2d 790, 803—where lender did not require borrower to obtain loss payable insurance but borrower voluntarily obtained policy containing "standard" mortgagee loss payable clause, lender entitled to loss proceeds since subject clause created separate, independent contract between insurer and lender]

[6:381.4] ***Reserved.***

4/ [6:381.5] **Compare—lender's rights *after full credit bid foreclosure:*** A lender who acquires the secured property by "full credit bid" (*¶ 6:535.1*) ordinarily is not entitled to insurance proceeds payable for prepurchase damage to the security. Rationale: The lender's only interest in the property (repayment of its loan) is deemed satisfied and any further payment would result in a double recovery. [*Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1238-1239, 44 CR2d 352, 359; see also *Washington Mut. Bank v. Jacoby* (2009) 180 CA4th 639, 646, 103 CR3d 245, 250]

But in narrow circumstances, the lender *may* have a right to share in common fund insurance proceeds in its capacity as unit *owner* in a common interest development; *see ¶ 6:535.6a*.

b) [6:382] **Limitations on application of proceeds toward loan:** Although the deed of trust often authorizes the lender to apply insurance proceeds toward reduction of amounts due under the loan, the lender's right to do so is subject to the implied covenant of good faith and fair dealing. [*Schoolcraft v. Ross* (1978) 81 CA3d 75, 80, 146 CR 57, 59]

1/ [6:383] **Not allowed if security unimpaired:** The implied covenant of good faith and fair dealing obliges the lender to allow the borrower to use insurance proceeds to rebuild any damaged improvements "unless [the

lender] can show that his security is impaired" (i.e., borrower is unwilling or unable to continue making the loan payments and the market value of the secured property does not adequately secure the borrower's obligation). [*Schoolcraft v. Ross* (1978) 81 CA3d 75, 80-81, 146 CR 57, 59-60]

2/ [6:384] **Compare—defaults:** However, if the borrower is in default, the lender may apply all insurance proceeds to the loan. [*Ford v. Manufacturers Hanover Mortgage Corp.* (9th Cir. 1987) 831 F2d 1520, 1524-1525]

Here, it is immaterial whether the market value of the trust deed property still adequately secures the borrower's obligation. Regardless of the value of the property, the purpose of the deed of trust would be defeated if the borrower were allowed to rely on the insured casualty loss to cure the borrower's default and deprive the lender of its contractual right to foreclose at any time; the implied covenant of good faith and fair dealing will not be applied to significantly prejudice the lender's express contractual rights under the trust deed. [*Ford v. Manufacturers Hanover Mortgage Corp.*, supra, 831 F2d at 1524-1525—where borrower in default, lender's security deemed impaired "as a matter of law"]

(g) [6:385] **Payment of advances:** Trustor must pay all sums advanced by beneficiary or trustee pursuant to the deed of trust or the obligations secured.

(h) [6:386] **Other covenants:** Various additional covenants might appear in other loan documents secured by the deed of trust. For example, a loan agreement might require the borrower to maintain a certain minimum net worth or liquidity, or to periodically deliver certain financial and other information to the lender.

(2) [6:387] **Disposition of condemnation proceeds:** The beneficiary of a deed of trust has a sufficient ownership interest in the secured property to be entitled to a portion of any condemnation proceeds in an amount equivalent to the impairment of its security interest. [See CCP § 1265.225—lienholder may share in condemnation award "only to the extent determined by the court to be necessary to prevent an impairment of the security"; *D & M Fin'l Corp. v. City of Long Beach* (2006) 136 CA4th 165, 176-177, 38 CR3d 562, 568-569 (inverse condemnation action)]

The beneficiary's disposition of any condemnation proceeds is at its discretion, subject to limitations similar to those relating to the use of insurance proceeds—including the implied covenant of good faith and fair dealing (*¶ 6:380 ff.*). [See *Milstein v. Security Pac. Nat'l Bank* (1972) 27 CA3d 482, 486-487, 103 CR 16, 18-19—implied covenant of good faith and fair dealing requires beneficiary to exercise its discretion with respect to condemnation proceeds "in such fashion that it distribute to … borrowers all proceeds in excess of those necessary to recoup any impairment in security caused by the eminent domain proceeding"] Thus, after applying any condemnation proceeds to reduce the amount of its secured indebtedness, as with insurance proceeds, the beneficiary must permit the borrower to use the balance of the proceeds to rebuild.

(a) [6:387.1] **Damaged security; equitable conversion theory:** When a beneficiary's security is damaged (e.g., by flood or fire), the lender is entitled to recover, on an equitable conversion theory, the amount by which its security was damaged from the borrower's tort damages fund (i.e., based on the borrower's recovery of inverse condemnation damages from the third party tortfeasor(s) responsible for the damage). This theory rests on the idea that money awarded by the court as damages to the realty must be treated, in equity, as the land itself. [See *American Sav. & Loan Ass'n v. Leeds* (1968) 68 C2d 611, 614-615, 68 CR 453, 456, fn. 2; *Thoryk v. San Diego Gas & Elec. Co.* (2014) 225 CA4th 386, 407, 170 CR3d 309, 323]

A typical form trust deed grants the lender the right to obtain the borrower's eminent domain or inverse condemnation damages. But, again, such contract rights are limited by statute to the amount necessary to prevent impairment of the lienholder's security (*¶ 6:387*). Moreover, to show entitlement to this "substitute" form of security, the lender must retain a proportional security interest in the real property that is still in force at the relevant times. [See *Thoryk v. San Diego Gas & Elec. Co.*, supra, 225 CA4th at 407-408, 170 CR3d at 323-324—lender who opted to take damaged security through foreclosure under power of sale had no basis to seek proportional equitable conversion damages against borrower's future tort damages fund (*¶ 6:561.2*)]

(3) [6:388] **Due-on-sale provisions:** By a "due-on-sale clause," lenders often reserve the right to *accelerate* all amounts due under the loan if the trustor transfers all or any portion of its interest in the encumbered property.

A due-on-sale clause does not ipso facto make the loan immediately due and payable upon occurrence of the triggering event (sale of the security). It simply gives the lender the *option* of accelerating the debt (in the manner and within the

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time specified in the trust deed) and demanding immediate payment of the balance; the right to accelerate can be waived. [*Fischer v. First Int'l Bank* (2003) 109 CA4th 1433, 1450, 1 CR3d 162, 173, fn. 3]

(a) [6:389] **Purpose:** A due-on-sale clause protects two important concerns of the lender:

1) [6:390] **New buyer's creditworthiness:** The lender originally qualified the borrower based on that borrower's financial condition and the lender is concerned about a new buyer's creditworthiness.

2) [6:391] **Fiscal incentive:** Lenders are in the business of making new loans. Each time a loan is paid off, a lender might receive a prepayment fee; and each time a new loan is made, the lender generates a profit from loan fees and other charges. Thus, it behooves the lender to require the seller to pay off its loan, positioning the lender to make a new loan to the buyer.

Moreover, when the prior loan is accelerated by a sale, the lender may also be in a position to reap the benefit of higher interest rates (either by a new loan to the subsequent buyer or simply by repayment of the outstanding obligation, the proceeds of which will then be available to loan to others perhaps at a more advantageous interest rate).

3) [6:392] **Compare—residential variable rate loans:** Residential variable interest rate loans from institutional lenders usually permit assumption by new buyers. The lender does not necessarily need the protection of a due-on-sale clause to reap the benefit of higher interest rates because the new buyer will be subject to a variable rate that generally moves with the market rate over time.

(Nevertheless, any new buyer will probably be required to meet certain creditworthiness standards and pay a loan assumption fee.)

(b) [6:393] **Validity—federal preemption:** At one time, due-on-sale clauses were deemed unenforceable as an unreasonable restraint on alienation unless the lender could demonstrate enforcement was reasonably necessary to protect against impairment to its security or the risk of default. [*Wellenkamp v. Bank of America* (1978) 21 C3d 943, 953, 148 CR 379, 385-386 (superseded by regulation as stated in *Fidelity Federal Sav. & Loan Ass'n v. de la Cuesta* (1982) 458 US 141, 170, 102 S.Ct. 3014, 3031, fn. 24)—opinion limited to institutional lenders; *Dawn Invest. Co. v. Sup.Ct. (Beck)* (1982) 30 C3d 695, 702, 180 CR 332, 335—same rule applicable to noninstitutional, private lenders]

However, this authority is now *preempted* by federal law. [12 USC § 1701j-3 (Garn-St. Germain Depository Institutions Act of 1982, or "Garn Act")—Federal Home Loan Bank Board's regulations regarding due-on-sale clauses supersede state law] Under this preemptive federal law, due-on-sale clauses are valid *except in limited circumstances*. [See 12 CFR § 591.5(b)(1)]

1) [6:394] **Limited exceptions to validity:** The federal exceptions to enforceable due-on-sales provisions parallel state statutory exceptions (Civ.C. § 2924.6).

A lender may *not* accelerate the principal and accrued interest on a loan secured by a deed of trust on *residential* real property (containing at least one but no more than four housing units) *solely* by reason of any of the following transfers (Civ.C. § 2924.6):

- a transfer resulting from the obligor's death to the obligor's spouse (or registered domestic partner, see Fam.C. § 297.5(c)) who is also an obligor (Civ.C. § 2924.6(a)(1));

- a transfer by an obligor to their spouse (or registered domestic partner, see Fam.C. § 297.5(a)) as co-owner of the property (Civ.C. § 2924.6(a)(2));

- a transfer resulting from judgment of dissolution or legal separation or from a property settlement incident to such judgment that requires the obligor to continue making the loan payments by which a spouse (or registered domestic partner, see Fam.C. §§ 297.5(b), 299(d)) who is an obligor becomes sole owner of the property (Civ.C. § 2924.6(a)(3));

- a transfer by the obligor(s) into an inter vivos trust in which the obligor(s) are beneficiaries (Civ.C. § 2924.6(a)(4)); *or*

- the secured property (or any part of it) is made subject to a junior encumbrance or lien (Civ.C. § 2924.6(a)(5)).

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a) [6:395] **Nonwaivable:** These exceptions to a lender's right of acceleration are *nonwaivable;* and any purported waiver is *void and unenforceable* (contrary to public policy). [Civ.C. § 2924.6(b)]

2) [6:396] **Formalities—residential secured loans:** Further, no due-on-sale-clause under a secured loan on property containing four or fewer residential units (or on property for which four or fewer residential units are to be constructed) is valid *unless* the clause is set forth *in its entirety* in *both* the body of the *deed of trust* and the *promissory note* (or other document evidencing the secured obligation). [Civ.C. § 2924.5]

(4) [6:397] **Due-on-encumbrance provisions:** A "due-on-encumbrance provision" addresses the lender's concern that the borrower might saddle the secured property with too much debt and thereby be unable to pay the loan obligation. Such provision permits the lender to call (accelerate) the loan if the borrower further encumbers the property.

(a) [6:398] **Generally valid:** Like due-on-sale clauses, due-on-encumbrance provisions generally are enforceable, pursuant to the preemptive Garn Act (*¶ 6:393*).

(b) [6:399] **Exception re loans secured by single-family/owner-occupied dwelling:** However, both the Garn Act and California law *prohibit* the enforcement of a due-on-encumbrance clause under a loan secured by a single-family, owner-occupied dwelling (Civ.C. § 2949):

No deed of trust on real property containing *only* a single-family, owner-occupied dwelling may be declared in default, *nor may the maturity date* of the loan secured thereby *be accelerated*, *solely by reason of the owner further encumbering* the secured property (or any portion thereof) with a junior loan. [Civ.C. § 2949(a)]

A "single-family, owner-occupied dwelling" for this purpose is a dwelling that will be owned and occupied by a signatory to the deed of trust secured by such dwelling within 90 days of executing the deed of trust. [Civ.C. § 2949(b)]

(5) [6:400] **Inspections:** The deed of trust usually reserves to the beneficiary (lender) the right to enter upon and inspect the property from time to time—in particular, if the borrower defaults on the loan. The lender's right of inspection may even include the right to charge a delinquent borrower reasonable "property inspection fees" (*see ¶ 6:229*).

(*See also ¶ 6:629 ff.* re statutory right of entry/inspection for hazardous substances.)

(6) [6:401] **Recourse vs. nonrecourse:** A deed of trust (and/or promissory note) sometimes indicates the loan is "nonrecourse." "Recourse" or "nonrecourse" bears on the scope of the lender's *remedies* should the borrower default on the loan:

(a) [6:402] **"Nonrecourse"—foreclosure as exclusive remedy:** Under a "*nonrecourse*" loan, the lender's *sole remedy* in the event of a default is to *foreclose* on its collateral; the borrower will not be liable for any deficiency between the value of the collateral and the amount of the unpaid secured obligation. [*Aozora Bank, Ltd. v. 1333 North Calif. Blvd.* (2004) 119 CA4th 1291, 1295, 15 CR3d 340, 342]

1) [6:403] **Comment:** As a practical matter, commercial nonrecourse loans rarely leave the borrower completely insulated from personal liability. Lenders often *exempt* or "carve out" claims they may have against the trustor for such things as fraud, waste, environmental liability, or misapplication of insurance or condemnation proceeds. [See *Aozora Bank, Ltd. v. 1333 North Calif. Blvd.* (2004) 119 CA4th 1291, 1295, 15 CR3d 340, 342—fraud, material misrepresentation, and waste claims excepted from nonrecourse loan but no implied carve-out for lender's attorney fees in enforcing nonrecourse exceptions (*¶ 6:249*)]

(Generally, any post-nonjudicial foreclosure act or omission by the borrower that would give rise to a claim by the lender should be a nonrecourse "carve out.")

(b) [6:404] **"Recourse"—borrower open to deficiency judgment:** Conversely, a "*recourse*" loan generally means the borrower remains liable for such a deficiency—i.e., the lender is not limited to what it can recoup through foreclosure. (*But see ¶ 6:560 ff.* re *antideficiency laws*.)

(7) [6:405] **Substitution of trustee:** The beneficiary (lender) almost always reserves the right, in its sole discretion, to *substitute trustees*. This is essential for a lender because if the trustee (for any reason) refuses to proceed with a nonjudicial foreclosure, the beneficiary will need to find another trustee who will so act.

(Once the borrower satisfies the loan, the beneficiary also has a right to substitute the title company conducting the escrow for the trustee of record, pursuant to Civ.C. § 2934a (¶ 6:405a ff.). This is so if necessary to complete the reconveyance process. See Civ.C. § 2941(b)(7); *and ¶ 6:408.16*.)

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(a) [6:405a] **Statutory substitution procedures:** There are two statutory procedures to effect a trust deed trustee substitution, both accomplished by recording prescribed documents evidencing the substitution (Civ.C. § 2934a(a); *Dimock v. Emerald Properties LLC* (2000) 81 CA4th 868, 871, 97 CR2d 255, 257):

1) [6:405.1] **Single loan transactions—recording acknowledgment signed by all beneficiaries:** Notwithstanding any contrary provision in a trust deed executed on or after January 1, 1968, a trustee substitution may be effected by recording in the county where the property is located a substitution executed and acknowledged by *all beneficiaries* under a trust deed (or their successors in interest). [Civ.C. § 2934a(a)(1)(A)]

2) [6:405.2] **Series loans with same security—recording acknowledgment signed by majority interest holders:** Where there are a series of notes secured by the same real property or undivided interests in a note secured by real property equivalent to a series transaction, a trustee substitution may be effected by recording in the county where the property is located a substitution executed and acknowledged by the holders of *more than 50%* of the record beneficial interest (*exclusive* of notes or interests issued or serviced and held by a *licensed real estate broker* or affiliate of the broker), to *which is attached* a separate written document signed under penalty of perjury by all parties who signed the substitution and containing the statements prescribed by Civ.C. § 2934a(a)(2). [Civ.C. § 2934a(a)(1)(B), (2); see also Civ.C. § 2941.9 (establishing procedure by which all trust deed beneficiaries may agree to be governed by holders of more than 50% interest in series loans secured by same property)]

3) [6:405.3] **Typographical errors; nonstatutory procedures:** Minor typographical errors do not invalidate a trustee substitution, nor will the court interpret a trust deed's provisions to add to the statutory procedures. [See *Kalnoki v. First American Trustee Servicing Solutions, LLC* (2017) 8 CA5th 23, 37-41, 214 CR3d 294, 302-304—omission of "Inc." in signature block and absence of power of attorney establishing attorney-in-fact's authority to execute substitution for beneficiary did not invalidate substitution]

4) [6:405.4] **Waiver of statutory procedures:** The parties to a trust deed may *waive* the Civ.C. § 2934a statutory substitution of trustee procedures. Rationale: Public policy would not be compromised by allowing the waiver, parties to a trust deed may agree to a form of substitution *other* than that provided by § 2934a, and no statute expressly prohibits a waiver of § 2934a. [*Jones v. First American Title Ins. Co.* (2003) 107 CA4th 381, 390, 131 CR2d 859, 865; see also *Ram v. OneWest Bank, FSB* (2015) 234 CA4th 1, 16, 183 CR3d 638, 648—"It is well settled that parties to a deed of trust may agree to a form of substitution of trustee other than that provided in Civil Code section 2934a"]

(b) [6:405.5] **Mailed notice of substitution:** If the substitution is executed, but not recorded, *before or concurrently* with recordation of a notice of default (¶ 6:524), the beneficiary "shall mail" notice of the substitution, before or concurrently with the recordation, in the manner prescribed by Civ.C. § 2924b, to all persons entitled to mailed notice of default under § 2924b (*see ¶ 6:527*). [Civ.C. § 2934a(b) (affidavit of notice given must be attached to substitution)]

If the substitution is effected *after recording* of a notice of default but *before* recording of the notice of sale (*¶ 6:530*), the beneficiary "shall mail a copy" of the substitution before or concurrently with the recordation, as prescribed by Civ.C. § 2924b, to the trustee then of record and all persons entitled to mailed notice of default under § 2924b. [Civ.C. § 2934a(c) (affidavit of notice given must be attached to substitution)]

(c) [6:405.6] **Trustee's right to resign or refuse appointment:** A trustee named in a recorded substitution of trustee may resign or decline the appointment as trustee *without the consent of the beneficiaries or their agents*. [Civ.C. § 2934a(d)(2)(A)]

In doing so, the trustee must (Civ.C. § 2934a(d)(2)(A)):

- Give prompt *written* notice of their resignation or refusal to accept appointment to all beneficiaries (or their authorized agents) by registered or certified mail, postage prepaid, at the address shown on the last-recorded substitution of trustee for the real property in that county, *and*

- Record the notice of resignation or refusal to accept appointment in all counties where the substitution of trustee appointing the withdrawing trustee was recorded, accompanied by an affidavit affirming the trustee has mailed the notice to all beneficiaries (or their authorized agents).

1) [6:405.7] **Resignation or refusal to accept appointment effective upon recordation; duty to maintain records:** The trustee's resignation or refusal to accept appointment is effective upon recordation of the notice of resignation

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or refusal to accept appointment in each county where the substitution of trustee appointing the withdrawing trustee was recorded. [Civ.C. § 2934a(d)(2)(B)]

Notwithstanding the above, the trustee (or their successor in interest) must maintain all records relating to the trust deed for five years after mailing and recording the notice of resignation or refusal to accept appointment. [Civ.C. § 2934a(d)(2)(F)]

2) [6:405.8] **Impact on enforcement of trust deed:** The trustee's withdrawal does not affect the validity of the mortgage or trust deed. Nonetheless, until the beneficiaries (or their authorized agents) appoint a subsequent trustee as prescribed under Civ.C. § 2934a, no action required to be performed by the trustee, either by the statutes governing mortgages (Civ.C. § 2920 et seq.) or the trust deed itself, may be taken. [Civ.C. § 2934a(d)(2)(C)]

[6:405.9] ***Reserved.***

(d) [6:405.10] **Effect of recorded substitution on new (substituted) trustee's authority:** Once the substitution is recorded properly, the new (substituted) trustee succeeds to "all the powers, duties, authority, and title" granted the prior trustee and is deemed authorized to act as trustee under the deed of trust for all purposes from the date it is executed by the beneficiaries (or their authorized agents). [Civ.C. § 2934a(a)(4), (d); *Jones v. First American Title Ins. Co.* (2003) 107 CA4th 381, 383, 131 CR2d 859, 860; see also Civ.C. § 2941(b)(7)—title company substituted as trustee for reconveyance purposes assumes trustee's statutory obligation to effect reconveyance as prescribed by Civ.C. § 2941(b)]

1) [6:405.11] **Conclusive evidence of substituted trustee's authority to act:** A recorded substitution constitutes "*conclusive evidence"* of the authority of the substituted trustee or their authorized agents to act pursuant to Civ.C. § 2934a, unless prompt written notice of the trustee's resignation is given as statutorily prescribed. [Civ.C. § 2934a(d)(4) (emphasis added); see also *Ram v. OneWest Bank, FSB* (2015) 234 CA4th 1, 16, 183 CR3d 638, 648; *In re Turner* (9th Cir. 2017) 859 F3d 1145, 1150 (applying Calif. law) (same)]

2) [6:405.12] **Prior trustee divested of power:** The recorded substitution effectively *ousts* the prior trustee of its powers as trustee under the deed of trust, and only the new (substituted) trustee has the power to conduct a nonjudicial (trustee's) foreclosure sale of the trustor's property; a sale by the prior trustee is void and of no force and effect. [*Dimock v. Emerald Properties LLC* (2000) 81 CA4th 868, 871, 874-875, 97 CR2d 255, 257, 259-260—recorded substitution transfers to successor trustee "exclusive power to conduct a trustee's sale"; compare *In re Cedano* (9th Cir. BAP 2012) 470 BR 522, 532 (applying Calif. law)—for purposes of instituting nonjudicial (trustee's) foreclosure sale, "there is no requirement that the Substitution of Trustee be recorded, only that it be executed" (*¶ 6:524a*)]

3) [6:405.13] **Restoration of prior trustee's power; reformation:** Other than by recording a further substitution of trustee, there are *no statutory means* by which the effect of a recorded substitution can be avoided. [*Dimock v. Emerald Properties LLC* (2000) 81 CA4th 868, 871, 97 CR2d 255, 257]

However, in an appropriate case, general contract law and remedies may be applied to permit *reformation* (*¶ 11:410 ff.*) of the controlling documents in order to *validate* a foreclosure sale conducted by a former trustee. [See *Jones v. First American Title Ins. Co.* (2003) 107 CA4th 381, 389-390, 131 CR2d 859, 864-865—reformation validated sale by trustee whose resubstitution had not been recorded; but see also *Dimock v. Emerald Properties LLC*, supra, 81 CA4th at 871, 97 CR2d at 257—on record presented, court *not* "disposed to create any nonstatutory means" to avoid effect of recorded substitution]

(8) [6:406] **Release and reconveyance provisions:** A deed of trust is released—and the real property security is released from its lien—by means of a "reconveyance." [*Ricketts v. McCormack* (2009) 177 CA4th 1324, 1327, 99 CR3d 817, 819, fn. 1—reconveyance is an instrument that clears title to property subject to a recorded trust deed]

The trustor has a statutory right to full reconveyance when the obligation secured by the deed of trust has been satisfied (Civ.C. § 2941(b)(1)).

(a) [6:407] **Reconveyance process initiated by trust deed beneficiary:** The beneficiary has the duty to initiate the reconveyance process when the secured obligation is satisfied. (A deed of trust customarily provides that the beneficiary will cause the trustee to reconvey the lien of the deed of trust upon satisfaction of the obligations secured.) [*Trustors Security Service v. Title Recon Tracking Service* (1996) 49 CA4th 592, 600-601, 56 CR2d 793, 798 (superseded by statute on other grounds as stated in *Ricketts v. McCormack* (2009) 177 CA4th 1324, 1327, 99 CR3d 817, 819, fn. 1, and in *Markowitz v. Fidelity Nat'l Title Co.* (2006) 142 CA4th 508, 524, 48 CR3d 217, 228); *Ricketts v. McCormack*,

supra—lender/beneficiary initiates process of reconveying title to debtor/trustor by delivering to trustee original note, trust deed and full reconveyance request; see also *State of Calif. ex rel. Bowen v. Bank of America Corp.* (2005) 126 CA4th 225, 232-233, 23 CR3d 746, 750-752 (describing statutory scheme for reconveyance process)]

1) [6:407.1] **30 days to deliver request for reconveyance, etc.:** Within *30 calendar days* after satisfaction of the secured obligation, the beneficiary (or its assignee) must execute and deliver to the trustee the original note, deed of trust, request for reconveyance, and other documents necessary to reconvey the deed of trust. [Civ.C. § 2941(b)(1); see also Civ.C. § 2941(a)—mortgagee required to execute and record certificate of discharge within 30 days after mortgage has been satisfied]

a) [6:407.2] **Alternative deadline for delivery of original note and trust deed:** So long as the beneficiary delivers the *request for reconveyance* to the trustee within the 30-day limit (¶ 6:407.1), the beneficiary has *120 days* after satisfaction of the obligation to deliver the *original note and deed of trust* to either the trustee or trustor. Following such delivery, the note and deed of trust "shall be" altered to show that the obligation is paid in full. [Civ.C. § 2941(b)(8)]

b) [6:407.2a] **No duties imposed on escrow holder facilitating document exchange:** The obligations under Civ.C. § 2941(b) regarding execution and delivery of the original documents to the trustee rest at all times with the *beneficiary* and do not "shift" to any escrow holder (*¶ 4:604.1*) used to facilitate exchange of the documents; the statute "only speaks to the duties and obligations of trustees and beneficiaries." [*Markowitz v. Fidelity Nat'l Title Co.* (2006) 142 CA4th 508, 523-524, 48 CR3d 217, 228; *see also ¶ 6:408.10*]

2) [6:407.3] **Disposition of electronic versions of note and deed of trust:** When the note or deed of trust, or any copy thereof, is electronic, upon satisfaction of the secured obligation, any electronic original, or electronic copy that has not been previously marked solely for use as a copy, must be altered to show that the obligation has been paid in full. [Civ.C. § 2941(b)(1)(D)]

3) [6:407.4] **Allowable reconveyance fees:** *See discussion at ¶ 6:408.30 ff.*

(b) Effecting reconveyance

1) [6:408] **Trustee's primary obligation:** The *trustee*, being the one who holds legal title to the property under a deed of trust (*¶ 6:342*), has the primary obligation (and right) to reconvey the deed of trust pursuant to the beneficiary's request (¶ 6:407 ff.) by recording a full (or partial, *¶ 6:409*) reconveyance. [Civ.C. § 2941(b)(1)(A); see also *State of Calif. ex rel. Bowen v. Bank of America Corp.* (2005) 126 CA4th 225, 232-233, 23 CR3d 746, 750-752 (describing statutory scheme for reconveyance process)]

a) [6:408.1] **No duty to verify satisfaction of underlying debt:** Upon receipt of the request for reconveyance from the beneficiary, the trustee's duty to timely record the reconveyance is *absolute*. The trustee has *no duty* to confirm that the underlying debt has been repaid before reconveying. [*Vournas v. Fidelity Nat'l Title Ins. Co.* (1999) 73 CA4th 668, 677, 86 CR2d 490, 497]

b) [6:408.2] **21-day deadline to record:** The trustee must record or "cause" to be recorded (in the office of the county recorder where the deed of trust is recorded) the executed reconveyance within *21 calendar days* after receipt of the original note, deed of trust, request for reconveyance, authorized reconveyance fees (*¶ 6:408.30 ff.*), recorder's fees "and other documents as may be necessary to reconvey, or cause to be reconveyed, the deed of trust." [Civ.C. § 2941(b)(1)(A); *Vournas v. Fidelity Nat'l Title Ins. Co.* (1999) 73 CA4th 668, 677, 86 CR2d 490, 497]

c) [6:408.3] **"Causing" reconveyance to be recorded:** The trustee may "cause" the reconveyance to be recorded by sending it in a recordable form along with all required fees by way of certified mail with the U.S. Postal Service or an independent courier that has a tracking service to provide documentation of receipt and delivery (including the recipient's signature), in an envelope addressed to the recorder's office of the county where the deed of trust is recorded. [Civ.C. § 2941(c)]

Thereafter, within two days of receipt, so long as received in recordable form with all required fees, the county recorder "shall" stamp and record the reconveyance. [Civ.C. § 2941(c)]

1/ [6:408.4] **Presumption of receipt in due course:** The § 2941(c) procedure is not the exclusive way to "cause" a reconveyance to be recorded (see Civ.C. § 2941(c)—"cause it to be recorded" includes, but is not limited to …).

However, compliance with that procedure entitles the trustee to the benefit of the Ev.C. § 641 presumption (letter correctly addressed and mailed presumed to have been received in ordinary course of mail). [Civ.C. § 2941(c)]

Comment: Given the 21-day deadline (¶ *6:408.2*) and potential penalties (¶ *6:408.40*), this presumption can become important for trustees relying on the mail or a courier service to record the reconveyance.

2/ [6:408.4a] **Indexing distinguished:** The recorder is required to do nothing more than "stamp and record" reconveyances. Thus, indexing—a separate and distinct function—is *not* part of the Civ.C. § 2941(c) "stamp and record" requirement. [*Ricketts v. McCormack* (2009) 177 CA4th 1324, 1332-1334, 99 CR3d 817, 823-824—county recorder's § 2941(c) obligation to process reconveyances within two business days of receipt does not include additional, separate obligation to index documents in appropriate databases; see also *First Bank v. East West Bank* (2011) 199 CA4th 1309, 1316, 132 CR3d 267, 273 (lien priority case)—although courts may conflate the two duties, recording and indexing are "two distinct functions" (¶ *6:350*)]

d) [6:408.4b] **Delivering copy of reconveyance; returning recorded reconveyance instrument:** The trustee must deliver a copy of the reconveyance to the beneficiary, its successor in interest, or its servicing agent, if known. [Civ.C. § 2041(b)(1)(B)]

Once recorded, the reconveyance instrument will be returned by the recorder. For that purpose, the reconveyance instrument must specify either of the following options: (i) the trustor, or successor in interest, and their last known address, as the person to whom the recorder will return the recorded instrument pursuant to Gov.C. § 27321; *or* (ii) that the recorder must deliver the recorded instrument to the trustee's address (in which event, the trustee has the obligation to mail the recorded instrument to the trustor or successor in interest at its last known address). [Civ.C. § 2941(b)(1)(B)(i) & (ii)]

The *recorder* has *no duty* to validate the addresses specified on the reconveyance instrument. [Civ.C. § 2941(b)(1)(B)]

e) [6:408.5] **Return of original note and trust deed:** Following execution and recordation of the reconveyance, upon receipt of written request, the trustee must deliver (or cause to be delivered) the original note and deed of trust to the trustor (or trustor's heirs, successors or assignees). [Civ.C. § 2941(b)(1)(C)]

1/ [6:408.6] **Disposition of note/trust deed in electronic form:** *See* ¶ *6:407.3*.

[6:408.7 - 6:408.9] ***Reserved.***

f) [6:408.10] **No duties imposed on escrow holder:** The duties described at ¶ 6:408 ff. are imposed *solely* on the trustee and do *not* "shift" at any time to an intermediary company conducting the escrow through which the debt is satisfied; the statute "only speaks to the duties and obligations of trustees and beneficiaries." [*Markowitz v. Fidelity Nat'l Title Co.* (2006) 142 CA4th 508, 524-525, 48 CR3d 217, 228-229—title company, acting as sub-escrow to hold trustor's loan proceeds and pay off note upon beneficiary's demand and request for reconveyance, owed no duty to trustor to record reconveyance; *see also* ¶ *6:407.2a*]

[6:408.11 - 6:408.14] ***Reserved.***

2) [6:408.15] **Substitution of trustees to effect reconveyance after 60-day delay:** If the trustee does not execute and record a reconveyance within *60 calendar days* of satisfaction of the secured obligation, the beneficiary, upon receipt of written request from the trustor (or trustor's heirs, successor, agent or assignee), must substitute itself or another as trustee pursuant to Civ.C. § 2934a (¶ *6:405 ff.*) and issue the reconveyance. [Civ.C. § 2941(b)(2); *State of Calif. ex rel. Bowen v. Bank of America Corp.* (2005) 126 CA4th 225, 245, 23 CR3d 746, 761]

a) [6:408.16] **Title company as substituted trustee:** At its discretion, the beneficiary may (in accordance with Civ.C. § 2934a procedures) substitute the title company conducting the escrow through which the obligation is satisfied as trustee; in that event, the title company assumes the Civ.C. § 2941(b) obligation to effect the reconveyance and may collect the authorized reconveyance fee (¶ *6:408.30 ff.*). [Civ.C. § 2941(b)(7)]

[6:408.17 - 6:408.19] ***Reserved.***

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3) [6:408.20] **Release by title insurer after 75-day delay:** As a final fall-back remedy, if a reconveyance has not been executed and recorded by the trustee or substitute trustee pursuant to Civ.C. § 2941(b)(1) or (2) (¶ 6:408 ff.) within *75 calendar days* of satisfaction of the secured obligation, a *title insurance company* may prepare and record a *release* of the obligation. [Civ.C. § 2941(b)(3); *State of Calif. ex rel. Bowen v. Bank of America Corp.* (2005) 126 CA4th 225, 243, 23 CR3d 746, 759-760—§ 2941(b)(3) remedy authorized only if trustee or substitute trustee *both* failed to issue reconveyance despite opportunity to do so]

a) [6:408.21] **Advance notice:** But at least 10 days before issuing and recording a release, the title insurer must mail notice of its intent to do so to the trustee, trustor and trust deed beneficiary. [Civ.C. § 2941(b)(3)—notice to be given by postage prepaid first-class mail at each party's last known address; *Trustors Security Service v. Title Recon Tracking Service* (1996) 49 CA4th 592, 602, 56 CR2d 793, 799 (superseded by statute on other grounds as stated in *Ricketts v. McCormack* (2009) 177 CA4th 1324, 1327, 99 CR3d 817, 819, fn. 1, and in *Markowitz v. Fidelity Nat'l Title Co.* (2006) 142 CA4th 508, 524, 48 CR3d 217, 228)]

The 10-day notice requirement permits the lender/beneficiary/trustee *one last chance* to issue and record a reconveyance. [*Trustors Security Service v. Title Recon Tracking Service*, supra, 49 CA4th at 602, 56 CR2d at 799-800]

b) [6:408.22] **Effective as reconveyance:** Provided the procedure is properly employed (*see* ¶ *6:408.23*), a release in the form prescribed by Civ.C. § 2941(b)(3)(A) is entitled to recordation and, when recorded, is deemed the equivalent of a trust deed reconveyance. [Civ.C. § 2941(b)(3)(B); *State of Calif. ex rel. Bowen v. Bank of America Corp.* (2005) 126 CA4th 225, 233, 23 CR3d 746, 752 & fn. 3]

Courts thus have no authority thereafter to compel the lender to execute and record a full reconveyance. [*Prudential Home Mortg. Co. v. Sup.Ct. (Diaz)* (1998) 66 CA4th 1236, 1248, 78 CR2d 566, 572]

c) [6:408.23] **Compare—premature/improper title insurer's release ineffective:** Civ.C. § 2941 creates a *hierarchical* system for issuing reconveyances, permitting title insurers to issue and record releases of obligations for clearing title *only as a last resort* where neither the trustee nor the beneficiary performs its statutory obligations. *Until* the 75-day period expires (*after* the giving of 10-day notice, ¶ *6:408.20 ff.*) without a reconveyance by the trustee or beneficiary, a title insurer's recordation of a release is *ineffective* to clear title. [*Trustors Security Service v. Title Recon Tracking Service* (1996) 49 CA4th 592, 602-607, 56 CR2d 793, 799-802—§ 2941 does not create "co-equal method" for title insurers to compete with trustees and beneficiaries to clear title]

Moreover, a title insurer cannot be positioned in the hierarchical system to effectively clear title unless the trustee has first been given the *opportunity and means*—i.e., possession and control of the reconveyance documents and fees—to perform its statutory obligations. [*Trustors Security Service v. Title Recon Tracking Service*, supra, 49 CA4th at 607-608, 56 CR2d at 803]

[6:408.24 - 6:408.29] ***Reserved.***

(c) [6:408.30] **Authorized "reasonable fees" for reconveyance services:** The beneficiary or trustee may charge the trustor a "reasonable fee" for all services involved in preparation, execution and recordation of the reconveyance. A fee not exceeding *$45* is *conclusively presumed reasonable*. [Civ.C. § 2941(e)(1) & (2)]

1) [6:408.31] **Payoff demand prerequisite:** A reconveyance fee may not be charged *unless* demand for the fee was included in the Civ.C. § 2943 payoff demand statement provided by the lender (¶ *4:304.1 ff.*). [Civ.C. § 2941(e)(3)]

2) [6:408.32] **No nonstatutory fees:** *No* reconveyance fee or charge may be imposed on the trustor other than as expressly authorized by Civ.C. § 2941. [Civ.C. § 2941(g)]

3) [6:408.33] **Time for payment:** The reconveyance fee may be made payable no earlier than opening of a bona fide escrow or no more than 60 days before satisfaction of the secured obligation. [Civ.C. § 2941(e)(1)]

4) [6:408.34] **Beneficiary's duty to refund if no recorded reconveyance:** When the beneficiary collects a reconveyance fee and thereafter has or should have knowledge that no reconveyance has been recorded, the beneficiary must either cause the reconveyance to be recorded or, if a title company release has been earlier and timely recorded (¶ *6:408.20*), refund to the trustor the fee charged to perform the reconveyance. [Civ.C. § 2941(j)]

Evidence of knowledge includes, but is not limited to, notice of release pursuant to Civ.C. § 2941(b)(3) (¶ *6:408.21*). [Civ.C. § 2941(j)]

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Compare: The beneficiary has no § 2941(j) obligation to refund reconveyance fees where the beneficiary had no opportunity to issue a reconveyance *before* the title insurer recorded a release. [*State of Calif. ex rel. Bowen v. Bank of America Corp.* (2005) 126 CA4th 225, 243, 23 CR3d 746, 760]

[6:408.35 - 6:408.39] ***Reserved.***

(d) [6:408.40] **Penalties for § 2941 violations:** Noncompliance with Civ.C. § 2941 subjects the violator (trustees and trust deed beneficiaries) to a $500 civil penalty, *plus* all consequential damages suffered by the affected person. Additionally, a willful violation of any provision of § 2941 is a misdemeanor, punishable by a minimum $50, maximum $400 fine and/or up to six months' imprisonment. [Civ.C. §§ 2941(d), 2941.5; see *SMS Fin'l XXIII, LLC v. Cornerstone Title Co.* (2018) 19 CA5th 1092, 1097-1098, 228 CR3d 562, 565-566—purchaser of secured obligation could sue title company for § 2941 damages for erroneously releasing trust deed prior to trustee's sale; *State of Calif. ex rel. Bowen v. Bank of America Corp.* (2005) 126 CA4th 225, 234, 23 CR3d 746, 752—injured party's recovery measured by general rule of tort damages (i.e., all detriment proximately caused by breach of legal duty, including emotional distress damages)]

Trustees and beneficiaries remain liable for failing to perform their statutory reconveyance obligations even though a title insurer ultimately steps in as a last resort to clear title by recording a release of the obligation. [See Civ.C. § 2941(b)(5); *Trustors Security Service v. Title Recon Tracking Service*, supra, 49 CA4th at 603, 56 CR2d at 800]

1) [6:408.41] **Causation limitation on consequential damages recovery:** Consequential damages are recoverable under Civ.C. § 2941(e) only to the extent *caused by* the error in not timely or properly reconveying the deed of trust. Otherwise, recovery is limited to the statutory $500 penalty. [*Panagotacos v. Bank of America* (1998) 60 CA4th 851, 856-857, 70 CR2d 595, 598—because prospective buyers did not have binding purchase contract with sellers, they suffered no consequential damages *as a result of* bank's delayed reconveyance of trust deed on property they wished to use as security for loan]

2) [6:408.42] **One-year statute of limitations:** Because Civ.C. § 2941 imposes a statutory *penalty* for violations, it is subject to the CCP § 340(a) one-year limitations period governing actions based on a "statute for a penalty or forfeiture." [*Prudential Home Mortg. Co. v. Sup.Ct. (Diaz)* (1998) 66 CA4th 1236, 1242, 78 CR2d 566, 568]

a) [6:408.43] **Tolling under "delayed discovery rule":** Generally, the cause of action accrues upon commission of the wrongful act (failure to reconvey). However, the borrower is entitled to assume the lender performed its statutory duty and, therefore, has the benefit of the "delayed discovery rule": Commencement of the limitations period is tolled until the borrower discovers or, through the exercise of reasonable diligence, should have discovered, all facts essential to their cause of action. [*Prudential Home Mortg. Co. v. Sup.Ct. (Diaz)* (1998) 66 CA4th 1236, 1248-1249, 78 CR2d 566, 572-573—borrowers *not* deemed on "inquiry notice" through public records that reconveyance had not been made because they were "entitled to expect" lenders would perform their statutory reconveyance duty]

(e) [6:409] **Compare—"partial" release/reconveyance:** A "full" release and reconveyance occurs when the secured obligation is completely paid off. However, a release/reconveyance may also be "partial" … where only a portion of the secured property is released from the lien of the deed of trust.

1) [6:410] **Development/construction loans:** Development and construction loans often contain partial release provisions, requiring the lender to release (reconvey) portions of the secured property incrementally as the debt is paid off. Under such loans, a "release price" is assigned to each portion of the property (typically, each lot). Provided certain conditions are met, the lender will release each lot upon payment of the corresponding release price. [See, e.g., *Resolution Trust Corp. v. Bayside Developers* (ND CA 1993) 817 F.Supp. 822, 823, aff'd (9th Cir. 1994) 43 F3d 1230—pursuant to developer's "price release" agreement with lender, as each lot was sold it was released from deed of trust and a portion of sales proceeds paid to lender]

However, in addition to payment of the release price, the lender usually requires that the remaining portions of the encumbered property have access to utilities and public streets; that they be in compliance with zoning and other laws; that the borrower not be in default under the loan; and that the borrower provide the lender with an endorsement to the lender's title insurance policy insuring the continuing priority of the lien of the deed of trust on the portion of the property that remains encumbered by the deed of trust.

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2) [6:411] **Right to partial release solely contractual:** Unlike the beneficiary's and trustee's duty to effect a full release and reconveyance (Civ.C. § 2941, *¶ 6:406 ff.*), there is *no statutory* obligation to issue a *partial* reconveyance. [See Civ.C. § 2912—“partial performance of an act secured by a lien does not extinguish the lien upon any part of the property subject thereto, even if it is divisible”]

Rather, partial reconveyance obligations are strictly a creature of *contract;* and, absent an applicable contract provision, the beneficiary has no obligation to issue partial releases. [*Karlsen v. American Sav. & Loan Ass'n* (1971) 15 CA3d 112, 118, 92 CR 851, 854; see *Dieckmeyer v. Redevelopment Agency of City of Huntington Beach* (2005) 127 CA4th 248, 258-259, 24 CR3d 895, 903—where trust deed secured promissory note as well as borrower's performance of CC&Rs recorded against secured property and loan agreement, loan prepayment by itself did not entitle borrower to reconveyance of trust deed]

a) [6:412] **Certainty of terms:** Further, contractual provisions for a partial release and reconveyance are unenforceable unless *clear and unambiguous*. [*White Point Co. v. Herrington* (1968) 268 CA2d 458, 468, 73 CR 885, 890-891—release clause is “material and substantial term” of parties' agreement, ambiguity as to which cannot be resolved by judicial standards of fairness; see *Lawrence v. Shutt* (1969) 269 CA2d 749, 763, 75 CR 533, 541—clause requiring partial release of property “contiguous” to that previously released deemed too uncertain and unreasonable for specific performance]

3) [6:413] **Map Act limitations:** Partial releases should not be given unless the released parcels are *lawfully and properly subdivided*. Otherwise, issuance of a partial reconveyance will violate the Subdivision Map Act (Gov.C. § 66410 et seq.). [See Gov.C. § 66499.30]

[6:413.1 - 6:413.4] ***Reserved.***

(f) [6:413.5] **Subsequent encumbrancer's rights upon *erroneous reconveyance:*** Recordation of a reconveyance removes the lien of the reconveyed trust deed from the public records even if the reconveyance was in error. A subsequent “good faith encumbrancer for value,” upon recordation, takes its interest free and clear of all unrecorded interests—including the mistakenly reconveyed senior trust deed. [*First Fidelity Thrift & Loan Ass'n v. Alliance Bank* (1998) 60 CA4th 1433, 1440-1441, 71 CR2d 295, 300]

1) [6:413.6] **“Good faith” status:** A subsequent encumbrancer is in “good faith” if it acts *without knowledge or notice* of competing liens on the same property. Lacking knowledge that a first-in-time trust deed was erroneously reconveyed, a subsequent encumbrancer is entitled to rely on the status of record title, as shown in a title report, to ensure its lien will have the desired priority. [*First Fidelity Thrift & Loan Ass'n v. Alliance Bank* (1998) 60 CA4th 1433, 1441, 71 CR2d 295, 300; *Triple A Mgmt. Co., Inc. v. Frisone* (1999) 69 CA4th 520, 530, 81 CR2d 669, 675-676]

2) [6:413.7] **Exception—void reconveyance:** A senior trust deed's priority position is *not* displaced by a *void* (forged) reconveyance. [See *WFG Nat'l Title Ins. Co. v. Wells Fargo Bank, N.A.* (2020) 51 CA5th 881, 885-886, 890, 264 CR3d 717, 721, 725—lender (subsequent encumbrancer) did not obtain valid interest in property where third party recorded forged trustee's deed upon sale and purportedly sold property to lender's borrower as part of sham transaction (¶ 6:413.8)]

On the other hand, a fraudulently-induced reconveyance is simply *voidable* (not void), and subsequent encumbrancers/purchasers thus take free of the erroneously released trust deed lien. [*Schiavon v. Arnaudo Brothers* (2000) 84 CA4th 374, 376-378, 100 CR2d 801, 802-804—where *request* for reconveyance was forged, but reconveyance itself was executed by trustee with full awareness of effect of doing so, reconveyance was *voidable* and subsequent purchaser took title free and clear]

a) [6:413.8] **No duty to monitor for fraudulent/erroneous reconveyances:** A property owner (or beneficiary of an interest in property) has no ongoing duty to monitor public records in order to find and correct fraudulent or erroneous recordings. Thus, an encumbrancer is neither negligent, nor do they lose their priority, if they fail to detect a forged deed and take immediate action to prevent others from relying on it. [See *WFG Nat'l Title Ins. Co. v. Wells Fargo Bank, N.A.* (2020) 51 CA5th 881, 885-886, 892-894, 264 CR3d 717, 721, 726-728—where third party recorded forged deed upon sale and sold underlying property to subsequent encumbrancer's borrower, who defaulted on loan, beneficiary/lender of “indisputably” valid trust deed, recorded well before forged deed upon sale, was not estopped from quieting title to property despite failing to monitor and correct public records]

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3) [6:413.9] **Compare—actual knowledge of unrecorded senior lien:** By contrast, a junior encumbrancer, although shown first in time in the public records, takes *subject to* prior unrecorded liens *of which it has notice*. [See generally, Civ.C. § 1217] This includes prior liens that had been recorded but were mistakenly reconveyed, where the junior lender had *notice* of the erroneous reconveyance. (But again, knowledge there had been a first-in-time senior lien that does not now appear of record does not impart constructive notice that the prior trust deed may have been erroneously reconveyed.) [*First Fidelity Thrift & Loan Ass'n v. Alliance Bank* (1998) 60 CA4th 1433, 1443, 71 CR2d 295, 301]

4) [6:413.10] **Compare—*constructive knowledge; information triggering duty of inquiry:*** A subsequent encumbrancer is not entitled to ignore reasonable warning signs appearing in recorded documents or information coming from sources outside the recorded chain of title. [*Triple A Mgmt. Co. v. Frisone* (1999) 69 CA4th 520, 531, 81 CR2d 669, 676; see *OC Interior Services, LLC v. Nationstar Mortg., LLC* (2017) 7 CA5th 1318, 1332, 1336, 213 CR3d 395, 406, 410—third party who purchased property with knowledge of prior mortgage lien vacated by default judgment took subject to said lien when judgment later voided]

Thus, information that reasonably brings into question the state of the title triggers "a *limited duty of inquiry*." [*Triple A Mgmt. Co. v. Frisone*, supra, 69 CA4th at 531, 81 CR2d at 676 (emphasis added); *First Fidelity Thrift & Loan Ass'n v. Alliance Bank* (1998) 60 CA4th 1433, 1444-1445 71 CR2d 295, 303]

Moreover, a subsequent encumbrancer is *charged with constructive knowledge* of what a reasonable investigation *would have revealed*. [*Triple A Mgmt. Co. v. Frisone*, supra, 69 CA4th at 532, 81 CR2d at 677]

a) [6:413.11] **No duty to inquire based solely on knowledge of reconveyance:** Nonetheless, "good faith" status is not negated simply by the fact the subsequent encumbrancer was aware of the *former* existence of a senior trust deed lien and that it had been reconveyed. That itself does not impart any "constructive knowledge" or "duty of inquiry" regarding a possible mistaken reconveyance. "[T]here is no authority for the proposition that a prospective lender, learning that a prior deed of trust had been reconveyed, has a duty to investigate further to determine whether that reconveyance was in error." [*First Fidelity Thrift & Loan Ass'n v. Alliance Bank* (1998) 60 CA4th 1433, 1444-1445, 71 CR2d 295, 303—subsequent lender's knowledge of preexisting trust deed lien gives rise only to a duty of "reasonable inquiry, not an exhaustive one"]

b) [6:413.12] **Example:** Senior Lender's trust deed lien was mistakenly reconveyed and removed from the public records. In the meantime, Borrower had applied for a loan from Junior Lender and disclosed the prior lien on its loan application. Junior Lender then asked for clarification from Borrower and another encumbrancer, both of whom indicated the prior trust deed lien had been released by reconveyance; Junior Lender also consulted a title report, which no longer showed a senior lien in the public records. Junior Lender then recorded its trust deed lien, before former Senior Lender could obtain a judgment reinstating its lien.

Although second in time to Senior Lender's lien, Junior Lender's lien was now first of record and had priority. Having inquired as to the status of the former senior trust deed lien, Junior Lender had no further duty to inquire whether the reconveyance might have been mistaken. "In view of the fact that most parcels of real estate have likely been subject to a lien that has been reconveyed, a broad rule would seriously complicate the lending process far beyond anything which seems contemplated by the statutes by creating a duty to investigate beyond the state of record title in virtually all cases." [*First Fidelity Thrift & Loan Ass'n v. Alliance Bank* (1998) 60 CA4th 1433, 1445, 71 CR2d 295, 303]

(9) [6:414] **Lender's subordination of deed of trust to subdivision documents (construction loans):** Lenders under development and construction loans are often required to subordinate the lien of their deed of trust to a new subdivision map, legally-required easements and covenants, conditions and restrictions, and a host of other instruments required by governmental entities to be recorded as conditions precedent to subdivision of the property. [Gov.C. § 66436]

Cross-refer: Trust deed subordination may also occur at the borrower's urging in connection with any real property financing transaction. *See discussion at ¶ 6:450 ff.* re subordination agreements.

(10) [6:415] **Remedies available upon default:** The deed of trust will set forth the beneficiary's various remedies available upon the borrower's default. The two most important remedies are the right to *collect rents, income and profits* from the secured property (*¶ 6:430 ff.*) and the right to proceed with a *nonjudicial* ("*private power of sale*") *foreclosure* (*¶ 6:514 ff.*).

(a) [6:416] **Nonjudicial foreclosure:** Nonjudicial foreclosure is not an inherent remedy under a deed of trust. The deed of trust must expressly grant a "private power of sale." [See *Ung v. Koehler* (2005) 135 CA4th 186, 192, 37 CR3d 311, 314]

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Most deeds of trust invariably contain the basic "private power of sale" procedures, including a broad "enabling" provision permitting the trustee to conduct the nonjudicial foreclosure sale. However, nonjudicial foreclosures are subject to extensive legislative and case law regulation. *See detailed discussion at ¶ 6:514 ff.*

(b) [6:417] **Compare—judicial foreclosure:** By contrast, "judicial foreclosure" involves a lawsuit where the court supervises the foreclosure sale (*see ¶ 6:540 ff.*). Consequently, the deed of trust need not address the procedures for a judicial foreclosure.

[6:417.1 - 6:417.4] ***Reserved.***

(11) [6:417.5] **Attorney fees and costs of collection:** Like the underlying promissory note, the trust deed often contains an attorney fees clause giving the lender the right to collect its expenses and reasonable attorney fees incurred in pursuing foreclosure or other remedies upon the borrower's default. (*See ¶ 6:241 ff.*)

(a) [6:417.6] **Civ.C. § 1717 "prevailing party on the contract" rules apply:** Pursuant to Civ.C. § 1717, the attorney fees clause will be construed as creating a *reciprocal* right to recover fees in favor of *whichever party prevails* in the action to enforce the secured obligation; and therefore, the Civ.C. § 1717 rules for identifying the "party prevailing on the contract" apply. [*Chase Manhattan Mortg. Corp. v. Lessel* (1997) 55 CA4th 10, 13, 64 CR2d 113, 115—per Civ.C. § 1717(b)(2), no "prevailing party" in lender's judicial foreclosure action that was voluntarily dismissed; see also *Andrade v. Western Riverside Council of Governments* (2024) 99 CA5th 1020, 1029-1030, 318 CR3d 396, 403-404 (distinguishing between § 1717 fees available to party who recovered greater relief in contract action (i.e., party "prevailing on the contract") and CCP § 1032 fees available to party who received net monetary recovery (i.e., "prevailing party")]

(b) [6:417.7] **CCP § 730 not an independent basis for fee award:** CCP § 730 directs the court, in a judicial foreclosure action, to fix attorney fees. However, that statute does not provide an independent basis for awarding attorney fees; rather, it simply authorizes the court to settle or determine the amount of fees in a foreclosure action *provided fees are awardable pursuant to a provision in the security instrument* (or, presumably, the promissory note or other contract between the parties). (As stated by one court, "section 730 is somewhat like a person's appendix; it's not necessary.") [*Chase Manhattan Mortg. Corp. v. Lessel* (1997) 55 CA4th 10, 13-14, 64 CR2d 113, 115]

(c) [6:417.8] **Collateral protection provision not an independent basis for fee award:** Trust deeds customarily permit lenders to take steps, including legal action, to protect their interest in collateral, and then to add those costs to the secured debt. Lenders may not, however, parlay the typical collateral protection provision into an independent attorney fee award. [See *Chacker v. JPMorgan Chase Bank, N.A.* (2018) 27 CA5th 351, 356-357, 237 CR3d 921, 925-926 (unsuccessful action to prevent foreclosure filed against lender's assignee)—trust deed's collateral protection provision permitted assignee to add legal fees to secured indebtedness, *not* to sue for fees independently; *Hart v. Clear Recon Corp.* (2018) 27 CA5th 322, 327, 237 CR3d 907, 911 (unsuccessful action to prevent foreclosure filed by borrower's nonsignatory family members based on intra-family title dispute)—lender could not recover attorney fees against borrower's family members by invoking trust deed's collateral protection provision since said provision fell outside Civ.C. § 1717's ambit]

(12) [6:418] **Beneficiary statements:** The trustor has a statutory right to compel the beneficiary (lender), upon request, to issue periodic written "beneficiary statements" concerning basic information about the loan—e.g., balance due, interest rate, maturity date, etc. (This is distinct from the lender's "payoff demand statement" upon which the borrower may rely as establishing the *full amount* necessary to satisfy the secured obligation; *see ¶ 6:561.10*.) [Civ.C. § 2943; *Venhaus v. Shultz* (2007) 155 CA4th 1072, 1080, 66 CR3d 432, 437—trust deed holder's failure to submit beneficiary statement upon request deemed "sufficiently wrongful" to support property owner's negligent interference with prospective economic relations claim]

The parameters of beneficiary statement obligations (e.g., contents thereof) are sometimes included in the trust deed; but Civ.C. § 2943 sets forth the time limits for the beneficiary's response.

Cross-refer: Beneficiary statements and payoff demand statements are discussed in greater detail at *¶ 4:301 ff. See also ¶ 6:561.10*.

(13) [6:419] **Assignment of rents and profits:** The income stream from a property is an important asset. Therefore, the lender will require that all rents, profits and other income produced by the secured property be pledged as additional security for the loan. Concomitantly therewith, the trust deed will specify that, upon a default, the lender may collect all such rents and profits (and, if necessary, have a receiver appointed for that purpose). *See further discussion at ¶ 6:430 ff.*

(14) [6:420] **Securitization; assignability of note and deed of trust provisions:** A common practice in the mortgage banking industry involves lenders pooling a variety of residential loans that are then securitized and sold to investors. Securitization allows the lender to monetize a long-term asset (the mortgage) and make other loans with the proceeds. The pooled mortgages usually are combined into trusts "created to receive the stream of interest and principal payments from the mortgage borrowers. The right to receive trust income is parceled into certificates and sold to investors, called certificateholders. The trustee hires a mortgage servicer to administer the mortgages by enforcing the mortgage terms and administering the payments." [*Yvanova v. New Century Mortg. Corp.* (2016) 62 C4th 919, 930, 199 CR3d 66, 74, fn. 5]

To facilitate the securitization process, most banks have a provision in their standard residential deed of trust allowing the lender to assign its loan or change the loan servicer without the borrower's consent. Indeed, even absent consent, "a borrower can generally raise no objection to assignment of the note and deed of trust. A promissory note is a negotiable instrument the lender may sell without notice to the borrower … The deed of trust, moreover, is inseparable from the note it secures, and follows it even without a separate assignment." [*Yvanova v. New Century Mortg. Corp.*, supra, 62 C4th at 927, 199 CR3d at 72 (internal citation omitted); see also *Fontenot v. Wells Fargo Bank, N.A.* (2011) 198 CA4th 256, 267, 129 CR3d 467, 476-477 (disapproved on other grounds by *Yvanova v. New Century Mortg. Corp.*, supra, 62 C4th at 939, 199 CR3d at 82, fn. 13)—banking industry established Mortgage Electronic Registration System (MERS) to assist securitization process (i.e., members may assign limited interests in real property to MERS as grantee of record while retaining right to transfer notes absent recordation)]

(15) [6:421] **Miscellaneous provisions:** Like any contract, deeds of trust contain a variety of miscellaneous and "boilerplate" provisions (governing law, manner of giving notices, "time of the essence," severability provisions, etc.). (*See Forms 6:H & 6:I.)*

(a) [6:422] **Incorporated reference to "fictitious" deed of trust:** In lieu of reciting the many routine "boilerplate" provisions, many preprinted deeds of trust refer to designated provisions in a previously recorded "fictitious deed of trust" and incorporate and adopt same by reference as though fully set forth in the borrower's trust deed. (*See Form 6:H*.)

[6:423 - 6:424] ***Reserved.***

2. [6:425] **Option to Purchase:** In addition to taking a security interest in the property by deed of trust, the lender may be granted an *option to purchase the real property collateral* as security for the loan. There are, however, some statutory provisions to protect unsophisticated borrowers from unknowingly impairing their rights of redemption upon default under the security agreement. [*Wachovia Bank v. Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 1057-1058, 52 CR3d 168, 181-182]

The concern is that a lender whose right to exercise the option is dependent on the borrower's default will then have an avenue to acquire the real property collateral outright from the borrower, without providing the borrower an opportunity to cure the loan default (pay the sums due) and redeem the property before foreclosure (Civ.C. §§ 2903, 2924c(e), ¶ *6:532 ff.*). Under a common law rule against "clogging" or impairing a borrower's "equity of redemption," the secured lender's purchase option in such circumstances might be declared invalid. [See *Wachovia Bank v. Lifetime Indus., Inc.*, supra, 145 CA4th at 1057-1058, 52 CR3d at 182; see also Civ.C. § 2889—all contracts in restraint of the right of redemption from a lien are void]

a. [6:425.1] **"Safe harbor" in financing transactions *not involving residential property of four or fewer units:*** Lenders in commercial real property financing transactions have a statutory "safe harbor" against the risk an option to purchase the real property collateral given as additional security for the loan will be invalidated as impairing the borrower's equity of redemption: So long as the option concerns real property collateral *other than residential property of four units or less* and its exercise is *not dependent upon the borrower's default* under the security agreement, the option will not thereafter be declared void as a restraint on the borrower's right to redeem the property, and the lender's priority (as against subsequent encumbrancers and purchasers) will relate back to the date the option was recorded. [Civ.C. § 2906; *Wachovia Bank v. Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 1058, 52 CR3d 168, 182-183]

But note: This "safe harbor" does not ipso facto validate an *otherwise unlawful* option. [See Civ.C. § 2906]

(1) [6:425.2] **Default as one of several bases for exercising option?** To come under the § 2906 umbrella, the right to exercise the option must not be "dependent upon the occurrence of a default with respect to the security agreement" (Civ.C. § 2906). It is unclear whether this statutory language means that, for the safe harbor to apply, a default cannot trigger the lender's right to exercise the option *or* whether a default cannot be the *only* basis for triggering the right to exercise the

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option. [See *Wachovia Bank v. Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 1060, 52 CR3d 168, 184, fn. 5—"We need not, and do not, decide this issue"]

b. [6:425.3] **Validity if exercise of option dependent on default:** A purchase option given by a borrower to the secured lender is *not* necessarily invalid simply because it lies outside the purview of Civ.C. § 2906, as where its exercise is dependent upon the borrower's default. The facts and circumstances surrounding the transaction and the parties' intent may nevertheless reveal that the option should be enforceable according to its terms. Moreover, courts may simply treat the instrument as a mortgage, requiring the lender-optionee to use *judicial foreclosure* procedures to obtain the property, thereby allowing the borrower-optionor an opportunity to cure the default and redeem the property (¶ *6:543*). [*Wachovia Bank v. Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 1058-1059, 52 CR3d 168, 183]

[6:426 - 6:429] ***Reserved.***

3. Assignment of Rents and Profits

a. [6:430] **Necessity for:** To maximize their security, lenders usually want the right to collect the rents and profits from the secured property during the term of the loan. However, a secured lien on the property does not itself assign the rents and profits therefrom. Absent a specific agreement between trustor and beneficiary, the beneficiary is not entitled to possession of the secured property or to the collection of its rents or profits. [*Snyder v. Western Loan & Building Co.* (1934) 1 C2d 697, 701-702, 37 P2d 86, 88; see also *Bailey v. Citibank, N.A.* (2021) 66 CA5th 335, 353, 280 CR3d 546, 560—trust deed does not entitle trustee or beneficiary to possession of property, only right to convey same upon default]

b. [6:431] **Assignment formalities:** The trustor's assignment of rents and profits to the beneficiary may be included in the deed of trust or be made by separate assignment document. [See Civ.C. § 2938(b)]

➪ [6:431.1] ***PRACTICE POINTER:*** Either approach is of equal force and effect to create an enforceable assignment. However, including the assignment in the trust deed will circumvent potential lien priority subordination vis à vis subsequent junior creditors: i.e., problems relating to priority of the assignment of rents can arise if a separate assignment of rents document is not recorded immediately after the deed of trust.

c. [6:432] **Transitional rules:** The rules governing assignments of interest in leases, rents, issues or profits were substantially overhauled effective 1997, resulting in two separate bodies of applicable law depending upon when the assignment was created. [Stats. 1996, Ch. 49 (repealing and adding Civ.C. § 2938, repealing Civ.C. § 2938.1, and amending CCP § 564)]

The version of Civ.C. § 2938 that took effect January 1, 1997 governs contracts entered into *on and after January 1, 1997* (¶ *6:433 ff.*). Conversely, *former* Civ.C. §§ 2938 and 2938.1, in effect before January 1, 1997, govern contracts entered into *before January 1, 1997* and actions and proceedings initiated on the basis of those contracts (¶ *6:434 ff.*). [Civ.C. § 2938(i); see *Federal Nat'l Mortg. Ass'n v. Bugna* (1997) 57 CA4th 529, 537, 67 CR2d 233, 238 (applying former law to dispute concerning assignment of rents under 1986 trust deed)]

The sections at ¶ 6:433 ff. separately address significant aspects of pre-1997 and post-1996 applicable law. (Note, however, that the present statutory scheme is quite comprehensive and addresses many issues that are beyond the scope of this Practice Guide.)

d. [6:433] **Post-1996 assignments—"absolute" notwithstanding label used:** The former distinction in types of assignments of rents/profits (¶ *6:434 ff.*) is abolished with regard to assignments granted on or after January 1, 1997. Any post-1996 written assignment of an interest in rents, issues or profits in real property creates a present security interest in existing and future rents, issues or profits, regardless of how the assignment is denoted (i.e., whether it is labeled "absolute," "absolute conditioned upon default," "additional security" or otherwise). [Civ.C. § 2938(a)]

(1) [6:433.1] **Perfection upon recordation:** The assignment is fully perfected (entitling the lender to collect the assigned rents and profits and imparting constructive notice thereof) once the instrument creating the assignment is duly recorded in the office of the county recorder where the underlying real property is located. [Civ.C. § 2938(b); see *Federal Nat'l Mortg. Ass'n v. Bugna* (1997) 57 CA4th 529, 538, 67 CR2d 233, 239, fn. 6]

Perfection occurs upon recordation notwithstanding any other provision of the assignment or of law that would otherwise preclude or defer its enforcement until the occurrence of a subsequent event (including, but not limited to, a subsequent

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default by the assignor or the assignee's obtaining possession of the real property or the appointment of a receiver). [Civ.C. § 2938(b)]

(2) [6:433.2] **Enforcement upon default:** There are four possible methods by which the lender-assignee may enforce the assignment upon the borrower-assignor's default (Civ.C. § 2938(c)):

- Appointment of a receiver. [Civ.C. § 2938(c)(1); CCP § 564(b)(11) & (12); *see also* ¶ *6:441*]

- Obtaining possession of the rents, issues or profits. [Civ.C. § 2938(c)(2)]

- Delivering to one or more of the tenants a written demand to turn over rents, issues and profits (in the form prescribed by Civ.C. § 2938(k), "Demand to Pay Rent to Party Other Than Landlord"), with a copy delivered to the assignor-borrower and another copy mailed to all other assignees of record of the rents, issues and profits of the property. [Civ.C. § 2938(c)(3), (d)]

- Delivering a written demand for rents, issues or profits to the assignor-borrower, with a copy mailed to all other assignees of record of the rents, issues and profits of the property. [Civ.C. § 2938(c)(4)]

(a) [6:433.3] **Not an "action" triggering "one action rule" or barring deficiency judgment:** An enforcement action taken under Civ.C. § 2938(c) is *not* an "action" violating the CCP § 726 one-action rule (¶ *6:551, 6:554 ff.*) or barring a deficiency judgment; nor does it otherwise limit any rights available to the assignee with respect to its security. [Civ.C. § 2938(e)(2) & (3)]

(b) [6:433.4] **Postenforcement collection:** Once it takes one or more of the enforcement steps set forth at ¶ 6:433.2, the assignee is entitled to collect and receive *all* rents, issues and profits that have accrued but remain unpaid and uncollected by the assignor (or for the assignor's benefit) as of the enforcement date, and all rents, issue and profits that accrue thereafter. [Civ.C. § 2938(c)]

(c) [6:433.5] **Compare—assignee not entitled to preenforcement rents:** The assignee's right to collect the assigned rents is *conditioned* on its taking one of the statutory enforcement steps (¶ 6:433.2). Notwithstanding "perfection" of the assignment, postdefault rents collected *before* the assignee (lender) takes one of the enforcement steps belong to the *borrower* (assignor). [*Federal Nat'l Mortg. Ass'n v. Bugna* (1997) 57 CA4th 529, 538, 67 CR2d 233, 239, fn. 6—"the new statute clearly provides that a creditor holding an absolute assignment is not entitled to rents collected prior to the date it takes one of the enforcement steps"]

(d) [6:433.6] **Assignor's rights in lease extinguished by foreclosure:** Upon assignment, the rights in a lease belong to the lender; the assignor's rights are extinguished, although their liabilities may remain. [See *Gietzen v. Covenant RE Mgmt., Inc.* (2019) 40 CA5th 331, 339-340, 253 CR3d 97, 101-103—following foreclosure, assignor's third-party beneficiary could not invoke non-recourse provision in lease to defend against liability to lessee]

e. [6:434] **Pre-1997 assignments—distinction among types:** Assignments of interest in rents, issues and profits granted *before 1997* remain subject to prior law (¶ *6:432*), under which there were three distinct kinds of assignments:

(1) [6:435] **Absolute assignment:** An *absolute assignment* grants the beneficiary the *immediate right* to collect rents on the secured property. It is a *present transfer* of the assignor's interest in existing and future rents, issues and profits effective upon the assignor's *execution and delivery* of the assignment. [Former Civ.C. § 2938(a)]

(a) [6:436] **Optional recordation to perfect assigned interest:** As between trustor and beneficiary, the absolute assignment takes immediate effect even if not recorded (¶ 6:435). However, recordation (in the county where the secured property is located) is prudent because:

- It gives constructive notice of the content and effect of the assignment "with the same force and effect as any other duly recorded conveyance of an interest in real property"; and

- As a matter of law, it perfects the interest granted by the assignment as of the recordation date, "notwithstanding any provision of the assignment or of any other provision of law that would otherwise preclude or defer enforcement of the rights granted the assignee under the assignment until the occurrence of a subsequent event, including, but not limited to, a subsequent default of the assignor" (*see* ¶ *6:437*). [Former Civ.C. § 2938(b)]

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(2) [6:437] **Absolute assignment conditional on default:** This form of assignment also effects an immediate and present transfer of the trustor's interest in rents and profits but *conditions* the beneficiary's right to *collect* the assigned rights and profits on the borrower's default. [Former Civ.C. § 2938(b)]

Like an unconditional absolute assignment, the conditional assignment should be recorded to perfect the beneficiary's interest in the assigned rents and profits as against subsequent transferees/encumbrancers (*¶ 6:436*).

(a) [6:437.1] **Postdefault enforcement step required:** "Perfection" of the assignment does not itself entitle the assignee to collect postdefault rents. The assignee must take an additional *enforcement step* (e.g., making a written demand for the rents) to begin collecting the assigned rents; until then, the *borrower* (assignor) remains entitled to the collected rents notwithstanding the default. [*Federal Nat'l Mortg. Ass'n v. Bugna* (1997) 57 CA4th 529, 539-541, 67 CR2d 233, 239-240 (decided under prior law and noting same result obtains under present law, *¶ 6:433.5*); see also *In re GOCO Realty Fund I* (BC ND CA 1993) 151 BR 241, 248]

(3) [6:438] **Assignment of rents as additional security:** By contrast, an assignment of rents/profits "as additional security" does *not* effect a present assignment. Rather, it grants the lender an inchoate lien on rents and profits. [See former Civ.C. § 2938.1(b)—beneficiary "shall not exercise any rights to collect the (assigned) rents, issues, and profits" until trustor is in default]

(a) [6:439] **Recordation essential:** An assignment "as additional security" may be perfected *only* by *recordation* of the instrument granting the assignment in the county where the secured property is located. [See former Civ.C. § 2938.1(a)—recordation perfects assignment without necessity of beneficiary obtaining possession of secured property, appointing a receiver or taking any other action; but see also former Civ.C. § 2938.1(d)—recordation prerequisite applicable only to assignments as additional security executed on and after 1/1/93]

(b) [6:440] **Distinguished from absolute assignment conditioned on default:** Insofar as they affect the beneficiary's right to *collect* the assigned rents and profits, there is no practical difference between an absolute assignment conditioned on default and an assignment as additional security.

Nevertheless, perfection issues and the lender's rights upon the borrower's bankruptcy *might* be impacted by the kind of assignment used. [See former Civ.C. §§ 2938 & 2938.1 (¶ *6:436, 6:439*); *In re Ventura-Louise Properties* (9th Cir. 1974) 490 F2d 1141, 1143, 1145, fn. 1]

f. [6:441] **Appointment of receiver to enforce assignment:** As noted, a lender-assignee may enforce its right to collect rents, issues and profits in an action to appoint a receiver. [Civ.C. § 2938(c)(1); CCP § 564(b)(11) & (12); see, e.g., *Resolution Trust Corp. v. Bayside Developers* (ND CA 1993) 817 F.Supp. 822, 828, fn. 4, aff'd (9th Cir. 1994) 43 F3d 1230]

(1) [6:441.1] **Continuation of receivership pending nonjudicial foreclosure:** The receivership appointment may be continued after entry of a judgment for specific performance in the action, when appropriate to protect, operate or maintain the secured real property or to collect the rents therefrom while a pending nonjudicial foreclosure sale under the deed of trust is being completed. [CCP § 564(b)(11)]

(2) [6:442] **Receivership without assignment:** Even if the trustor has not granted an assignment of rents and profits, the beneficiary (lender) can still seek appointment of a receiver if it has commenced a judicial foreclosure action. [CCP § 564(b)(2)]

Cross-refer: Receiverships are discussed in detail in Weil & Brown et al., *Cal. Prac. Guide: Civ. Pro. Before Trial* (TRG), Ch. 9 Part II; and Ahart, *Cal. Prac. Guide: Enforcing Judgments & Debts* (TRG), Ch. 4. (*See also ¶ 6:633* re receiverships to facilitate lender's statutory right of entry/inspection concerning environmental impairment.)

[6:443 - 6:449] ***Reserved.***

4. [6:450] **Subordination:** For various reasons, a buyer sometimes wants the lender to *subordinate* the lien of its deed of trust to a future secured loan from a third party. This often occurs when the buyer intends to develop the property and anticipates a future construction loan but does not plan to pay off its existing loan with construction loan proceeds. [See *Swiss Property Management Co., Inc. v. Southern Calif. IBEW-NECA Pension Plan* (1997) 60 CA4th 839, 841, 70 CR2d 587, 588—under rider to deeds of trust given in seller-financed transaction, sellers agreed "to subordinate this Deed of Trust for construction and development financing required for the development of the property …" (subject to specified conditions)]

Subordination agreements may accompany any financing transaction. As a practical matter, however, they typically occur only in connection with *seller-financed* loans … because institutional lenders rarely are amenable to a subordination of their liens to additional financing.

a. [6:451] **Seller's motivation to subordinate:** The seller might be willing to subordinate its deed of trust for two reasons:

• Subordination may be a necessary inducement to procure a buyer (especially if the property is raw land and the buyer will need a subsequent construction loan).

• So long as the proceeds of the new loan are being used to further improve the property, the value of the seller's security is enhanced. (A seller who has subordinated its lien will, nevertheless, still bear the risk of having to cure any default under the new, senior loan.)

b. Nature and effect of subordination

(1) [6:452] **Moves original lender's (seller's) lien to junior position:** Priorities between encumbrances on the same parcel of property usually are determined by the "first in time, first in priority" rule (Civ.C. § 2897) or the rule giving purchase money deeds of trust priority over other liens, subject to operation of the recording laws (Civ.C. § 2898(a)). [See *MTC Fin'l Inc. v. California Dept. of Tax & Fee Admin.* (2019) 41 CA5th 742, 747, 254 CR3d 485, 489—under "first in time, first in right" system, priorities among "competing enforceable interests" are based on "time of their creation"]

"Subordination" refers to the establishment of priorities among encumbrancers whose priorities otherwise would be fixed under these two statutory rules. [*Middlebrook-Anderson Co. v. Southwest Sav. & Loan Ass'n* (1971) 18 CA3d 1023, 1029-1030, 96 CR 338, 341; *Bratcher v. Buckner* (2001) 90 CA4th 1177, 1185, 109 CR2d 534, 539—exception to "first in time, first in priority" rule is when one party agrees to subordinate priority of its lien to another; see also *Bear Creek Master Ass'n v. Southern California Investors, Inc.* (2018) 28 CA5th 809, 812, 239 CR3d 547, 549-550—HOA's assessment lien against golf course for maintenance costs had priority over lender's previously-recorded third trust deed pursuant to priority/subordination provisions in developer's recorded CC *DMC, Inc. v. Downey Sav. & Loan Ass'n* (2002) 99 CA4th 190, 196, 120 CR2d 761, 765—different types of liens are not on equal footing (purchase money mortgage has priority over all other liens)]

By subordinating its lien to a new secured loan, the lender's (original) loan becomes "junior" (lower in priority) to the new loan. Thus, e.g., in a seller-financed transaction, the seller-financed first position deed of trust loan will be subordinated to a second position at the time the buyer obtains its construction loan.

The reordering of lien priorities pursuant to a subordination agreement may, however, be subject to *conditions; see ¶ 6:457*.

(2) [6:453] **May affect purchase money antideficiency protection:** Seller-financed subordination may also have serious implications for borrowers seeking "antideficiency" protection: Although a seller-financed loan is subject to California's purchase money antideficiency laws (CCP § 580b, *see ¶ 6:563 ff.*), the borrower risks losing its antideficiency protection if the purchase money loan is subsequently subordinated to a construction loan. [*DeBerard Properties, Ltd. v. Lim* (1999) 20 C4th 659, 665-666, 85 CR2d 292, 296; *Spangler v. Memel* (1972) 7 C3d 605, 614, 102 CR 807, 814; *see ¶ 6:568.3*]

[6:453.1 - 6:453.9] ***Reserved.***

c. [6:453.10] **How subordination effected:** Subordination is most commonly effected by either (1) express subordination agreement (*¶ 6:454 ff.*) or (2) "automatic subordination"—i.e., recording the third party trust deed *before* the seller's (original lender's) purchase money deed of trust. [*Brown v. Boren* (1999) 74 CA4th 1303, 1314, 88 CR2d 758, 765]

(1) [6:453.11] **Automatic subordination through escrow:** Automatic subordination typically occurs through escrow—i.e., when, without express agreement to subordinate on specified conditions, the escrow instructions provide that a third party loan is to be recorded *before* the seller's (original lender's) purchase money deed of trust, the seller effectively taking back a second trust deed. [*Brown v. Boren* (1999) 74 CA4th 1303, 1314, 88 CR2d 758, 765]

(2) Subordination agreements vs. agreements to subordinate

(a) [6:454] **Subordination agreement—effects subordination:** A subordination agreement is the instrument by which the existing senior deed of trust is actually subordinated (made junior) to the new deed of trust. The subordination agreement typically is recorded concurrent with recordation of the new deed of trust.

A subordination agreement need not contain the terms and conditions of the new loan because it simply effectuates the change in priority of the two liens.

• ***FORM:*** Subordination Agreement, *see Form 6:J*.

1) [6:454a] **May be conditional:** *See ¶ 6:457 ff.*

(b) [6:455] **Agreement to subordinate—executory contract for future subordination:** An agreement to subordinate is an *executory contract* by which the holder of the existing (senior) deed of trust *agrees to* subordinate its lien in the future. Unlike a subordination agreement (¶ 6:450 ff.), it does *not effectuate* the subordination but simply *contemplates* a future subordination.

An agreement to subordinate should be set forth in the deed of trust.

1) [6:455a] **May be conditional:** *See ¶ 6:457 ff.*

2) [6:456] **Limitations on enforceability:** Both subordination agreements and agreements to subordinate are subject to mandatory disclosure requirements (*¶ 6:461 ff.*). In addition, enforceability of an agreement to subordinate (by way of specific performance) turns on compliance with the following requirements:

a) [6:456.1] **"Just and reasonable":** An agreement to subordinate must be "just and reasonable" as to the subordinating lender (Civ.C. § 3391(2)). [*Handy v. Gordon* (1967) 65 C2d 578, 582, 55 CR 769, 771-772]

b) [6:456.2] **Certainty of terms:** It must be *certain* and *unambiguous*. [*Handy v. Gordon* (1967) 65 C2d 578, 581, 55 CR 769, 771; *Magna Develop. Co. v. Reed* (1964) 228 CA2d 230, 238, 39 CR 284, 290]

c) [6:456.3] **Essential terms:** The agreement should state the maximum *interest rate*, maximum *term*, and *terms of payment of the new loan*. [*Gould v. Callan* (1954) 127 CA2d 1, 6, 273 P2d 93, 96]

It must also state the maximum *amount* of the contemplated new loan. [*Roven v. Miller* (1959) 168 CA2d 391, 398, 335 P2d 1035, 1040]

And the agreement should state the *purpose* of the contemplated new loan. For example, the subordinating lender will want the proceeds of the new loan to be used to either pay down its existing loan or improve the property (thereby increasing the value of the security). [See *Ruth v. Lytton Sav. & Loan Ass'n of Northern Calif.* (1968) 266 CA2d 831, 840, 72 CR 521, 527 (corrected on other grounds by *Ruth v. Lytton Sav. & Loan Ass'n of Northern Calif.* (1969) 272 CA2d 24, 25-26, 76 CR 926, 927, and disapproved on other grounds by *Hatch v. Collins* (1990) 225 CA3d 1104, 1112, 275 CR 476, 480, fn. 4)]

[6:456.4 - 6:456.9] ***Reserved.***

(c) [6:456.10] **Agreement ordering recording sequence:** Technically, an agreement to record one instrument before another is not a true "subordination agreement" (*¶ 6:454*) because the rank of the liens is not altered by agreement but, instead, results from normal operation of the recording statutes (Civ.C. § 2897—first in time, first in priority).

Courts, however, have characterized this scenario as subordination and applied subordination rules to determine the rights and obligations of the parties. [*Brown v. Boren* (1999) 74 CA4th 1303, 1314, 88 CR2d 758, 765]

(3) [6:457] **Conditional subordination agreements:** The reordering of lien priorities pursuant to a subordination agreement or agreement to subordinate is *limited strictly* by the *express terms and conditions* of the agreement. [*Gluskin v. Atlantic Sav. & Loan Ass'n* (1973) 32 CA3d 307, 313, 108 CR 318, 322; *Miller v. Citizens Sav. & Loan Ass'n* (1967) 248 CA2d 655, 663, 56 CR 844, 851; see also *Bratcher v. Buckner* (2001) 90 CA4th 1177, 1186, 109 CR2d 534, 540—subordination agreements (like contracts generally) interpreted to enforce parties' *objective intent*]

Thus, e.g., where a seller's subordination agreement specifies the buyer's new loan may be used only for construction purposes, the seller's lien is *not* subordinated to a subsequent loan obtained and used for a *different* purpose; i.e., a subordination agreement *breached* by the buyer is *unenforceable* by the subsequent lender. [See *Protective Equity Trust #83, Ltd. v. Bybee* (1991) 2 CA4th 139, 150-151, 2 CR2d 864, 870-871—buyer breached seller-financed subordination

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agreement (specifying subordination limited to construction loan) by applying part of new loan toward underlying (original) purchase obligation]

Therefore, where a subsequent lender's lien priority derives solely through the original lender's subordination agreement, upon failure of that agreement the seller's (original lender's) trust deed will be deemed senior to the subsequent lender's trust deed. [*Protective Equity Trust #83, Ltd. v. Bybee*, supra, 2 CA4th at 151, 2 CR2d at 871]

(a) [6:457.1] **Contract principles apply:** A claim of loss of priority resulting from unfulfilled conditions in a subordination agreement is based on principles of contract law. This is so whether the third party lender's claim to priority derives from a formal subordination agreement where the seller records first and then agrees their lien will be junior to a third party loan, or from an agreement by the seller to record after the third party lender. [*Brown v. Boren* (1999) 74 CA4th 1303, 1315-1316, 88 CR2d 758, 766-767—claim that senior lender failed to comply with conditions of subordination must be supported by contractual theory, which plaintiff failed to plead]

(b) [6:457.2] **Subject to seller's waiver by agreeing to subsequent unconditional subordination:** A subordinating seller cannot invoke conditions in its subordination agreement to protect its priority as against a subsequent lender where it *consents* to a subsequent *unconditional* subordination agreement that makes no reference to the prior conditional subordination.

By executing the subsequent unconditional subordination, the seller effectively *removes* the former restrictions on subordination; having been superseded, there no longer remain any conditions of subordination to be breached. [*Swiss Property Management Co., Inc. v. Southern Calif. IBEWNECA Pension Plan* (1997) 60 CA4th 839, 849-850, 70 CR2d 587, 593-594—new lender's lien entitled to first position priority even though buyer's deed of trust in favor of seller provided specific conditions to subordination, where seller consented to subsequent unconditional subordination in favor of new lender]

(4) [6:458] **Implied good faith duty owed to subordinating seller/lender:** Public policy considerations warrant protecting the rights of a subordinating seller (or other first-in-time lender) who willingly agrees to take a junior position in reliance on the fact the proceeds of the subsequent loan (to which it has agreed to subordinate) will be used to enhance the value of the property. For that reason, the subsequent lender is held to a good faith duty *implied in the subordination agreement* not to do anything that will defeat the subordinating seller's security interest. [*Gluskin v. Atlantic Sav. & Loan Ass'n* (1973) 32 CA3d 307, 313-314, 108 CR 318, 322]

For the same policy reasons, a buyer/borrower and new lender may not bilaterally make a material modification of the loan to which the seller has subordinated without the seller's knowledge and consent. The buyer/borrower and new lender may be liable to the subordinating seller if, without the latter's consent, they agree to a modification that materially increases the risk the new loan will become a subject of default. [*Gluskin v. Atlantic Sav. & Loan Ass'n*, supra, 32 CA3d at 314-315, 108 CR at 323-324; see *Citizens Business Bank v. Gevorgian* (2013) 218 CA4th 602, 626, 160 CR3d 49, 67 (applying *Gluskin*)—agreement subordinating seller's purchase money security interest to lien of subsequent construction loan unenforceable where buyer and new lender materially modified construction loan without seller's knowledge and consent; *Resolution Trust Corp. v. BVS Develop., Inc.* (9th Cir. 1994) 42 F3d 1206, 1214—*Gluskin* rule aims to protect subordinated sellers from secret agreements between buyers and lenders against subordinated seller's interest]

(a) [6:458.1] **Compare—no comparable duty owed to *nonsubordinating junior lienholders:*** Absent facts giving rise to a "special relationship" between junior and senior lienholders, no comparable rule protects a *nonsubordinating* junior lienholder against a risk that the senior loan might be modified in a manner that materially affects the security of the junior lien. [*Friery v. Sutter Buttes Sav. Bank* (1998) 61 CA4th 869, 877-878, 72 CR2d 32, 37-38]

Thus, e.g., a senior lender owed no implied duty to a junior lienholder (seller who took back a second trust deed) in renegotiating the terms of its loan with a new buyer; and, therefore, the junior could not prevail on its claim that by renegotiating without the junior's consent, the senior lender subordinated its lien to the junior lien. "Renegotiation of the senior loan upon transfer of ownership without the lender's consent was precisely one of the hazards which [seller] accepted when she sold the property and took back a second deed of trust. We see no public policy reasons to saddle [senior lender] with a duty of care to protect her security when its own superior lien was jeopardized by a sale of the property to a less solvent owner." [*Friery v. Sutter Buttes Sav. Bank*, supra, 61 CA4th at 879, 72 CR2d at 38-39]

[6:459] ***Reserved.***

➪ [6:460] ***PRACTICE POINTER FOR SUBORDINATING SELLERS:*** Subordinating lenders in a *seller-financed* transaction are principally concerned with keeping the permissible terms for the new loan as *restrictive as possible*. For example, the seller does not want to have its lien junior to a new excessively-large senior deed of trust that accrues interest at a high rate.

In addition, the seller should require that all proceeds from the new loan be used to either pay down the seller's loan or finance construction of improvements on the property (thereby enhancing the value of the seller's security). (Problems usually arise when the buyer wants to allocate a portion of the new loan proceeds to pay so-called "soft" costs, such as the buyer's overhead expenses and legal, accounting, engineering and architectural fees, while the seller wants the new loan proceeds to be used only for "hard" construction costs. *See ¶ 6:50 ff.* re "hard" vs. "soft" construction costs.)

In all events, remember that *conditions* to subordination must be *spelled out* in the subordination agreement. [See *Swiss Property Management Co., Inc. v. Southern Calif. IBEW-NECA Pension Plan* (1997) 60 CA4th 839, 849-850, 70 CR2d 587, 593-594—sellers' conditional subordination agreement superseded by subsequent *unconditional* subordination agreement to which sellers consented; *and ¶ 6:457.2*]

d. [6:461] **Statutory disclosure requirements re small secured loans:** By statute, certain disclosures *must* be included in both subordination agreements and instruments containing executory subordination agreements. [Civ.C. §§ 2953.1-2953.5; see Civ.C. § 2953.1(b) & (c), defining "subordination clause" and "subordination agreement"]

(1) [6:462] **Exception if loan exceeds $25,000:** The disclosure and voidability provisions discussed at ¶ 6:463 ff. do *not* apply to:

- Any subordination clause or subordination agreement that expressly states the subordinating loan shall exceed $25,000 (Civ.C. § 2953.5(a)); *or*

- Any subordination clause or subordination agreement executed in connection with a loan exceeding $25,000 (Civ.C. § 2953.5(b)).

(2) Mandatory notices

(a) Subordination agreements

1) [6:463] **Legend:** If the document is a subordination agreement, the words "Subordination Agreement" must appear in at least 10-point bold type (or, if typewritten, in capital letters and underlined) at the top of the agreement. [Civ.C. § 2953.3(a)]

2) [6:464] **Impact on lien priority:** Further, the following notice must appear immediately below the legend (¶ 6:463) in at least eight-point bold type (or, if typewritten, in capital letters):

"Notice: This subordination agreement ('*may result*' or '*results*,' as appropriate) in your security interest in the property becoming subject to and of lower priority than the lien of some other or later security instrument." [Civ.C. § 2953.3(b)]

3) [6:465] **Use of new loan proceeds:** If the terms of the agreement permit the obligor to use the new loan proceeds for a purpose *other than* defraying contract costs for improvement of the secured property, the agreement must contain the following additional notice in at least eight-point bold type (or, if typewritten, in capital letters) directly above the space reserved for the subordinating lender's signature:

"Notice: This subordination agreement contains a provision which ('*allows*' or '*may allow*,' as appropriate) the person obligated on your real property security to obtain a loan a portion of which may be expended for other purposes than improvement of the land." [Civ.C. § 2953.3(c)]

(b) Security instruments containing subordination clause

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1) [6:466] **Legend:** If the security instrument (deed of trust) contains or has attached a subordination clause, the word "Subordinated" must appear in at least 10-point bold type (or, if typewritten, in capital letters and underlined) at the top of the instrument, followed by a description of the type of security instrument. [Civ.C. § 2953.2(a)]

2) [6:467] **Impact on lien priority:** Further, the following notice must appear immediately below the Civ.C. § 2953.2(a) legend (¶ 6:466) in at least eight-point bold type (or, if typewritten, in capital letters):

"Notice: This … (*insert description of real property security instrument*) contains a subordination clause which may result in your security interest in the property becoming subject to and of lower priority than the lien of some other or later security instrument." [Civ.C. § 2953.2(b)]

3) [6:468] **Use of new loan proceeds:** And, if the subordination clause allows the obligor to use the new loan proceeds for a purpose *other than* defraying the costs for improvements on the secured property, the following additional notice must appear in at least eight-point bold type (or, if typewritten, in capital letters) directly above the space reserved for the subordinating lender's signature:

"Notice: This … (*insert description of real property security instrument*) contains a subordination clause which allows the person obligated on your real property security instrument to obtain a loan a portion of which may be expended for other purposes than improvement of the land." [Civ.C. § 2953.2(c)]

(3) [6:469] **Consequences of noncompliance—subordinated lender's avoidance power:** A subordination clause or subordination agreement that does not "substantially comply" with the disclosure requirements set forth at ¶ 6:461 ff. is *voidable* at the subordinating lender's (or its successor in interest's) election *exercised within two years* of the date on which the deed of trust is executed ... *unless* it had "actual knowledge" of the existence and terms of the subordination clause or agreement. [Civ.C. § 2953.4]

(a) [6:470] **Mechanics for avoidance:** An election to void the subordination clause or agreement must be exercised by *recording* a notice stating that the Civ.C. §§ 2953.2/2953.3 requirements have not been complied with; that the person making the election is the holder of the security instrument which is or was to become subordinated; and that they elect to avoid the effect of the subordination clause or agreement. [Civ.C. § 2953.4(b)]

(b) [6:471] **Waiver:** The right to void the noncomplying subordination may be waived by the secured lender's subsequent execution and recordation of a statement that it knows of the existence of the subordination clause or agreement and of its terms, and that it waives the Civ.C. § 2953.4 voidability provisions and the Civ.C. §§ 2953.1-2953.3 requirements. [Civ.C. § 2953.4(c)]

e. [6:472] **Subordination of deeds of trust to leases:** Foreclosures can wipe out leases that are subordinate to deeds of trust. [*Aviel v. Ng* (2008) 161 CA4th 809, 816, 74 CR3d 200, 205-206; see also *Dr. Leevil, LLC v. Westlake Health Care Ctr.* (2017) 9 CA5th 450, 454-455, 215 CR3d 127, 130-131 (reversed on other grounds by *Dr. Leevil, LLC v. Westlake Health Care Center* (2018) 6 C5th 474, 484-485, 241 CR3d 12, 20)—foreclosure sale under deed of trust extinguished lease pursuant to its automatic subordination provision; *and ¶ 6:534.2*]

Consequently, tenants are concerned about preserving their leaseholds after foreclosure. And, lenders generally are willing to accommodate tenants' concerns because lenders do not want to foreclose-out paying tenants. Therefore, tenants and lenders often enter into "nondisturbance and attornment agreements" (or "subordination, nondisturbance and attornment agreements"), governing how foreclosure will affect their respective rights. Such agreements generally have the following principal components:

• [6:472.1] *Attornment:* The tenant agrees to "attorn" to the successful bidder at the foreclosure sale (i.e., agrees to become the tenant of the new owner). [See *Miscione v. Barton Development Co.* (1997) 52 CA4th 1320, 1327-1328, 61 CR2d 280, 285]

• [6:472.2] *Nondisturbance:* The lender agrees that, in the event of a foreclosure, the tenant's right of possession will not be "disturbed"—i.e., the tenant retains the right to remain on the leased premises so long as the tenant is not in default under the lease. [*Miscione v. Barton Develop. Co.* (1997) 52 CA4th 1320, 1327-1332, 61 CR2d 280, 285-288]

• [6:472.3] *Subordination:* The tenant agrees that its lease will become subordinate to any liens or encumbrances on the landlord's property that attach after the lease is executed. [*Dover Mobile Estates v. Fiber Form Products, Inc.* (1990) 220 CA3d 1494, 1498, 270 CR 183, 185; see also Civ.C. § 2934]

Cross-refer: Nondisturbance and attornment agreements are discussed in detail in *Ch. 7* in connection with ground leases; *see ¶ 7:273 ff.*

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f. [6:473] **Subordination to liens subject to intervening lien:** When a first priority lien is subordinated to a later lien that is subject to an intervening lien, the liens subject to the subordination agreement "switch places" in priority, but only to the extent of the total amount of the subordinated lien (the former first priority lien). This result is "most logical and fair" because it does not affect the intervening lienholder's rights and its original position in the chain of priorities. [*Bratcher v. Buckner* (2001) 90 CA4th 1177, 1187, 109 CR2d 534, 540; see also *Wells Fargo Bank v. Neilsen* (2009) 178 CA4th 602, 611-612, 100 CR3d 547, 552-553 (applying *Bratcher* reasoning to nonjudicial foreclosure proceeding)—per subordination agreement, third lienholder was superior to first but still junior to second, whereas first was junior to third but still senior to second (*discussed further at ¶ 6:535.14g*)]

• [6:473.1] **Example:** Defendant executes a deed of trust encumbering his property in the amount of $200,000 (L1). A $100,000 judgment lien (L2) is then recorded against the property. Defendant executes a third deed of trust against the property in the amount of $50,000 (L3). Thereafter, written agreements are executed subordinating L1 to L3, with no mention of L2.

Bratcher determines the priority of the liens as follows: L3's $50,000 lien now takes the L1 first priority position. After subtracting L3's $50,000 lien, L1 retains priority over L2 in the amount of $150,000 (the $50,000 balance is now junior to L2's judgment lien). [See *Bratcher v. Buckner* (2001) 90 CA4th 1177, 1188, 109 CR2d 534, 542]

g. [6:474] **Multiple loans secured by single deed of trust; subordination's effect on lien priority:** Several loans on real property may be secured by a single deed of trust and cross-defaulted—i.e., a default on one will be a default on all. Unless the parties otherwise agree, however, the priority of the loans does not change. Thus, a lender's agreement to subordinate its loan to *one* of several loans secured by the same deed of trust does *not* subordinate the lender's loan to any of the other loans. [See *R.E. Loans, LLC v. Investors Warranty of America, Inc.* (2013) 212 CA4th 1432, 1433, 151 CR3d 799, 800—lender did not breach subordination agreement when new loans secured by same trust deed exceeded amount specified in the agreement]

• [6:475] **Example:** Lender 1 agrees to subordinate its existing trust deed to a new loan from Lender 2 in the approximate amount of $4,000,000, secured by a new first deed of trust in favor of Lender 2. Lender 2's trust deed secures the $4,000,000 loan, plus two other loans for a total of $21,000,000. The loans are cross-defaulted and cross-collateralized. To the extent Lender 2's trust deed secures a note in the amount of $4,000,000, it is senior to Lender 1's trust deed. To the extent Lender 2's trust deed secures the other loans, it is junior to Lender 1's trust deed. [See *R.E. Loans, LLC v. Investors Warranty of America, Inc.* (2013) 212 CA4th 1432, 1437, 151 CR3d 799, 803]

[6:476 - 6:479] ***Reserved.***

5. Fixtures and Fixture Filings

a. [6:480] **"Fixtures" defined:** A "fixture" is essentially anything that becomes so attached to real property as to become a permanent part of it. [Civ.C. § 660; see also Comm'l C. § 9102(a)(41)—fixtures are "goods that have become so related to particular real property that an interest in them arises under real property law"; *People v. Acosta* (2014) 226 CA4th 108, 119, 171 CR3d 774, 782—something is deemed affixed to land when it is attached by roots (e.g., trees), embedded in it (e.g., walls), permanently resting upon it (e.g., buildings) or permanently attached to what is already permanent (e.g., by cement, plaster, nails, bolts, or screws); *and further discussion at ¶ 4:42 ff.*]

b. [6:481] **Necessity of fixture filing:** A secured creditor may take an interest in fixtures only by completing a "fixture filing" (Comm'l C. §§ 9102(a)(40) & 9502(a) & (b)). Usually, the deed of trust will suffice as a fixture filing (*see ¶ 6:484 ff.*).

➪ [6:482] ***PRACTICE POINTER FOR LENDERS:*** There are at least two reasons why the trust deed beneficiary (lender) wants to make certain it is secured as to fixtures:

• A completed fixture filing ensures that the beneficiary will retain a perfected security interest in the fixtures even if they are removed.

• Before they are built into the real estate, fixtures constitute personal property which could be subject to another creditor's prior claims. If the fixture filing is properly made, the beneficiary will be a *secured creditor* from the instant the personal property becomes so incorporated into the real estate as to become a fixture.

c. [6:483] **Place of filing:** A fixture filing must be filed in the office of the county recorder where a mortgage (or deed of trust) on the real estate would be recorded (i.e., in the county where the subject real property is located; see generally, Civ.C. § 1169). [Comm'l C. §§ 9102(a)(37) & 9501(a)(1)(B)]
d. [6:484] **Deed of trust as fixture filing:** A deed of trust can constitute a fixture filing *provided all* of the following conditions are met (Comm'l C. § 9502(c)):

• The deed of trust indicates the goods that it covers;

• The goods are or are to become fixtures related to the real property described in the deed of trust;

• The deed of trust complies with the requirements for a financing statement set forth in Comm'l C. § 9502 other than an indication that it is to be filed in the real property records; and

• The deed of trust is duly recorded. [Comm'l C. § 9502(c)]
(1) [6:485] **"Fixture filing" legend not essential:** Most deeds of trust will satisfy the requirements set forth at ¶ 6:484. The deed of trust need not expressly bear a "fixture filing" legend, although some include such legend (usually on the title page).
(2) [6:486] **Alternative UCC financing statement; distinction in duration:** Alternatively, a trust deed beneficiary may make a fixture filing by recording a separate UCC financing statement (*see ¶ 4:36*). However, whereas a deed of trust operates as fixture filing until actually released by the beneficiary, a separate financing statement must be renewed every five years (otherwise, it automatically expires by law). [Comm'l C. § 9515(a), (g)]

[6:487 - 6:489] *Reserved.*

6. Personal Property Security Agreements

a. Lender's concerns

(1) [6:490] **Maximizing security interest:** A fixture filing (¶ 6:481 ff.) does not give the lender any security interest in movable (nonfixture) personal property relating to the secured real property. Yet, institutional lenders often want to maximize the security of their loans by taking a security interest in all personal property relating to ownership or operation of the real property for which the loan is being made. Therefore, in loan transactions involving properties other than single family residences or small apartment buildings, lenders often require the buyer to grant the lender a security interest in all tangible and intangible personal property relating to the real property.
(2) [6:491] **Resolving "personal" vs. "real" property issues:** Many office buildings and apartment projects include few items of personal property (e.g., only a small amount of maintenance equipment, washers and dryers, drapes/blinds in the units). Nevertheless, a personal property security agreement will be desirable from the lender's perspective because it circumvents possible future dispute over the scope of secured property embraced in the trust deed or a fixture filing—e.g., lighting fixtures, power panels, boilers, commercial kitchen equipment (such as large freezers or ovens), etc. are not necessarily easily categorized as "personal property" (which would not be covered by the trust deed or fixture filing) as opposed to "real property" (which would be covered by the trust deed or fixture filing).
So long as the lender has a perfected first position security interest in the subject property, it is immaterial whether the property is real or personal.
b. [6:492] **Necessity for security agreement:** A security agreement is the document by which the borrower grants a security interest to the lender. [See Comm'l C. § 9102(a)(74)—defining "security agreement" as an agreement that "creates or provides for a security interest"]

• ***FORM:*** Personal Property Security Agreement, *see Form 6:K*.
(1) [6:493] **Deed of trust as security agreement:** A personal property security agreement is incorporated into many deeds of trust. In those instances, it may be unnecessary for the lender to require a separate security agreement (so long as the

minimum essential terms are set forth in the trust deed; *see ¶ 6:494 ff.*). In either case, however, the lender will need to *perfect* its security interest in personal property (*see ¶ 6:503*).

c. Creation of effective security agreement

(1) [6:494] **Formalities; minimum terms:** To create a valid security interest in personal property, the agreement must, at a minimum, satisfy the following requirements:

(a) [6:495] **Signed record:** Security agreements must be *signed by the debtor* (borrower). [See Comm'l C. § 9203(b)(3)(A) (amended Stats. 2023, Ch. 210; eff. 1/1/24); Comm'l C. § 1201(b)(37) (amended Stats. 2023, Ch. 210; eff. 1/1/24)—"sign" means to execute or adopt a tangible symbol, or attach an electronic symbol, to a record with present intent to authenticate or adopt the record]

(b) [6:496] **Security interest in fact:** Whether an agreement creates a security interest depends not on whether the parties intend that the law characterize the transaction as a security interest but rather on whether the transaction falls within the statutory definition of "security interest"—i.e., an interest in personal property or fixtures that secures payment or performance of an obligation (Comm'l C. § 1201(b)(35)). [See Comm'l C. § 9102, Assemb. Comm. Comment No. 3 (1999 Addition) and Unif. Comm'l C. Comment No. 3]

[6:497] ***Reserved.***

(c) [6:498] **Description of collateral or collateral in creditor's possession:** In addition to the security agreement (¶ 6:490 ff.), enforceability requires compliance with the evidentiary standard established for the type of collateral taken. [See Comm'l Code § 9203's Uniform Comm'l Code Comment-2022 Update, Comments 3 & 4]

For most types of personal property, the security agreement must sufficiently describe the collateral (Comm'l C. §§ 9108 & 9203(b)(3)(A)). If the security agreement does not, the collateral (other than a certificated security) must be in the secured party's possession or control under Comm'l C. § 7106 (electronic documents of title), § 9104 (deposit accounts), § 9105.1 (electronic money), § 9106 (investment property), § 9107 (letter of credit rights), § 9107.1 (controllable electronic records, accounts or payments intangible), § 9313 (uncertificated securities), or § 9314.1 (chattel paper). [Comm'l C. § 9203(b)(3)(B)-(E)]

(d) [6:499] **Statement of secured obligation:** The agreement must recite the obligation(s) secured. [*Needle v. Lasco Industries, Inc.* (1970) 10 CA3d 1105, 1108, 89 CR 593, 596]

However, a broad reference to "all obligations" or future advances is not fatal to the security agreement. So long as the agreement evidences the parties' *intent* to create a security interest (¶ 6:494 ff.), the gap left by an imprecise or general description of the secured obligation may be filled by reference to the parties' "reasonable expectations"; and their reasonable expectations may be ascertained by testimony concerning the parties' course of dealing, usage of trade, course of performance and other relevant circumstances. [See *New West Fruit Corp. v. Coastal Berry Corp.* (1991) 1 CA4th 92, 98-100, 1 CR2d 664, 667-669—delineation of precise obligation secured by agreement between lender and strawberry growers satisfied by testimony on industry custom and parties' course of dealing]

(2) [6:500] **Additional terms:** Though not essential to create a valid security interest, the following additional provisions generally should be included in the security agreement (*see Form 6:K*):

(a) [6:501] **Debtor's agreements:** The debtor should represent it owns the collateral and (among other things) should agree to:

• allow the secured party access to the collateral;

• refrain from moving the collateral (except as otherwise agreed);

• maintain the collateral in good condition and repair;

• not sell the collateral or permit any subsequent lien to encumber it;

• deliver the collateral to the secured party upon the debtor's default.

(b) [6:502] **Events of default; remedies:** The agreement should also specify what constitutes a default by the debtor and set forth the secured party's remedies upon default—typically, to take possession of the collateral and sell it at either a public or private sale pursuant to applicable California Commercial Code provisions. [See Comm'l C. § 9601 et seq.]

d. [6:503] **Perfection of security interest:** Even though a security interest is validly created (¶ *6:494 ff.*), the secured party must still perfect its interest in the collateral so as to ensure the priority of its lien over other creditors. A security interest in personal property ordinarily is perfected in California by filing a UCC-1 financing statement with the Secretary of State of California. [See Comm'l C. § 9301 et seq.]

[6:504 - 6:509] ***Reserved.***

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Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 6. Financing and Appraisals

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[6:510] Although a detailed treatment of debtor-creditor issues is beyond the scope of this Practice Guide, the sections at ¶ 6:511 ff. provide an overview of the general procedural framework for foreclosures and the basic rules concerning California's antideficiency laws.

➪ [6:510.1] ***CAVEAT:*** The rights and remedies of lenders and borrowers in secured real property transactions are the subject of a substantial body of statutory and case law, and include some of the most complicated—and, in many respects, unsettled

—legal issues in California. General practitioners are cautioned not to tread too deeply into these waters without consulting appropriate experts and/or specialized treatises on the subject.

1. [6:511] **Residential Foreclosure Prevention Laws and Programs:** In 2008-2009, Congress enacted an exhaustive body of consumer protective legislation meant to reduce the rise in residential foreclosures and stabilize property values. The Federal Reserve Board has issued related consumer protection regulations (*¶ 6:99.1*) and, in 2009, the U.S. Treasury Department instituted residential mortgage modification and refinancing programs to assist distressed homeowners. State law too was revised to help stave off the mounting foreclosure crisis in California.

A comprehensive treatment of these developments is beyond the scope of this Practice Guide. However, a summary of the most relevant programs is set forth at ¶ 6:511.1 ff.:

a. [6:511.1] **California Homeowner Bill of Rights:** Effective January 1, 2013, the Homeowner Bill of Rights (HBOR) modified the nonjudicial foreclosure process by ensuring that specified borrowers who may qualify for a foreclosure alternative "are considered for, and have a meaningful opportunity to obtain, available loss mitigation options …" [See Civ.C. § 2923.4; *Morris v. JPMorgan Chase Bank, N.A.* (2022) 78 CA5th 279, 296, 293 CR3d 417, 442—"[a]t the heart of the HBOR are mandated procedures designed to promote good faith negotiation of some form of foreclosure alternative …, typically modification of the borrower's loan terms"]

Key provisions of the law include:

• [6:511.2] **Notice requirements:** Prior to recording a notice of default, lenders, mortgage servicers, mortgagees, trustees, beneficiaries and their authorized agents must contact the defaulting borrower to provide specified information regarding options for avoiding foreclosure. *See¶ 6:524.3 and 6:524.9*.

• [6:511.3] **Single point of contact for "high volume" foreclosures:** Mortgage servicers conducting a large volume of residential foreclosures must assign each borrower a single point of contact to handle the process. *See¶ 6:524.13*.

• [6:511.4] **No "dual-tracking" of foreclosure and loan modification processes:** Nonjudicial foreclosures may not proceed while borrowers have complete applications for foreclosure prevention alternatives pending, or while borrowers are in compliance with approved modifications. *See¶ 6:524.6 ff. and 6:524.16 ff.*

• [6:511.5] **Private right of action:** Borrowers may bring suit against mortgage servicers to enforce the statute *before* a foreclosure sale takes place, or to seek damages for violations *after* the sale. *See¶ 6:524.8 and 6:524.20*.

• [6:511.6] **Application to residential property:** Most of the statutory provisions apply to owner-occupied residential real property of not more than four units that serves as the owner's principal residence and secures a first lien mortgage or deed of trust obtained for personal, family or household purposes. *See¶ 6:524.1.*

***ALERT*—extended application due to COVID-19 pandemic:** In response to the COVID-19 pandemic, California extended the HBOR protections to any property owned by a small landlord (one or more individuals who owned no more than three residential properties) and occupied as a principal residence by a tenant pursuant to an arm's length lease entered into before, and in effect on, March 4, 2020. The inclusion of such rental properties under the HBOR ended on January 1, 2023, *unless* the borrower had been approved or submitted a completed application for foreclosure prevention before January 1, 2023. [See Civ.C. § 2924.15; *discussed further at*¶ 6:524.1a]

• [6:511.7] **"Sunset" and current provisions; large and small volume services:** From its effective date until January 1, 2018, HBOR prescribed a bifurcated system of preforeclosure requirements depending on the volume of residential foreclosures the lender or servicer conducted in the prior year. Low volume servicers (defined as certain chartered and licensed entities that foreclosed on 175 or fewer homes in the prior year) were subject to slightly less onerous foreclosure prevention procedures (*see*¶ 6:524.3 ff.). From January 1, 2018 to December 31, 2018, there was only one set of requirements applicable to all lenders or servicers, with very few exemptions for low volume servicers (¶ 6:524.21 ff.). Commencing January 1, 2019, however, the Legislature re-enacted HBOR in nearly identical form to the original 2012 statute, but without the "sunset" provisions (see Stats. 2018, Ch. 404). And in response to the COVID-19 pandemic, the Legislature again amended HBOR to extend its protections to certain residential properties only until January 1, 2023, *unless* the borrower had been approved or submitted a completed application for foreclosure prevention before January 1, 2023. [See Civ.C. § 2924.15; *and*¶ 6:524.1]

Caution: As a result of the foregoing, HBOR contains some provisions that expired on 1/1/18 but were reinstated effective 1/1/19 (e.g., Civ.C. §§ 2923.55, 2924.9, 2924.10, 2924.17, 2924.18, 2924.19), and others that have one

version that expired on 1/1/18 but reverted substantially to the 2012 form effective 1/1/19, and another version that was effective only during calendar year 2018 (see, e.g., 2018 operative versions of Civ.C. §§ 2923.5, 2923.6, 2924.11, 2924.12, 2924.15). Thus, practitioners must always exercise care in ascertaining which HBOR provisions apply given the particular circumstances at hand.

[6:511.8] **No abatement due to "sunsetting":** The 2018 HBOR amendments (¶ 6:511.7) did *not* alter any liability for violations of the statute in its previous forms. [See Stats. 2018, Ch. 404, §§ 25, 26 (disavowing statutory repeal of prior law unless expressly provided); *Morris v. JPMorgan Chase Bank, N.A.* (2022) 78 CA5th 279, 307-308, 293 CR3d 417, 451-452—plaintiff's claim for violating HBOR's dual-tracking prohibition not abated when original HBOR "sunsetted" because prohibition was moved to another code section and reenacted in substantially identical form; *Schmidt v. Citibank, N.A.* (2019) 28 CA5th 1109, 1117, 239 CR3d 648, 653-654 (decided prior to reinstatement of pre-2018 HBOR scheme) —statutory repeal doctrine did not prevent homeowners from suing for pre-2018 HBOR violations because Legislature re-enacted most of said statute's protections, eff. 1/1/18]

b. [6:511.9] **California residential mortgage loan modification laws:** *See* ¶ *6:99.5 ff.*

c. [6:511.10] **Housing and Economic Recovery Act of 2008 (HERA):** The Housing and Economic Recovery Act of 2008 (HERA, Pub.L. 110-289, 122 Stat. 2654) was signed into law July 30, 2008. Among other things, HERA enhanced the statutory foreclosure protections afforded servicemembers. *See* ¶ *6:512.1*.

➪ [6:511.10a] ***PRACTICE POINTER:*** HERA (¶ 6:511.10) empowered the Federal Housing Finance Agency (FHFA) to place the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae) into conservatorship to protect the U.S. housing market. This legislation shields the conservatorship assets from certain taxes, penalties, fines and collection actions, including foreclosures conducted without FHFA's consent (generally referred to as the "Federal Foreclosure Bar"). [12 USC § 4617(j); *Federal Home Loan Mortgage Corp. v. SFR Investments Pool 1, LLC* (9th Cir. 2018) 893 F3d 1136, 1142-1143; *Berezovsky v. Moniz* (9th Cir. 2017) 869 F3d 923, 926-928; see also *Collins v. Yellen* (2021) _ US _, _, 141 S.Ct. 1761, 1700 (outlining history of Fannie Mae, Freddie Mac, and FHFA)]

The Federal Foreclosure Bar (above) restricts foreclosures by private entities as well as state and local tax foreclosures. It also preempts conflicting state laws. [See *Nationstar Mortg. LLC v. Saticoy Bay LLC, Series 9229 Millikan Ave.* (9th Cir. 2021) 996 F3d 950, 958 (Nevada statute establishing HOA's superior lien preempted)—foreclosure sale conducted by HOA without FHFA's consent did not extinguish Freddie Mac's mortgage lien; *Berezovsky v. Moniz,* supra, 869 F3d at 926-930 (same)]

Freddie Mac and Fannie Mae account for a substantial portion of residential mortgage financing, and their conservatorship continues in 2018 (see *Federal Home Loan Mortgage Corp. v. SFR Investments Pool 1, LLC,* supra, 893 F3d at 1140-1141). Accordingly, practitioners should always evaluate whether the Federal Foreclosure Bar applies to their client's circumstances.

d. [6:511.11] **Helping Families Save Their Homes Act of 2009:** The Helping Families Save Their Homes Act was signed into law May 20, 2009. Its purpose is to prevent mortgage foreclosures and enhance mortgage credit availability. Among other things, the Act authorizes mortgage loan servicers to modify loans and engage in other loss mitigation activities consistent with guidelines issued by the Secretary of the Treasury. It also provides a servicer "safe harbor" for mortgage loan modifications. [See 15 USC § 1639a; compare Civ.C. § 2923.6—California's "safe harbor" provision for mortgage servicers considering mortgage loan modifications]

e. [6:511.12] **Making Home Affordable Program (MHA):** The Making Home Affordable Program (MHA) was developed by the U.S. Treasury Department and the Department of Housing and Urban Development as a broad strategy to help avoid foreclosure on residential properties, stabilize the country's housing market and improve the U.S. economy. The program, which provided loan modification guidelines for the mortgage industry, ended December 31, 2016, except with respect to certain loan modification applications made prior thereto. [See Pub.L. 114-113, Div. O, Title VII, § 709(a), (b); Supplemental Directive 16-02, "Making Home Affordable Program - MHA Program Termination and Borrower Application Sunset"]

A variety of component programs designed to address mortgage distress situations included:

— Home Affordable Modification Program (HAMP and HAMP Tier II) (¶ *6:511.13*);

— Principal Reduction Alternative SM;

— Second Lien Modification Program;

— FHA Home Affordable Modification Program;

— USDA's Special Loan Servicing;

— Veteran's Affairs Home Affordable Modification;

— Second Lien Modification Program for Federal Housing Administration Loans;

— Home Affordable Refinance Program (HARP) (¶ 6:511.28);

— FHA Refinance for Borrowers with Negative Equity;

— Home Affordable Unemployment Program;

— Housing Finance Agency Innovation Fund for the Hardest Hit Housing Markets;

— Home Affordable Foreclosure Alternatives Programs (HAFA) (¶ 6:511.29).

f. [6:511.13] **Home Affordable Modification Program (HAMP and HAMP Tier II):** The Home Affordable Modification Program (HAMP) was developed by the U.S. Treasury Department as part of the MHA (¶ 6:511.12). HAMP allowed homeowners who are behind on their mortgage payments to modify the terms of their first mortgage by lowering monthly payments to 31% of their gross income. This level was achieved by reducing the interest rate to as low as 2% and extending the term of the loan or deferring payment on part of the principal. The program included the use of short sales and deeds in lieu of foreclosure if a borrower could not complete the modification process.

A critical eligibility requirement was that the borrower's default be reasonably foreseeable. Servicer participation in HAMP was voluntary; however, Fannie Mae, Freddie Mac and financial institutions receiving assistance under the Financial Stability Plan were required to implement the plan. HAMP ended December 31, 2016, except for certain loan modification applications made prior thereto. [See Supplemental Directive 16-02, "Making Home Affordable Program - MHA Program Termination and Borrower Application Sunset"]

Effective June 1, 2012, the U.S. Treasury created a second class of HAMP modifications known as HAMP Tier II. This program was available to homeowners who were not eligible, or were previously rejected, for a regular HAMP modification. Homeowners who obtained, but failed, a regular HAMP modification could apply under HAMP Tier II if at least 12 months had elapsed from the effective date of the previous modification or if their circumstances changed. The Tier II program allowed borrowers to reduce their monthly payment to between 25% and 45% of their income. It also provided for principal forbearance on the lesser of (1) 30% of the principal balance; or (2) the excess of the principal balance over the balance that would yield a loan to value of 115%. In either case, principal balance included capitalization of arrears. HAMP TIER II ended December 31, 2016, except for certain loan modification applications made prior thereto. [See Supplemental Directive 16-02, "Making Home Affordable Program - MHA Program Termination and Borrower Application Sunset"]

(1) [6:511.14] **Participating servicers who fail to provide HAMP loan modifications to eligible homeowners; damages liability and possible defense to foreclosure:** Servicers participating in HAMP are required to review a borrower's eligibility for the program and cannot conduct a foreclosure sale absent such a review. In fact, HAMP servicers are not even supposed to initiate foreclosure proceedings until a borrower has been evaluated and determined ineligible for the program, or if the borrower fails to respond to the servicer's Trial Period Plan (TPP) offer. [See Pub.L. 111-22, § 401]

The HAMP guidelines—explicitly adopted by Congress in the Helping Families Save Their Homes Act (¶ *6:511.11*) —are directly analogous to FHA rules requiring servicers to engage in loss mitigation. As with the FHA program, participating servicers must sign a contract with the Treasury financial agent agreeing to review all eligible borrowers according to a Net Present Value (NPV) analysis before proceeding with a foreclosure sale. A servicer's failure to comply with the HAMP NPV analysis arguably constitutes "unclean hands" and therefore should preclude foreclosure.

Moreover, if the NPV analysis determines that the mortgage's value, as modified, exceeds the expected return from foreclosure, the HAMP supplemental guidelines obligate the servicer to offer the borrower a TPP with modified loan

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repayment terms. After the borrower's compliance, the servicer is compelled to offer a permanent modification of the loan. Indeed, the servicer's failure to do so exposes it to liability on a variety of contract and tort theories. [See *Corvello v. Wells Fargo Bank, N.A.* (9th Cir. 2013) 728 F3d 878, 884 (applying Calif. law)—"Where … borrowers allege … that they have fulfilled all of their obligations under the TPP, and the loan servicer has failed to offer a permanent modification, the borrowers have valid claims for breach of the TPP agreement"; *West v. JPMorgan Chase Bank, N.A.* (2013) 214 CA4th 780, 154 CR3d 285—TPP interpreted to include HAMP requirements, including obligation to offer permanent modification upon borrower's compliance]

(a) Application

• [6:511.15] A lender who initiated a loan modification review while simultaneously proceeding to foreclose on the borrower's property ("dual tracking") violated California's Unfair Competition Law (UCL, Bus. & Prof.C. § 17200 et seq.). [*Majd v. Bank of America, N.A.* (2015) 243 CA4th 1293, 1302-1304, 197 CR3d 151, 158-159—although lender's actions predated "dual tracking" statute (¶ 6:524.16), practice still considered "unfair" in HAMP context and for UCL purposes; see also *Oskoui v. J.P. Morgan Chase Bank, N.A.* (9th Cir. 2017) 851 F3d 851, 857-858—lender who falsely promised to initiate loan modification to entice borrower into making payments and simultaneously proceeded to foreclose on borrower's property subject to UCL claim]

• [6:511.16] Borrowers whose pleadings did not sufficiently clarify the terms of a servicer's alleged agreement to modify their loan were entitled to amend the contract claim to assert that HAMP guidelines applied. [*Daniels v. Select Portfolio Servicing, Inc.* (2016) 246 CA4th 1150, 1177, 201 CR3d 390, 415 (disapproved on other grounds by *Sheen v. Wells Fargo Bank, N.A.* (2022) 12 C5th 905, 948, 290 CR3d 834, 864, fn. 12); see also *Rufini v. CitiMortgage, Inc.* (2014) 227 CA4th 299, 305-306, 173 CR3d 422, 427-428—borrower entitled to amend complaint for breach of contract, negligent misrepresentation and unfair business practices to allege planned home loan modification was pursuant to written TPP under HAMP]

• [6:511.17] Causes of action for breach of contract, promissory estoppel and fraud based on false promise will lie against a lender who fails to modify a loan despite the borrower having fully complied with the borrower's TPP. [*Bushell v. JPMorgan Chase Bank, N.A.* (2013) 220 CA4th 915, 918-919, 163 CR3d 539, 541-542; see also *Oskoui v. J.P. Morgan Chase Bank, N.A.* (9th Cir. 2017) 851 F3d 851, 858—borrower stated breach of contract claim against lender who offered permanent modification agreement but withdrew same after borrower complied with terms; *Fleet v. Bank of America, N.A.* (2014) 229 CA4th 1403, 1410-1412, 178 CR3d 18, 24-26—borrowers stated claims for breach of contract/covenant of good faith and fair dealing, promissory estoppel and fraud where lender foreclosed while borrowers were complying with TPP]

[6:511.18] ***Reserved.***

• [6:511.19] A homeowner's breach of contract and wrongful foreclosure claims can survive the lender's demurrer when the homeowner has fully complied with the homeowner's TPP and modification agreement. [*Chavez v. Indymac Mortg. Services* (2013) 219 CA4th 1052, 1059, 162 CR3d 382, 387]

• [6:511.20] *Compare:* Mere submission of a HAMP application did not provide adequate consideration for a lender's subsequent unsolicited promise to delay foreclosure. Consequently, the borrowers' breach of oral contract claim was barred. Moreover, the borrowers' cause of action for promissory estoppel failed because they did not allege reliance on the lender's promise. [*Orcilla v. Big Sur, Inc.* (2016) 244 CA4th 982, 1006-1007, 198 CR3d 715, 734-735]

[6:511.21 - 6:511.25] ***Reserved.***

(b) [6:511.26] **Application of statute of frauds to HAMP modifications:** As with promissory notes and deeds of trust, agreements to modify real property loans must be memorialized by writings that satisfy the statute of frauds (Civ.C. § 1624; *see detailed discussion at ¶ 4:263 ff.*). [*Rossberg v. Bank of America, N.A.* (2013) 219 CA4th 1481, 1503, 162 CR3d 525, 543]

Nonetheless, a lender who offers a HAMP modification to a *performing* borrower but fails to return the signed documentation cannot assert the statute of frauds as a defense to the borrower's action for breach of the HAMP

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modification contract. [See *Daniels v. Select Portfolio Servicing, Inc.* (2016) 246 CA4th 1150, 1176, 201 CR3d 390, 414 (disapproved on other grounds by *Sheen v. Wells Fargo Bank, N.A.* (2022) 12 C5th 905, 948, 290 CR3d 834, 864, fn. 12)—complaint alleging oral agreement to modify loan terms not barred by statute of frauds where borrowers included allegations reflecting their “full performance”; *Corvello v. Wells Fargo Bank, N.A.* (9th Cir. 2013) 728 F3d 878, 885 (applying Calif. law)—borrower's breach of contract claim alleging full performance under TPP survived statute of frauds defense; *Chavez v. Indymac Mortg. Services* (2013) 219 CA4th 1052, 1061, 162 CR3d 382, 388—lender equitably estopped from asserting statute of frauds defense where borrower complied fully with TPP and modification agreement]

(2) [6:511.27] **Application of HAMP principles to other foreclosure avoidance programs:** A lender's obligation under the HAMP program to modify troubled mortgages once the borrower has complied with the TPP requirements may be applicable to other foreclosure avoidance programs. [See *Lueras v. BAC Home Loans Servicing, LP* (2013) 221 CA4th 49, 73-76, 163 CR3d 804, 824-827 (Fannie Mae HomeSaver Forbearance Program)—forbearance agreement interpreted to incorporate Fannie Mae's HAMP-like policy that lenders *should* work with borrowers in “good faith” to identify and implement modifications provided borrower with basis for asserting breach of contract claim against lender]

g. [6:511.28] **Making Home Affordable Refinance Program (HARP):** The Making Home Affordable Refinance Program (HARP) was developed by the U.S. Treasury Department and implemented in March 2009. It assists homeowners who are current on their mortgage (and those unable to refinance because of declining property values) to refinance into more affordable loans. The end date for obtaining HARP refinance was December 31, 2018.

To qualify, a homeowner must, among other things, be the owner occupant of a one-to-four-unit property, current on their mortgage and the loan must be owned or securitized by Fannie Mae or Freddie Mac.

(Fannie Mae and Freddie Mac each have toll free telephone numbers and websites to provide information on loans they own or securitize.)

h. [6:511.29] **Home Affordable Foreclosure Alternatives (HAFA):** Effective April 5, 2010, the U.S. Treasury Department introduced the Home Affordable Foreclosure Alternatives program (HAFA), which contained viable options for homeowners who were unable to keep their homes through HAMP (¶ 6:511.13). Specifically, HAFA provided servicers with incentives to allow short sales or deeds in lieu of foreclosure for eligible homeowners who wished to avoid foreclosure. While participation in HAFA could not save a homeowner from losing their property, it could eliminate the effects of a foreclosure on the homeowner's credit. Servicers participating in HAMP were required to comply with HAFA. HAFA ended December 31, 2016.

2. Other Legislative Protections From Foreclosure and Other Enforcement Remedies

a. [6:512] **Residential care facility residents:** People who live in residential care facilities for the elderly (RCFEs) are entitled to notice and protection whenever the facility is subject to foreclosure or any other event indicating significant financial distress. Licensees of such facilities are required to provide written notice, as statutorily prescribed, to the residents and their legal representatives, if applicable, as well as to the State Department of Social Services and Long-Term Care Ombudsman, when a notice of default, notice of trustee's sale or any other indication of foreclosure is issued on the land or building in which the RCFE is located. Thereafter, the Department of Social Services is charged with initiating a “compliance plan, noncompliance conference, or other appropriate action.” [See Health & Saf.C. § 1569.686(a), (b), (e) (exempting licensees holding certificates of authority as defined)]

A licensee who fails to comply with the statutory notification procedure may be liable for civil penalties up to $2,000. If a resident is relocated without such notice and suffers transfer trauma or other harm, the licensee's license may be suspended or revoked. [Health & Saf.C. § 1569.686(c)]

b. Military service personnel

(1) [6:512.1] **Federal law:** Under the Servicemembers Civil Relief Act, an action to foreclose on a servicemember's secured real property that is filed during, or within one year after, the servicemember's military service period may be stayed, as defined, for a period of time “as justice and equity require.” Moreover, any sale, foreclosure or seizure of the real property is invalid if made during, or within one year after, the servicemember's service period except upon court order or if made by agreement, as specified. [50 USC § 3953(b), (c)]

Servicemembers may sue for equitable/declaratory relief, or to recover monetary damages, from lenders who violate the above provision. [50 USC § 4042(a); see also *McGreevey v. PHH Mortg. Corp.* (9th Cir. 2018) 897 F3d 1037, 1040-1041 (acknowledging in "case of first impression" servicemember's right of action but finding his suit barred by four-year limitations period applicable to private actions alleging § 3953(c) violations)]

In addition, a trust deed (or other security in the nature of a mortgage) taken by a servicemember alone or jointly with their spouse, before the servicemember enters military service, may not bear interest in excess of 6% per year during the servicemember's service period and for one year thereafter. [50 USC § 3937(a)]

(2) [6:512.2] **State law:** Unless otherwise agreed by the parties following nonpayment or a breach, or unless previously court-ordered, state law prohibits any sale, foreclosure or seizure of a servicemember's secured real property during their military service and for one year thereafter. [Mil. & Vet.C. § 408(c)]

Moreover, an action to enforce a servicemember's real property obligation payable in installments under a purchase contract or secured by a mortgage (or other security) may be deferred for a period equal to the period of military service, as statutorily specified. During the deferment period, the lender may not assess penalties or charge or accumulate interest on the principal and interest deferred, nor foreclose or repossess the collateral for the obligation. The deferral period terminates, however, upon sale or further encumbrance of the property or upon maturity of the obligation, as extended by the deferral period. [See Mil. & Vet.C. § 409.3(d)(1), (e)(1), (f)]

The interest rate for a real property obligation (i.e., mortgage, trust deed or other security) incurred by the servicemember before their current period of military service may not exceed 6% per annum during any part of such service and for one year thereafter, unless the member's ability to pay in excess of 6% is not materially affected while on active duty. [See Mil. & Vet.C. § 405(a)(1)]

c. [6:512.3] **Coronavirus Economic Stabilization Act of 2020 ("CARES Act"):** In response to the COVID-19 pandemic, Congress enacted a loan payment forbearance program and temporary foreclosure moratorium on federally backed mortgages. The application requirements and relief available depend on whether the mortgage encumbers a property designed principally for 1-4 family occupancy ("consumer mortgages"), or properties comprising 5 or more units ("multifamily mortgages"). [15 USC §§ 9056, 9057]

CAUTION: The CARES Act measures were temporary and some have expired despite several extensions by the federal agencies regulating residential mortgages and servicers. Thus, practitioners are advised to check for any changes and determine whether and to what extent the statutory measures, as well as their implementing regulations, remain extant.

(1) [6:512.4] **Federally backed consumer mortgages:** Federally backed consumer mortgages include loans made, insured or guaranteed by one of the federal agencies or programs listed in the statute, or purchased or securitized by Freddie Mac or Fannie Mae. [See 15 USC § 9056(a)(2)]

(a) [6:512.5] **Loan forbearance:** Borrowers with federally backed consumer mortgages may defer their mortgage payments due to financial difficulties during the "covered period." This is so even if they have not contracted the virus and regardless of whether the loan is delinquent. Indeed, a borrower need only submit a request for forbearance to the servicer "affirming that the borrower is experiencing a financial hardship during the COVID-19 emergency" (15 USC § 9056(b)(1)). The servicer may not demand additional documentation or impose any fees, penalties or interest (beyond regularly scheduled payments), and must forbear for up to 180 days, extendable for another 180 days at the borrower's request. [See 15 USC § 9056(b)(2)-(3), (c)]

(b) [6:512.6] **Foreclosure moratorium:** Unless secured property is abandoned or vacant, the servicer of a federally backed consumer mortgage may not initiate any judicial or non-judicial foreclosure process, nor execute a foreclosure sale or foreclosure-related eviction, for a specified period (originally not less than a 60-day period beginning on March 18, 2020). [15 USC § 9056(c)]

Comment: The original 60-day foreclosure moratorium was set to expire on June 17, 2020 (see 15 USC § 9056(c)), but the relevant federal agencies extended it multiple times. At the time we went to press, the moratoria had expired for any loans where foreclosure had not been initiated before January 1, 2022.

(2) [6:512.7] **Federally backed multifamily mortgages:** Federally backed multifamily mortgages include loans made in whole or in part, or insured, guaranteed, supplemented or assisted in any way, by a federal officer or agency; under or in connection with a housing or urban development program; or purchased or securitized by Freddie Mac or Fannie Mae. [15 USC § 9057(f)(2)(B)]

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(a) [6:512.8] **Loan forbearance:** Borrowers with federally backed multifamily mortgages may request forbearances due to COVID-19 related financial difficulties if their loans were current on February 1, 2020. The request may be oral or written, but must be submitted during the "covered period." [See 15 USC § 9057(a), (b), (f)(5) (defining "covered period" as that which began on 3/27/20 and will end on either 12/31/20 or termination date of national COVID-19 emergency, as declared by the President on 3/13/20, whichever is sooner)]

Upon receiving a request, servicers must document the financial hardship and forbear for up to 30 days. Borrowers may obtain 2 additional 30-day forbearance periods by requesting an extension during the "covered period," and at least 15 days before the end of the previous forbearance period. [15 USC § 9057(c)(1)]

(b) [6:512.9] **Eviction moratorium:** A multifamily borrower who receives a forbearance may not evict any tenants solely for nonpayment of rent or other fees, nor assess any late fees, penalties or other charges for late payment of rent, during the forbearance period. [15 USC § 9057(d)]

Moreover, during the forbearance period, the borrower may not issue a notice to vacate to any nonpaying tenant, or require a tenant to vacate on less than 30 days' notice. [15 USC § 9057(e)]

d. [6:512.10] **COVID-19 Small Landlord and Homeowner Relief Act of 2020 ("Homeowner Act"):** Enacted in response to the COVID-19 pandemic, the Homeowner Act (Civ.C. § 3273.01 et seq.) includes new foreclosure prevention measures applicable to (i) loans secured by residential property with no more than four dwelling units (including individual units of condominiums or cooperatives), (ii) depository institutions chartered under state or federal law, and (iii) any person licensed under Fin.C. § 22000 et seq. (consumer and commercial finance lenders and brokers), Fin.C. § 50000 et seq. (residential mortgage lenders) or Bus. & Prof.C. § 10000 et seq. (real estate professionals). Each of the foregoing must comply with federal guidance on options to be afforded borrowers following a COVID-19-related forbearance. [See Civ.C. §§ 3273.2 & 3273.11(a)]

(1) [6:512.11] **Pre-foreclosure requirements:** The Homeowner Act (¶ 6:512.10) imposes new pre-foreclosure steps with respect to forbearance requests *made during the period between the Act's operational date and December 1, 2021* (the "effective time period," Civ.C. § 3273.1(b)). If a mortgage servicer denies a forbearance application by a borrower who was (i) current on payments as of February 1, 2020, *and* (ii) experiencing a financial hardship due, directly or indirectly, to the COVID-19 emergency, then the servicer is required to provide written notice to the borrower explaining the specific reason (or reasons) for the denial. If the servicer denies the borrower's application because of a curable defect, the servicer must identify the defect in the written notice and allow the borrower to cure the defect within 21 days (from the written notice's mailing date). [See Civ.C. §§ 3273.1(c) (defining "mortgage servicer") & 3273.10]

Mortgage servicers also have to comply with applicable federal guidance regarding borrower options following a COVID-19-related forbearance. [See Civ.C. § 3273.11; *and*¶ 6:512.10]

(2) [6:512.12] **Private right of action:** A borrower may bring an action for injunctive relief, damages, restitution, and any other remedy to redress a material violation of the Homeowner Act (¶ 6:512.10). If the borrower prevails, the court may award the borrower reasonable attorney fees and costs. [See Civ.C. § 3273.15(a), (b)]

3. [6:513] **Foreclosure Remedies:** While enforcement of an assignment of rents provision is one of the lender's most important remedies upon a borrower's default (*see*¶ *6:430 ff.*), *foreclosure* is the *principal* (and sometimes only) remedy of a secured real property lender.

A California foreclosure may be accomplished in one of two ways: by a nonjudicial "private power" (or "trustee's") sale (¶ 6:514 ff.); or by a judicial foreclosure (¶ 6:540 ff.). [*Ung v. Koehler* (2005) 135 CA4th 186, 192, 37 CR3d 311, 314; *Garretson v. Post* (2007) 156 CA4th 1508, 1515, 68 CR3d 230, 235; see also *Coker v. JPMorgan Chase Bank, N.A.* (2016) 62 C4th 667, 672-673, 197 CR3d 131, 134—lender actually has third route to recovery by permitting "short sale" and agreeing to release its lien so borrower can sell property to third party]

a. [6:513.1] **Election of foreclosure remedies:***Commencement* of a judicial or nonjudicial foreclosure does *not* itself result in an election of remedies. A beneficiary under a deed of trust may initiate either remedy or institute both concurrently without consequence. [See *Oxford Street Properties, LLC v. Rehabilitation Assocs., Inc.* (2012) 206 CA4th 296, 304, 141 CR3d 704, 709, fn. 3; *Vlahovich v. Cruz* (1989) 213 CA3d 317, 322, 261 CR 565, 567]

However, once the beneficiary takes a judicial foreclosure to *judgment or completes* a nonjudicial foreclosure by trustee's sale, the beneficiary effectively elects its remedy, thereby forfeiting the other. [*Flack v. Boland* (1938) 11 C2d 103, 107, 77

P2d 1090, 1092; see also *Oxford Street Properties, LLC v. Rehabilitation Assocs., Inc.*, supra, 206 CA4th at 304, 141 CR3d at 709, fn. 3—beneficiary precluded from claiming deficiency judgment in judicial foreclosure proceeding once subject property was sold at trustee's sale; *California Golf, L.L.C. v. Cooper* (2008) 163 CA4th 1053, 1065, 78 CR3d 153, 164—election of remedies doctrine prevents multiple suits between parties and prejudice to defendants]

(1) [6:513.2] **Trustor/debtor defense:** The election of remedies defense may be raised in a subsequent foreclosure proceeding only by the trustor or debtor from the original foreclosure action. Nonparties are “in no position to complain about the manner or means of actual foreclosure.” [*California Golf, L.L.C. v. Cooper* (2008) 163 CA4th 1053, 1065, 78 CR3d 153, 163-164—bidders at nonjudicial foreclosure sale who reneged on their bid could not use election of remedies defense to avoid liability to foreclosing beneficiary (beneficiary's predecessor in interest obtained *judicial* foreclosure judgment prior to transferring subject property)]

[6:513.3 - 6:513.4] ***Reserved.***

(2) [6:513.5] **Compare—deed in lieu of foreclosure:** To avoid the inconvenience that often accompanies a formal foreclosure, the beneficiary may agree to accept a “deed in lieu of foreclosure” from the trustor. This can be advantageous to both parties—i.e., the beneficiary can avoid the delays and costs of foreclosure and the trustor, to some extent, may be spared the embarrassment and impaired credit rating a public foreclosure sale produces. [See *Decon Group, Inc. v. Prudential Mortg. Capital Co., LLC* (2014) 227 CA4th 665, 670, 174 CR3d 205, 208]

(a) [6:513.6] **Potential risks associated with junior encumbrances:** There may be risks attendant to taking a deed in lieu of foreclosure if the subject property is encumbered by junior liens. This is so because a conveyance through a deed in lieu of foreclosure passes title to the transferee subject to all existing liens. Thus, if the title is encumbered by two deeds of trust, the grantee takes subject to both (e.g., if the grantee is the beneficiary under the junior deed of trust, its junior lien may be eliminated by merger and it takes subject to the senior deed of trust). [*Decon Group, Inc. v. Prudential Mortg. Capital Co., LLC* (2014) 227 CA4th 665, 670, 174 CR3d 205, 207]

By the same token, if the grantee is the beneficiary under the senior deed of trust, under traditional merger concepts its lien would normally merge into its title and be destroyed (*but see*¶ *6:513.7*). [*Decon Group, Inc. v. Prudential Mortg. Capital Co., LLC*, supra, 227 CA4th at 671, 174 CR3d at 208]

1) [6:513.7] **Presumption favoring senior lienholders:** Allowing traditional merger concepts to prevail when a senior lienholder accepts a deed in lieu of foreclosure would make its title subject to the (former) junior deed of trust … a result clearly at odds with what the senior lienholder and trustor intended. Thus, California courts have long held “when a senior lienholder accepts a deed in lieu of foreclosure the senior lien and title do not merge, so the senior lienholder retains the power to foreclose, and thereby eliminate the junior liens.” [See *Decon Group, Inc. v. Prudential Mortg. Capital Co., LLC* (2014) 227 CA4th 665, 671, 174 CR3d 205, 208—senior lienholder presumed to have intended no merger when it accepted deed in lieu of foreclosure, rendering its subsequent foreclosure on subject property and elimination of junior mechanic's lien valid; see also *Sheldon v. La Brea Materials Co.* (1932) 216 C 686, 691-692, 15 P2d 1098, 1100-1101 (applying “no-merger” rule to deeds of trust); *Hines v. Ward* (1898) 121 C 115, 117, 53 P 427, 428—presumptively, there is no merger if grantee is senior lienholder]

b. [6:514] **Nonjudicial trustee's sale:** Provided the deed of trust includes appropriate enabling language (*see*¶ *6:415*), upon the borrower's default, the beneficiary can compel the trustee to conduct a private power of sale foreclosure. [*Garfinkle v. Sup.Ct. (Wells Fargo Bank)* (1978) 21 C3d 268, 277, 146 CR 208, 214—trustee's power to sell upon default “is a right authorized solely by the contract between the lender and the trustor as embodied in the deed of trust”; *Bank of America, N.A. v. La Jolla Group II* (2005) 129 CA4th 706, 712, 28 CR3d 825, 828—power of sale in trust deed is “creature of contract” that exists only if expressly granted by trustor in security documents]

(1) [6:514.1] **Constitutionality:** This kind of foreclosure sale does not involve any court proceeding, nor any judicial supervision whatsoever. Although it is subject to statutes restricting and regulating *exercise* of the power of sale (¶ 6:520 ff.), a nonjudicial foreclosure remedy is a right authorized *solely by contract* between the lender and trustor (embodied in the deed of trust) and *thus is exempt from procedural due process challenge* under the federal and state Constitutions. [*Garfinkle v. Sup.Ct. (Wells Fargo Bank)* (1978) 21 C3d 268, 272, 281-282, 146 CR 208, 210-211, 217—nonjudicial foreclosure involves *private* (not state) action authorized by contract and thus is immune from 14th Amendment and state constitutional procedural due process requirements; *Morris v. JPMorgan Chase Bank, N.A.* (2022) 78 CA5th 279, 294,

293 CR3d 417, 440—nonjudicial foreclosure system presupposes adequate, and thus constitutionally valid, presale notice to borrower; see also *Lyons v. Santa Barbara County Sheriff's Office* (2014) 231 CA4th 1499, 1504, 181 CR3d 186, 190—state's statutory regulation of nonjudicial foreclosures does *not* convert foreclosing lender's conduct into state action]

(2) [6:514.2] **Legislative purpose:** The comprehensive statutory scheme governing nonjudicial foreclosures (Civ.C. § 2924 et seq.) has three purposes: "(1) to provide the creditor/beneficiary with a quick, inexpensive and efficient remedy against a defaulting debtor/trustor; (2) to protect the debtor/trustor from wrongful loss of the property; and (3) to ensure that a properly conducted sale is final between the parties and conclusive as to a bona fide purchaser." [*Biancalana v. T.D. Service Co.* (2013) 56 C4th 807, 814, 156 CR3d 437, 441; *Gomes v. Countrywide Home Loans, Inc.* (2011) 192 CA4th 1149, 1154, 121 CR3d 819, 823-824—state's nonjudicial foreclosure provisions are so "exhaustive" appellate courts refuse to read in any additional requirements; *Banc of America Leasing & Capital, LLC v. 3 Arch Trustee Services, Inc.* (2009) 180 CA4th 1090, 1095-1096, 103 CR3d 397, 399-400—"comprehensive statutory scheme" governing nonjudicial foreclosures delineates trustee's *limited* role and duties in nonjudicial foreclosure sales]

(3) Pros and cons from lender's perspective

(a) [6:515] **Advantages:** Nonjudicial foreclosure offers the following advantages for lenders:

1) [6:515.1] **Nonadversarial, time-saving/cost-saving final adjudication:** A properly conducted trustee's sale does not require judicial oversight and constitutes a final adjudication of the borrower's and lender's rights. [*Dreyfuss v. Union Bank of Calif.* (2000) 24 C4th 400, 411, 101 CR2d 29, 37; *Nguyen v. Calhoun* (2003) 105 CA4th 428, 440-441, 129 CR2d 436, 446-447; *Garretson v. Post* (2007) 156 CA4th 1508, 1516, 68 CR3d 230, 235—nonjudicial foreclosure constitutes "final adjudication" notwithstanding transaction's "private" nature]

Because judicial proceedings are not involved, a trustee's sale is relatively fast, inexpensive and not per se adversarial. Indeed, there is minimal (if any) need for legal counsel (¶ 6:522). [*Alliance Mortg. Co. v. Rothwell* (1995) 10 C4th 1226, 1236, 44 CR2d 352, 358; see also *Coker v. JPMorgan Chase Bank, N.A.* (2016) 62 C4th 667, 673, 197 CR3d 131, 134—nonjudicial foreclosures are "overwhelmingly preferred by lenders" and far more common than judicial foreclosures; *Gomes v. Countrywide Home Loans, Inc.* (2011) 192 CA4th 1149, 1155, 121 CR3d 819, 824—nonjudicial foreclosure is less expensive and concludes more quickly than judicial foreclosure because no court oversight is involved, no appraisal or judicial fair value determination is required and debtor has no postsale redemption rights (¶ 6:515.3)]

2) [6:515.2] **Remedy available when judicial foreclosure time-barred:** A nonjudicial trustee's sale may be available to enforce a trust deed even though a *judicial* action to foreclose the deed is time-barred. [See *Nicolopulos v. Sup.Ct. (Bourgeois)* (2003) 106 CA4th 304, 309-310, 130 CR2d 626, 630, *discussed at* ¶ *3:299 ff.*; compare *Robin v. Crowell* (2020) 55 CA5th 727, 751, 270 CR3d 25, 42—once judicial foreclosure sale is complete and time for seeking deficiency judgment has lapsed, borrower has no further obligations under trust deed and there can be no subsequent default (senior lienholder could not pursue nonjudicial foreclosure against junior lienholder omitted from prior judicial foreclosure)]

3) [6:515.3] **No postsale redemption rights:** Generally, there is no right of redemption once the trustee's sale is completed. Indeed, a properly conducted nonjudicial foreclosure sale constitutes a final adjudication of the borrower's and lender's rights. The purchaser ordinarily receives title under the trustee's deed free and clear of any right, title or interest of the trustor (¶ *6:532.1*). [*Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1236, 44 CR2d 352, 358; compare *Multani v. Witkin & Neal* (2013) 215 CA4th 1428, 1445, 155 CR3d 892, 904—homeowner in common interest development has statutory right to redeem within 90 days following nonjudicial foreclosure sale to collect delinquent assessments (¶ *6:532.1a*)]

(b) [6:516] **Disadvantages:** By the same token, two significant considerations may make judicial foreclosure the lender's more desirable remedy:

1) [6:517] **Deficiency judgment forfeited:** By electing to pursue a trustee's sale, the lender loses the right to recover any "deficiency" judgment against the borrower—i.e., if the property has declined in value and thus is worth less than the secured debt at the time of foreclosure, the lender forfeits any claim against the borrower for the difference (deficiency). [CCP § 580d; see *Black Sky Capital, LLC v. Cobb* (2019) 7 C5th 156, 158, 246 CR3d 583, 585; *Coker*

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v. JPMorgan Chase Bank, N.A. (2016) 62 C4th 667, 673, 197 CR3d 131, 135; *Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1236, 44 CR2d 352, 358]

a) [6:517.1] **Compare—sold-out junior lienholders:**CCP § 580d does not bar *junior lienholders* from suing the obligor directly after the security is extinguished by nonjudicial foreclosure of the senior lien. [*Cadlerock Joint Venture, L.P. v. Lobel* (2012) 206 CA4th 1531, 1541-1542, 143 CR3d 96, 104-105; *Bank of America Nat'l Trust & Sav. Ass'n v. Graves* (1996) 51 CA4th 607, 611-613, 59 CR2d 288, 290-292]

CCP § 580a, however, limits a junior lienholder's deficiency judgment to the difference between the fair market value of the property and the debt. [*Coker v. JPMorgan Chase Bank, N.A.* (2016) 62 C4th 667, 673, 197 CR3d 131, 135]

2) [6:518] **All junior encumbrances released:** A foreclosure by trustee's sale *wipes out all junior encumbrances* (*see*¶ *6:534*). (But certain *tax liens* survive; *see*¶ *6:529.2, 6:534.1*.)

On the other hand, by electing judicial foreclosure, the lender can choose which junior encumbrances it wishes to eliminate through foreclosure and which ones it wants to preserve.

For example, the lender will probably not want to wipe out junior leases which are favorable to the owner. In those instances (absent applicable nondisturbance and attornment agreements, ¶ *6:472*), the only way to preserve such leases would be to conduct a judicial foreclosure.

➪ [6:519] ***PRACTICE POINTER:*** Where the continued viability of junior encumbrances is important to the lender, *or* where it appears the property is likely to bring less in foreclosure proceeds than the amount due on the secured obligation, the remedy of judicial foreclosure will almost always be preferable to a trustee's sale.

[6:519.1 - 6:519.4] ***Reserved.***

(4) [6:520] **Mechanics of trustee's sale:** Despite comprehensive statutory regulation (¶ 6:520.1 ff.), the entire private foreclosure sale process usually can be completed in a relatively short period of time (approximately three months plus three weeks from the time of filing the notice of default; Civ.C. § 2924). [See generally, *Kachlon v. Markowitz* (2008) 168 CA4th 316, 334-335, 85 CR3d 532, 546 (summarizing nonjudicial foreclosure process); *Garretson v. Post* (2007) 156 CA4th 1508, 1516, 68 CR3d 230, 235 (same)]

➪ [6:520a] ***PRACTICE POINTER:*** The Homeowner Bill of Rights (¶ *6:524.1 ff.*), applicable to certain residential real property, imposes specific notice requirements before the lender may proceed with foreclosure and suspends the foreclosure process while a loan modification application is pending. These procedural requisites may result in significant delays to what traditionally has been an expeditious foreclosure process.

(a) [6:520.1] **Strictly regulated by statute and deed of trust:** Every trustee's sale is subject to compliance with strict statutory requirements (Civ.C. § 2924 et seq.). [*Miller v. Cote* (1982) 127 CA3d 888, 894, 179 CR 753, 756-757; see also *Banc of America Leasing & Capital, LLC v. 3 Arch Trustee Services, Inc.* (2009) 180 CA4th 1090, 1097, 103 CR3d 397, 401—trustee's rights and powers strictly limited and defined by statute and parties' contract]

This comprehensive statutory scheme is intended to provide the lender with a “quick, inexpensive and efficient” remedy against a defaulting borrower, to protect the borrower from wrongful loss of the subject property, and to ensure that a properly conducted trustee's sale is final between the parties and conclusive as to a bona fide purchaser (*see*¶ *6:536 ff.*). [*Knapp v. Doherty* (2004) 123 CA4th 76, 87, 20 CR3d 1, 9]

But the Civ.C. § 2924 provisions establish only *minimum standards* for conducting nonjudicial foreclosures. [*Garfinkle v. Sup.Ct. (Wells Fargo Bank)* (1978) 21 C3d 268, 278, 146 CR 208, 215; *Homestead Savings v. Darmiento* (1991) 230 CA3d 424, 433, 281 CR 367, 372]

Provisions concerning the substance and procedure of a nonjudicial foreclosure sale also commonly are contained in deeds of trust. For example, if a deed of trust imposes certain conditions precedent to exercising the power of sale, a lender's failure to comply with those conditions may be invoked as a defense to foreclosure. [See *Pfeifer v. Countrywide Home Loans, Inc.* (2012) 211 CA4th 1250, 1255, 150 CR3d 673, 677—nonjudicial foreclosure proceeding subject to injunction based on lender's failure to first perform HUD servicing requirements incorporated by reference in trust deed]

(b) [6:520.2] **Foreclosure procedure privileged:** Mailing, publication, delivery and recordation of documents pursuant to the Civ.C. § 2924 procedures are privileged communications. [Civ.C. § 2924(d); *Schep v. Capital One, N.A.* (2017)

12 CA5th 1331, 1336, 220 CR3d 408, 412—trustees' acts in recording notice of default, notice of sale and trustee's deed upon sale deemed privileged communications; *and see* ¶ *6:524c, 6:528.1 ff.*]

(c) [6:521] **Conducted by trustee:** A nonjudicial foreclosure sale is conducted by the *trustee* under the deed of trust's power of sale. [*Nguyen v. Calhoun* (2003) 105 CA4th 428, 440, 129 CR2d 436, 446]

Alternatively, the trustee's attorney or any duly authorized agent, as “auctioneer for the trustee,” may conduct it. [See Civ.C. § 2924a]

1) [6:521.1] **Effect of substitution of trustees:** The recording of a *substitution* of trustee (¶ *6:405 ff.*) *divests* the prior trustee of all powers, duties, authority and title granted to it by the deed of trust. Thereafter, the *substituted trustee* has the *exclusive power* to conduct a nonjudicial foreclosure sale. “[T]here simply cannot be at any given time more than one person with the power to conduct a sale under a deed of trust.” [*Dimock v. Emerald Properties LLC* (2000) 81 CA4th 868, 871, 876, 97 CR2d 255, 257, 259-260; but see also *Jones v. First American Title Ins. Co.* (2003) 107 CA4th 381, 389-390, 131 CR2d 859, 864-865—reformation validated sale by former trustee whose resubstitution had not been recorded; *and*¶ *6:405.12*]

2) [6:521.2] **Exempt from state FDCPA:** A trustee performing the statutory acts required to conduct a nonjudicial foreclosure pursuant to Civ.C. § 2924 et seq. is expressly exempt from the limitations of the Rosenthal Fair Debt Collection Practices Act (Civ.C. § 1788 et seq.). [Civ.C. § 2924(b)]

A loan servicer's conduct in connection with a nonjudicial foreclosure, however, can fall within the ambit of the Rosenthal Act if the loan servicer does not comply with the above statutorily prescribed procedures. [*Best v. Ocwen Loan Servicing, LLC* (2021) 64 CA5th 568, _, 279 CR3d 69, 77 (acknowledging debt collection activities “beyond the scope of the ordinary foreclosure process” can violate Rosenthal Act)—lender and loan servicer could be liable under Rosenthal Act for alleged unethical mismanagement of loan escrow account and refusal to correct accounting errors; compare *Davidson v. Seterus, Inc.* (2018) 21 CA5th 283, 299-300, 230 CR3d 441, 451-452 (distinguishing between foreclosing trustees who are expressly exempt from state FDCPA and loan servicers who could be liable for violating said Act)]

3) [6:521.3] **Exempt from federal FDCPA:** A trustee conducting nonjudicial foreclosure proceedings is not a debt collector under the *federal* FDCPA (15 USC § 1692 et seq.). Thus, they are exempt from “the lion's share” of its prohibitions. “[T]he debt-collector-related prohibitions of the FDCPA (with the exception of 15 USC § 1692f(6)) do *not* apply to those who … are engaged in no more than security-interest enforcement.” [*Obduskey v. McCarthy & Holthus LLP* (2019) _ US _, _, _, 139 S.Ct. 1029, 1037, 1040 (parentheses and emphasis in original) (resolving split of authority among Circuits); see also *Vien-Phuong Thi Ho v. ReconTrust Co., N.A.* (9th Cir. 2016) 858 F3d 568, 574, fn. 7 (trustee exempt even though trustee's notice of sale stated it was “debt collector attempting to collect a debt”); *Schlegel v. Wells Fargo Bank, NA* (9th Cir. 2013) 720 F3d 1204, 1206 (mortgagee/assignee exempt); *In re Nordeen* (9th Cir. BAP 2013) 495 BR 468, 488-489 (trustee and mortgage servicer exempt)]

Comment: As noted in *Obduskey*, supra, the federal FDCPA contains limited restrictions on entities whose principal purpose is enforcing security interests (e.g., a foreclosing trustee). [See 15 USC §§ 1692a(6) (definitions), 1692f(6) (proscribing certain collection practices by those seeking to enforce security interests); *Vien-Phuong Thi Ho v. ReconTrust Co., N.A.*, supra, 858 F3d at 574, fn. 6]

Cross-refer: For a detailed treatment of the state and federal FDCPAs, see Ahart, *Cal. Prac. Guide: Enforcing Judgments & Debts* (TRG), Ch. 2.

(d) [6:522] **Attorney involvement:** Attorneys are neither legally nor ethically barred from acting as trustees under deeds of trust and conducting nonjudicial foreclosure sales. In practice, however, lender's counsel generally plays no role in a nonjudicial foreclosure other than monitoring the trustee's prosecution of the foreclosure.

➪ [6:523] ***PRACTICE POINTER—LENDER'S COUNSEL AS TRUSTEE*:** It is a *risky* practice for attorneys to act as trustees in foreclosure proceedings because the process is fraught with potential liability (e.g., a mistake in the foreclosure steps—such as failing to properly notify all junior encumbrancers—can subject the attorney acting as trustee to liability for wrongful foreclosure, negligence and perhaps other causes of action).

Also, because a trustee is considered an agent of both the beneficiary and trustor (¶ *6:343*), an attorney who acts as the trustee might be in a conflict of interest position.

In any event, counsel are best advised to defer to the expertise of an *institutional trustee* (such as a title insurance company or other entity specializing in trustee foreclosure sales), who can conduct a trustee's sale more efficiently and less expensively than an attorney.

(e) [6:524] **Recordation of "notice of default"; exceptions:** A nonjudicial foreclosure is commenced by the "trustee, mortgagee, or beneficiary, or any of their authorized agents" *recording a "notice of default"* in the office of the county recorder for each county where the secured real property (or any part thereof) is located. [Civ.C. § 2924(a)(1)—power of sale may not be exercised until notice of default is recorded; see also *Knapp v. Doherty* (2004) 123 CA4th 76, 99, 20 CR3d 1, 18—"One of the signal purposes of the notice of default is to advise the trustor of the amount required to cure the default"]

Narrow exceptions to the notice of default procedure include mortgages or transfers made pursuant to an order, judgment or decree of a court of record. [See Civ.C. § 2924(a); *Lyons v. Santa Barbara County Sheriff's Office* (2014) 231 CA4th 1499, 1505, 181 CR3d 186, 190—exceptions include equitable mortgages or mortgages without a power of sale, which can only be foreclosed by judicial action]

1) [6:524a] **Entities entitled to record notice of default:** Besides the trustee, mortgagee, beneficiary or any of their authorized agents (¶ 6:524), other entities entitled to record notices of default include those designated in an *executed* substitution of trustee (¶ 6:405 ff.) or their agents. This is so even if the substitution of trustee is not recorded. [Civ.C. § 2924b(b)(4); see also Civ.C. § 2934a(d)(1)—trustee named in recorded substitution of trustee is authorized to act as trustee from date substitution is executed; *In re Turner* (9th Cir. 2017) 859 F3d 1145, 1150 (applying Calif. Law)—successor trustee authorized to initiate foreclosure proceedings by executing and recording notice of default even though substitution of trustee was recorded *after* notice of default issued; *In re Cedano* (9th Cir. BAP 2012) 470 BR 522, 532 (applying Calif. law)—substitute trustee appointed by lender's nominee (MERS) entitled to initiate foreclosure proceedings by filing notice of default even though executed substitution of trustee not recorded; *Rossberg v. Bank of America, N.A.* (2013) 219 CA4th 1481, 1495, 162 CR3d 525, 536-537—successor trustee authorized to record notice of default before substitution of trustee notarized or recorded]

The only entities entitled to initiate the foreclosure process are (a) the holder of the beneficial interest under a mortgage/trust deed *or* its designated agent; and (b) the original or substituted trustee under a trust deed. In addition, the holder's designated agent and the original or substituted trustee may only commence the foreclosure process when acting within the scope of the authority designated by the holder of the beneficial interest. [Civ.C. § 2924(a)(6); see also *Yvanova v. New Century Mortg. Corp.* (2016) 62 C4th 919, 927-928, 199 CR3d 66, 72-73]

a) [6:524b] **Interest in promissory note unnecessary:** The party initiating foreclosure proceedings is not required to have a beneficial or economic interest in, or possession of, the underlying promissory note. [See *In re Cedano* (9th Cir. BAP 2012) 470 BR 522, 530 (applying Calif. law); *Kalnoki v. First American Trustee Servicing Solutions, LLC* (2017) 8 CA5th 23, 42, 214 CR3d 292, 306; *Orcilla v. Big Sur, Inc.* (2016) 244 CA4th 982, 1004, 198 CR3d 715, 733; *see also* ¶ *6:524h* re authority of lender's nominee]

2) [6:524c] **Mailing, publication and delivery:** Mailing, publication and delivery of the notice of default pursuant to Civ.C. § 2924 constitutes a *privileged publication* under Civ.C. § 47. [Civ.C. § 2924(d)(1)] However, courts disagree whether the privilege is absolute or qualified (*see*¶ *6:528.2*).

3) [6:524d] **Prerecordation review of "competent and reliable evidence":** Under the Homeowner Bill of Rights (¶ *6:524.1 ff.*), mortgage servicers must, prior to recording a notice of default, review "competent and reliable evidence" to substantiate the borrower's default and the right to foreclose, and must ensure that the recorded document is accurate, complete and supported by reliable evidence. [Civ.C. § 2924.17(a), (b)]

This prerecordation requirement also applies to any other foreclosure-related documents filed by mortgage servicers, including:

— declarations required under Civ.C. § 2923.5 (¶ *6:524.4*) and Civ.C. § 2923.55 (¶ 6:524.10);

— notices of sale;

— trust deed assignments;

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— trustee substitutions;

— any declaration/affidavit filed in any court relative to foreclosure proceedings. [See Civ.C. § 2924.17(a); compare *Billesbach v. Specialized Loan Servicing LLC* (2021) 63 CA5th 830, 846-847, 278 CR3d 213, 222-223—default notice erroneously stating loan servicer met HBOR's foreclosure prevention requirements not void and did not need to be re-recorded after loan servicer remedied violations]

Mortgage servicers who repeatedly violate Civ.C. § 2924.17 are liable for civil penalties up to $7,500 per mortgage or trust deed in proceedings brought by their licensing agency. [Civ.C. § 2924.17(c); see also *Saterbak v. JPMorgan Chase Bank, N.A.* (2016) 245 CA4th 808, 818, 199 CR3d 790, 798—§ 2924.17 does not apply retroactively or confer standing on borrower to challenge allegedly ineffective deed of trust assignment (¶ 6:524e, 6:535.15d)]

[6:524e - 6:524g] ***Reserved.***

4) [6:524h] **Authority of lender's (beneficiary's) nominee to initiate foreclosure proceedings may not be challenged:** The authority of the lender's (beneficiary's) nominee to initiate nonjudicial foreclosure proceedings is beyond judicial challenge notwithstanding the fact the nominee merely holds legal title to the subject property and is not the owner of the underlying promissory note. [See *Gomes v. Countrywide Home Loans, Inc.* (2011) 192 CA4th 1149, 1154, 121 CR3d 819, 823; see also *Saterbak v. JPMorgan Chase Bank, N.A.* (2016) 245 CA4th 808, 814, 199 CR3d 790, 795—borrower lacked standing to bring preemptive action to forestall foreclosure]

"[N]owhere does [Civ.C. § 2924(a)] provide for a judicial action to determine whether the person initiating the foreclosure process is indeed authorized, and we see no ground for implying such an action … The recognition of the right to bring a lawsuit to determine a nominee's authorization to proceed with foreclosure on behalf of the noteholder would fundamentally undermine the nonjudicial nature of the process and introduce the possibility of lawsuits filed solely for the purpose of delaying valid foreclosures." [*Gomes v. Countrywide Home Loans, Inc.*, supra, 192 CA4th at 1155, 121 CR3d at 824 (underscoring debtor's attempt, absent any legal authority, to interject courts into comprehensive *nonjudicial* scheme); *Perez v. Mortgage Electronic Registration Systems, Inc.* (9th Cir. 2020) 959 F3d 334, 340 (applying Calif. law)—borrower may not bring preemptive action to challenge party's authority to pursue foreclosure *before* foreclosure has taken place; *In re Cedano* (9th Cir. BAP 2012) 470 BR 522, 531 (applying Calif. law)—Civ.C. § 2924 does *not* provide for judicial action when issue is "not whether the wrong entity initiated foreclosure but whether the entity was merely authorized to do so by the owner of the note"]

a) [6:524i] **Compare—*postforeclosure actions:*** While a borrower may not be able to bring a *preemptive* action assailing the right of the beneficiary's nominee to foreclose (¶ 6:524h), the borrower *does* have standing to sue for wrongful foreclosure *after* the trustee's sale if the purported assignment of the note and deed of trust bore defects rendering the assignment void. [See *Yvanova v. New Century Mortg. Corp.* (2016) 62 C4th 919, 923-924, 199 CR3d 66, 69-70 (¶ 6:535.15 ff.)]

5) [6:524.1] **Requirements for certain residential loans; "owner-occupied" property:** The Homeowners Bill of Rights (HBOR) affords homeowners certain safeguards for "owner-occupied" residential real property containing no more than four dwellings that secures a first lien mortgage or deed of trust. [See *Sheen v. Wells Fargo Bank, N.A.* (2022) 12 C5th 905, 921, 290 CR3d 834, 841-842 (finding HBOR "by its plain terms" applies only to first lien mortgages) —HBOR did not impose statutory duty of care on beneficiary of second and third lien mortgages (¶ 6:539.16)]

The borrower does not have to own the property for it to be "owner-occupied." [See Civ.C. § 2924.15—"owner-occupied" means property that is "the principal residence of the borrower and is security for a loan made for personal, family or household purposes"; *Adams v. Bank of America, N.A.* (2020) 51 CA5th 666, 672-673, 265 CR3d 415, 419-420]

CAUTION—HBOR's different forms: As previously stated (¶ 6:511.7), HBOR has existed in three different forms since its enactment in 2012 (below):

• Effective 1/1/13, the initial HBOR consisted of two identical bills (A.B. 278 and S.B. 900) that established a bifurcated system depending on the volume of residential foreclosures the lender or servicer conducted. The majority of the provisions applicable to large volume foreclosure lenders and servicers (more than 175

foreclosures in the prior reporting year) had a 1/1/18 "sunset" date. [2012 Stats., Chs. 86 (A.B. 278) & 87 (S.B. 900); *see also*¶ 6:524.21 ff.]

• Effective 1/1/19, the Legislature reenacted the lapsed 2012 HBOR provisions in nearly identical form, but without the "sunset" provisions (see 2018 Stats., Ch. 404 (the "2019" HBOR)). This legislation repealed A.B. 278's unexpired duplicate sections and made the following two *notable* changes:

— If the borrower requests in writing that the servicer cease communication pertaining to the borrower's loan account, the servicer has satisfied the preforeclosure "contact" requirement (see Civ.C. § 2923.5(e)(2)(C)(ii), applicable to low volume foreclosure lenders and servicers, ¶ 6:524.3; Civ.C. § 2923.55(f)(2)(C)(ii), applicable to large volume foreclosure lenders and servicers, ¶ 6:524.9).

— The borrower's ability to suspend the foreclosure process by submitting a complete application for a first lien loan modification offered by the lender ends *five business days* before the scheduled foreclosure sale (see Civ.C. § 2923.6(c), applicable to large volume foreclosure lender's and servicers, ¶ 6:524.16); Civ.C. § 2924.18(a)(1) (applicable to low volume foreclosure lenders and servicers, ¶ 6:524.6).

a) [6:524.1a] **Temporary extension of HBOR safeguards to rental property due to COVID-19 pandemic:** For the period from August 31, 2020 until January 1, 2023, HBOR's protections also extended to rental property securing a first lien mortgage or deed of trust that was:

• Owned by a small landlord (i.e, one or more individuals who own no more than three residential properties);

• Occupied as a principal residence by a tenant pursuant to an arm's length lease entered into before, and in effect on, March 4, 2020; *and*

• Occupied by a tenant who was unable to pay rent due to a reduction in income resulting from COVID-19. [See former Civ.C. § 2924.15(a)(2)(A), (B); Civ.C. § 2924.15(a)(2)(A)(ii) (defining "arm's length transaction" as "a lease entered into in good faith and for valuable consideration that reflects the fair market value in the open market between informed and willing parties")]

HBOR's protections were only available for tenant-occupied properties for so long as the property remained occupied by a tenant pursuant to a lease entered in an arm's length transaction. [See former Civ.C. § 2924.15(a)(2)(C)]

Caution—1/1/23 "sunset" date; exception: The inclusion of rental properties under the HBOR umbrella due to the COVID-19 pandemic ended on January 1, 2023. However, borrowers who made sufficient progress on a foreclosure prevention alternative by January 1, 2023, remain eligible for relief after that date. [See Civ.C. § 2924.15]

To qualify for this "grandfather" provision, a first lien mortgage or deed of trust must satisfy one of the following conditions (Civ.C. § 2924.15(a)(2)(C)):

— borrower received written approval for a loan modification before January 1, 2021; *or*

— borrower submitted a completed application for a loan modification before January 1, 2023, but as of that date servicer had not determined borrower's eligibility or appeal period for servicer's denial had not expired.

Otherwise, on or after January 1, 2023, HBOR once again embraces only "owner-occupied" residential real property (¶ 6:524.1). [Civ.C. § 2924.15]

b) [6:524.2] **Affected entities:** The HBOR foreclosure avoidance measures apply not only to mortgagees, trustees, beneficiaries, and their authorized agents, but also extend to "mortgage servicers" (e.g., persons/entities who directly service loans or are responsible for interacting with borrowers, managing loan accounts daily, managing escrow accounts or enforcing notes/security instruments, either as current owners or their agents). [See Civ.C. § 2920.5(a)—trustees and their authorized agents acting under trust deed's power of sale are *not* "mortgage servicers"]

From January 1, 2013 until January 1, 2018, HBOR distinguished—and commencing January 1, 2019 it continues to distinguish—between entities having an annual foreclosure volume of 175 residential properties or fewer (¶ 6:524.3 ff.), and entities that handled a higher volume of residential foreclosures, with more stringent requirements imposed upon the latter (*¶ 6:524.9 ff.*). Entities subject to the low volume foreclosure duties included any depository institution chartered under state or federal law, or any person licensed under Fin.C. §§ 22000 et seq. (consumer and commercial finance lenders and brokers) and 50000 et seq. (residential mortgage lenders), or under Bus. & Prof.C. § 10000 et seq. (real estate professionals), that during the previous annual reporting period foreclosed on 175 or fewer California residential real properties containing no more than four dwelling units. [Civ.C. § 2924.18(b)]

From January 1, 2018 until January 1, 2019, the requisite foreclosure avoidance steps for *all* lenders and servicers tracked the pre-1/1/18 procedures applicable to low-volume foreclosures (*see ¶ 6:524.21 ff.*).

Compare—title companies: Unless acting as trustees, licensed or underwritten title companies are exempt from liability under the HBOR foreclosure avoidance requirements. [See Civ.C. § 2924.26]

c) Low volume foreclosures (175 or fewer annually) ***from January 1, 2013 until January 1, 2018, and as of January 1, 2019*** **(*see* ¶ *6:524.1*)**

1/ [6:524.3] **"Contact" requirement:** Mortgage servicers, mortgagees, trustees, beneficiaries and their authorized agents may *not* record a notice of default until (i) 30 days after the mortgage servicer makes or attempts with due diligence (as defined) to make initial contact, as statutorily specified, with the borrower to assess the borrower's financial situation and explore options to avoid foreclosure; *and* (ii) if the borrower has submitted a complete (as defined) first lien loan modification application that is pending, the mortgage servicer complies with Civ.C. § 2924.18(a)(1) (Civ.C. § 2924.11(a) for calendar year 2018). [See Civ.C. §§ 2923.5(a)(1) & 2924.18—notice of default may not be recorded until borrower is provided with written determination regarding eligibility for requested modification]

During the initial contact, the borrower must be advised of their right to request a subsequent meeting and, if requested, the servicer must schedule the meeting within 14 days. [See Civ.C. § 2923.5(a)(2)—servicer may make initial contact in person or by phone, and must provide borrower with HUD's toll-free telephone number for purpose of finding HUD-certified housing counseling agency; see also *Mabry v. Sup.Ct. (Aurora Loan Services)* (2010) 185 CA4th 208, 214, 110 CR3d 201, 204 (decided under predecessor statute)]

Whether a lender has complied with the contact requirement is a question of fact. [*Skov v. U.S. Bank Nat'l Ass'n* (2012) 207 CA4th 690, 694-697, 143 CR3d 694, 697-699 (decided under predecessor statute)—unlawful business practices cause of action alleging lender's failure to explore options for avoiding foreclosure sufficiently pled Civ.C. § 2923.5 violations to withstand demurrer; compare *Rossberg v. Bank of America, N.A.* (2013) 219 CA4th 1481, 1494, 162 CR3d 525, 536 (decided under predecessor statute)—cause of action against lender for failing to comply with contact requirement properly dismissed where borrowers alleged no contact occurred *"in the 30-days leading up to"* recordation (statute requires contact occur *more than 30 days* before recordation)]

The borrower's only remedy for violation of the "contact" requirement is postponement of the foreclosure sale. [*In re Turner* (9th Cir. 2017) 859 F3d 1145, 1150 (applying Calif. law)—no remedy available to borrowers after foreclosure sale has occurred; *Lueras v. BAC Home Loans Servicing, LP* (2013) 221 CA4th 49, 77, 163 CR3d 804, 828 (decided under predecessor statute)—cause of action against lender and trustee for failure to initiate foreclosure alternatives properly dismissed where borrower did not seek postponement of sale and alleged sale already occurred (§ 2923.5 's only remedy is "one-time" postponement of foreclosure sale); see also *Stebley v. Litton Loan Servicing, LLP* (2011) 202 CA4th 522, 526, 134 CR3d 604, 607 (decided under predecessor statute)—wrongful foreclosure claim seeking damages and other relief based on defendants' alleged failure to fully explore alternatives before abruptly foreclosing properly dismissed (§ 2923.5 's sole remedy is "more time" before foreclosure occurs; it does *not* provide relief once sale takes place; *but see*¶ *6:524.8 re post-2012 law*)]

2/ [6:524.4] **Mandatory declaration:** Every notice of default must include a declaration that the mortgage servicer has contacted or tried with due diligence (as defined) to contact the borrower, or that contact was not required because the individual did not meet the statutory definition of "borrower" (below). [Civ.C. § 2923.5(b); see also *Mabry v. Sup.Ct. (Aurora Loan Services)* (2010) 185 CA4th 208, 232-235, 110 CR3d 201, 219-221 (decided under predecessor statute)—declaration need not be made under penalty of perjury and is sufficient if it simply tracks statutory language (stating precisely which of three categories applies is unnecessary); *In re Cedano* (9th Cir. BAP 2012) 470 BR 522, 533 (same)]

"Borrowers" entitled to statutory protection are defined as natural persons, potentially eligible for foreclosure prevention programs, who (i) have not surrendered their property in writing or by delivery of keys, (ii) have not contracted with entities whose business is extending the foreclosure process and avoiding contractual obligations; *or* (iii) have an active Chapter 7, 11, 12 or 13 bankruptcy case. [Civ.C. § 2920.5(c); see also *Morris v. JPMorgan Chase Bank, N.A.* (2022) 78 CA5th 279, 298-299, 293 CR3d 417, 443-444—borrower entitled to claim HBOR relief where alleged violation occurred before bankruptcy and remained unremedied at time of foreclosure, following bankruptcy's termination]

3/ [6:524.5] **Borrower's advisor:** A borrower may designate, with consent given in writing, a HUD-certified housing counseling agency, attorney or other advisor to discuss with the mortgage servicer the borrower's financial situation and options for avoiding foreclosure. [Civ.C. § 2923.5(d)]

4/ [6:524.6] **Suspension of foreclosure process while loan modification application pending:** Once the borrower submits a complete application for a first lien loan modification offered by or through the borrower's mortgage servicer, a mortgage servicer, trustee, mortgagee, beneficiary or authorized agent must suspend the foreclosure process until the servicer provides the borrower with a written determination whether the modification is approved. [See Civ.C. §§ 2923.5(a)(1)(B), 2924.18(a)(1), (d)]

Caution: Commencing *January 1, 2019*, borrowers must submit complete applications for a first lien loan modification at least *five business days* before a scheduled trustee's sale in order to suspend the foreclosure process. [Civ.C. § 2924.18(a)(1)]

5/ [6:524.7] **Suspension of foreclosure process when foreclosure alternative approved:** If a written foreclosure prevention alternative is approved, a mortgage servicer, trustee, beneficiary or authorized agent may not record a notice of default provided (i) the borrower is in compliance with the terms of the modification, forbearance or repayment plan; *or* (ii) all parties to the foreclosure prevention alternative have approved it in writing and the mortgage servicer has received proof of funds. [See Civ.C. § 2924.18(a)(2), (e)—subsequent mortgage servicer must honor previously approved first lien loan modification or other foreclosure prevention alternative]

6/ [6:524.8] **Private right of action/remedies:** Borrowers enjoy a private right of action to enforce compliance with Civ.C. §§ 2923.5 ("contact" requirement), 2924.17 ("competent and reliable" evidence requirement) and 2924.18 (foreclosure suspension pending loan modification requirement). [Civ.C. § 2924.19; see also *Lucioni v. Bank of America, N.A.* (2016) 3 CA5th 150, 155, 207 CR3d 418, 419—Civ.C. § 2924.19(a)(1) injunctive relief unavailable for violations of Civ.C. § 2924(a)(6), which requires entity initiating foreclosure be legally entitled to do so; *Intengan v. BAC Home Loans Servicing LP* (2013) 214 CA4th 1047, 1054, 154 CR3d 727, 732—borrower entitled to maintain private action without first tendering full amount of mortgage indebtedness where beneficiary's agent allegedly failed to comply with § 2923.5 "contact" requirement; *Mabry v. Sup.Ct. (Aurora Loan Services)* (2010) 185 CA4th 208, 225, 110 CR3d 201, 213 (decided under predecessor statute)—§ 2923.5 "contact" requirement may be enforced by private right of action that is not dependent on borrower first tendering full amount of mortgage indebtedness]

The servicer, mortgagee, beneficiary or agent, however, is not liable for a violation that they or a third party acting on their behalf corrected and remedied before the trustee's deed upon sale was recorded. [See Civ.C. § 2924.19(c)]

There is no liability for a violation unless it is material and results in actual economic damages to the borrower. [Civ.C. § 2924.19(a)(1), (b); see also *Morris v. JPMorgan Chase Bank, N.A.*(2022) 78 CA5th 279,

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303-304, 293 CR3d 417, 448-449 (analyzing Civ.C. § 2924.12(b)'s similar language applicable to high volume foreclosures) (¶ 6:524.20)]

Significant departure from pre-2013 law: HBOR permits borrowers to sue mortgage servicers, mortgagees, beneficiaries or their authorized agents for damages *after* the trustee's sale deed has been recorded. [See Civ.C. § 2924.19(b)—court may award actual damages where material violation not corrected prior to recordation of sale deed; greater of treble damages or $50,000 available if material violation was intentional, reckless or resulted from willful misconduct]

Compare: Pre-2013 case law interpreted the remedial provisions of the predecessor statute more restrictively. [See *Mabry v. Sup.Ct. (Aurora Loan Services)* (2010) 185 CA4th 208, 226, 231, 110 CR3d 201, 213, 218 (decided under predecessor statute)—private right of action relief limited to postponing impending foreclosure; *Skov v. U.S. Bank Nat'l Ass'n* (2012) 207 CA4th 690, 699-702, 143 CR3d 694, 701-703 (decided under predecessor statute) (finding *Mabry* analysis both "persuasive" and "convincing"); see also *In re Cedano* (9th Cir. BAP 2012) 470 BR 522, 533 (applying pre-2013 Calif. law)—even when debtor sufficiently establishes claim for violation of § 2923.5, sole remedy is *postponement of impending* foreclosure; *Hamilton v. Greenwich Investors XXVI, LLC* (2011) 195 CA4th 1602, 1616-1617, 126 CR3d 174, 185-186 (same)]

d) High volume foreclosures (over 175 annually) ***from January 1, 2013 until January 1, 2018, and as of January 1, 2019*** **(*see* ¶ *6:524.1*)**

1/ [6:524.9] **"Contact" requirement:** In addition to all the restrictions placed on entities that conduct low volume foreclosures (*see*¶ *6:524.3 ff.*), a mortgage servicer, mortgagee, trustee, beneficiary or authorized agent conducting high volume foreclosures may not record a notice of default until the borrower is informed in writing that (i) if they are a servicemember (or the servicemember's dependent), they may be entitled to certain protections under the Servicemembers Civil Relief Act; and (ii) they may obtain copies of the note, trust deed and any assignment, if applicable, and their payment history, as specified. [See Civ.C. § 2923.55]

A lender fulfills the above "contact" requirement if it can show that the required contacts occurred and covered the items specified in the statute. The lender need not be the party who initiated the contacts. [*Schmidt v. Citibank, N.A.* (2019) 28 CA5th 1109, 1122, 239 CR3d 648, 658]

2/ [6:524.10] **Mandatory declaration:** As with "low volume" foreclosures (¶ *6:524.4*), every notice of default must include a declaration that the mortgage servicer has contacted or tried with due diligence (as defined) to contact the borrower, or that contact was not required because the individual did not meet the statutory definition of "borrower." [Civ.C. § 2923.55(c); see also Civ.C. § 2920.5(c) (defining borrowers entitled to statutory protection); *Mabry v. Sup.Ct. (Aurora Loan Services)* (2010) 185 CA4th 208, 232-235, 110 CR3d 201, 219-221 (decided under predecessor statute)—declaration need not be made under penalty of perjury and is sufficient if it simply tracks statutory language (stating precisely which of three categories applies is unnecessary); *In re Cedano* (9th Cir. BAP 2012) 470 BR 522, 533 (same)]

3/ [6:524.11] **Disclosures after notice of default recordation:** Within five business days after recording a notice of default, high volume mortgage servicers offering foreclosure prevention alternatives must inform borrowers in writing of the availability and process for requesting such alternatives, as specified. (Mortgage servicers need not provide this information if a borrower previously exhausted the loan modification process.) [See Civ.C. § 2924.9]

4/ [6:524.12] **Borrower's advisor:** As with low volume foreclosures (¶ *6:524.5*), borrowers may designate, with consent given in writing, a HUD-certified housing counseling agency, attorney or other advisor to discuss with the lender the borrower's financial situation and options for avoiding foreclosure. [Civ.C. § 2923.55(e)]

5/ [6:524.13] **Single point of contact:** If requested, the mortgage servicer must promptly provide a borrower who has requested a foreclosure alternative with a single point of contact (SPOC) to assist the borrower in navigating the servicer's procedures, as specified. [See *Morris v. JPMorgan Chase Bank, N.A.* (2022) 78 CA5th 279, 296, 293 CR3d 417, 442—SPOC requirement applies only to "mortgage servicer," *not* mortgagee, trustee, beneficiary or authorized agent; *Gillies v. JPMorgan Chase Bank, N.A.* (2017) 7 CA5th 907, 912, 213 CR3d 210, 214-215 & fn. 3 (dictum)—lender complied with SPOC requirement by assigning customer service representative to process

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loan modification application even though borrower ignored lender's direction to send all communications to its counsel]

The borrower need not specifically request a SPOC. A general request for a foreclosure prevention alternative is sufficient to trigger the servicer's obligation to provide one. [*Morris v. JPMorgan Chase Bank, N.A.*, supra, 78 CA5th at 301-302, 293 CR3d at 446-447 (concluding statutory language in effect until 2019, requiring assignment of SPOC "[u]pon request from a borrower," indicated only *timing* of required appointment)]

Among other things, the SPOC must remain assigned to the borrower until all loss mitigation options are exhausted or the borrower's account is current. [See Civ.C. § 2923.7; *Jolley v. Chase Home Finance, LLC* (2013) 213 CA4th 872, 905, 153 CR3d 546, 573—SPOC requirement helps prevent borrowers from being "given the run-around, being told one thing by one bank employee while something entirely different is being pursued by another"]

6/ [6:524.14] **Acknowledgment of receipt of first lien modification application and related documents:** Within five business days, a mortgage servicer must provide written acknowledgment of receipt of a complete first lien modification application or any documents submitted by the borrower in support of the application. In its initial acknowledgment of the modification application, the mortgage servicer must include a description of the loan modification process, timing and any deficiencies in the application. [Civ.C. § 2924.10(a)]

7/ [6:524.15] **Prohibited fees:** Mortgage servicers may not charge borrowers any application, processing or other fee for a first lien loan modification or other foreclosure prevention alternative. [Civ.C. § 2924.11(e)]

Late fees also are prohibited for periods during which the borrower's complete first lien loan modification is under consideration or on appeal, while the borrower is making timely modification payments or while a foreclosure prevention alternative is being evaluated or exercised. [Civ.C. § 2924.11(f)]

8/ [6:524.16] **Suspension of foreclosure process while loan modification application is pending (no "dual tracking"):** Once a borrower has submitted a complete first lien loan modification application by or through the borrower's mortgage servicer, a mortgage servicer, mortgagee, trustee, beneficiary or authorized agent may not advance the foreclosure process while the application is pending. [Civ.C. § 2923.6(c); see also *Jolley v. Chase Home Finance, LLC* (2013) 213 CA4th 872, 904, 153 CR3d 546, 572 (noting mortgage lenders refer to prohibited practice as "dual tracking" while homeowners struggling to avoid foreclosure know it as "the double cross")]

If the borrower receives a verbal notice denying the loan modification application, or the notice of denial fails to include required information, the borrower's request for a loan modification is considered still pending for HBOR purposes. [See *Morris v. JPMorgan Chase Bank, N.A.* (2022) 78 CA5th 279, 310-312, 293 CR3d 417, 454-455—borrower who alleged servicer completed foreclosure sale without providing her with written denial of her timely, complete loan modification request stated claim for material violation of Civ.C. § 2923.6; see also *Valbuena v. Ocwen Loan Servicing, LLC* (2015) 237 CA4th 1267, 1273-1275, 188 CR3d 668, 672-674 (failure to tender loan balance did not defeat § 2923.6 claim)—by alleging submission of loan modification application three days after receipt of Offer Letter, and transmittal of additional documents requested by lender on date of request, borrowers sufficiently pled complete loan modification application was pending when lender foreclosed on their home in violation of § 2923.6]

Moreover, lenders may not record a notice of default (or notice of sale) and may not conduct a trustee's sale until (i) the mortgage servicer makes a written determination that the borrower is not eligible for a first lien modification and the 30-day appeal period has expired (¶ 6:524.18); (ii) the borrower does not accept a modification offered by the lender within 14 days of the offer; *or* (iii) the borrower accepts the modification but breaches their obligations thereunder. [Civ.C. § 2923.6(c); compare *Billesbach v. Specialized Loan Servicing LLC* (2021) 63 CA5th 830, 849-851, 278 CR3d 213, 225-226—mortgage servicer did not violate dual-tracking prohibition by foreclosing after homeowner failed to accept servicer's offer of trial-period modification plan before stated expiration date; *Gillies v. JPMorgan Chase Bank, N.A.* (2017) 7 CA5th 907, 912, 213 CR3d 210, 214-215 & fn. 3 (dictum)—lender's resumption of sale process four months after sending modification offer did not violate dual tracking prohibition where borrower requested additional time to review offer but never accepted same]

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9/ [6:524.17] **Suspension of foreclosure process when foreclosure alternative approved; rescission of notice of default:** If a foreclosure prevention alternative is approved in writing, a mortgage servicer, mortgagee, trustee, beneficiary or other authorized agent may not proceed with foreclosure provided (i) the borrower is in compliance with the modification terms, forbearance or repayment plan; *or* (ii) all parties to the foreclosure prevention alternative approved it in writing and the mortgage servicer received proof of funds. [See Civ.C. § 2924.11(a), (b), (g)—subsequent mortgage servicer must honor previously approved first lien loan modification or other foreclosure prevention alternative]

Once the borrower executes a permanent foreclosure prevention alternative, the mortgagee, beneficiary or authorized agent must record a rescission of the notice of default or cancel the trustee's sale, if applicable. In the case of a short sale, the cancellation of the pending trustee's sale must occur when all parties approve the short sale and the beneficiary, mortgagee or authorized agent receive proof of funds or financing. [See Civ.C. § 2924.11(d)]

10/ [6:524.18] **Denial of modification; right to appeal:** Lenders must send written notice when they deny a borrower's application for a first lien loan modification. The notice must, among other things, identify the reasons for the denial, the amount of time the borrower has to appeal and any other available foreclosure prevention alternatives. [See Civ.C. § 2923.6(f)]

The borrower has "at least" 30 days from the date of the written denial to appeal and provide evidence that the mortgage servicer's determination was in error. If the borrower does not appeal within 30 days after written notice of the denial, the servicer may proceed with the foreclosure on the 31st day. [Civ.C. § 2923.6(d)-(f); *Berman v. HSBC Bank USA, N.A.* (2017) 11 CA5th 465, 473, 217 CR3d 674, 680—denial letter purporting to give borrower only 15 days to appeal deemed material violation supporting injunctive relief]

If the borrower timely appeals, however, the mortgage servicer may not proceed with foreclosure until the *later* of (i) 15 days after the appeal is denied; (ii) 14 days after the borrower declines a modification offered following the appeal; or (iii) if the lender offers a modification after the appeal and the borrower accepts, the date on which the borrower fails to timely submit the first payment or otherwise breaches the offer's terms. [See Civ.C. § 2923.6(e)(2)]

11/ [6:524.19] **Protection against multiple applications (dilatory tactics):** To protect lenders against borrowers who submit multiple first lien loan applications for the purpose of delay, HBOR excuses servicers from evaluating applications from borrowers who have already been evaluated or were afforded a fair opportunity to be evaluated prior to January 1, 2013, *or* who have been evaluated or afforded a fair opportunity to be evaluated consistent with the statute's requirements. [See Civ.C. § 2923.6(g)]

Compare: The above exceptions do *not* apply if the borrower provides the servicer with documentation evidencing a "material change" in the borrower's financial circumstances since the previous application. [Civ.C. § 2923.6(g)]

12/ [6:524.20] **Private right of action/remedies:** As with low volume foreclosures (¶ 6:524.8), borrowers enjoy a private right of action. Thus, borrowers may seek to enforce compliance with Civ.C. §§ 2923.55 ("contact" requirement), 2923.6 (foreclosure suspension requirement), 2923.7 (single point of contact requirement), 2924.9 (disclosure requirements after recording notice of default), 2924.10 (notice and disclosure requirements after borrower submits modification application), 2924.11 (foreclosure suspension requirement after written approval of foreclosure prevention alternative), or 2924.17 ("competent and reliable" evidence requirement). [Civ.C. § 2924.12(a); see also *Lucioni v. Bank of America, N.A.* (2016) 3 CA5th 150, 155, 207 CR3d 418, 419—Civ.C. § 2924.12(a)(1) injunctive relief unavailable for violations of Civ.C. § 2924(a)(6), which requires entity initiating foreclosure be legally entitled to do so]

The servicer, mortgagee, beneficiary or agent is not liable for a violation they or a third party working on their behalf corrected and remedied before the trustee's deed upon sale was recorded. This "safe harbor" shields the lender and its agent from liability for mere technical violations that do not (i) affect the borrower's loan obligations, (ii) disrupt the loan modification process, or (iii) otherwise harm the borrower's efforts to avoid foreclosure. [See Civ.C. § 2924.12(c); *Billesbach v. Specialized Loan Servicing LLC* (2021) 63 CA5th 830, 836, 845-846, 278 CR3d 213, 215, 221-222—borrower could not sue loan servicer for failing to comply with

HBOR's single point of contact (¶ 6:524.13), pre-default notice contact (¶ 6:524.3) and compliance declaration (¶ 6:524d) requirements because servicer corrected those defects prior to foreclosure]

Following foreclosure, the borrower may sue the mortgage servicer, mortgagee, trustee, beneficiary or authorized agent to recover actual economic damages resulting from a material violation of the HBOR. [Civ.C. § 2924.12(b); see *Morris v. JPMorgan Chase Bank, N.A.* (2022) 78 CA5th 279, 303-305, 293 CR3d 417, 448-449 (prescribing three-step process for evaluating successful claim for relief)—borrower's claim must allege *actual economic* damages that arise from an *HBOR violation* that is deemed *material*]

Moreover, borrowers may recover reasonable attorney fees and costs if they "prevail" in their enforcement action by obtaining injunctive relief or damages. [Civ.C. § 2924.12(h); see *Bustos v. Wells Fargo Bank, N.A.* (2019) 39 CA5th 369, 374, 380, 252 CR3d 172, 174, 179—borrower who obtained temporary restraining order (TRO) enjoining foreclosure sale pending lender's compliance with HBOR rules may recover attorney fees and costs even if TRO later vacated; *Hardie v. Nationstar Mortg. LLC* (2019) 32 CA5th 714, 723, 243 CR3d 911, 916—homeowners who obtained temporary restraining order enjoining trustee's sale held in violation of Civ.C. §§ 2923.55 & 2923.6 "prevailed," entitling them to seek fees and costs; *Monterossa v. Sup.Ct. (PNC Bank)* (2015) 237 CA4th 747, 749, 188 CR3d 453, 454—borrowers who obtain either preliminary or permanent injunction enjoining trustee's sale in violation of § 2923.6 's foreclosure suspension requirement "prevail" for purposes of Civ.C. § 2924.12 attorney fee awards; compare *Chen v. Valstock Ventures, LLC* (2022) 81 CA5th 957, 980, 297 CR3d 666, 682-683 (distinguishing HBOR's "unique, statutory scheme" re interim fee awards from Civ.C § 1717, which generally applies in "civil litigation concerning contracts"), *discussed* at ¶ 6:242.3]

Significant departure from pre-2013 law: As with low volume foreclosures (*¶ 6:524.8*), HBOR permits borrowers to sue high volume mortgage servicers, mortgagees, trustees, beneficiaries or their authorized agents for damages *after* the trustee's sale deed has been recorded. [Civ.C. § 2924.12(b)—court may award actual damages where material violation not corrected prior to recordation of sale deed; greater of treble damages or $50,000 available if material violation was intentional, reckless or resulted from willful misconduct; compare Civ.C. § 2924.19(b) (applicable to low volume foreclosures)—parties liable to borrower include mortgage servicer, mortgagee, beneficiary or authorized agent, but *not* trustee (*¶ 6:524.8*)]

Compare: Pre-2013 case law interpreted the remedial provisions of the predecessor statute in a much more restrictive fashion. *See¶ 6:524.8*.

e) Mandatory foreclosure prevention procedures *for calendar year 2018 only* (applicable to all lenders and servicers regardless of foreclosure volume) (*see* ¶ *6:524.1*)

1/ [6:524.21] **"Contact" requirement:** During 2018, mortgage servicers, mortgagees, trustees, beneficiaries and their authorized agents were not permitted to record a notice of default until (i) 30 days after the mortgage servicer made or attempted with due diligence (as defined) to make initial contact, as statutorily specified, with the borrower to assess the borrower's financial situation and explore options to avoid foreclosure; *and* (ii) if the borrower had submitted a complete (as defined) first lien loan modification application that was pending, the mortgage servicer had complied with former Civ.C. § 2924.11(a). [See former Civ.C. § 2923.5(a)(1)—notice of default may not be recorded until either 30 days after initial contact *or* 30 days after satisfying due diligence requirements, as defined, *and* borrower is provided with written determination regarding eligibility for requested modification under former Civ.C. § 2924.11(a)]

During the initial contact, the borrower must have been advised of their right to request a subsequent meeting and, if requested, the servicer must have scheduled the meeting within 14 days. [See former Civ.C. § 2923.5(a)(2)—servicer may make initial contact in person or by phone, and must provide borrower with HUD's toll-free telephone number for purpose of finding HUD-certified housing counseling agency; *see also ¶ 6:524.3*]

2/ [6:524.22] **Mandatory declaration:** Every notice of default must have included a declaration that the mortgage servicer had contacted or tried with due diligence (as defined) to contact the borrower, or that contact was not required because the individual did not meet the statutory definition of "borrower." [Former Civ.C. § 2923.5(b); see also former Civ.C. § 2920.5(c) (defining borrowers entitled to statutory protection as natural

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persons, potentially eligible for foreclosure prevention programs, who have not surrendered their property in writing or by delivery of keys, contracted with entities whose business is extending the foreclosure process and avoiding contractual obligations, or filed for bankruptcy and the bankruptcy court has not entered an order closing or dismissing the case or granting relief from foreclosure); *see also ¶ 6:524.4*]

3/ [6:524.23] **Borrower's advisor:** During 2018, a borrower was permitted to designate, with consent given in writing, a HUD-certified housing counseling agency, attorney or other advisor to discuss with the mortgage servicer the borrower's financial situation and options for avoiding foreclosure. [Former Civ.C. § 2923.5(d)]

4/ [6:524.24] **Suspension of foreclosure process while loan modification application pending:** Once the borrower had submitted a complete application for a first lien loan modification offered by or through the borrower's mortgage servicer, a mortgage servicer, trustee, mortgagee, beneficiary or authorized agent was required to suspend the foreclosure process until the servicer provided the borrower with a written determination whether the modification is approved. [See former Civ.C. §§ 2923.5(a)(1)(B), 2924.11(a)]

5/ [6:524.25] **Suspension of foreclosure process when foreclosure alternative approved:** If a written foreclosure prevention alternative was approved, a mortgage servicer, mortgagee, trustee, beneficiary or authorized agent was not permitted to record a notice of default, notice of sale or conduct a trustee's sale provided (i) the borrower was in compliance with the terms of the modification, forbearance or repayment plan; *or* (ii) all parties to the foreclosure prevention alternative had approved it in writing and the mortgage servicer had received proof of funds or financing. [See former Civ.C. § 2924.11(c), (d)]

6/ [6:524.26] **Private right of action/remedies:** Borrowers enjoyed a private right of action to enforce compliance with former Civ.C. §§ 2923.5 (“contract” requirement), 2923.7 (“single point of contact” requirement —only applicable to large volume foreclosure servicers, even *after* 1/1/18), 2924.11 (foreclosure suspension pending loan modification requirement) and 2924.17 (“competent and reliable evidence” requirement); *see also ¶ 6:524.8*.

Significant departure from pre-2013 law: During 2018, HBOR permitted borrowers to sue mortgage servicers, mortgagees, trustees, beneficiaries or their authorized agents for damages *after* the trustee's sale deed had been recorded. [See former Civ.C. § 2924.12(b)—court may award actual damages where material violation not corrected prior to recordation of sale deed; greater of treble damages or $50,000 available if material violation was intentional, reckless or resulted from willful misconduct]

Compare: Pre-2013 case law interpreted the remedial provisions of the predecessor statute more restrictively; *see also ¶ 6:524.8*.

6) [6:525] **Preliminary “declaration of default” from lender:** Most trustees require, as a condition to their filing a notice of default, that the beneficiary (lender) first execute and deliver to the trustee a “declaration of default.” The declaration of default describes the loan documents and the nature of the default. The trustee will also require delivery of the *original* note (or other evidence of the secured obligation), as well as the *original* deed of trust.

7) [6:526] **Content of notice:** The notice of default must contain certain basic information: trustor's name; book and page, or instrument number (if applicable), where deed of trust is recorded or a description of the secured real property; statement that the secured obligation is in default and nature of each default (¶ *6:526.1*), and election of foreclosure remedy to satisfy the defaulted obligation. [Civ.C. § 2924(a)(1)]

In addition, where the default is “curable” (see Civ.C. § 2924c(a)(1)), the notice must contain the statement prescribed by Civ.C. § 2924c(b)(1) (basically advising trustor of the right to avoid foreclosure by paying all overdue amounts plus permitted costs/expenses within the time allowed by law for reinstatement; *see*¶ *6:532*). [Civ.C. § 2924c(b)(1)]

If the borrower cures the default, the beneficiary must deliver, and the trustee must record, a notice of rescission. [Civ.C. § 2924c(a)(2); *Orcilla v. Big Sur, Inc.* (2016) 244 CA4th 982, 1000-1001, 198 CR3d 715, 730-731 & fn. 6—borrowers who did not make required loan modification payments did not cure default and therefore could not claim lender violated Civ.C. § 2924c]

a) [6:526.1] **Statement of default:** To be valid, a notice of default must contain “a correct statement of some breach or breaches *sufficiently substantial* in their nature to authorize the trustee or beneficiary to declare a default and proceed with a foreclosure.” [*Knapp v. Doherty* (2004) 123 CA4th 76, 99, 20 CR3d 1, 18 (emphasis added)]

By the same token, so long as the above requirements are met, erroneous statements in the notice about other breaches may be treated as *immaterial* and will not invalidate the notice. [*Knapp v. Doherty*, supra, 123 CA4th at 98-99, 20 CR3d at 18-19—incorrect statement in notice of date of breach immaterial; *see also¶ 6:535.15 ff.*]

1/ [6:526.2] **Limited to "actually known" defaults; qualified default description ineffective:**Civ.C. § 2924(a)(1)(C) requires the notice to set forth the nature of each breach *actually known* to the beneficiary. A notice of default that qualifies an assertion of one or more breaches with the words "if any" does *not satisfy* this requirement. [*Anderson v. Heart Fed'l Sav. & Loan Ass'n* (1989) 208 CA3d 202, 213, 256 CR 180, 186—qualification "if any" indicates party claiming default has *no knowledge* of truth or falsity of the assertion]

Compare—effect of omitting "known defaults": The beneficiary is rebuttably presumed to know of all payment defaults on the secured obligation owed to the beneficiary subject to the notice of default; but the beneficiary's failure to include any of the actually known defaults does not itself invalidate the notice of sale and those omitted defaults may be asserted in a separate notice of default. [See Civ.C. § 2924(e)]

[6:526.3 - 6:526.8] ***Reserved.***

b) [6:526.9] **"Contact" declaration required for "*owner-occupied" residential property (HBOR provisions for low and high volume foreclosures):***See¶ *6:524.4 and 6:524.10*.

c) [6:526.10] **Statutory statement required for residential properties (four units or less):** For residential properties containing no more than four dwelling units, the following statement must appear in English, Spanish, Chinese, Tagalog, Vietnamese and Korean at the beginning of the notice of default: "NOTE: THERE IS A SUMMARY OF THE INFORMATION IN THIS DOCUMENT ATTACHED." [See Civ.C. § 2923.3(c)(1); *see also¶ 6:527.3* re attached summary requirement]

d) [6:526.11] **Trustee's immunity from liability for "good faith error" in nature/amount of default:** In recording the notice of default pursuant to Civ.C. § 2924, the trustee incurs *no liability* for any "good faith error resulting from reliance on information provided in good faith by the beneficiary" regarding the nature and amount of the default under the deed of trust. [Civ.C. § 2924(b); but see Civ.C. § 2924.12(b) (applicable to high volume foreclosures)—trustees who violate Civ.C. § 2924.17 by failing to review "competent and reliable evidence" before recording notice of default may be liable for damages after deed of sale recorded]

8) [6:527] **Copies of notice mailed to trustor and certain interested parties:** The trustee also must mail a copy of the recorded notice of default to the trustor (at the trustor's "last known address" if different from that specified in the deed of trust, *see ¶ 6:527a*), parties holding an interest of record in the secured property who would be affected by the foreclosure, and all parties who have duly recorded a request for a copy of the notice and notice of sale (pursuant to Civ.C. § 2924b(a)). [Civ.C. § 2924b(b)(1), (c) & (e); see also *Banc of America Leasing & Capital, LLC v. 3 Arch Trustee Services, Inc.* (2009) 180 CA4th 1090, 1097, 103 CR3d 397, 401—trustee has no duty to give notice to anyone except as specifically provided for by statute or in trust deed; *Estate of Yates* (1994) 25 CA4th 511, 521-522, 32 CR2d 53, 57-58—executor/administrator for deceased trustor's estate also must be mailed notice of default when trustee has actual knowledge trustor is dead and estate is in probate]

The trustee will purchase a "trustee's sale guarantee" from a title insurance company to determine which parties of record are entitled to a copy of the notice of default. *See¶ 3:37*.

a) [6:527a] **"Last known address":** The trustor's "last known address" to which the copy of the recorded notice must be mailed is the trustor's *physical* address—not an email or other form of electronic address. [Civ.C. § 2924b(b)(3)]

Moreover, the notice must be sent to the "last known address" that is "*actually known*" by the trustee or other person authorized to record the notice. An address is considered "actually known" if it is contained in the *original trust deed*, *or* in any *subsequent written notification of a changeof physical address* provided by the *trustor*. [Civ.C. § 2924b(b)(3) (emphasis added)]

b) [6:527.1] **Actual receipt not required:** On the other hand, nothing in the statutory scheme requires that the trustor actually *receive* the mailed notice of default. [*Lupertino v. Carbahal* (1973) 35 CA3d 742, 746-747, 111 CR 112, 115; see also *Knapp v. Doherty* (2004) 123 CA4th 76, 89, 20 CR3d 1, 10]

c) [6:527.2] **Compare—easement holders:** Trustees are not required to give a copy of the notice of default to easement holders absent the holder's specific request pursuant to Civ.C. § 2924b(b)(2). [*Perez v. 222 Sutter St. Partners* (1990) 222 CA3d 938, 943, 948-949, 272 CR 119, 121, 125; see *Diamond Benefits Life Ins. Co. v. Troll* (1998) 66 CA4th 1, 6, 77 CR2d 581, 585]

d) [6:527.3] **Attachment summarizing notice of default information required for residential properties (four units or less):** For residential properties containing no more than four dwelling units, a separate, statutorily-prescribed summary of the notice of default information must be attached to the copy of the recorded notice of default mailed to the trustor. The summary must be in English, Spanish, Chinese, Tagalog, Vietnamese and Korean, but need not be recorded or published. [See Civ.C. §§ 2923.3(a), (b)(1), (c)(2) & 2924(f)]

(f) [6:528] **Notice of trustee's sale; timing:** Except as otherwise provided by statute (below), if the trustor does not "reinstate" the secured obligation (i.e., cure the default) within *three months* after the date of recordation of the notice of default, the trustee may proceed to give a "notice of sale" as prescribed in Civ.C. § 2924f. [See Civ.C. § 2924(a)(2), (3); *Knapp v. Doherty* (2004) 123 CA4th 76, 90-92, 20 CR3d 1, 11-13—trustee must wait three calendar months before proceeding with sale, but sale not invalidated by slightly premature notice of sale that was served on borrowers more than requisite 20 days before initial sale date (¶ *6:529*)]

The trustee has the option of *recording* the "notice of sale" up to five days before the three-month period lapses provided the sale date is no earlier than three months and 20 days after the notice of default was recorded. [Civ.C. § 2924(a)(4)]

These statutory notice requirements "ensure a fair sale." [*Residential Capital, LLC v. Cal-Western Reconveyance Corp.* (2003) 108 CA4th 807, 823, 134 CR2d 162, 174]

1) [6:528.1] **Privileged publication:** Mailing, publication and delivery of a notice of sale pursuant to Civ.C. § 2924 constitute a *privileged publication* under Civ.C. § 47. [Civ.C. § 2924(d)(1); see also *Schep v. Capital One, N.A.* (2017) 12 CA5th 1331, 1336, 220 CR3d 408, 412—privilege protects both trustee performing statutory foreclosure procedures and principal (i.e., beneficiary) who directs trustee to do so]

a) [6:528.2] **Absolute vs. qualified privilege:** Courts disagree whether the privilege accorded *nonjudicial* foreclosure proceedings is "absolute" (Civ.C. § 47(b) litigation privilege) or "qualified" (Civ.C. § 47(c) common interest privilege). [See *Garretson v. Post* (2007) 156 CA4th 1508, 1518, 68 CR3d 230, 237—Legislature extended *litigation* (absolute) privilege to nonjudicial foreclosures to protect trustees performing their contractual/statutory duties; *Kachlon v. Markowitz* (2008) 168 CA4th 316, 339-341, 85 CR3d 532, 550-551—common interest (qualified) privilege applies to nonjudicial foreclosures because it is consistent with nonjudicial foreclosure process, which bears none of the "attributes essential for absolute privilege"; compare *Schep v. Capital One, N.A.* (2017) 12 CA5th 1331, 1337, 220 CR3d 408, 413 (recognizing both a Civ.C. § 47(b) "absolute" privilege that applies irrespective of speaker's motive and a Civ.C. § 47(c) "qualified" privilege applicable to communications made without malice)]

b) [6:528.3] **Compare—no protection under anti-SLAPP statute:** On the other hand, nonjudicial foreclosure proceedings, *including the notice of foreclosure*, are purely private commercial transactions—*not* constitutionally-protected speech or petitioning activity within the meaning of CCP § 425.16 ("anti-SLAPP statute"—a procedural device for screening out meritless claims brought to chill the valid exercise of the constitutional rights of free speech and petition). [*Garretson v. Post* (2007) 156 CA4th 1508, 1517-1524, 68 CR3d 230, 236-242—defendant's § 425.16 motion to strike wrongful foreclosure cause of action dismissed (Civ.C. § 47(b) and CCP § 425.16 "are not coextensive or congruent in scope as applied"); compare *Crossroads Investors, L.P. v. Federal Nat'l Mortgage Ass'n* (2017) 13 CA5th 757, 778-785, 222 CR3d 1, 20-25—although defendant's actions would not be protected by anti-SLAPP statute in nonjudicial foreclosure proceeding, they were protected during pendency of plaintiff's bankruptcy since they related to issues in that case; *Trapp v. Naiman* (2013) 218 CA4th 113, 120-121, 159 CR3d 462, 467-468—error to dismiss defendant's § 425.16 motion to strike complaint arising out of prior foreclosure sale and subsequent unlawful detainer (UD) actions (plaintiffs impermissibly sought to "bootstrap" foreclosure proceeding to defendant's "protected" UD actions to avoid application of anti-SLAPP statute)]

c) [6:528.4] **Compare—trustee's immunity from liability for "good faith error" in nature/amount of default:** In giving the notice of sale pursuant to Civ.C. § 2924, the trustee incurs *no liability* for any "good faith error

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resulting from reliance on information provided in good faith by the beneficiary" regarding the nature and amount of the default under the deed of trust. [Civ.C. § 2924(b); but see Civ.C. § 2924.12(b) (applicable to high volume foreclosures)—trustees who violate Civ.C. § 2924.17 by failing to review "competent and reliable evidence" before recording notice of sale may be liable for damages after deed of sale recorded; *see also*¶ *6:531.1*]

2) [6:529] **To whom notice given; 20-day presale deadline:** The trustee's notice of sale must be sent by *registered or certified mail, postage prepaid*, at least *20 days* before the date of sale, to the trustor, all other parties to whom the notice of default was required to be given (¶ *6:527*), plus any state taxing agency that has recorded a notice of tax lien on the property. [Civ.C. § 2924b(b)(2), (c)(3) & (e)]

a) [6:529a] **Actual receipt not required:** So long as the notice of sale is properly and timely mailed, the fact that the trustor does not *actually* receive it will not invalidate a subsequent sale. [*Knapp v. Doherty* (2004) 123 CA4th 76, 88-89, 20 CR3d 1, 10]

b) [6:529.1] **25-day notice to IRS:** Additionally, when a "Notice of Federal Tax Lien under Internal Revenue Laws" has been recorded against the property, a copy of the trustee's notice of sale must be given to the IRS by registered or certified mail or personal service not less than *25 days* before the sale. [Civ.C. § 2924b(c)(4); IRC § 7425(c)(1)]

1/ [6:529.2] **Federal tax lien survives absent notice:** Federal law does not mandate notice to the IRS as a prerequisite to a valid trustee's sale. But if 25-day presale notice is not given to the IRS, any federal tax lien that was properly recorded more than 30 days before the trustee's sale will *survive* the sale (IRC § 7425(b)(1)). "The decision to give notice and risk intervention by the IRS or not give notice and risk the IRS coming after the property at a later time is left to the trustee …" [*Diediker v. Peelle Fin'l Corp.* (1997) 60 CA4th 288, 293-294, 70 CR2d 442, 445-446—Congress' "obvious intent" was to put IRS "in a better position than other junior lienholders"]

2/ [6:529.3] **Option to rescind sale if IRS notice not given:** Failure to give the IRS notice as prescribed by Civ.C. § 2924b(c)(4) is itself sufficient ground to *rescind* the trustee's sale and invalidate the deed at the option of either the successful bidder or the trustee and with the beneficiary's consent. But the option to rescind must be exercised before the successful bidder transfers the property to a BFP (*see*¶ *6:536 ff.*). [Civ.C. § 2924b(c)(4)]

3/ [6:529.4] **Trustee liability for failure to give IRS notice?** Under the current statutory scheme, however, it is not clear whether (if the sale is not rescinded, ¶ 6:529.3), the trustee may be held liable to the purchaser (or purchaser's title insurer) who ends up being responsible for the federal tax lien because the IRS notice was not given.

One case, decided under the prior version of Civ.C. § 2924b(c), when neither state nor federal law "required" notice of the same to the IRS, held the trustee could not incur such liability absent actual deceit by the trustee. [See *Diediker v. Peelle Fin'l Corp.* (1997) 60 CA4th 288, 297-298, 70 CR2d 442, 447-448] But no reported case has addressed the issue since notice to the IRS has been made a *state law requirement* (¶ *6:529.1*).

4/ [6:529.5] **IRS right of redemption:** Even when the IRS is given notice of the sale, it retains the right to redeem property subject to a tax lien for *120 days* after the trustee's sale. [*Vardanega v. I.R.S.* (9th Cir. 1999) 170 F3d 1184, 1186—IRS could redeem *entire* property even though it had tax lien on only part of property held in joint tenancy]

c) [6:529.6] **Attachment summarizing notice of sale information required for residential properties (four units or less):** For residential properties containing no more than four dwelling units, a separate, statutorily-prescribed summary of the notice of sale information must be attached to the copy of the recorded notice of sale mailed to the trustor. The summary must be in English, Spanish, Chinese, Tagalog, Vietnamese and Korean, but need not be recorded or published. [See Civ.C. §§ 2923.3(a), (b)(2), (d)(2) & 2924f(d)]

d) [6:530] **Posting, publication and recordation also required:** In addition to the requisite mailed notice, written notice of the sale must be (i) posted (at least 20 days before the date of sale) in a public place in the city (or county seat) where the property is to be sold and in a "conspicuous place" on the property to be sold; (ii) published once a week for three consecutive calendar weeks (the first publication to be at least 20 days before the date of sale) in a newspaper of general circulation in the public notice district or county where the property is located; and (iii) recorded with the county recorder of the county where the property (or any part thereof) is located at least 20 days before the date of sale. [Civ.C. § 2924f(b)(1)-(4); see also Gov.C. §§ 6000 & 6006 (defining "newspaper of general

circulation" and its narrow exception respectively); *In re Establishment of the Press-Enterprise as a Newspaper of General Circulation* (2015) 236 CA4th 757, 760, 186 CR3d 768, 770]

3) [6:531] **Content of notice of sale:** The notice of sale must set forth the *time and place* of the trustee's foreclosure sale (street address and specific place at that address where the sale will be held). [Civ.C. § 2924f(b)(1)]

It must also (i) describe the property to be sold (street address or other common designation, plus county assessor's parcel number); (ii) identify the trustee by name, California address (which may reflect the trustee's agent), and either a toll-free phone number or California phone number; (iii) identify the original trustor; (iv) state the total amount of the unpaid principal obligation and reasonably estimated costs, expenses and advances; and (v) contain a statutorily-prescribed default warning notice to the trustor (see Civ.C. § 2924f(c)(3)). [See Civ.C. § 2924f(b)(1), (5), (7)]

Additionally, if the foreclosure is to be a "unified sale" of the secured real property as well as secured fixtures/ personal property, the notice must describe the personal property or fixtures to be sold. [Civ.C. § 2924f(b)(9)]

a) [6:531.1] **No trustee liability for "good faith" erroneous statement of amount:** The trustee incurs no liability for a "good faith error" in stating the proper amount of the principal balance, including any amount provided in good faith by or on behalf of the beneficiary. [Civ.C. § 2924f(b)(7); but see Civ.C. § 2924.12(b) (applicable to high volume foreclosures)—trustees who violate Civ.C. § 2924.17 by failing to review "competent and reliable evidence" before recording notice of sale may be liable for damages after deed of sale recorded; *see also* ¶ *6:528.4*]

b) [6:531.2] **Additional requirements (properties containing one-to-four single-family residences):** On and after April 1, 2012, a notice of sale given pursuant to a deed of trust secured by real property containing from one-to-four single-family residences also must include (i) language notifying potential bidders of specified risks involved in bidding on property at a trustee's sale; and (ii) notice to the property owner about how to obtain information regarding any postponement of the sale. The mortgagee, beneficiary, trustee, or authorized agent must also make a "good faith effort" to provide current information regarding sale dates and postponements via an internet website, telephone recording, or "any other means that allows 24 hours a day, seven days a week, no-cost access to updated information." [See Civ.C. § 2924f(b)(8)(A), (B) (specifying language sale notice must "substantially" follow)]

In addition, the following statement must appear in English, Spanish, Chinese, Tagalog, Vietnamese and Korean at the beginning of the notice of sale: "NOTE: THERE IS A SUMMARY OF THE INFORMATION IN THIS DOCUMENT ATTACHED." [See Civ.C. § 2923.3(d)(1); *see also* ¶ *6:529.6* re attached summary requirement]

1/ [6:531.3] **Notice to tenants:** From January 1, 2021 to December 31, 2030, the trustee's notice of sale (¶ 6:528 ff.) must also include a notice to the property's tenants. The notice to tenants must explain: (i) an "eligible tenant buyer" (¶ 6:535.10h) can buy the property by *matching* the last and highest bid placed at the trustee's auction; (ii) an "eligible bidder" (¶ 6:535.10i) may be able to buy the property by *exceeding* the last and highest bid placed at the trustee's auction; and (iii) the three steps required to exercise these purchase rights. [See Civ.C. § 2924f(b)(8)(A) (1/1/31 "sunset" date) (specifying language notice to tenant must "substantially" follow); compare Civ.C. § 2924f(b)(8)(A) (oper. 1/1/31) (eliminating notice to tenant); see also Civ.C. § 2924m(a)(2), (3) (1/1/31 "sunset" date) (defining "eligible tenant buyer" and "eligible bidder"); *and* ¶ 6:535.10 ff.]

The trustee (or an authorized agent) must maintain an internet website and telephone number to provide, among other things, information on the sale date, amount of the last and highest bid, and the trustee's address. The information must be available 24 hours a day, seven days a week, free of charge, and accessible using the file number assigned to the case and listed on the notice to tenant. [See Civ.C. § 2924f(b)(8)(E) (1/1/31 "sunset" date)]

(g) [6:532] **Trustor's interim right of reinstatement; five-day presale deadline:** Notwithstanding the trustee's recordation of a notice of default and notice of sale, the trustor has the right to *reinstate* the secured obligation by paying all amounts in default (plus the trustee's costs and expenses, see Civ.C. § 2924c(c) & (d), ¶ *6:243 ff.*) *no later than five business days* before the date of sale set forth in the initial recorded notice of sale. [Civ.C. § 2924c(e)—"Nothing contained herein shall give rise to a right of reinstatement during the period of five business days prior to the date of sale"; see *Hicks v. E.T. Legg & Assocs.* (2001) 89 CA4th 496, 504, 108 CR2d 10, 16] Moreover, the lender must provide the trustor with a written itemization of the amounts due if requested. [Civ.C. § 2924c(b)(1)]

Thus, even though the lender has accelerated the loan and declared *all* sums due by the recorded notice of default, the statutory right of reinstatement enables the trustor to avoid foreclosure by paying only the nonaccelerated amounts actually in default (plus trustee's fees). Moreover, the borrower cannot waive its right to reinstate the loan "at the time of or in connection with the making of or renewing of any loan secured by a deed of trust" (Civ.C. § 2953). And, if the defaulted loan has been amended to defer pre-modification arrears, the lender may not be able to demand that the borrower pay the earlier, deferred amounts to exercise its Civ.C. § 2924c right of reinstatement. [See *Taniguchi v. Restoration Homes LLC* (2019) 43 CA5th 478, 490, 256 CR3d 679, 688—lender's demand for both missed payments under modified terms plus deferred amounts under original terms impermissibly deprived borrowers of right to reinstate because post-default loan modification that adjusted principal balance and reduced interest rate and monthly payment was "the making or renewal of a loan … subject to the anti-waiver provisions of [Civ.C. § 2953]"]

If the lender refuses the borrower's tender of the statutory reinstatement amount and proceeds to foreclosure, the trustee's sale is void and may give rise to tort liability for wrongful foreclosure. [*Turner v. Seterus, Inc.* (2018) 27 CA5th 516, 530-531, 238 CR3d 528, 540-541 (¶ 6:539.12)] A cause of action under California's Unfair Competition Law (Bus. & Prof.C. § 17200) also may lie. [See *Taniguchi v. Restoration Homes, LLC*, supra, 43 CA5th at 490-491, 256 CR3d at 688—lender that insisted borrower cure both pre-modification and post-modification loan defaults to reinstate restructured loan may have violated Civ.C. § 2924c, giving rise to unlawful business practices claim]

After the reinstatement period has passed, the trustor still has an equitable right of redemption any time before the foreclosure sale occurs. [See Civ.C. §§ 2903, 2905]

1) [6:532a] **Trustor's successor in interest:** The reinstatement right is available not only to the trustor, but also to "their successor in interest in the mortgaged or trust property or any part thereof" (Civ.C. § 2924(c)(a)(1)). Purchasers of property at foreclosure sales are successors in interest because they follow the mortgagor in ownership and control of the foreclosed property. Thus, one who purchases property at a foreclosure sale subject to a senior mortgage has a statutory right to reinstate the senior mortgage despite not being the original borrower. [*Shetty v. HSBC Bank USA, N.A.* (2023) 91 CA5th 796, 801-802, 308 CR3d 625, 629—condominium purchaser at HOA foreclosure sale had standing to seek mortgage's reinstatement after mortgagor defaulted]

2) [6:532b] **Comment:** The default amount changes daily as interest on the obligation accrues. Moreover, if the note has a yield maintenance (prepayment) feature, that amount may increase or decrease as interest rates fluctuate. To complicate matters, if the lender decides to update the statement of indebtedness contained in the notice of default or notice of sale, it can be difficult for a borrower or its counsel to determine the exact amount needed to reinstate the obligation. Thus, under these circumstances, the borrower must tender, at a minimum, a specific amount based on the information in its possession (e.g., the amount stated in the notice of sale) in order to stop the foreclosure or, if the lender proceeds, to retain a claim for wrongful foreclosure. [See *Crossroads Investors, L.P. v. Federal Nat'l Mortgage Ass'n* (2017) 13 CA5th 757, 791, 222 CR3d 1, 30-31 (noting beneficiary bears burden of informing trustor of correct amount then due on obligation and his/her failure to do so entitles trustor to "prevail" on the merits when it claims proper tender)]

3) [6:532c] **Effect of sale postponement:** If the foreclosure sale is postponed (¶ *6:532.10 ff.*), the right to reinstate is extended to five business days before the new foreclosure sale date. [Civ.C. § 2924c(e)]

Because of the five-day presale deadline, there is no revival of the trustor's right of reinstatement where the sale is postponed for no more than five business days. [See *Hicks v. E.T. Legg & Assocs.* (2001) 89 CA4th 496, 504-508, 108 CR2d 10, 16-19 (25 postponements over 5 months)—reinstatement period not revived by serial postponements for successive periods of five or fewer business days during bankruptcy and injunction stays]

4) [6:532d] **Waiver of five-day deadline by agreement:** The trustor and beneficiary may *override* (or effectively waive) the Civ.C. § 2924c(e) five-day presale reinstatement deadline by agreement providing for cure of the default and reinstatement of the loan within the five-day period. [*Bank of America, N.A. v. La Jolla Group II* (2005) 129 CA4th 706, 712, 28 CR3d 825, 829]

5) [6:532e] **Compare—no waiver of borrower's redemption right:** While the *lender* may waive the five-day deadline for reinstatement, the *borrower* cannot waive its right to reinstate the loan prior to the five-day deadline. [See Civ.C. § 2953]

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6) [6:532.1] **Compare—no postsale redemption rights:** The trustor has no rights of reinstatement or redemption once the trustee's sale is completed. A properly-conducted nonjudicial foreclosure sale constitutes a final adjudication of the borrower's and lender's rights; and the purchaser ordinarily receives title under the trustee's deed free and clear of any right, title or interest of the trustor. [*Moeller v. Lien* (1994) 25 CA4th 822, 831, 30 CR2d 777, 783; *Melendrez v. D & I Investment, Inc.* (2005) 127 CA4th 1238, 1250, 26 CR3d 413, 423; *see also*¶ *6:536 ff.*]

a) [6:532.1a] **Common interest development unit sales distinguished:** A nonjudicial foreclosure by a common interest development association to collect delinquent assessments is subject to a right of redemption. [See CCP § 729.035; Civ.C. § 5715(b); *Barry v. OC Residential Properties, LLC* (2011) 194 CA4th 861, 866, 123 CR3d 727, 731-732; see also *Multani v. Witkin & Neal* (2013) 215 CA4th 1428, 1445, 155 CR3d 892, 904—homeowner in common interest development has statutory right to redeem within 90 days following foreclosure sale]

7) [6:532.2] **Compare—reinstatement and termination of pending foreclosure by estoppel:** In some circumstances, the beneficiary (lender) may be *estopped* to proceed with a pending nonjudicial foreclosure if it accepts payments from the trustor (albeit less than the full amount in default) without objection and misleads the trustor into believing the default has been cured and the foreclosure proceedings terminated. Such an estoppel may arise from a loan repayment agreement between the lender and borrower. [See *Tully v. World Sav. & Loan Ass'n* (1997) 56 CA4th 654, 659-660, 65 CR2d 545, 547-548—triable issues of fact re terms of alleged repayment agreement]

a) [6:532.3] **Tender of payment prerequisite:** But *no* estoppel can arise if the trustor made *no viable tender* of payment of the obligation owing (belated or otherwise). [*MCA, Inc. v. Universal Diversified Enterprises Corp.* (1972) 27 CA3d 170, 177, 103 CR 522, 526; *Karlsen v. American Sav. & Loan Ass'n* (1971) 15 CA3d 112, 117, 92 CR 851, 854; compare *Pfeifer v. Countrywide Home Loans, Inc.* (2012) 211 CA4th 1250, 1280, 150 CR3d 673, 696-697—no tender required when seeking to enjoin pending foreclosure based on lender's alleged failure to comply with HBOR provisions; *see also*¶ *6:535.15f* re additional exceptions to tender rule]

8) [6:532.4] **Limitations on lender charges to reinstate loan:** A lender is limited in the fees it may charge a borrower to reinstate or redeem a defaulted loan secured by a deed of trust. [Civ.C. §§ 2924c, 2924d; *Walker v. Countrywide Home Loans, Inc.* (2002) 98 CA4th 1158, 1173, 121 CR2d 79, 89]

However, Civ.C. §§ 2924c and 2924d do *not* apply to charges incurred *before* notices of default and sale have been recorded. [*Walker v. Countrywide Home Loans, Inc.*, supra, 98 CA4th at 1174, 121 CR2d at 90—§§ 2924c and 2924d do not prohibit lender from charging borrower property inspection fees after borrower defaults on loan but before foreclosure sale noticed]

[6:532.5 - 6:532.9] ***Reserved.***

(h) Postponement of sale

1) [6:532.10] **Discretionary vs. mandatory postponement:** A nonjudicial foreclosure sale may be postponed at any time prior to completion of the sale (¶ *6:535.10 ff.*) at the trustee's discretion or upon instruction by the beneficiary. [Civ.C. § 2924g(c)(1) & (1)(D); *Hicks v. E.T. Legg & Assocs.* (2001) 89 CA4th 496, 507, 108 CR2d 10, 18]

However, the trustee *must* postpone a sale upon court order (injunction or restraining order), where a stay is required by operation of law (e.g., bankruptcy automatic stay under 11 USC § 362 or automatic stay effected under CCP § 916(a) by filing notice of appeal), or pursuant to mutual agreement (oral or written) between trustor and beneficiary. [Civ.C. § 2924g(c)(1)(A), (B) & (C); *Residential Capital, LLC v. Cal-Western Reconveyance Corp.* (2003) 108 CA4th 807, 814, 823, 134 CR2d 162, 167, 174, & fn. 2—“the postponement right prevents a sale when there may be no default by a trustor”; see also *Royal Thrift & Loan Co. v. County Escrow, Inc.* (2004) 123 CA4th 24, 34-38, 20 CR3d 37, 44-47—beneficiary's postponement of sale proper where no showing that exception to appellate automatic stay applied]

(The trustee is required to keep records of each postponement and its reasons. Civ.C. § 2924g(d).)

a) [6:532.11] **No restriction on number of postponements; 365-day limitation:** Technically, there is no limit on the number of postponements allowed under Civ.C. § 2924g. However, if the sale proceedings are postponed for a period or periods totaling *more than 365 days* from the date set forth in the notice of sale, the scheduling

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of any further sale proceedings must be preceded by giving a *new notice of sale* as prescribed by Civ.C. § 2924f (requirements for original notice of trustee's sale, *¶ 6:528 ff.*). [Civ.C. § 2924g(c)(1), (2)]

b) [6:532.11a] **Oral postponements:** Although Civ.C. § 2924g allows for oral postponement of a foreclosure sale, any agreement between the lender and borrower to delay the sale constitutes a loan modification subject to the statute of frauds. [See *Granadino v. Wells Fargo Bank, N.A.* (2015) 236 CA4th 411, 413, 186 CR3d 408, 416; *Jones v. Wachovia Bank* (2014) 230 CA4th 935, 943-944, 179 CR3d 21, 27 & fn. 5; *and further discussion at ¶ 4:272.3 ff.*]

2) [6:532.12] **Notice of postponement:** The trustee must give public notice of each postponement and the reason therefor at the time and place of the last publicized sale (*¶ 6:531*). The notice must state the new date, time and place of sale (the same place originally fixed by the trustee for the sale). [Civ.C. § 2924g(a) & (d); *but see also¶ 6:532.11* (new notice of sale required after 365 days from original date)]

In addition, if the trustee postponed the sale for 10 business days or longer, the mortgagee, beneficiary or authorized agent has to provide written notice to the borrower of the new time and date of sale within five business days following the postponement. [Civ.C. § 2924(a)(5)] This written notice, however, does not satisfy the Civ.C. § 2924g*public* notice requirement (above).

a) [6:532.13] **Notice not itself violative of bankruptcy automatic stay:** While the foreclosure sale itself cannot proceed during the period of an automatic stay against the debtor in bankruptcy (11 USC § 362), mere publication of a notice of postponement of sale does *not* violate the stay. [*Hicks v. E.T. Legg & Assocs.* (2001) 89 CA4th 496, 512-513, 108 CR2d 10, 22-23—notice published one day after inception of automatic stay did *not* violate stay]

3) [6:532.14] **Effect on debtor's right of reinstatement:***See discussion at¶ 6:532b*.

4) [6:532.15] **Seven-day hold on sale after postponement on account of injunction or stay:** A trustee's foreclosure sale postponed by reason of an injunction or stay by operation of law may be conducted *no sooner than the seventh day* after the earlier of dismissal of the action, or expiration or termination of the injunction or stay … *unless* a court order *expressly* directs the sale to occur within that seven-day period. [Civ.C. § 2924g(d); *Hicks v. E.T. Legg & Assocs.* (2001) 89 CA4th 496, 504, 108 CR2d 10, 16; see also *Ragland v. U.S. Bank Nat'l Ass'n* (2012) 209 CA4th 182, 202, 147 CR3d 41, 59—purpose of seven-day waiting period is to provide trustors sufficient time to determine sale date so they can attend and protect their interests]

If a sale had been scheduled to occur during the seven-day period, a new notice of postponement must be given. [Civ.C. § 2924g(d)]

a) [6:532.16] **Special rule for sales postponed by bankruptcy:** The seven-day "waiting period" does *not* apply if the postponement was occasioned by the bankruptcy automatic stay (11 USC § 362). Here, the postponed sale may occur as soon as the stay expires and the seven-day hold (¶ 6:532.15) does not apply. [Civ.C. § 2924g(e)]

Moreover, so long as the creditor properly postponed the sale during the bankruptcy, the sale can occur on the new date with no further notice to the borrower. [*In re Nghiem* (9th Cir. BAP 2001) 264 BR 557, 561, aff'd (9th Cir. 2002) 53 Fed.Appx. 489—creditor's oral postponements of trustee's sale during bankruptcy allowed sale to proceed immediately upon dismissal of bankruptcy case; *Tully v. World Sav. & Loan Ass'n* (1997) 56 CA4th 654, 664, 65 CR2d 545, 550]

5) [6:532.17] **Private right of action:** Although not expressly authorized by statute, the trustor may bring a private cause of action to enforce compliance with the Civ.C. § 2924g(d) foreclosure postponement requirements. This is so because no administrative mechanism to implement § 2924g(d) exists, making a private remedy necessary to its effectiveness. [See *Ragland v. U.S. Bank Nat'l Ass'n* (2012) 209 CA4th 182, 201, 147 CR3d 41, 57-58 (also noting § 2924g(d) is part of foreclosure process and therefore not subject to federal preemption)]

(i) [6:533] **Foreclosure sale by public auction:** The trustee's foreclosure sale is conducted by *public auction* in the county where the property (or any part thereof) is located. [Civ.C. § 2924g(a)]

The sale is held basically like any other auction: The trustee announces the property is for sale and potential purchasers make their bids (provided *that same day* the potential purchasers demonstrate they have the ability to pay by cash, cashier's check, check drawn by a credit union, savings and loan association or other financial institution, or with a "cash equivalent" designated in the notice of sale as acceptable to the trustee). [See Civ.C. § 2924h(b); *California Golf, L.L.C. v. Cooper* (2008) 163 CA4th 1053, 1068, 1071, 78 CR3d 153, 166, 168—"cash equivalent" is term of art, referring to "something different from" cash, cashier's check or bank drawn check (e.g., a *personal* check)]

1) [6:533a] **Temporary prohibition on bundling properties:** From January 1, 2021 to December 31, 2030, trustees must allow a separate bid on each property offered at a foreclosure sale. Bundling properties for sale is not permitted unless the mortgage or trust deed requires otherwise. [Civ.C. § 2924g(a)(4) (1/1/31 "sunset" date)]

2) [6:533.1] **Who may bid:** Anyone, including the beneficiary (lender, *¶ 6:535 ff.*), may bid at a trustee's foreclosure sale. [*Dreyfuss v. Union Bank of Calif.* (2000) 24 C4th 400, 410, 101 CR2d 29, 36; see *Jones v. Wagner* (2001) 90 CA4th 466, 473-474, 108 CR2d 669, 674-675—bidder may include former partner of partnership formed to purchase property or tenant in common]

a) [6:533.2] **Bidding rights of prospective owner-occupants, eligible tenant buyers and eligible bidders (until 1/1/31):** In response to the COVID-19 pandemic, the Legislature granted "eligible tenant buyers" (¶ 6:535.10h) and "eligible bidders" (¶ 6:535.10i) the right to bid on property containing one to four residential units after the trustee's sale. If a "prospective owner occupant" is not the last and highest bidder at the trustee's sale, an "eligible tenant buyer" can purchase the property by matching the last and highest bid placed at the trustee's auction, and an "eligible bidder" may be able to purchase the property by exceeding the last and highest bid placed at the trustee's auction. [See Civ.C. § 2924f(b)(8)(A) (1/1/31 "sunset" date); compare Civ.C. § 2924f(b)(8)(A) (oper. 1/1/31) (eliminating bidding rights for tenant buyers); see also Civ.C. § 2924m(a)(1)-(3) (1/1/31 "sunset" date) (defining "prospective owner-occupant," "eligible tenant buyer" and "eligible bidder"); *and*¶ 6:535.10 ff.]

3) [6:534] **Title to highest bidder:** A bid at a trustee's sale is considered the bidder's *irrevocable offer* to purchase the property for that amount. The trustee's sale is deemed final when the last and highest bid is accepted. [Civ.C. § 2924h(a) & (c); see also *Millennium Rock Mortgage, Inc. v. T.D. Service Co.* (2009) 179 CA4th 804, 809, 102 CR3d 544, 548—sale normally is complete when auctioneer accepts final bid, even though trustee's deed not given to purchaser until subsequent date]

Caution: From January 1, 2021 through December 31, 2030, certain parties have rights to match or exceed the last and highest bid *after* a trustee's sale of residential property containing one to four units, *unless* the last and final bidder at the trustee's sale is a "prospective owner-occupant." [See Civ.C. §§ 2924h(c) (1/1/31 "sunset" date), 2924m(c) (1/1/31 "sunset" date); *and*¶ 6:535.10a ff.]

a) [6:534a] **Relation back:** Assuming the foreclosure sale was properly conducted, free of substantial defects in procedure (*see¶ 6:535.15 ff.*), the *highest bidder* receives title to the property by means of a trustee's deed that "*relates back*" to the date when the deed of trust was recorded. [*Bailey v. Citibank, N.A.* (2021) 66 CA5th 335, 356, 280 CR3d 546, 563; *United States v. Real Property at 2659 Roundhill Dr., Alamo, Calif.* (9th Cir. 1999) 194 F3d 1020, 1026, 1028 (applying Calif. law)—foreclosure purchaser's interest related back to date trust deed was recorded, thereby extinguishing government's subsequently recorded forfeiture claim against property]

b) [6:534b] **Termination of subordinate liens:** As a result of the trustee's deed "relating back" (¶ 6:534a), all liens and encumbrances that attached to the property *after* the deed of trust was recorded and before the foreclosure sale are *extinguished*, *unless* the successful bid exceeds the amount necessary to pay off the senior lien. [*South Bay Bldg. Enterprises, Inc. v. Riviera Lend-Lease, Inc.* (1999) 72 CA4th 1111, 1120, 85 CR2d 647, 652; see also *Bailey v. Citibank, N.A.* (2021) 66 CA5th 335, 356-357, 280 CR3d 546, 563—foreclosure extinguished adverse possession claim commenced *after* trust deed's execution; *Zieve, Brodnax & Steele, LLP v. Dhindsa* (2020) 49 CA5th 27, 36, 262 CR3d 567, 573—successful purchaser takes title free of all rights of trustor or anyone claiming through trustor, including rights under liens that attached after foreclosed trust deed; *Vallely Investments, L.P. v. BancAmerica Comm'l Corp.* (2001) 88 CA4th 816, 824, 106 CR2d 689, 695—valid foreclosure terminates *all* interests *junior* to mortgage but *not senior* interests]

c) [6:534.1] **Exception for certain tax liens:** Federal tax liens recorded more than 30 days before the trustee's sale *survive* the sale unless notice of the sale was properly given to the IRS pursuant to federal law (*see¶ 6:529.1 ff.*).

Certain *state* tax liens also survive a nonjudicial foreclosure sale regardless of the time of their creation. [See Rev. & Tax.C. §§ 2187, 2192.1; *Barer v. County of Riverside* (1997) 57 CA4th 558, 566-571, 67 CR2d 241, 246-249—ad valorem tax liens on possessory interest in tax-exempt land not extinguished by senior lienholder's nonjudicial foreclosure sale of possessory interest]

d) [6:534.2] **Compare—subordinate leaseholds:** Subordinate leasehold interests also are extinguished by a nonjudicial foreclosure absent an effective "nondisturbance and attornment agreement" preserving the junior

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leaseholds (¶ 6:472 ff.). [*Dover Mobile Estates v. Fiber Form Products, Inc.* (1990) 220 CA3d 1494, 1498, 270 CR 183, 185; see also *Dr. Leevil, LLC v. Westlake Health Care Ctr.* (2017) 9 CA5th 450, 455, 215 CR3d 127, 131 (reversed on other grounds by *Dr. Leevil, LLC v. Westlake Health Care Center* (2018) 6 C5th 474, 484-485, 241 CR3d 12, 20); *Aviel v. Ng* (2008) 161 CA4th 809, 813, 74 CR3d 200, 203—trustee sale under trust deed extinguished commercial lease made subject to future *mortgages only* by subordination clause (mortgages and trust deeds are functionally and legally equivalent); *see also ¶ 7:273 ff.*]

e) [6:534.3] **Sale of common interest development units:** A homeowner's association may request a copy of the trustee's deed upon sale of any of the separate interests it governs. The association's request must be recorded *before* the notice of default (*¶ 6:524*) is filed, and the trustee must mail the trustee's deed to the association within 15 business days of the trustee's sale. [Civ.C. § 2924b(f)(1)]

The request does *not,* for purposes of Gov.C. § 27288.1 (re content requirements for real property instruments), constitute a document that (i) effects or evidences a transfer or encumbrance of a real property interest; or (ii) releases or terminates a real property interest, right or encumbrance. [Civ.C. § 2924b(f)(2)]

4) [6:535] **"Credit bidding" by beneficiary:** Unlike other purchasers at a nonjudicial foreclosure sale, the lender (beneficiary) is not required to pay cash, but may credit bid up to the amount of the outstanding indebtedness (including trustee's fees and expenses). [Civ.C. § 2924h(b); *Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1238, 44 CR2d 352, 359; *Dreyfuss v. Union Bank of Calif.* (2000) 24 C4th 400, 410, 101 CR2d 29, 36; *Kalnoki v. First American Trustee Servicing Solutions, LLC* (2017) 8 CA5th 23, 45, 214 CR3d 292, 308-309]

The reason is that it would be pointless to require the lender to tender cash to itself. [*Alliance Mortgage Co. v. Rothwell*, supra, 10 C4th at 1238, 44 CR2d at 359; *Kolodge v. Boyd* (2001) 88 CA4th 349, 356, 105 CR2d 749, 754-755]

a) [6:535.1] **Debt and security interest extinguished by full credit bid:** By making a successful "full credit bid" (an amount equal to the unpaid principal and interest of the secured debt, together with costs, fees and other expenses of the foreclosure), the lender effectively pays the full outstanding balance of the debt and foreclosure costs to itself and takes title to the secured property. In turn, the borrower is released from further obligations under the defaulted note; both the underlying debt and lender's lien to secure the debt are *extinguished*, and the lender cannot thereafter pursue any other remedies even if the property is actually worth less than the amount of its bid. [*Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1238, 44 CR2d 352, 359; see also *Najah v. Scottsdale Ins. Co.* (2014) 230 CA4th 125, 133-134, 178 CR3d 400, 407-408—full credit bid rule prevents double recovery by lender whose only interest in property is repayment of debt and protects integrity of foreclosure auction by ensuring competitive bidding; *National Enterprises, Inc. v. Woods* (2001) 94 CA4th 1217, 1230, 115 CR2d 37, 45—lien extinguished by merger when lienholder acquires ownership of property]

The same holds true for a foreclosing junior lienholder who acquires the property by full credit bid: The debt secured by the junior lien is satisfied and the lien is extinguished, although the junior lienholder (like any other successful bidder) takes the property subject to the senior lien. [*Kolodge v. Boyd* (2001) 88 CA4th 349, 356, 105 CR2d 749, 755]

A full credit bid conclusively establishes the value of the property, extinguishes the lien and precludes the lender from pursuing any other remedy based on diminution of the value of the property. [See *Bank of America, N.T. & S.A. v. Quackenbush* (1997) 56 CA4th 1167, 1171, 66 CR2d 81, 83; *Najah v. Scottsdale Ins. Co.*, supra, 230 CA4th at 142, 178 CR3d at 415 (¶ 6:535.6); see also *Alliance Mortg. Co. v. Rothwell*, supra, 10 C4th at 1236-1237, 44 CR2d at 358—price obtained at foreclosure sale is not same as FMV because property sold within strictures of state-prescribed foreclosure laws is worth less than property sold pursuant to normal marketing techniques; *Washington Mut. Bank v. Jacoby* (2009) 180 CA4th 639, 646, 103 CR3d 245, 250—trustee/mortgagee not entitled to insurance proceeds for prepurchase damage to subject property once trustee forecloses and makes successful full credit bid (¶ 6:535.6)]

1/ [6:535.2] **Amounts properly included in "full credit bid":** The amount of a full credit bid is the full amount of the outstanding indebtedness at the time of the foreclosure sale. Generally, that includes the unpaid principal and interest, plus costs, fees and other expenses of the foreclosure. In an appropriate case, it may also include

any money the lender has advanced for real estate taxes unpaid by the debtor. [*Nippon Credit Bank, Ltd. v. 1333 North Calif. Boulevard* (2001) 86 CA4th 486, 500, 103 CR2d 421, 430]

However, fees and expenses of the foreclosure may not exceed statutorily-prescribed amounts. [See Civ.C. §§ 2924c(c), 2924d(b)(1) & (2); *Jones v. Union Bank of Calif.* (2005) 127 CA4th 542, 548, 25 CR3d 783, 788—*legal fees* incurred in foreclosure proceedings *not limited* by Civ.C. §§ 2924c or 2924d]

*Alert:*Civ.C. § 2924d(b)(2) (above), which authorizes limited additional trustee fees for responding to a bid or notice of intent to bid by an eligible bidder or eligible tenant bidder, has a 1/1/31 "sunset" date.

b) [6:535.3] **Tort claims based on impairment of security barred by full credit bid:** The lender's purchase of the secured property by full credit bid "establishes the value of the security as being equal to the outstanding indebtedness and ipso facto the nonexistence of any impairment of the security." Consequently, the lender's acquisition of the property by full credit bid effectively *estops it* from pursuing tort claims based on alleged impairment of its security (e.g., based on "bad faith waste"; *see*¶ *6:561.5d*). [*Cornelison v. Kornbluth* (1975) 15 C3d 590, 606-608, 125 CR 557, 568-570; *Kolodge v. Boyd* (2001) 88 CA4th 349, 357, 105 CR2d 749, 755—lender who makes full credit bid irrevocably warrants value of security foreclosed upon is equal to outstanding indebtedness and not impaired (a "legal fiction")]

1/ [6:535.4] **Third party fraud exception:** A full credit bid does *not* bar the lender from pursuing a fraud cause of action against a *third party* nonborrower when the lender can establish: (i) it was induced to enter into the loan by the third party's false representation (i.e., lender was "intentionally and materially misled" by the third party "as to the value of the property *prior to even making the loan*"); *and* (ii) it still believed that the representation was true at the time it made the full credit bid. [*Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1245, 44 CR2d 352, 364-365 (emphasis added); *Michelson v. Camp* (1999) 72 CA4th 955, 969, 85 CR2d 539, 548; *In re King Street Investments, Inc.* (9th Cir. BAP 1998) 219 BR 848, 855—applicable to *constructive* fraud claim]

This exception does not apply, however, if the lender's reliance on a prior fraudulent misrepresentation was *manifestly unreasonable*. [*Michelson v. Camp*, supra, 72 CA4th at 969, 85 CR2d at 548—manifestly unreasonable to rely on prior misrepresentation where lender obtained new appraisal "expressly to resolve the issue of value at the time of foreclosure"; see *Kolodge v. Boyd* (2001) 88 CA4th 349, 373-374, 105 CR2d 749, 768—requisite factual inquiry whether plaintiff was justified in believing appraiser representation in light of "own knowledge and experience" not made]

2/ [6:535.4a] **Exception for other third party tort claims:***Alliance*, supra, did not expressly limit the exception to third party fraud; and other courts have since extended the exception to cover *negligence* claims against third parties. [*Kolodge v. Boyd* (2001) 88 CA4th 349, 364-365, 105 CR2d 749, 761—"everything the *Alliance* court said about fraud can also be said about … negligence claims"; see also *First Comm'l Mortgage Co. v. Reece* (2001) 89 CA4th 731, 743-745, 108 CR2d 23, 32-34 (fraud, negligent misrepresentation and breach of contract claims upheld; ¶ *6:535.5*)]

Contra authority: One case held otherwise, concluding that the *Alliance* exception applies only to fraud claims. [*Pacific Inland Bank v. Ainsworth* (1995) 41 CA4th 277, 283, 48 CR2d 489, 492—full credit bid barred lender from suing appraiser for undervaluation of foreclosed-upon properties]

But *Pacific Inland Bank* has not been followed by any other court and, in fact, has been criticized as "wrongly decided." The purpose of the full credit bid bar, "which is to insure the integrity of foreclosure sales in situations covered by the antideficiency statues, relates *only to the debtor-creditor* relationship. The bar of the rule was not designed to relieve *third parties* of the consequences of tortious conduct … Application of the rule to bar claims against tortfeasors not party to the note goes far beyond the purpose of the rule and is simply irrational." [See *Kolodge v. Boyd*, supra, 88 CA4th at 370-372, 105 CR2d at 765-767 (emphasis added); see also *In re King Street Investments, Inc.* (9th Cir. BAP 1998) 219 BR 848, 855 (construing Calif. law) (dictum rejecting *Pacific Inland Bank*)]

3/ [6:535.5] **Exception applies to claim arising from originating lender's compelled repurchase after servicing lender's full credit bid:** The *Alliance* exception also applies where an originating lender justifiably relied on third party misrepresentations in making the loan and selling it to another lender (the "servicing lender") and then, after the foreclosing servicing lender's successful full credit bid, suffered damages when it

was compelled (by its contract with the servicing lender or by federal regulations) to repurchase the foreclosed property only to sell it at a loss. [*Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1248-1249, 44 CR2d 352, 366; *First Comm'l Mortgage Co. v. Reece* (2001) 89 CA4th 731, 742, 108 CR2d 23, 31]

Although a full credit bid is deemed an admission of the property's value (¶ *6:535.3*), a repurchasing lender does not control the amount the servicing (successor) lender bids at the foreclosure sale. Therefore, the rationale for holding the foreclosing lender to its full credit bid is *inapplicable* in this situation. [*First Comm'l Mortgage Co. v. Reece*, supra, 89 CA4th at 742, 108 CR2d at 31, fn. 4]

c) [6:535.6] **Right to insurance proceeds for prepurchase damage:** Since acquisition of the property by full credit bid satisfies the secured lender's only interest in the property (repayment of its debt), it also wipes out any entitlement the lender may have had to *insurance proceeds* for prepurchase damage to the property. When the debt is extinguished, so is the lender's insurable interest. [*Cornelison v. Kornbluth* (1975) 15 C3d 590, 606-607, 125 CR 557, 568-569; *Washington Mut. Bank v. Jacoby* (2009) 180 CA4th 639, 646, 103 CR3d 245, 250; see also *Najah v. Scottsdale Ins. Co.* (2014) 230 CA4th 125, 142, 178 CR3d 400, 415—full credit bid at foreclosure sale under second trust deed precluded lienholder from making claim on insurance proceeds for preforeclosure damage]

1/ [6:535.6a] **Compare—lender's rights in common fund insurance proceeds as property owner:** Where insurance proceeds for prepurchase damage are held by a homeowners' association for the benefit of the common owners, a full-credit bid foreclosing lender is entitled to share in the proceeds in its *capacity as owner and association member* (rather than as a lender). [*Countrywide Home Loans, Inc. v. Tutungi* (1998) 66 CA4th 727, 731-732, 78 CR2d 203, 205]

d) [6:535.7] **Distinguish—*partial credit bids:*** Nothing in the law requires a secured lender involved in a trustee's sale to make a full credit bid. The lender may bid whatever they believe the property is worth (although the secured lender is most often tempted to make a full credit bid because CCP § 580d prohibits a deficiency judgment after nonjudicial foreclosure in any event, ¶ *6:570*). [See *Dreyfuss v. Union Bank of Calif.* (2000) 24 C4th 400, 413-414, 101 CR2d 29, 38-39—foreclosing lender entitled to credit bid in whatever amount it thinks property is worth; *Kolodge v. Boyd* (2001) 88 CA4th 349, 357, 105 CR2d 749, 755—many creditors enter low bids to provide access to additional security]

1/ [6:535.7a] **Recoverable damages for prepurchase property damage:** A *partial*-credit-bid foreclosing lender is not barred from pursuing claims against a third party for alleged impairment of its security. However, the lender's recovery is limited generally to the unpaid balance of the debt. [*Track Mortg. Group, Inc. v. Crusader Ins. Co.* (2002) 98 CA4th 857, 865, 120 CR2d 228, 234—partial-credit-bid foreclosing lender's compensatory damages for property insurer's breach of contract and bad faith in failing to repair property reduced by amount of lender's partial bid]

Damages *exceeding* the unpaid portion of the debt are recoverable only when the lender shows that the third party's conduct caused the lender's bid to be higher than the actual value of the property. [*Track Mortg. Group, Inc. v. Crusader Ins. Co.*, supra, 98 CA4th at 866, 120 CR2d at 234; *see also*¶ *6:535.4*]

e) [6:535.8] **Application of full credit bid rule where multiple notes secured by single property:** Where a lender has made several loans secured by the same piece of property, a full credit bid in the amount of the junior obligation satisfies the total indebtedness under *all* the notes held by that creditor, even if the creditor forecloses on the junior lien alone. This rule is premised on the property's value being equivalent to the value of the total debt held by the junior lienholder at the time of sale. [See *Najah v. Scottsdale Ins. Co.* (2014) 230 CA4th 125, 141-143, 178 CR3d 400, 414-415; *Romo v. Stewart Title of Calif.* (1995) 35 CA4th 1609, 1617-1618, 42 CR2d 414, 420-421; but see also *Kolodge v. Boyd* (2001) 88 CA4th 349, 361-362, 105 CR2d 749, 759-760—where lender made several loans secured by same property it is question of fact whether amounts due under all notes should be considered collectively in determining whether lender made full credit bid (courts generally focus on whether notes or writings between parties reflect their *express intent* that liens would merge with security's title and, if not, full credit bid rule does not apply)]

➪ [6:535.9] **Comment:** In *Kolodge*, supra, the lender held three trust deeds secured by two properties. When the owner defaulted on all three loans, the lender held a foreclosure sale on the third trust deed, bidding only the amount of principal due thereunder based upon appraisals supporting inflated values for the underlying

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properties. The lender then pursued claims for fraud and negligence against the appraiser whose evaluations allegedly induced him to make the loans, and the court concluded such claims were not precluded by the full credit bid rule.

In distinguishing *Kolodge,* the *Najah* court observed, "*Kolodge* stand[s] for nothing more than that the full credit bid rule is inapplicable where the lender is fraudulently or negligently induced to make the bid." [*Najah v. Scottsdale Ins. Co.* (2014) 230 CA4th 125, 141, 178 CR3d 400, 413 (brackets in original; internal quotes omitted)]

5) [6:535.10] **Completion of sale:** A nonjudicial foreclosure sale is deemed *final* when the trustee accepts the last and highest bid. [Civ.C. § 2924h(c); *Nguyen v. Calhoun* (2003) 105 CA4th 428, 441, 129 CR2d 436, 447; see also *Matson v. S.B.S. Trust Deed Network* (2020) 46 CA5th 33, 41-42, 259 CR3d 526, 533—because sale is complete upon final bid's acceptance, trustee's ministerial act of recording sale deed over purchaser's objection does not justify overturning sale; *Millennium Rock Mortgage, Inc. v. T.D. Service Co.* (2009) 179 CA4th 804, 809, 102 CR3d 544, 548—sale normally complete when auctioneer accepts final bid, even though trustee's deed not given to purchaser until subsequent date; *but see¶ 6:535.15 ff.* re bases for avoiding sale]

a) [6:535.10a] **Special post-sale bidding rules for residential properties with 1-4 units in 2021-2030:** In order to forestall evictions during the COVID-19 pandemic, the Legislature temporarily changed the nonjudicial foreclosure process to afford qualifying tenants and certain nonprofits and governmental agencies an opportunity to bid *after* a trustee's sale of residential properties containing one to four residential units. This is so *unless* the successful bidder at the trustee's sale is a "prospective owner-occupant" (¶ 6:535.10c). [See Civ.C. § 2924m(c) (1/1/31 "sunset" date) —date trustee's sale is deemed final varies according to purchaser's status]

Once the COVID-19 pandemic subsided, the Legislature extended the above program's duration and introduced an affordable housing restriction as a means of addressing California's continuing housing crisis (¶ 6:535.10k).

Caution: After introducing the special bidding rules in 2020, the Legislature amended the operative statutes in 2021, and again in 2022 (see Stats. 2020, Ch. 202, eff. 1/1/21; Stats 2021, Ch. 255, oper. 1/1/22; Stats. 2022, Ch. 642, eff. 1/1/23). Each amendment made substantial changes to the definitions for potential bidders and to the procedures and requirements involved. Thus, practitioners should exercise caution in determining which rules apply to a given situation.

1/ [6:535.10b] **"Prospective owner-occupant" is successful bidder:** Prospective owner-occupants (¶ 6:535.10c) have priority rights to purchase residential property from foreclosure. If a prospective owner-occupant is the last and highest bidder at a trustee's sale of a one-to four-unit residential property, the sale is deemed final when the trustee accepts the prospective owner-occupant's bid. [Civ.C. § 2924m(c)(1) (1/1/31 "sunset" date); see also Civ.C. § 2924h (outlining procedures and conditions for trustee to accept bid)]

2/ [6:535.10c] **"Prospective owner-occupant" defined; mandatory affidavit or declaration:** A "prospective owner-occupant" is a natural person who presents to the trustee an affidavit or declaration under penalty of perjury certifying that they will occupy the property as their primary residence within 60 days of the trustee's deed being recorded and will maintain their occupancy for at least one year. [Civ.C. § 2924m(a)(1)(A), (B) (1/1/31 "sunset" date)]

The above affidavit or declaration also must aver that the prospective owner-occupant is (i) not the mortgagor/trustor or the child, spouse, parent, employee, officer, or member of the mortgagor/trustor; (ii) not the grantor of a living trust named in the property title when the notice of default was recorded; (iii) not a person with an ownership interest in the mortgagor (unless the mortgager is a publicly traded company); and (iv) not purchasing the property as the agent of any other person or entity. (Civ.C. § 2924m(a)(1)(C)-(D) (1/1/31 "sunset" date)). No later than 5 p.m. on the next business day following the trustee's sale, the prospective owner-occupant must submit the affidavit or declaration affirming that they fulfill the prospective owner-occupant requirements. [Civ.C. § 2924m(c)(1) (1/1/31 "sunset" date)]

Note: An "eligible tenant buyer" (¶ 6:535.10h) also may qualify as a prospective owner-occupant. [Civ.C. § 2924m(b) (1/1/31 "sunset" date)]

3/ [6:535.10d] **Prospective owner-occupant not successful bidder; notice to potential bidders:** If a prospective owner-occupant (¶ 6:535.10c) is not the last and highest bidder, an "eligible tenant buyer" (¶

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6:535.10h) or "eligible bidder" (¶ 6:535.10i) may bid on the residential property after the trustee's sale and must "be deemed the last and highest bidder pursuant to the power of sale." This is so provided the statutory requirements are met (¶ 6:535.10g ff.). [See Civ.C. § 2924m(c)(2), (3), (4) (1/1/31 "sunset" date)]

Within 48 hours after the trustee's sale to a party *other* than a prospective owner-occupant, the trustee (or an authorized agent) must post on its internet website, and make available by calling the telephone number set forth in the notice of sale (¶ 6:531.2 ff.), *only* the following information: (i) the date the trustee's sale took place; (ii) the amount of the last and highest bid; *and* (iii) an address at which the trustee can receive documents sent by U.S. mail and overnight delivery. This information must remain available for at least 45 days after the property sale, and must be accessible using the file number assigned to the case that is set forth on the notice of sale. [Civ.C. § 2024m(e) (1/1/31 "sunset" date)]

4/ [6:535.10e] **15-day deadline to deliver notice of intent to bid or sale is final:** If a prospective owner-occupant (¶ 6:535.10c) is not the last and highest bidder, then eligible tenant buyers (¶ 6:535.10h) and eligible bidders (¶ 6:535.10i) have 15 days to deliver either a bid or a nonbinding notice of intent to bid to the trustee. The notice of intent to bid must (i) be sent by certified mail, overnight delivery or other method that allows verification of the delivery date; (ii) be accompanied by an affidavit or sworn declaration identifying the specific category of eligible bidder (¶ 6:535.10i) in which that person or entity claims membership and affirming that the person meets the applicable criteria for that category; (iii) be received by the trustee no later than 5 p.m. on the 15th day following the trustee's sale (or the next business day thereafter if the 15th day is a weekend or holiday); and (iv) include the bidder's current telephone number and return address. [Civ.C. § 2924m(c)(1), (2) (1/1/31 "sunset" date)]

If no eligible tenant buyer or eligible bidder submits a bid or a notice of intent to bid, the trustee's sale is deemed final 15 days after the trustee's sale. [Civ.C. § 2924m(c)(2) (1/1/31 "sunset" date)]

5/ [6:535.10f] **Notice of intent to bid timely delivered; maximum 45 days to deliver bid:** If a trustee receives timely notice of an intent to bid (¶ 6:535.10e), eligible tenant buyers (¶ 6:535.10h) and eligible bidders (¶ 6:535.10i) have up to 45 days after the trustee's sale to submit a bid on the property. The bidding party must send the bid to the trustee by certified mail, overnight delivery, or other method that allows verification of the delivery date, and the bid must be in the form of cash or a cashier's check, accompanied by an affidavit or sworn declaration, along with the bidder's current telephone number and return address. If the bidder submitted a timely notice of intent to bid, the trustee must *receive* the bid no later than 5 p.m. on the 45th day following the trustee's sale (or the next business day thereafter if the 45th day is a weekend or holiday). On the other hand, if the bidder did *not* submit a timely notice of intent to bid, the trustee must *receive* the bid no later than the 15th day following the trustee's sale (or the next business day thereafter if the 15th day is a weekend or holiday). [See Civ.C. § 2924m(c)(3), (4) (1/1/31 "sunset" date)]

6/ [6:535.10g] **Priority for eligible tenant buyers; bid requirements:** If the trustee receives a timely bid from the representative of all eligible tenant buyers (¶ 6:535.10h) and the bid *equals* the full amount of the last and highest bid at the trustee's sale, then the eligible tenant buyers "shall be deemed the last and highest bidder pursuant to the power of sale" and the sale will be deemed final as of the date the representative submitted the bid to the trustee. The bid must be accompanied by an affidavit or declaration under penalty of perjury stating that the persons represented meet the statutory criteria of eligible tenant buyers and constitute all of the eligible tenant buyers. The bid must be limited to a single amount and cannot contain instructions for successive bid amounts. [Civ.C. § 2924m(c)(3) (1/1/31 "sunset" date)]

7/ [6:535.10h] **"Eligible tenant buyer" defined:** For calendar year 2022, an "eligible tenant buyer" was defined as a natural person who at the time of the trustee's sale was (i) occupying the property as their primary residence; (ii) under a rental or lease agreement entered into as the result of an arm's length transaction with the mortgagor/ trustor on a date prior to the recording of the notice of default against the property; and (iii) not the mortgagor/ trustor, or the child, spouse, or parent of the mortgagor/trustor. [Civ.C. § 2924m(a)(2) (amended Stats. 2021, Ch. 255; oper. 1/1/22) (1/1/26 "sunset" date); see also Civ.C. § 2924m(n) & (o) (added Stats. 2022, Ch. 642) (specifying 2021 amendments became oper. 1/1/22-1/1/23) (1/1/31 "sunset" date)]

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Commencing January 1, 2023, an "eligible tenant buyer" is defined as a natural person who at the time of the trustee's sale is (i) occupying the property as their primary residence; (ii) under a rental or lease agreement entered as the result of an arm's-length transaction with the mortgagor/trustor or their predecessor in interest on a date prior to the recording of the notice of default against the property; (iii) not the mortgagor/trustor, or the child, spouse, or parent of the mortgagor/trustor; (iv) not acting as an agent of another (except when submitting a bid on behalf of all eligible tenant buyers under Civ.C. § 2924m(c)(3)); and (v) not the debtor in a Chapter 7, 11, 12 or 13 bankruptcy case filed during the period starting on the date of the trustee's sale and ending on the 45th day after the sale (or the next business day thereafter if the 45th day is a weekend or holiday). [Civ.C. § 2924m(a)(2) (amended Stats. 2022, Ch. 642; eff. 1/1/23) (1/1/31 "sunset" date)]

To demonstrate eligibility, the tenant buyer must submit a declaration or affidavit under penalty of perjury with the bid, attaching a copy of the signed and dated rental or lease agreement or, if unavailable, evidence of six months' rent or utility payments made by the tenant prior to recordation of the notice of default. [Civ.C. § 2924m(a)(2)(B), (4) (1/1/31 "sunset" date); see also Civ.C. § 2924m(o) (subd. added Stats. 2022, Ch. 642; eff. 1/1/23) (expanding "eligible tenant buyer" definition) (1/1/31 "sunset" date)]

8/ [6:535.10i] **"Eligible bidder" defined:** For calendar year 2022, an "eligible bidder" was defined as (i) an eligible tenant buyer (¶ 6:535.10h); (ii) a "prospective owner-occupant" (*¶ 6:535.10c)*; (iii) a nonprofit association, nonprofit corporation, or cooperative corporation in which an eligible tenant buyer or a prospective owner-occupant is a voting member or director; (iv) an eligible nonprofit corporation based in California whose primary activity is the development and preservation of affordable rental housing; (v) a limited partnership or limited liability company in which the managing general partner or managing member is an eligible nonprofit corporation based in California whose primary activity is the development and preservation of affordable housing; (vi) a community land trust (see Rev. & Tax.C. § 402.1(a)(11)(C)(ii); (vii) a limited-equity housing cooperative (see Civ.C. § 817); or (viii) the state, the Regents of the University of California, a county, city, district, public authority, or public agency, and any other political subdivision or public corporation in the state. [Civ.C. § 2924m(a)(3) (amended Stats. 2021, Ch. 255, oper. 1/1/22) (1/1/26 "sunset" date); see also Civ.C. § 2924m(n) & (o) (added Stats. 2022, Ch. 642) (specifying 2021 amendments became oper. 1/1/22-1/1/23) (1/1/31 "sunset" date)]

Commencing January 1, 2023, an "eligible bidder" is (i) an eligible tenant buyer (¶ 6:535.10h); (ii) a prospective owner-occupant (¶ 6:535.10c); (iii) a nonprofit association, nonprofit corporation, or cooperative corporation in which an eligible tenant buyer is a voting member or director; (iv) an eligible non profit corporation that is certified by the IRS as being tax-exempt, is not a private foundation, is in good standing with the Attorney General's Registry of Charities and Fundraisers, is based in California with all of its board members having their primary residences in California, and whose primary activities include the development and preservation of affordable rental or homeownership housing; (v) a limited liability company wholly owned by one or more eligible nonprofit corporations as described in (iii) and (iv) above; (vi) a community land trust (see Rev. & Tax.C. § 402.1(a)(11)(C)(ii); (vii) a limited-equity housing cooperative (see Civ.C. § 817); or (viii) the state, the Regents of the University of California, a county, city, district, public authority, or public agency, and any other political subdivision or public corporation in the state. [See Civ.C. § 2924m(a)(3) (amended Stats. 2022, Ch. 642; eff. 1/1/23, and further amended by Stats. 2023, Ch. 478; eff. 1/1/24 to reflect name change from Registry of Charitable Trusts to Registry of Charities and Fundraisers) (1/1/31 "sunset" date)]

9/ [6:535.10j] **Eligible bidders; bid requirements:** If the trustee receives timely bids from one or more eligible bidders (¶ 6:535.10i), and the bids *exceed* the full amount of the last and highest bid at the trustee's sale, then the eligible bidder who submitted the highest bid "shall be deemed the last and highest bidder pursuant to the power of sale" and the sale will be deemed final at 5 p.m. on the 45th day after the trustee's sale. Eligible bidders must submit an affidavit or sworn declaration that identifies which category of eligible bidder (¶ 6:535.10i) they fall into, and must attest that they meet the applicable statutory criteria for that category. [Civ.C. § 2924m(c)(4) (1/1/31 "sunset" date)]

10/ [6:535.10k] **Affordable housing restriction for certain eligible bidders:** Commencing January 1, 2023, any entity eligible to bid post-sale on a foreclosure property—other than (i) a "prospective owner-occupant" (¶

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6:535.10c), (ii) an "eligible tenant buyer" (¶ 6:535.10h), or (iii) the State, the Regents of the University of California, a county, city, district, public authority, agency or corporation, or any other political subdivision in the state—must encumber the subject property with a recorded covenant ensuring the property will be sold or rented at an affordable rate for lower income households (as defined in Health & Saf.C. §§ 50052.5, 50053, 50079.5) for at least 30 years from the date of the trustee's deed. [Civ.C. § 2924***o*** (1/1/31 "sunset" date)]

Tenants of the subject property have a right of action to enforce this restriction, either by bringing suit at law or in equity, or to defend against an unlawful detainer action. [Civ.C. § 2924***o***(b) (1/1/31 "sunset" date)]

11/ [6:535.10***l***] **Trustee's post-sale duties:** The trustee may reasonably rely on the eligibility affidavit or declaration submitted by the bidders (¶ 6:535.10j) and must attach the affidavit or declaration regarding bidder eligibility as an exhibit to the recorded trustee's deed. [Civ.C. § 2924m(d) (1/1/31 "sunset" date)]

In addition, if an eligible bidder (¶ 6:535.10i) is the successor buyer, the trustee must electronically transmit to the State Attorney General, within 15 days of the sale's deemed finality, all of the following (Civ.C. § 2924m(i)) (1/1/31 "sunset" date):

— dates when trustee's sale took place and when it was deemed final;

— winning bidder's name;

— property's street address and assessor's parcel number;

— copy of recorded trustee's deed and winning bidder's attached affidavit/declaration;

— category to which eligible bidder belongs.

12/ [6:535.10m] **Property title and insurance during post-sale bidding procedure:** Until the sale of a residential property containing one to four residential units is deemed final under Civ.C. § 2924m's special bidding rules, title to the property remains with the trustor. The fact the finality of the trustee's sale is pending during this period does not operate to terminate hazard insurance coverage in effect at the time of the trustee's sale. [Civ.C. § 2924m(f), (*l*) (1/1/31 "sunset" date)]

b) [6:535.11] **Recording deadline to trigger "relation-back" effect:** Except for the ten-year period between January 1, 2021 and December 31, 2030 (¶ 6:535.11a), a trustee's sale will be deemed *perfected* as of 8 a.m. on the date of the sale provided the trustee's deed is *recorded within 15 calendar days* after the sale (or the next business day thereafter if the county recorder in which the property is located is closed on the 15th day). [Civ.C. § 2924h(c) (amended Stats. 2022, Ch. 642; eff. 1/1/23, oper. 1/1/31)]

1/ [6:535.11a] **Special rules in 2021 and 2022-2030:** From January 1, 2021 to December 31, 2021, a trustee's sale was deemed perfected as of 8 a.m. on the date of the sale, provided the trustee's deed was recorded within *18 calendar days* after the sale (or the next business day following the 18th day if the county recorder in which the property is located was closed on the 18th day). This was so *unless* an eligible bidder submitted written notice of an intent to bid (¶ 6:535.10e). In that case, the trustee's sale was deemed perfected as of 8 a.m. on the date of the sale, provided the trustee's deed was recorded within 48 calendar days after the sale (or the next business day following the 48th day if the county recorder in which the property is located was closed on the 48th day). [See Stats. 2020, Ch. 202, adding Civ.C. § 2924m(a)(3) (defining "eligible" bidder), and amending Civ.C. § 2924h(c)]

The Legislature lengthened the above recording deadlines in 2021 (see Stats. 2021, Ch. 255, amending Civ.C. § 2924h(c) (oper. 1/1/22)) (allowing 21 days to record if there was no eligible bidder and 60 days if there was). Thereafter, in 2022, the special bidding procedure was again extended, this time through 2030. [See Civ.C. §§ 2924h(h), 2924m(m) (Stats. 2022, Ch. 642; eff. 1/1/23) (1/1/31 "sunset" date)]

Beginning January 1, 2031, the special bidding rights in Civ.C. § 2924m expire and the 15-day recording deadline (¶ 6:535.11) will be reinstated. [See Civ.C. § 2924m(m) (1/1/31 "sunset" date for special bidding rights) and Civ.C. § 2924h(c), (h) (amended Stats. 2022, Ch. 642, § 8, oper. 1/1/31) (reinstating 15-day deadline)]

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2/ [6:535.11b] **“Relation-back” protection:** The relation-back provision (¶ 6:535.11) protects all parties to the sale. The trustee and mortgagee benefit because the statute allows time for the successful bidder's check to clear. [See *Dr. Leevil, LLC v. Westlake Health Care Center* (2018) 6 C5th 474, 481-482, 241 CR3d 12, 18]

The relation-back provision (¶ 6:535.11) also shields the foreclosure purchaser from the risk that the debtor (trustor) will sell to someone else after the trustee's sale, who might record its deed before the foreclosure purchaser records the trustee's deed. So long as the foreclosure purchaser records within *15 calendar days* of the trustee's sale, they will prevail over intervening purchasers and encumbrances. [*In re Bebensee-Wong* (9th Cir. BAP 2000) 248 BR 820, 822; but see special rules for calendar years 2021-2030 (¶ 6:535.11a)]

➪ [6:535.11c] ***PRACTICE POINTER:*** The relation-back benefit (¶ 6:535.11) does not accrue until the trustee's sale deed is recorded. Thus, counsel should ensure that recording actually has occurred *before* advising the client it may exercise the rights of an owner with perfected title. On this point, *Dr. Leevil,* supra, is instructive. In that case, the successful bidder on a commercial property sent an unlawful detainer notice to a tenant whose leasehold was extinguished by foreclosure one day following the sale. The new owner, however, did not record the trustee's sale deed until six days after the sale. Since the deed had not been recorded, and the deemed perfection had not yet been triggered, the new owner's unlawful detainer notice was void.

3/ [6:535.11d] **Compare—30-day recording deadline for common interest development units:** “Notwithstanding any other law,” the transfer of property in a common interest development pursuant to a nonjudicial foreclosure sale must be *recorded within 30 days after the sale date.* [Civ.C. § 2924.1]

c) [6:535.12] **Effect of intervening bankruptcy:** The Civ.C. § 2924h(c) relation-back provision also protects foreclosure purchasers from the risk the sale will be avoided in bankruptcy should the debtor file a bankruptcy petition after the sale but before the trustee's deed is recorded. The sale survives the debtor's postforeclosure bankruptcy filing provided the trustee's deed is recorded by the deadlines established in § 2924h(c) (*see discussion at* ¶ 6:535.11 to 6:535.11a) because, pursuant to § 2924h(c), the transfer of title will then relate back prepetition). [*In re Bebensee-Wong* (9th Cir. BAP 2000) 248 BR 820, 823; see also *In re Perl* (9th Cir. BAP 2016) 811 F3d 1120, 1127-1129—no violation of automatic stay where prebankruptcy foreclosure sale and subsequent issuance of adverse unlawful detainer judgment extinguished legal and equitable interests claimed by Chapter 13 debtor]

On the other hand, a foreclosure sale conducted *after* the debtor files a bankruptcy petition is *void* as violating the automatic stay in bankruptcy (11 USC § 362), regardless of when the trustee's deed is recorded. [*In re Bebensee-Wong*, supra, 248 BR at 822; see *In re Sanders* (BC SD CA 1996) 198 BR 326, 329—§ 2924h(c) relation-back may only be invoked upon a valid foreclosure sale that occurs prepetition]

6) [6:535.13] **Distribution of sale proceeds:** Proceeds from the trustee's foreclosure sale are applied (i) first, to pay the trustee's fees and expenses in exercising the power of sale and conducting the sale; (ii) next, to satisfy the debt to the beneficiary (lender); (iii) next, to the payment of junior creditors in the order of their priority; and (iv) the balance, if any, to the trustor (or its successor in interest). [Civ.C. § 2924k(a); *Caito v. United Calif. Bank* (1978) 20 C3d 694, 701, 144 CR 751, 754; *MTC Fin'l, Inc. v. Nationstar Mortgage, LLC* (2018) 19 CA5th 811, 814, 228 CR3d 238, 240]

a) Application

1/ [6:535.13a] The holder of a junior lien encumbering a cotenant's 75% undivided interest in foreclosed property was entitled to 75% of the surplus proceeds. The cotenant owner of the remaining 25% undivided interest in property was entitled to 25% of the surplus. [*Zieve, Brodnax & Steele, LLP v. Dhindsa* (2020) 49 CA5th 27, 40-41, 262 CR3d 567, 576-577]

2/ [6:535.13b] An interpleader action to determine the distribution of funds between a trustor and purchaser at a trustee's sale was unnecessary even though the borrower filed a wrongful foreclosure action challenging the sale. Reason: Civ.C. § 2924k(a) dictates payment of surplus funds to parties who *recorded* their interests before the trustee's sale. [*Placer Foreclosure, Inc. v. Aflalo* (2018) 23 CA5th 1109, 1114, 233 CR3d 694, 698]

3/ [6:535.13c] A county that recorded a lis pendens, but failed to follow the statutory procedures for seizing property in satisfaction of its criminal restitution claim, had no rights in the foreclosed property or surplus proceeds. [*Integrated Lender Services, Inc. v. County of Los Angeles* (2018) 22 CA5th 867, 877-878, 231 CR3d 902, 910]

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4/ [6:535.13d] A Fam.C. § 290 order for distribution of surplus proceeds to a wife to satisfy her husband's obligation for a community property equalizing payment was unenforceable because no valid lien secured the order. Reason: Civ.C. § 2924k(a) authorizes distribution of sale proceeds only to satisfy *secured* obligations. [*Cal-Western Reconveyance Corp. v. Reed* (2007) 152 CA4th 1308, 1317-1318, 62 CR3d 244, 250-251]

b) [6:535.14] **Additional notice to potential claimants:** When proceeds remain after the beneficiary's debt is satisfied and all of the trustee's fees and expenses have been paid, unless an interpleader action has been filed within 30 days of execution of the deed after the foreclosure sale, the trustee is required to send written notice to those persons with recorded interests in the property who would have been entitled to receive a copy of the "notice of default" pursuant to Civ.C. § 2924b(b) & (c) (*see*¶ *6:527*). [Civ.C. § 2924j(a); see also *Banc of America Leasing & Capital, LLC v. 3 Arch Trustee Services, Inc.* (2009) 180 CA4th 1090, 1102-1106, 103 CR3d 397, 405-408 (citing text)—trustee has no duty to search for judgment lien holders who fail to request special notice; *Cal-Western Reconveyance Corp. v. Reed* (2007) 152 CA4th 1308, 1322-1323, 62 CR3d 244, 254-255—trustor's former attorney not entitled to Civ.C. § 2924j notice despite having filed notice of fee lien against trustor's eventual surplus recovery (lawyer not a party to action and "not among those persons with recorded interests" immediately prior to trustee's sale; moreover, lien on *prospective* recovery must be enforced in separate action)]

The notice must inform each such person that there has been a trustee's sale; they may have a claim to all or a portion of the remaining proceeds; they may contact the trustee to pursue any possible claim; and before the trustee may act on any such claim, they must provide the trustee with certain written information regarding the claim. [See Civ.C. § 2924j(a); *Banc of America Leasing & Capital, LLC v. 3 Arch Trustee Services, Inc.*, supra, 180 CA4th at 1102, 103 CR3d at 405]

c) [6:535.14a] **Determination of claims to surplus proceeds:** The trustee must exercise "due diligence" in determining the priority of written claims received from those persons to whom the notice set forth at ¶ 6:535.14 was sent. If there is no dispute as to the priority of written claims to the surplus proceeds, the trustee shall pay the proceeds within 30 days after conclusion of said notice period. But if the trustee has failed to determine the priority of the claims within 90 days following the 30-day notice period, within 10 days thereafter the trustee must either deposit the funds with the court clerk or file an interpleader action. [Civ.C. § 2924j(b); *Banc of America Leasing & Capital, LLC v. 3 Arch Trustee Services, Inc.* (2009) 180 CA4th 1090, 1102, 103 CR3d 397, 405 (citing text); *Cal-Western Reconveyance Corp. v. Reed* (2007) 152 CA4th 1308, 1322-1323, 62 CR3d 244, 254, fn. 8]

The Civ.C. § 2924j disputed claims procedures apply to those persons making claims *before* the foreclosure sale (e.g., lienholders), *not* purchasers at the sale. [See *Placer Foreclosure, Inc. v. Aflalo* (2018) 23 CA5th 1109, 1114, 233 CR3d 694, 698—interpleader action to determine allocation of surplus proceeds between trustor who filed wrongful foreclosure suit challenging trustee's sale and purchaser at sale deemed improper (¶ 6:535.13)]

If the trustee decides to deposit the funds with the court clerk, the trustee must *first* send written notice to all interested persons, as defined, informing them of the trustee's intention to deposit the funds and that their claims must be filed *within 30 days* from the date of the notice. The trustee also files a "declaration of the unresolved claims" at this time (below) (see Civ.C. § 2924j(c), (d)). Each claimant has the burden of proving the priority of their claim to surplus proceeds. [*MTC Fin'l Inc. v. California Dept. of Tax & Fee Admin.* (2019) 41 CA5th 742, 749, 254 CR3d 485, 491]

FORM: Judicial Council form CIV-170 (Petition and Declaration Regarding Unresolved Claims and Deposit of Undistributed Surplus Proceeds of Trustee's Sale) must be used to commence the proceeding, available on the California Courts website (www.courts.ca.gov).

1/ [6:535.14b] **Compare—federal tax liens:** The United States is *not* required to file a claim to surplus proceeds within 30 days from the date of a trustee's Civ.C. § 2924j(d) notice of intent to deposit funds (¶ 6:535.14a). Instead, federal law provides the government with a 60-day period to respond to any state law interpleader-type action and preempts state law to the extent the latter is inconsistent. [See *Quality Loan Service Corp. v. 24702 Pallas Way, Mission Viejo, CA 92691* (9th Cir. 2011) 635 F3d 1128, 1133 (interpreting Civ.C. § 2924j deposit procedure as "functionally equivalent" to interpleader action)]

Moreover, "the priority of a federal tax lien does not depend on the vagaries of when the United States files a claim in state court relative to a competing claimant … *Federal law* governs the relative priority of federal

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tax liens and state-created liens … As a general rule, a lien in favor of the United States is not disturbed by a nonjudicial sale of the property." [See *Quality Loan Service Corp. v. 24702 Pallas Way, Mission Viejo, CA 92691*, supra, 635 F3d at 1134 (emphasis in original; internal quotes and brackets omitted)—federal tax liens filed first in time had priority over individual's judgment lien notwithstanding government's failure to file surplus proceeds claim within 30 days from date of Civ.C. § 2924j(d) notice]

[6:535.14c - 6:535.14f] ***Reserved.***

2/ [6:535.14g] **Determining claims where partial subordination agreement creates inconsistent priority among multiple lienholders:** Sometimes a superior trust deed is subordinated to another trust deed that is subject to intervening liens to which the subordinated trust deed is otherwise paramount. When this occurs and the trustee is unable to determine lien priority for the purpose of distributing surplus funds, the matter passes to the court to decide. [See *Wells Fargo Bank v. Neilsen* (2009) 178 CA4th 602, 614-615, 100 CR3d 547, 554-555 (applying precedent under *judicial* foreclosure statutes (CCP § 704.760 et seq.) to determine lienholders' priority absent any such direction under *nonjudicial* foreclosure statutes (Civ.C. § 2924 et seq.) (*discussed further at¶ 6:473*))]

7) [6:535.14h] **Remedies against defaulting bidders:** There are statutory civil and criminal remedies, as well as common law tort remedies, against bidders who fail to honor their accepted final bids:

a) [6:535.14i] **Statutory civil and criminal remedies:** A last and highest bidder who fails to deliver to the trustee, upon demand, the amount of the final bid is liable to the trustee for all damages the trustee may sustain, including court costs and reasonable attorney fees. Moreover, for a *willful* default, the bidder is guilty of a misdemeanor, punishable by a fine of up to $2,500. [Civ.C. § 2924h(d)]

If the last and highest bidder cancels a "cash equivalent" instrument (e.g., a personal check) submitted to the trustee as payment, the trustee will renotice the sale and is entitled to recover its attendant costs. [Civ.C. § 2924h(d)]

b) [6:535.14j] **Common law tort remedies:** The statutory remedies (¶ 6:535.14i) are not exclusive. A creditor/ beneficiary may pursue additional, common law tort remedies against a bidder for misconduct arising out of a nonjudicial foreclosure sale, provided those remedies are not inconsistent with the nonjudicial foreclosure statutes' underlying policies and purpose (*¶ 6:514.2*). [See *Banc of America Leasing & Capital, LLC v. 3 Arch Trustee Services, Inc.* (2009) 180 CA4th 1090, 1103, 103 CR3d 397, 405-406 (citing text); *California Golf, L.L.C. v. Cooper* (2008) 163 CA4th 1053, 1067, 1069-1071, 78 CR3d 153, 165, 167-168—foreclosing beneficiary not limited to statutory remedies where bidders fraudulently and apparently feloniously stopped payment on 13 cashier's checks (upholding beneficiary's suit against bidders for fraud and breach of warranty); compare *Matson v. S.B.S. Trust Deed Network* (2020) 46 CA5th 33, 45, 259 CR3d 526, 536—purchaser who paid excessive price could not overturn properly conducted trustee's sale due to their own unilateral mistake of fact]

(j) [6:535.14k] **Owner's duty to maintain vacant residential property following foreclosure:** Legal owners must maintain the vacant residential property they purchase at foreclosure sales (or acquire through foreclosure) once the sale is deemed final. Failure to do so may result in fines and penalties of up to $2,000 per day for the first 30 days, and up to $5,000 per day thereafter, provided the owners are given statutorily-prescribed notice and an opportunity to correct. [See Civ.C. § 2929.3(a); Civ.C. § 2924h(c)—sale is "deemed final upon the acceptance of the last and highest bid"; *and* ¶ 6:534 ff., 6:535.10 ff.]

"Failure to maintain" vacant residential property means failing to (i) care for the property's exterior; (ii) take action to prevent trespassers or squatters; (iii) take action to prevent mosquito larvae from growing in standing water; and (iv) prevent other conditions that may create a public nuisance. [Civ.C. § 2929.3(b)]

(k) [6:535.14*l*] **Preeviction notice to tenants of foreclosed residential housing unit:** Residential property tenants in possession of foreclosed property under a month-to-month lease or periodic tenancy must be given 90 days' written notice to quit before they can be evicted. Tenants holding possession under a fixed term residential lease entered into before title transferred at the foreclosure sale have the right to remain in possession until the lease term's end, except in specified circumstances. [See CCP § 1161b]

1) [6:535.14m] **Pre-foreclosure procedures during COVID-19 pandemic:** In response to the COVID-19 pandemic, the Legislature created special notice and bidding rights for tenants of properties containing one to four residential

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units that are in foreclosure. These notice requirements and bidding rights are in effect from January 1, 2021 to December 31, 2030. *See discussion at* ¶ 6:535.10 ff.

A purchaser of property at a foreclosure sale is not exempt from complying with applicable law regarding the eviction or displacement of tenants. [See Civ.C. § 2924n]

(5) [6:535.15] **Challenging finality or validity of trustee's sale:** A borrower may challenge a trustee's foreclosure sale before the trustee's deed is delivered to the successful bidder (¶ 6:535.16 ff.) or afterward (¶ 6:535.35 ff.). Threshold questions in all foreclosure avoidance actions, however, include standing and whether the borrower must plead tender of payment to reinstate the loan or redeem their equity in the property (¶ 6:535.15a ff.).

(a) [6:535.15a] **Standing to challenge sale:** Generally, only parties with an interest in the secured loan or in the real property security itself have standing to challenge or attempt to set aside a nonjudicial foreclosure sale. [See *Banc of America Leasing & Capital, LLC v. 3 Arch Trustee Services, Inc.* (2009) 180 CA4th 1090, 1103, 103 CR3d 397, 406 (citing text); *Royal Thrift & Loan Co. v. County Escrow, Inc.* (2004) 123 CA4th 24, 33, 20 CR3d 37, 44; *Turner v. Seterus, Inc.* (2018) 27 CA5th 516, 524-525, 238 CR3d 528, 535-536—although he did not sign note and trust deed, Husband had standing to challenge foreclosure sale as "member of the community" that paid loan from community property earnings]

1) [6:535.15b] **Mandatory joinder:** By the same token, *all parties* to the sale transaction (i.e., those individuals with a "stake in the outcome") are deemed indispensable and *must be joined* in the set-aside action. Failure to do so renders any judgment against the omitted parties ineffective and subject to collateral attack. [See *Banc of America Leasing & Capital, LLC v. 3 Arch Trustee Services, Inc.*, supra (citing text); *Washington Mut. Bank v. Blechman* (2007) 157 CA4th 662, 665-668, 69 CR3d 87, 89-91—lender and trustee deemed indispensable parties to set-aside action even though they were voluntarily dismissed in response to having demurred to complaint]

2) Loans assigned to securitized trusts

a) [6:535.15c] **Void assignments:** The common practice of securitizing residential loans (¶ 6:420) has given rise to numerous cases challenging foreclosure sales on the theory that the lender's assignment of the underlying loan is void. The borrower's standing to challenge the assignment and sale derives from their interest in ensuring that the beneficiary had legal authority to foreclose. Indeed, "[t]he borrower owes money not to the world at large but to a particular person or institution, and only the person or institution entitled to payment may enforce the debt by foreclosing on the security." [*Yvanova v. New Century Mortg. Corp.* (2016) 62 C4th 919, 924, 938, 199 CR3d 66, 69-70, 79]

Thus, "[i]f a purported assignment necessary to the chain by which the foreclosing entity claims [the power to commence and complete a nonjudicial foreclosure sale] is *absolutely void* … the foreclosing entity has acted without legal authority by pursuing a trustee's sale, and such an unauthorized sale constitutes a wrongful foreclosure." [See *Yvanova v. New Century Mortg. Corp.*, supra, 62 C4th at 924, 938, 199 CR3d at 69-70, 79 (emphasis added)]

b) [6:535.15d] **Voidable assignments:** When the assignment of a loan is merely voidable, only the parties to the assignment have the power to ratify or avoid the contract. In other words, the transaction is *not* void unless and until one of those parties takes steps to make it so. [*Yvanova v. New Century Mortg. Corp.* (2016) 62 C4th 919, 936, 199 CR3d 66, 80]

"A borrower who challenges a foreclosure on the ground that an assignment to the foreclosing party bore defects rendering it *voidable* could thus be said to assert an interest belonging solely to the parties to the assignment." As a result, the borrower *lacks standing* to challenge the foreclosure. [See *Yvanova v. New Century Mortg. Corp.*, supra, 62 C4th at 931, 936-939, 199 CR3d at 76, 80-83 (expressing no opinion on whether subject assignment, securitized *after* investment trust's closing date, was void or voidable under New York law)]

After *Yvanova* (above), the majority of courts have concluded that an improper transfer to an investment trust is voidable rather than void, and thus does not confer standing on the borrower to sue for wrongful foreclosure. [See *Kalnoki v. First American Trustee Servicing Solutions, LLC* (2017) 8 CA5th 23, 43, 214 CR3d 292, 307-308 (applying New York law)—borrower lacked standing to sue for wrongful foreclosure because assignment of loan to investment trust after its closing date, although purportedly violative of trust's terms, rendered assignment

merely voidable; *Mendoza v. JPMorgan Chase Bank, N.A.* (2016) 6 CA5th 802, 817, 212 CR3d 1, 12 (same); *Saterbak v. JPMorgan Chase Bank, N.A.* (2016) 245 CA4th 808, 815, 199 CR3d 790, 796 (same); *In re Turner* (9th Cir. 2017) 859 F3d 1145, 1149 (same)—homeowners also lacked standing to assert breach of contract claims because they were not third party beneficiaries to investment trust agreements; but see also *Glaski v. Bank of America, N.A.* (2013) 218 CA4th 1079, 1083, 1097-1099, 160 CR3d 449, 452, 463-465 (apply New York precedent)—borrower had standing to sue for damages from wrongful foreclosure because attempted transfer of loan to securitized trust occurred after Trust's closing date, rendering transfer void]

Comment: Glaski (above) was decided pre-*Yvanova* and the "decision upon which [it] relied for its understanding of New York law has not only been reversed, but soundly and overwhelmingly rejected …" [*Yhudai v. Impac Funding Corp.* (2016) 1 CA4th 1252, 1259, 205 CR3d 680, 685]

(b) [6:535.15e] **Tender of payment prerequisite:** After a nonjudicial foreclosure sale, the traditional method by which a borrower in default may challenge the proceeding is to bring a suit in equity to set aside the trustee's sale and have title restored. Because the action lies in equity, however, the borrower is required to do equity—i.e., by offering to pay the delinquencies and costs due for redemption—*before* the court will exercise its equitable powers. "The rationale behind the rule is that if [the borrower] could not have redeemed the property had the sale procedures been proper, any irregularities in the sale did not result in damages to the [borrower]." [*Lona v. Citibank, N.A.* (2011) 202 CA4th 89, 103, 112, 134 CR3d 622, 632, 640 (brackets in original; internal quotes omitted); see also *Kalnoki v. First American Trustee Servicing Solutions, LLC* (2017) 8 CA5th 23, 48, 214 CR3d 292, 311—full tender allegation required when borrower seeks to set aside sale as voidable; *West v. JPMorgan Chase Bank, N.A.* (2013) 214 CA4th 780, 801-802, 154 CR3d 285, 302 (same); *Stebley v. Litton Loan Servicing, LLP* (2011) 202 CA4th 522, 526, 134 CR3d 604, 607—full tender must be made to *set aside* foreclosure sale based on equitable principles]

In addition to the traditional method for challenging an improper foreclosure sale (above), borrowers have at their disposal the common law tort of wrongful foreclosure (*see*¶ 6:539.8 ff.).

1) [6:535.15f] **Exception—action to forestall foreclosure:** If the borrower seeks to *prevent* the foreclosure sale, tender is not required. [See *Intengan v. BAC Home Loans Servicing LP* (2013) 214 CA4th 1047, 1053-1054, 154 CR3d 727, 731-732—no tender required to pursue injunctions against foreclosure sales when lenders fail to comply with Civ.C. § 2923.5 "contact" requirement; see also *Stebley v. Litton Loan Servicing, LLP* (2011) 202 CA4th 522, 526, 134 CR3d 604, 607—tender not required to *delay* foreclosure sales; *Pfeifer v. Countrywide Home Loans, Inc.* (2012) 211 CA4th 1250, 1280-1281, 150 CR3d 673, 696-698—failure to allege tender of full amount no bar to suit seeking to enjoin pending foreclosure sale where lenders allegedly failed to comply with servicing regulations that were conditions precedent to foreclosure]

2) [6:535.15g] **Equitable exceptions under *Lona*:** After the foreclosure sale has occurred, there are at least four additional exceptions to the tender requirement: "First, if the borrower's action attacks the validity of the underlying debt, a tender is not required since it would constitute an affirmation of the debt … Second, a tender will not be required when the person who seeks to set aside the trustee's sale has a counterclaim or setoff against the beneficiary … Third, a tender may not be required where it would be inequitable to impose such a condition on the party challenging the sale … Fourth, no tender will be required when the trustor is not required to rely on equity to attack the deed because the trustee's deed is void on its face." [*Lona v. Citibank, N.A.* (2011) 202 CA4th 89, 112-113, 134 CR3d 622, 640-641 (internal citations omitted) (action alleging, among other things, invalidity of underlying debt); see also *In re Mortgage Electronic Registration Systems, Inc.* (9th Cir. 2014) 754 F3d 772, 784-785—wrongful foreclosure claims failed because, among other things, homeowners could not show any excuse from compliance with tender requirement; *Ram v. OneWest Bank, FSB* (2015) 234 CA4th 1, 11, 183 CR3d 638, 644—trustors attacking *void* deeds are not required to meet any of the burdens generally imposed as a matter of equity, including tender; *Alvarez v. BAC Home Loans Servicing, L.P.* (2014) 228 CA4th 941, 951, 176 CR3d 304, 312 (disapproved on other grounds by *Sheen v. Wells Fargo Bank, N.A.* (2022) 12 C5th 905, 948, 290 CR3d 834, 864, fn. 12)—tender of unpaid debt "not necessarily required" to set aside trustee's sale in action for fraud/unlawful business practices re loan marketing]

3) [6:535.15h] **Exception—trustee's sale void because foreclosing party has no interest in note:** Several courts have declined to impose a tender requirement on borrowers who allege the foreclosing beneficiary had no interest in the promissory note. [See *Sciarratta v. U.S. Bank Nat'l Ass'n* (2016) 247 CA4th 552, 565, 202 CR3d 219, 229, fn.

10—no need to allege tender where borrower claimed note was previously assigned to different lender who was not foreclosing entity; *Glaski v. Bank of America, N.A.* (2013) 218 CA4th 1079, 1100, 160 CR3d 449, 466—no tender allegation required where borrower pled foreclosure sale void because party who initiated sale allegedly held no interest in underlying note]

4) [6:535.15i] **Exception—lender breaches loan contract by foreclosing:** Lenders who breach their contractual obligations, whether those obligations are incorporated by statute or in a loan modification agreement, may not insist that the borrower tender full repayment as a condition to overturning the sale. [See *Fonteno v. Wells Fargo Bank, N.A.* (2014) 228 CA4th 1358, 1374, 176 CR3d 676, 689—homeowners not required to tender delinquent amount before suing for equitable cancellation of trustee's deed where, prior to foreclosure, lender failed to fulfill HUD requirements expressly incorporated into trust deed (¶ 6:535.43); *Chavez v. Indymac Mortg. Services* (2013) 219 CA4th 1052, 1062-1063, 162 CR3d 382, 390—no tender allegation required where borrower pled lender refused to accept payment per loan modification terms; *Multani v. Witkin & Neal* (2013) 215 CA4th 1428, 1454-1456, 155 CR3d 892, 911-913—foreclosed owner in common interest development excused from tender requirement where trustee failed to furnish statutorily mandated notice of owner's redemption right; *Barroso v. Ocwen Loan Servicing, LLC* (2012) 208 CA4th 1001, 1017, 146 CR3d 90, 103—borrower not required to allege tender where lender foreclosed on loan after valid modification agreement cured defaults]

5) [6:535.15j] **Compare—partial tender sufficient to support wrongful foreclosure action based on right to reinstate:** Borrowers who offer to cure monetary defaults on their loans more than five days before a foreclosure sale need only plead tender of the reinstatement amount to maintain a wrongful foreclosure action against their lender for denying them their statutory right to reinstate the loan. [*Turner v. Seterus, Inc.* (2018) 27 CA5th 516, 527, 530-531, 238 CR3d 528, 537, 540-541 (finding full tender requirement applies in cases where borrowers seek to redeem property, *not* reinstate their loans (¶ 6:539.12)]

• [6:535.15k] Requiring tender was deemed inequitable where the lender wrongfully refused to grant a loan modification that would have provided an alternative to foreclosure. [*Majd v. Bank of America, N.A.* (2015) 243 CA4th 1293, 1305-1306, 197 CR3d 151, 161-162]

• [6:535.15***l***] Homeowners were not required to tender the delinquent amount before bringing an action for equitable cancellation of the trustee's deed where, prior to foreclosure, the lender failed to fulfill HUD requirements expressly incorporated into the trust deed, rendering the sale either void or voidable (¶ 6:535.43). [*Fonteno v. Wells Fargo Bank, N.A.* (2014) 228 CA4th 1358, 1374, 176 CR3d 676, 689]

• [6:535.15m] Tender of the unpaid debt is not necessarily required to set aside a foreclosure sale in an action based on fraudulent and unlawful business practices relating to the marketing of a loan. [See *Alvarez v. BAC Home Loans Servicing, L.P.* (2014) 228 CA4th 941, 951, 176 CR3d 304, 312 (disapproved on other grounds by *Sheen v. Wells Fargo Bank, N.A.* (2022) 12 C5th 905, 948, 290 CR3d 834, 864, fn. 12)]

• [6:535.15n] A foreclosed owner in a common interest development was excused from the tender requirement where the trustee failed to furnish the statutorily-mandated notice of the owner's redemption right. [*Multani v. Witkin & Neal* (2013) 215 CA4th 1428, 1454-1456, 155 CR3d 892, 911-913]

• [6:535.15***o***] A borrower was not required to allege tender where the lender foreclosed on his loan after a valid modification agreement cured the defaults. [*Barroso v. Ocwen Loan Servicing, LLC* (2012) 208 CA4th 1001, 1017, 146 CR3d 90, 103]

(c) *Before* trustee's deed delivered to successful bidder

1) [6:535.16] **In general—rebuttable presumption of validity:** There is a common law presumption that foreclosure sales are conducted regularly and fairly. [See *Biancalana v. T.D. Service Co.* (2013) 56 C4th 807, 814, 156 CR3d 437, 442; *6 Angels, Inc. v. Stuart-Wright Mortg., Inc.* (2001) 85 CA4th 1279, 1284, 102 CR2d 711, 714; and *Millennium Rock Mortgage, Inc. v. T.D. Service Co.* (2009) 179 CA4th 804, 809, 102 CR3d 544, 548]

But the presumption is rebuttable (permitting an otherwise completed trustee's sale to be set aside before the trustee's deed is delivered to the high bidder). Successful rebuttal of the presumption requires substantial evidence of a *failure to comply with the procedural requirements* (*¶ 6:524 ff.*) to the challenging party's *prejudice*. [*6 Angels, Inc. v. Stuart-Wright Mortgage, Inc.*, supra, 85 CA4th at 1284, 102 CR2d at 714; *Knapp v. Doherty* (2004) 123

CA4th 76, 86, 20 CR3d 1, 8, fn. 4; see *Residential Capital, LLC v. Cal-Western Reconveyance Corp.* (2003) 108 CA4th 807, 822, 134 CR2d 162, 173—"Only a properly conducted foreclosure sale, free of substantial defects in procedure, creates rights in the high bidder at the sale"]

2) [6:535.16a] **Circumstances supporting avoidance of sale:** Various circumstances occurring *before* a trustee's deed is delivered to the high bidder may warrant the avoidance of an otherwise completed trustee's sale (i.e., in these circumstances, the trustee may *refuse to issue a trustee's deed* to the successful bidder):

a) [6:535.17] **Irregularity in foreclosure notice procedures:** A trustee's sale may be aborted upon the trustee's discovery of a *material and prejudicial irregularity* in the foreclosure notice procedures (deficient notice of default/notice of sale) before delivery of the deed. [See *Angell v. Sup.Ct. (Verdugo Trustee Service Corp.)* (1999) 73 CA4th 691, 699-701, 86 CR2d 657, 662-663—notice of default and notice of sale grossly understated amount owed based on one note when in fact trust deed secured two notes; compare *Gillies v. JPMorgan Chase Bank, N.A.* (2017) 7 CA5th 907, 913, 213 CR3d 210, 215 & fn. 3 (dictum)—minor misspelling of homeowner's first name in notice of sale that correctly set forth his last name and property address would *not* confuse reasonable person; *Hicks v. E.T. Legg & Assocs.* (2001) 89 CA4th 496, 512-513, 108 CR2d 10, 22-23—sale *not* invalidated by publication of notice of postponement of sale during automatic bankruptcy stay (¶ 6:532.13); *see also ¶ 6:535.19* (irregularity in sale postponement)]

b) [6:535.18] **Inadequate sale price:** Mere inadequacy of the sale price generally is *not* the sort of material mistake that will warrant aborting the sale. [*6 Angels, Inc. v. Stuart-Wright Mortg., Inc.* (2001) 85 CA4th 1279, 1284-1285, 102 CR2d 711, 714-715—clerical error in instructing trustee re opening bid ($10,000 rather than $100,000) not ground for aborting sale; *Knapp v. Doherty* (2004) 123 CA4th 76, 93, 20 CR3d 1, 14]

However, a foreclosure sale may be avoided where an inadequate sale price is *coupled with a procedural irregularity* (*¶ 6:535.17*) that contributed to the inadequate price or otherwise injured the trustor. Indeed, *gross* inadequacy of price coupled with even slight unfairness or irregularity is a sufficient basis for setting aside the sale. [See *Biancalana v. T.D. Service Co.* (2013) 56 C4th 807, 810, 156 CR3d 437, 439—sale voidable where, before delivering deed to highest bidder, trustee discovered it mistakenly gave auctioneer opening bid that was less than 10% of beneficiary's actual bid (gross inadequacy of price and irregularity in sale process established); *Millennium Rock Mortgage, Inc. v. T.D. Service Co.* (2009) 179 CA4th 804, 810-811, 102 CR3d 544, 548-550—sale voidable at trustee's option where auctioneer mistakenly opened bidding with credit bid from different foreclosure that was only fraction of what was actually owed (irregularity, gross inadequacy of price and unfairness "all abundantly present"); *Angell v. Sup.Ct. (Verdugo Trustee Service Corp.)* (1999) 73 CA4th 691, 700, 86 CR2d 657, 663—trustee justified in aborting sale for slight irregularity when coupled with *grossly* inadequate sale price; compare *Matson v. S.B.S. Trust Deed Network* (2020) 46 CA5th 33, 41, 43, 259 CR3d 526, 533-534—successful bidder whose unilateral mistake caused it to pay excessive price could not rescind trustee's sale without showing irregularity, fraud or unfairness in foreclosure proceedings]

c) Sale postponements

1/ [6:535.19] **Irregularity in postponement procedure:** A trustee's sale may be avoided for noncompliance with the statutory sale *postponement* requirements (*¶ 6:532.10 ff.*). [*Residential Capital, LLC v. Cal-Western Reconveyance Corp.* (2003) 108 CA4th 807, 823, 134 CR2d 162, 174]

However, the postponement irregularity must arise from the foreclosure proceeding itself—e.g., in connection with any statutorily-required notices or the bidding process at the sale. [*Nguyen v. Calhoun* (2003) 105 CA4th 428, 445, 129 CR2d 436, 450—alleged nonreceipt of fax regarding sale postponement did not constitute irregularity in foreclosure proceeding itself]

2/ [6:535.20] **Breach of lender's promise to postpone sale:** A trustee's sale may be aborted where the foreclosure sale is conducted in violation of the lender's oral promise to postpone it, so long as the promise is supported by "good consideration." [*Raedeke v. Gibraltar Sav. & Loan Ass'n* (1974) 10 C3d 665, 673, 111 CR 693, 697-698—borrowers had cognizable cause of action to avoid sale where they procured responsible prospective purchaser in reliance on lender's promise to postpone sale; compare *Nguyen v. Calhoun* (2003) 105

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CA4th 428, 444-445, 129 CR2d 436, 450—borrowers had no basis for avoiding sale where they *failed to notify* lender in timely and accurate manner that prospective purchaser had funding to pay off their defaulted loan]

In the absence of "good consideration," a promissory estoppel claim may lie against a lender who breaches its promise to postpone a foreclosure sale. For example, borrowers who, in reliance on their lender's promise to delay foreclosure, procured a high cost, high interest loan by using other property they owned as security, presented sufficient evidence of their detrimental reliance on the lender's promise to support a promissory estoppel claim (however, the loan proceeds were received too late to invalidate the foreclosure sale). [See *Garcia v. World Savings, FSB* (2010) 183 CA4th 1031, 1040-1047, 107 CR3d 683, 691-697; compare *Granadino v. Wells Fargo Bank, N.A.* (2015) 236 CA4th 411, 416, 186 CR3d 408, 413—suit to set aside foreclosure properly dismissed where borrowers failed to establish elements of promissory estoppel (i.e., clear promise, reasonable reliance and injury); *Jones v. Wachovia Bank* (2014) 230 CA4th 935, 946-952, 179 CR3d 21, 29-34—suit to set aside foreclosure properly dismissed where homeowners failed to show any change in position based on lender's oral agreement to postpone sale by 10 days (homeowners merely claimed they could have brought loan current had lender honored agreement)]

3/ [6:535.21] **Compare—no trustee liability for failure to discover mandatory postponement:** A trustee has a general duty to conduct a nonjudicial foreclosure sale in a fair and proper manner (*¶ 6:539.21*). However, that duty does *not* give rise to an unsuccessful bidder's claim against the trustee for not discovering, before conducting the sale, that the trustor and beneficiary had agreed to postpone the sale. [*Residential Capital, LLC v. Cal-Western Reconveyance Corp.* (2003) 108 CA4th 807, 827, 134 CR2d 162, 177-178—unsuccessful bidder had no claim against trustee who failed to read email advising of trustor/beneficiary postponement agreement]

[6:535.22 - 6:535.24] ***Reserved.***

d) [6:535.25] **Lack of consideration:** A trustee's sale may be avoided for "failure of consideration" when the trustee accepts a check drawn by a credit union or savings and loan association or cash equivalent but the funds are not "available for withdrawal" under Ins.C. § 12413.1. [Civ.C. § 2924h(c); *Nguyen v. Calhoun* (2003) 105 CA4th 428, 441, 129 CR2d 436, 447]

e) [6:535.26] **Underlying debt satisfied:** A foreclosure sale may be avoided on adequate proof that payment of the secured obligation was properly made prior to the sale. [*Nguyen v. Calhoun* (2003) 105 CA4th 428, 440, 443, 129 CR2d 436, 446, 448-449—foreclosure sale could *not* be challenged on ground debt paid where payment not received by lender until 3 days after sale (borrower's *deposit* of payment in mail before sale did not constitute satisfaction of debt absent express direction from lender that mailing payment was adequate)]

[6:535.27 - 6:535.29] ***Reserved.***

3) Circumstances *not* supporting avoidance of sale

a) [6:535.30] **Lender's failure to follow internal procedures:** A lender's failure to follow its own internal procedures, where the failure does not constitute a breach of its contractual or statutory obligations to the borrower, is *not* a procedural irregularity rendering a trustee's sale voidable or void. [*Melendrez v. D & I Investment, Inc.* (2005) 127 CA4th 1238, 1261, 26 CR3d 413, 433 & fn. 30]

[6:535.31 - 6:535.34] ***Reserved.***

(d) *After* delivery of trustee's deed to successful bidder

1) [6:535.35] **Circumstances supporting avoidance of sale:** Under certain circumstances, an otherwise completed nonjudicial foreclosure sale may be set aside or voided *after* the trustee's deed is delivered to the high bidding purchaser, but subject to the rights of an intervening BFP (*¶ 6:536 ff.*):

The borrower must prove three elements, however, to have the sale set aside: wrongfulness, prejudice and tender. [See *Ram v. OneWest Bank, FSB* (2015) 234 CA4th 1, 11, 183 CR3d 638, 644; *West v. JPMorgan Chase Bank, N.A.* (2013) 214 CA4th 780, 800, 154 CR3d 285, 301]

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a) [6:535.36] **Statutorily-deficient notice:** A completed trustee's sale based on a statutorily-deficient notice of default and/or notice of sale is invalid and may be set aside. [*Miller v. Cote* (1982) 127 CA3d 888, 894, 179 CR 753, 756-757—sale invalidated based on premature notice of default; *System Invest. Corp. v. Union Bank* (1971) 21 CA3d 137, 152-153, 98 CR 735, 744-745—sale invalidated for failure to state nature of overdue payment in notice of default; see also *Morris v. JPMorgan Chase Bank, N.A.* (2022) 78 CA5th 279, 314-315, 293 CR3d 417, 457-458—monetary damages available for alleged violation of Civ.C. § 2924b presale notice requirements; compare *Orcilla v. Big Sur, Inc.* (2016) 244 CA4th 982, 1002, 198 CR3d 715, 731—failure to show prejudice resulting from incorrect date in notice of sale prevented borrowers from challenging sale based on procedural irregularity; *Knapp v. Doherty* (2004) 123 CA4th 76, 97-99, 20 CR3d 1, 17-19—inaccurate default date in notice of default deemed immaterial where no evidence showed notice failed to properly state nature or amount of default]

1/ [6:535.37] **Compare—erroneous "surplus" information:** But the validity of the sale is *not* affected by incorrect information given in a notice of default/notice of sale *in addition to* the information required by statute where the "surplus" information *did not mislead* the trustor/debtor. [*Hanlon v. Western Loan & Bldg. Co.* (1941) 46 CA2d 580, 600-601, 116 P2d 465, 476-477—notice of default valid despite misstatement of name of county where property located because property description was surplusage (notice referred to book and page where trust deed recorded), and description included reference to specific intersection of property location, making county misdesignation obvious]

b) [6:535.38] **Fraud or deceit:** Fraud or deceit in the foreclosure process likewise is ground to set aside the sale. [*South Bay Bldg. Enterprises, Inc. v. Riviera Lend-Lease, Inc.* (1999) 72 CA4th 1111, 1121, 85 CR2d 647, 652; see also *Lona v. Citibank, N.A.* (2011) 202 CA4th 89, 103-104, 134 CR3d 622, 633—trustee's illegal, fraudulent or willfully oppressive conduct is ground for equitable cause of action to set aside foreclosure sale; *Lo v. Jensen* (2001) 88 CA4th 1093, 1095-1096, 106 CR2d 443, 444-445 (two competitive bidders joined together in violation of Civ.C. § 2924h(g) and in restraint of competition, resulting in artificially low price); *see also*¶ *6:536.9, 6:539.8 ff.*]

1/ [6:535.38a] **Tort liability; criminal penalties:** Additionally, the trustee's or beneficiary's fraudulent conduct during foreclosure proceedings can give rise to tort damages. [*South Bay Bldg. Enterprises, Inc. v. Riviera Lend-Lease, Inc.* (1999) 72 CA4th 1111, 1121-1122, 85 CR2d 647, 652—trustee and senior creditor fraudulently conspired to prevent others from bidding in order to buy property at low price, thereby causing junior lienholder to lose its security interest; see also *Won Shil Park v. First American Title Co.* (2011) 201 CA4th 1418, 1423, 136 CR3d 684, 689—junior lienholder's action for tort damages dismissed for failure to show prospective buyer was "ready, willing and able" to purchase property but for delay in foreclosure proceeding caused by trustee's alleged negligent/fraudulent preparation of trust deed]

Moreover, anyone convicted of acts operating as a "fraud or deceit" on a beneficiary, trustor or junior lienholder can be punished with fines of up to $10,000 and imprisonment. [Civ.C. § 2924h(g)]

c) [6:535.39] **Mistake:** A foreclosure sale may also be set aside where there has been a *mistake* of such magnitude "that to allow it to stand would be inequitable to purchaser and parties." [See *Bank of America Nat'l Trust & Sav. Ass'n v. Reidy* (1940) 15 C2d 243, 248, 101 P2d 77, 80]

d) [6:535.40] **Inadequate sale price coupled with procedural irregularity:** An inadequate sale price coupled with a procedural irregularity may warrant a set-aside of a completed foreclosure sale just as it may be a basis for aborting a sale not yet completed (¶ *6:535.18*). [*Knapp v. Doherty* (2004) 123 CA4th 76, 94-97, 20 CR3d 1, 14-17—inadequate price coupled with premature notice of trustee's sale, in effect giving too much notice of sale, *not* ground for set-aside]

e) [6:535.41] **Void deed of trust:** If the foreclosed deed of trust is void, even a bona fide purchaser cannot receive good title to the underlying property. [See *La Jolla Group II v. Bruce* (2012) 211 CA4th 461, 477-479, 149 CR3d 716, 728-729—forged trust deed deemed void ab initio, precluding BFPs from acquiring title to home following foreclosure sale]

f) [6:535.42] **Loan modification agreement and reinstatement:** If the lender and borrower enter into a loan modification agreement that cures the default and reinstates the loan, there is no longer any basis to exercise the power of sale and the borrower has a valid cause of action for wrongful foreclosure. [See *Barroso v. Ocwen Loan Servicing, LLC* (2012) 208 CA4th 1001, 1017, 146 CR3d 90, 103—valid HAMP (¶ *6:511.13 ff.*) modification

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agreement that cured all defaults provided borrower with basis to challenge trustee's sale as wrongful under equitable principles]

g) [6:535.43] **Lender's failure to comply with HUD servicing requirements incorporated into FHA-insured loans:** Borrowers may seek equitable cancellation of the trustee's deed if their lender forecloses without first complying with the National Housing Act requirements (12 USC § 1701 et seq.) as contractually required by their "FHA California Deed of Trust." [*Fonteno v. Wells Fargo Bank, N.A.* (2014) 228 CA4th 1358, 1369-1371, 176 CR3d 676, 685-687]

2) [6:536] **Limitation—conclusive presumption re compliance with notice requirements in favor of BFP:** A bona fide purchaser for value (BFP) at a nonjudicial foreclosure sale has the benefit of a *conclusive presumption* that the foreclosure sale was *properly noticed:*

A recital in the trustee's deed (executed pursuant to the power of sale) of compliance with "all requirements of law" regarding mailing or personal delivery and publication or posting of the copies of *notice of default* and *notice of sale* "shall constitute prima facie evidence of compliance with these requirements and *conclusive evidence thereof in favor of bona fide purchasers and encumbrancers for value and without notice*." [Civ.C. § 2924(c) (emphasis added); see *Biancalana v. T.D. Service Co.* (2013) 56 C4th 807, 810, 156 CR3d 437, 439—conclusive presumption as to BFPs does not apply until trustee's deed is delivered (¶ 6:536.6); *Millennium Rock Mortgage, Inc. v. T.D. Service Co.* (2009) 179 CA4th 804, 809, 102 CR3d 544, 548 (same); see also *Orcilla v. Big Sur, Inc.* (2016) 244 CA4th 982, 999-1000, 198 CR3d 715, 729-730—conclusive presumption as to BFPs applies only to *statutory* compliance challenges and does not bar wrongful foreclosure actions based on underlying obligation's unconscionability]

a) [6:536.1] **"BFP" defined:** For purposes of the Civ.C. § 2924(c) presumption, a BFP is one who pays *value* for the property *without knowledge or notice* of "the asserted rights of another." [*Melendrez v. D & I Investment, Inc.* (2005) 127 CA4th 1238, 1253, 26 CR3d 413, 426; see also *Nguyen v. Calhoun* (2003) 105 CA4th 428, 442, 129 CR2d 436, 447-448; compare *Estate of Yates* (1994) 25 CA4th 511, 523, 32 CR2d 53, 59—purchaser who had notice of irregularity in sale and/or of superior claims to property not BFP]

1/ [6:536.2] **Payment of fair market value not required:** BFP status does not require payment of the property's fair market value; the buyer need only part with *something of value* in exchange for the property. [*Melendrez v. D & I Investment, Inc.* (2005) 127 CA4th 1238, 1251-1252, 26 CR3d 413, 424-425]

Thus, experienced purchasers at nonjudicial foreclosure sales who often pay substantially less than fair market value may nonetheless be BFPs. [*Melendrez v. D & I Investment, Inc.*, supra, 127 CA4th at 1252-1253, 26 CR3d at 425-426]

2/ [6:536.3] **Constructive notice of competing claim suffices:** Generally, on the question of BFP status, a buyer is deemed to have "notice" or "knowledge" of a competing claim if they "ha[ve] knowledge of *circumstances which, upon reasonable inquiry,* would lead" them to that claim. [*Melendrez v. D & I Investment, Inc.* (2005) 127 CA4th 1238, 1252, 26 CR3d 413, 425 (emphasis added)]

The buyer's foreclosure sale experience may be *considered* in determining whether they had knowledge or notice of a competing claim. But such experience does *not compel* the conclusion that notice of a competing claim should be *imputed* to the buyer when the buyer did not have *actual* knowledge or notice of the claim. [*Melendrez v. D & I Investment, Inc.*, supra, 127 CA4th at 1253-1255, 26 CR3d at 426-427, fn. 23—rejecting "theory of imputed notice" where experienced buyer had no actual notice or knowledge of agreement between borrowers and lender to postpone sale; see also *Sutton v. Eagle Vista Equities LLC* (ND CA 2020) 2020 WL 571056, *3-4—sophisticated buyer at trustee's sale with no actual or constructive notice of alleged defects in foreclosure process had no elevated duty of inquiry into records outside chain of title in order to obtain BFP status]

3/ [6:536.4] **BFP status tested at time of acquisition:** The BFP determination must be based upon the circumstances that existed at the time the buyer acquired the property; information learned after the acquisition does not affect a buyer's BFP status. [*Melendrez v. D & I Investment, Inc.* (2005) 127 CA4th 1238, 1254, 26 CR3d 413, 427]

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b) [6:536.5] **Subordinate encumbrances extinguished:** The Civ.C. § 2924(c) conclusive presumption operates to extinguish subordinate interests in the property such as junior liens and leaseholds. [See *Dr. Leevil, LLC v. Westlake Health Care Ctr.* (2017) 9 CA5th 450, 455, 215 CR3d 127, 131 (reversed on other grounds by *Dr. Leevil, LLC v. Westlake Health Care Center* (2018) 6 C5th 474, 484-485, 241 CR3d 12, 20)—lease containing automatic subordination clause was "fixed" in junior position to deed of trust and thus extinguished by foreclosure; *Zieve, Brodnax & Steele, LLP v. Dhindsa* (2020) 49 CA5th 27, 36, 262 CR3d 567, 573—after foreclosure of senior lien, purchaser at trustee's sale takes title free of junior liens, but sold out junior is entitled to share in any surplus sales proceeds; *Homestead Savings v. Darmiento* (1991) 230 CA3d 424, 436-437, 281 CR 367, 374-375—foreclosure terminated subordinate lienholder's interest even though junior lienholder may not have received actual notice of sale; *but see also ¶ 6:534.1* (exception for certain tax liens)]

c) [6:536.6] **Delivery of deed required:** The Civ.C. § 2924(c) conclusive presumption attaches *only upon delivery of the deed* to the high bidding purchaser. [*Biancalana v. T.D. Service Co.* (2013) 56 C4th 807, 810, 156 CR3d 437, 439; see also *Angell v. Sup.Ct (Verdugo Trustee Service Corp.)* (1999) 73 CA4th 691, 699-700, 86 CR2d 657, 662; *compare¶ 6:535.16* (*rebuttable* presumption of validity of sale to high bidding purchaser *before* trustee's deed delivered)]

d) [6:536.7] **Effect of irregularity in foreclosure procedures not relating to notice:** The Civ.C. § 2924(c) conclusive presumption applies only to the propriety of the *required notices;* it does not protect from challenge a nonjudicial foreclosure sale to a BFP that suffers from *other types of defects*. [*Bank of America, N.A. v. La Jolla Group II* (2005) 129 CA4th 706, 714-715, 28 CR3d 825, 830-831; *Melendrez v. D & I Investment, Inc.* (2005) 127 CA4th 1238, 1255-1256, 26 CR3d 413, 428 & fn. 26 (declining to follow dictum suggesting that Civ.C. § 2924 conclusive presumption applies to *any* claimed irregularities in trustee's sale)]

[6:536.8] Even though a nonjudicial foreclosure sale was conclusively presumed to have been duly noticed, the trust deed delivered to the BFP was properly canceled as void because the sale was conducted in violation of an agreement between the trustor and beneficiary to cure the default and reinstate the loan—i.e., the beneficiary had no right to exercise the power of sale.

"No statute creates a presumption—conclusive or otherwise—for any purchaser—bona fide or otherwise—that any recitals in a trustee's deed render effective a sale that had no contractual basis." [*Bank of America, N.A. v. La Jolla Group II* (2005) 129 CA4th 706, 714, 28 CR3d 825, 830]

[6:536.9] A trustee's deed is also subject to cancellation notwithstanding the BFP conclusive presumption when the BFP purchased the property *knowing that fraud had been committed* in connection with the foreclosure sale. However, any fraud by the *trustee and/or beneficiary* during the sale process is not imputed to the BFP and, thus, cannot itself support setting the sale aside. [*Melendrez v. D & I Investment, Inc.* (2005) 127 CA4th 1238, 1256-1258, 26 CR3d 413, 429-430—absent evidence BFP knew lender failed to instruct trustee to postpone sale based on repayment agreement between borrowers and lender, borrowers could not set BFP sale aside]

[6:536.10 - 6:536.14] ***Reserved.***

3) Circumstances *not* supporting avoidance of sale

a) [6:536.15] **Lender's failure to follow internal procedures:***See discussion at¶ 6:535.30*.

b) [6:536.16] **Automated signatures ("robo-signing"):** The use of automated signatures (colloquially referred to as "robo-signing") on statutory notices does not by itself invalidate the foreclosure. [See *Kalnoki v. First American Trustee Servicing Solutions, LLC* (2017) 8 CA5th 23, 46, 214 CR3d 292, 310—nothing about "robo-signing" notice of default or "notice of substitution" rendered documents invalid or ineffective where debtors did not dispute accuracy of "salient facts" (e.g., amount owed or that loan was in default)]

4) [6:537] **Compare—no trustee liability to purchaser for nondisclosure of outstanding liens:** A trustee conducting a nonjudicial foreclosure sale has no sua sponte duty to provide bidders with detailed explanations concerning the existence of outstanding liens and encumbrances on the foreclosed property.

Absent outright misrepresentation (affirmative misstatement concerning outstanding liens and encumbrances when bidders ask for that information), the trustee incurs *no liability* to a successful bidder who allegedly paid an

excessive price because of failure to account for outstanding senior liens. The sale to the successful bidder is *final* when the trustee accepts the bid, without regard to the purchaser's *own* economic error. [*Ostayan v. Serrano Reconveyance Co.* (2000) 77 CA4th 1411, 1418-1420, 92 CR2d 577, 583-584 (disapproved on other grounds by *Black Sky Capital, LLC v. Cobb* (2019) 7 C5th 156, 165, 246 CR3d 583, 591)—lender holding both senior and junior deeds of trust on property foreclosed only on junior lien, leaving foreclosure purchaser (who bid without accounting for senior lien) to take subject to senior lien]

5) [6:537.1] **Notice of rescission of invalidated sale:** When a trustee's deed is invalidated, a "notice of rescission" of the deed may be recorded. The notice effectively restores the condition of title to the property, including the priority of any lienholders (*see¶ 6:536.5*), to what it was before the date the deed was recorded. However, a notice of rescission may be recorded only by the trustee or beneficiary, or its successor in interest, who caused the deed to be recorded initially. [Civ.C. § 1058.5]

(e) [6:538] **Compare—validity not affected by beneficiary/payoff demand statement:** A trustee's foreclosure sale is *not* affected by the preparation and delivery of a beneficiary statement or payoff demand statement. [Civ.C. § 2943(f)]

[6:538.1 - 6:538.4] ***Reserved.***

(f) [6:538.5] **Compare—IRS redemption:***See discussion at¶ 6:529.5*.

(g) Monetary remedies and other causes of action

1) [6:539] **Successful bidder's remedy when trustee's sale invalidated limited to restitution:** When a trustee's sale is *aborted* (sale invalidated prior to issuance of the trustee's deed) upon discovery of a material and prejudicial irregularity in a statutory foreclosure procedure, the aggrieved successful bidder's remedy is limited to *restitution* —i.e., return of its purchase money plus interest; the remedy does not include breach of contract damages. [*Residential Capital, LLC v. Cal-Western Reconveyance Corp.* (2003) 108 CA4th 807, 823-824, 134 CR2d 162, 174-175—successful bidder who sued trustee and beneficiary for refusing to deliver deed upon discovery of mandatory postponement not entitled to "benefit-of-bargain" damages; see also *Pro Value Properties, Inc. v. Quality Loan Service Corp.* (2009) 170 CA4th 579, 583, 88 CR3d 381, 384—successful bidder's remedy following void trustee's sale limited to purchase price plus statutory 7% interest rate]

a) [6:539.1] **Broader damages after trustee's deed issued?** Whether the same rule applies when a trustee's sale is *set aside after the trustee's deed is issued* to the successful bidder has not been decided. [See *Residential Capital, LLC v. Cal-Western Reconveyance Corp.* (2003) 108 CA4th 807, 823-824, 134 CR2d 162, 174]

2) [6:539.2] **Generally no tort damages for trustee's breach of *statutory procedures:*** The duties of a trustee with respect to nonjudicial foreclosure procedures are *strictly limited* to those specified in the trust deed and Civ.C. § 2824 et seq., and do *not* include any *common law* duties. As such, a trustee's breach of any *statutory* nonjudicial foreclosure procedure does *not* give rise to an action for tort damages. [See *I.E. Assocs. v. Safeco Title Ins. Co.* (1985) 39 C3d 281, 287-288, 216 CR 438, 442; *Banc of America Leasing & Capital, LLC v. 3 Arch Trustee Services, Inc.* (2009) 180 CA4th 1090, 1097, 103 CR3d 397, 401; *Heritage Oaks Partners v. First American Title Ins. Co.* (2007) 155 CA4th 339, 345, 66 CR3d 510, 515—policy reasons militate against expansion of trustee's duties]

Creating a nonstatutory duty for trustees conducting foreclosure sales would "graft a tort remedy onto a comprehensive statutory scheme in the absence of a compelling justification for doing so." [*Residential Capital, LLC v. Cal-Western Reconveyance Corp.* (2003) 108 CA4th 807, 827, 134 CR2d 162, 177]

• [6:539.3] A defaulting trustor had no negligence claim against the trustee for breaching an alleged duty to make reasonable efforts to contact the trustor before sale beyond the statutorily-prescribed notification procedures. [*I.E. Assocs. v. Safeco Title Ins. Co.*, supra]

• [6:539.4] An unsuccessful bidder had no negligence claim against the trustee for failing to read an email advising of mandatory sale postponement before the trustee's sale occurred. [*Residential Capital, LLC v. Cal-Western Reconveyance Corp.* (2003) 108 CA4th 807, 824-827, 134 CR2d 162, 175-177]

• [6:539.5] A successful bidder had no negligence claim against the trustee for breaching an alleged duty to provide him with a detailed explanation concerning recorded encumbrances on the foreclosed property. [*Diediker v. Peelle Fin'l Corp.* (1997) 60 CA4th 288, 294-295, 70 CR2d 442, 446-447 (*discussed further at¶ 6:529.4*)]

• [6:539.6] A trustee who was allegedly negligent in believing it was the trustee of record, and who conveyed title to a successful bidder, owed no duty to subsequent purchasers of the foreclosed property. [See *Heritage Oaks Partners v. First American Title Ins. Co.* (2007) 155 CA4th 339, 348, 66 CR3d 510, 517 (nor could subsequent purchasers assert equitable indemnity action against trustee because they were not jointly and severally liable to original owners/debtors)]

• [6:539.7] A foreclosing trustee's failure to verify the validity of a loan assignment and the authority of the signatory on the substitution of trustee form were, at most, technical process violations that did not give rise to tort liability. [*Citrus El Dorado, LLC v. Chicago Title Co.* (2019) 32 CA5th 943, 952, 244 CR3d 372, 379]

3) [6:539.8] **Tort damages for wrongful foreclosure:** A trustee or beneficiary under a deed of trust who conducts an "illegal, fraudulent or willfully oppressive sale of property" may be liable to the borrower for wrongful foreclosure. [*Yvanova v. New Century Mortg. Corp.* (2016) 62 C4th 919, 929, 199 CR3d 66, 73-74; see also *Morris v. JPMorgan Chase Bank, N.A.* (2022) 78 CA5th 279, 315, 293 CR3d 417, 458—trustor could bring postforeclosure private action to recover "full spectrum of tort damages" occasioned by lender's failure to provide Civ.C. § 2924b preforeclosure notice; *Miles v. Deutsche Bank Nat'l Trust Co.* (2015) 236 CA4th 394, 408, 186 CR3d 625, 635 (noting mere technical violation of foreclosure process insufficient to support tort claim); *Munger v. Moore* (1970) 11 CA3d 1, 6-8, 89 CR 323, 325-326 (describing nature of wrongful foreclosure actions)]

The basic elements of the wrongful foreclosure tort track the elements of an equitable cause of action to set aside a foreclosure sale: (i) the trustee caused an illegal, fraudulent or willfully oppressive real property sale pursuant to a power of sale in a deed of trust; (ii) the party attacking the sale (usually, but not always, the trustor) was prejudiced or harmed; and (iii) in cases where the trustor challenges the sale, the trustor tendered the amount of the secured indebtedness or was excused from tendering (¶ 6:535.15 ff.). [*Sciarratta v. U.S. Bank Nat'l Ass'n* (2016) 247 CA4th 552, 561-562, 202 CR3d 219, 226]

• [6:539.9] A homeowner had standing to sue for wrongful foreclosure where, as a result of a void assignment of her note and deed of trust, the entity that conducted the sale had no interest in either document. The void assignment not only satisfied the illegal foreclosure element of the wrongful foreclosure tort, it provided a basis for the prejudice or damage required by the second element and excused the borrower from tendering payment under the third element. [*Sciarratta v. U.S. Bank Nat'l Ass'n* (2016) 247 CA4th 552, 555, 568, 202 CR3d 219, 221-222, 232 & fn. 10 (essentially holding *any homeowner* who suffers foreclosure due to a void assignment may sue for wrongful foreclosure); compare *Hacker v. Homeward Residential, Inc.* (2018) 26 CA5th 270, 280-281, 236 CR3d 790, 799-800—family trust that obtained borrower's grant deed had standing to assert wrongful foreclosure claim against successor beneficiary where beneficial interest assignment allegedly was void because assigning entity never held title; *Kalnoki v. First American Trustee Servicing Solutions, LLC* (2017) 8 CA5th 23, 49-50, 214 CR3d 292, 312-313 (distinguishing *Sciarratta* and finding subject foreclosure documents neither fraudulent nor invalid and borrowers not prejudiced)—"even assuming for sake of argument that prejudice can be established simply by alleging facts showing the wrong party foreclosed as found in *Sciarratta*, the judicially noticeable documents in this case show the proper party foreclosed notwithstanding the [borrower's] conflicting allegations"; *In re Turner* (9th Cir. 2017) 859 F3d 1145, 1149—although transfer of residential loan to investment trust after its closing date rendered transfer voidable, it did not affect validity of subsequent foreclosure sale or support debtors' wrongful foreclosure claim]

• [6:539.10] A loan made to borrowers with limited English proficiency and education, and that required monthly payments exceeding the borrowers' income, was deemed sufficiently unconscionable to be unenforceable, thereby providing the basis for a wrongful foreclosure action. [*Orcilla v. Big Sur, Inc.* (2016) 244 CA4th 982, 996-998, 198 CR3d 715, 726-729]

• [6:539.11] A wrongful foreclosure claim will lie against a lender who fails to honor its obligation to provide the borrower with a permanent loan modification. [*Majd v. Bank of America, N.A.* (2015) 243 CA4th 1293, 1306-1307, 197 CR3d 151, 162]

• [6:539.12] A loan servicer who refused an effective tender of the amount required to reinstate a defaulted mortgage under Civ.C. § 2924c, and who thereafter foreclosed without legal basis, could be held liable for wrongful foreclosure. [*Turner v. Seterus, Inc.* (2018) 27 CA5th 516, 530-531, 238 CR3d 528, 540-541]

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• [6:539.13] After entering into multiple loan modification agreements that never materialized, a borrower adequately stated a wrongful foreclosure action and was entitled to recover any damages proximately caused thereby, including lost rental income and emotional distress. [*Miles v. Deutsche Bank Nat'l Trust Co.* (2015) 236 CA4th 394, 408, 186 CR3d 625, 636]

Comment: Following the events in *Miles*, supra, the Legislature enacted Civ.C. § 2924.12(b), which provides a damages cause of action against lenders or loan servicers who foreclose on homes when there has been a loan modification and the borrower has not defaulted (*see* ¶ 6:524.20, 6:524.26). The applicability of this statutory cause of action was not raised in *Miles* and the court offered no opinion on how it would impact, if at all, a common law tort action for wrongful foreclosure. [See *Miles v. Deutsche Bank Nat'l Trust Co.*, supra, 236 CA4th at 410, 186 CR3d at 637, fn. 6]

And even though *Sciarratta,* supra, was decided after enactment of the above legislation, the court decided without mentioning either statute that "the measure of damages for wrongful foreclosure is the familiar measure of tort damages: all proximately caused damages." [*Sciarratta v. U.S. Bank Nat'l Ass'n* (2016) 247 CA4th 552, 567, 202 CR3d 219, 231]

[6:539.14] ***Reserved.***

4) [6:539.15] **Tort damages for *preforeclosure misrepresentations during loan modification negotiations:*** A trustee or beneficiary also may be liable for tort damages arising from its conduct during the loan modification process. For example, the lender's (or its agent's) false statements may give rise to claims for intentional or negligent representation. [See *Sheen v. Wells Fargo Bank, N.A.* (2022) 12 C5th 905, 943, 290 CR3d 834, 860, fn. 10 (dictum)—potential actions against lenders/servicers who fail to act reasonably in processing loan modification applications include negligent/ intentional misrepresentation, fraud and promissory estoppel; *Daniels v. Select Portfolio Servicing, Inc.* (2016) 246 CA4th 1150, 1172, 201 CR3d 390, 411 (disapproved on other grounds by *Sheen,* supra, 12 C5th at 948, 290 CR3d at 864, fn. 12)—trustee of securitized trust that purportedly owned loan was potentially liable under agency theory for former loan servicer's alleged fraudulent misrepresentations re borrower's failure to deliver requisite modification documents; see also *Rufini v. CitiMortgage, Inc.* (2014) 227 CA4th 299, 308, 173 CR3d 422, 430—borrower's allegation claiming lender falsely told him he was approved for permanent loan modification while lender pursued foreclosure remedy deemed sufficient to state negligent misrepresentation claim; *West v. JPMorgan Chase Bank, N.A.* (2013) 214 CA4th 780, 795, 154 CR3d 285, 295—lender's verbal assurance that borrower had received HAMP Trial Modification while it moved forward with foreclosure supported fraud/negligent misrepresentation claims]

5) [6:539.16] **Economic loss rule bars negligence claims in loan modification negotiations:** The general rule that a "financial institution owes no duty of care to a borrower when the institution's involvement in the loan transaction does not exceed the scope of its conventional role as a mere lender of money" applies to post-default loan modification negotiations. Thus, borrowers may not sue to recover negligently inflicted, purely *economic* losses that arise from the underlying contracts. [See *Sheen v. Wells Fargo Bank, N.A.* (2022) 12 C5th 905, 927-929, 942, 290 CR3d 834, 847-848, 859 (internal quotes and citation omitted) (also concluding *"Biakanja"* factors used by various lower courts to justify imposing such a duty are inapposite to borrower-lender relationships where parties are in contractual privity) —lender not liable for negligently failing to process borrower's foreclosure alternative application]

Comment: Sheen involved conduct by a lender and servicer in connection with second and third mortgages on the borrower's home. Thus, the HBOR requirements for handling an application to modify a *first lien* mortgage did not apply (¶ 6:511.1 ff.). [See *Sheen v. Wells Fargo Bank, N.A.*, supra, 12 C5th at 921, 290 CR3d at 841-842]

[6:539.17 - 6:539.20] ***Reserved.***

6) [6:539.21] **Trustee's breach of general duty to conduct sale fairly:** A foreclosing trustee has a general common law duty to ensure that a trustee's sale is *conducted fairly*, according to proper procedures, and to achieve the highest possible price. This duty runs to the beneficiary and trustor, as well as to unsuccessful bidders who are unfairly prevented from participating in the sale. [*Residential Capital, LLC v. Cal-Western Reconveyance Corp.* (2003) 108 CA4th 807, 824-825, 134 CR2d 162, 175-176]

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• [6:539.22] Junior lienholders adequately pled that the trustee breached a duty owed to them by not stopping the auction briefly to explain the bidding requirements. [*Bank of Seoul & Trust Co. v. Marcione* (1988) 198 CA3d 113, 119, 244 CR 1, 4]

• [6:539.23] The trustee breached a duty to potential bidders by disqualifying them merely because they had a different form of payment. [*Baron v. Colonial Mortg. Service Co.* (1980) 111 CA3d 316, 323, 168 CR 450, 454]

• [6:539.24] *Compare:* A trustee had *no* duty to sua sponte provide the successful bidder with a detailed explanation of recorded encumbrances on the foreclosed property. [*Ostayan v. Serrano Reconveyance Co.* (2000) 77 CA4th 1411, 1419-1420, 92 CR2d 577, 583-584 (disapproved on other grounds by *Black Sky Capital, LLC v. Cobb* (2019) 7 C5th 156, 165, 246 CR3d 583, 591); *see discussion at ¶ 6:537*]

[6:539.25 - 6:539.29] ***Reserved.***

7) [6:539.30] **Trustee's defense—nonmonetary status declaration:** A trustee named in an action involving a deed of trust may be excused from participating in the litigation and thereby avoid monetary damages if it files a declaration of nonmonetary status. There is no fee for filing the declaration. The declaration must, among other things, aver that the trustee reasonably believes it has been named solely in its capacity as trustee and *not* as a result of any wrongdoing. If no party who has appeared objects within 15 days, the trustee is exempt from participating further in the action. [See Civ.C. § 2924*l*; *Bae v. T.D. Service Co.* (2016) 245 CA4th 89, 104-105, 199 CR3d 282, 293-294—default judgment against trustee set aside based on trustee's unchallenged declaration of nonmonetary status]

c. [6:540] **Judicial foreclosure:** Unlike a trustee's sale, a *judicial foreclosure* is a lawsuit and involves a *court-supervised* foreclosure sale. The beneficiary must sue all parties having subordinate interests in the property in order to extinguish their interests upon the foreclosure sale. If successful, the beneficiary will obtain a judgment ordering sale of the property and the sale will be conducted by a court-appointed levying officer. The proceeds of the sale are then paid out—first, to the beneficiary, and thereafter in the same manner as a trustee's sale (*¶ 6:535.13*).

(1) Pros and cons from lender's perspective

(a) Advantages

1) [6:541] **Deficiency judgment:** The principal advantage to a lender (beneficiary) in pursuing a judicial foreclosure is that it can obtain a deficiency judgment *provided* (i) the loan documents do not provide the loan is a nonrecourse obligation (*¶ 6:402*); and (ii) no other antideficiency laws apply (such as purchase money antideficiency rules; *see¶ 6:563 ff.*). [*Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1236, 44 CR2d 352, 357]

a) [6:541.1] **"Fair value" deficiency limitation:***See¶ 6:577*.

2) [6:542] **Opportunity to preserve junior encumbrances:** A secondary advantage to pursuing a judicial foreclosure sale is that the lender can choose which junior encumbrances it wishes to wipe out upon its foreclosure. (Junior encumbrancers not named in the lawsuit will be unaffected by the judicial foreclosure; *see¶ 6:544.2*.) For example, a lender may wish to foreclose-out unfavorable leases yet preserve favorable leases.

(b) [6:543] **Disadvantages:** Of course, like any other lawsuit, a judicial foreclosure is an adversarial proceeding and involves considerable time and expense. In addition, the trustor retains a statutory *right of redemption* (opportunity to regain ownership of the property by paying the foreclosure sale price plus certain other amounts) for one year following the judicial foreclosure sale. [CCP §§ 729.010-729.090; *Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1236, 44 CR2d 352, 357; *see also ¶ 6:544.12*]

(2) [6:544] **Judicial foreclosure procedure:** Judicial foreclosures are governed by CCP § 725a et seq. and procedures relating to civil actions generally.

(a) [6:544.1] **Parties authorized to initiate proceeding:** The beneficiary, trustee, mortgagee with power of sale, or successor in interest to any of these entities, is statutorily empowered to file suit for judicial foreclosure. [CCP § 725a; see also *Arabia v. BAC Home Loans Servicing, L.P.* (2012) 208 CA4th 462, 469, 145 CR3d 678, 684]

In addition, loan servicers *assigned the right to foreclose* may initiate judicial foreclosure proceedings in their own names. They need not be assigned the note or deed of trust; assignment of the cause of action is sufficient. [See *Arabia*

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v. BAC Home Loans Servicing, L.P., supra, 208 CA4th at 472-473, 145 CR3d at 686-687 (servicer's right to foreclose arose out of assigned "legal obligation" and was not precluded by statute)]

(b) [6:544.2] **Notice requirement:** All persons holding a *recorded interest* in the property being foreclosed (even if only a *fractional* interest) must be given notice and made a party to the action. [*Diamond Benefits Life Ins. Co. v. Troll* (1998) 66 CA4th 1, 7, 77 CR2d 581, 585]

Absent such notice, holders of a recorded interest are *not bound by the foreclosure judgment*. [CCP § 726; see *Robin v. Crowell* (2020) 55 CA5th 727, 748, 270 CR3d 25, 39-40—judicial foreclosure action did not affect omitted junior lienholder (¶ 6:515.2); *Arabia v. BAC Home Loans Servicing, L.P.* (2012) 208 CA4th 462, 473-474, 145 CR3d 678, 687—although failure to join junior lienholder does not void sale, it renders foreclosure ineffective for purposes of extinguishing junior lien; *Diamond Benefits Life Ins. Co. v. Troll*, supra, 66 CA4th at 6-7, 77 CR2d at 584-585—easement holder who was not party to judicial foreclosure equitably entitled to one-year right of redemption in subsequent quiet title action]

(c) [6:544.3] **Challenging the judgment; mandatory joinder:** In an action to challenge a judicial foreclosure judgment, all parties to the execution sale are indispensable parties. [*Lee v. Rich* (2016) 6 CA5th 270, 277, 210 CR3d 828, 833—third party purchaser at execution sale who was not joined as indispensable party to debtor's motion to set aside and vacate judgment not bound by court's order granting same]

[6:544.4 - 6:544.9] ***Reserved.***

(3) [6:544.10] **Sale to third party generally absolute:** A judicial foreclosure sale to a party other than the beneficiary generally is "absolute," subject only to the trustor's right of redemption (¶ 6:543, 6:544.12), and "shall not be set aside for any reason." [CCP § 701.680(a); see *Lee v. Rich* (2016) 6 CA5th 270, 277-279, 210 CR3d 828, 833-834—execution sale of judgment debtor's residence to third party purchaser deemed "absolute" and not subject to set-aside even though underlying foreclosure judgment declared void; *Amalgamated Bank v. Sup.Ct. (Corinthian Homes)* (2007) 149 CA4th 1003, 1018-1019, 57 CR3d 686, 696-697—where trustor did not timely exercise redemption right and third party purchaser's title to property was perfected, there was "simply no room" in statutory scheme for trustor to deprive third party purchaser of interest in property by bringing set-aside motion]

(a) [6:544.11] **Compare—sale to beneficiary subject to challenge for irregularities:** A judicial foreclosure sale to the *beneficiary* (lender) may be set aside for "irregularities in the proceedings" on motion by the *trustor* or its successor in interest brought within 90 days after the sale. [CCP § 701.680(c)(1); *Amalgamated Bank v. Sup.Ct. (Corinthian Homes)* (2007) 149 CA4th 1003, 1018, 57 CR3d 686, 696; see also *Lee v. Rich* (2016) 6 CA5th 270, 278, 210 CR3d 828, 834—judgment debtor may commence action to set aside sale only if sale was improper and purchaser was judgment creditor]

(b) [6:544.12] **Compare—equitable right of redemption:** Notwithstanding CCP § 701.680's "absolute" language, nothing in the statute *affects, limits or eliminates* a judgment debtor's *equitable* right of redemption. [CCP § 701.680(e); see also *Lee v. Rich* (2016) 6 CA5th 270, 279-282, 210 CR3d 828, 834-837—although underlying foreclosure judgment declared void, homeowner had no equitable right of redemption where third-party purchaser did not secure judgment, was not associated with judgment creditor, did not manipulate legal system to buy property and execution sale price was not grossly inadequate]

d. [6:545] **Special provisions regulating residential foreclosures:** Special statutes are directed at protecting homeowners whose residences are in foreclosure from fraud, deception, harassment and unfair dealing by persons who represent they can assist in avoiding loss of the residence by foreclosure sale (so-called "foreclosure consultants") and others who attempt to induce defaulting homeowners to sell their homes pending foreclosure for a small fraction of fair market value ("equity purchasers"). [See Civ.C. § 1695(a) (legislative findings re home equity sales contracts), Civ.C. § 2945(a) (legislative findings re "foreclosure consultants")]

These statutes regulate "foreclosure consultants" and "foreclosure consultant service agreements" (Civ.C. § 2945 et seq.); and "home equity sales contracts" (Civ.C. § 1695 et seq.). They apply to any "residence in foreclosure," meaning residential real property consisting of one-to-four family dwelling units, one of which is owner-occupied as a principal residence. [Civ.C. §§ 1695.1(b), 2945.1(e)]

(1) [6:546] **Foreclosure consultants:** Subject to certain exceptions (e.g., real estate brokers acting under the authority of their licenses as described in Bus. & Prof.C. §§ 10131 and 10131.1, or attorneys rendering services in the course of their

practices; see Civ.C. § 2945.1(b) & (c)), any person who solicits, represents or offers to a homeowner to perform a service for compensation that will effectively save the homeowner from foreclosure is a "foreclosure consultant" and subject to the requirements of Civ.C. § 2945 et seq. [See Civ.C. § 2945.1 (defining "foreclosure consultant" and consultant "services"); see also *Onofrio v. Rice* (1997) 55 CA4th 413, 420, 64 CR2d 74, 78—trial court properly found real estate broker acted as "foreclosure consultant" and violated statutory requirements]

(a) [6:546.1] **Written contract required:** Any agreement to perform foreclosure consultant services must be in writing and fully disclose the exact nature of the services and the total amount and terms of compensation. [Civ.C. § 2945.3(a)]

1) [6:546.2] **Mandatory notices; specific language requirements:** The contract must contain statutory notices concerning the homeowner's legal rights, including a right to cancel and how to effect cancellation; a statutory notice of cancellation form (Civ.C. § 2945.3(f)) must be attached to the contract. [See Civ.C. § 2945.3(b), (d), (f), (g)—homeowner to be provided with copy of contract and attached notice of cancellation]

In addition, the contract must be written in the language principally used by the foreclosure consultant to describe their services or to negotiate the contract. Moreover, before the owner signs the contract, the foreclosure consultant must provide the owner with a copy of a completed contract written in any other language used in any communication with the owner and, if requested, in Civ.C. § 1632(b)-designated languages (Spanish, Chinese, Tagalog, Vietnamese, Korean). [Civ.C. §§ 2945.3(c) & 1632(b)(7)]

(b) [6:546.3] **Homeowner's right of cancellation:** In addition to any other right to rescind, the homeowner has the right to *cancel* the foreclosure consultant contract until midnight of the fifth business day (as defined by Civ.C. § 1689.5(e)) after the day on which they sign the contract (which complies with Civ.C. § 2945.3, ¶ 6:546.1 ff.). [Civ.C. § 2945.2(a)]

Also, any foreclosure consultant services contract is cancelable by the homeowner until the consultant complies with Civ.C. § 2945.3 (prescribing the form and content of the contract, ¶ 6:546.2). [Civ.C. § 2945.3(h)]

1) [6:546.3a] **Manner of cancellation:** Cancellation is effected by giving written notice thereof to the foreclosure consultant by mail at the address specified in the contract, or by facsimile or electronic mail at the number or address identified in the contract. Notice of cancellation, if given by mail, is effective when deposited in the mail properly addressed with postage prepaid; if given by fax or electronic mail, it is effective when successfully transmitted. [Civ.C. § 2945.2(b), (c)]

The cancellation form attached to the contract may, but need not, be used; any other form of cancellation notice also is effective so long as it indicates the owner's intent not to be bound by the contract. [Civ.C. § 2945.2(d)]

(c) [6:546.4] **Homeowner rights nonwaivable:** The rights conferred by Civ.C. § 2945 et seq. are *nonwaivable*. Indeed, any attempt by a foreclosure consultant to induce a homeowner to waive the homeowner's rights itself violates the statutory scheme. [Civ.C. § 2945.5]

(d) Consequences of violation

1) [6:546.5] **Damages liability:** A foreclosure consultant who violates any provision of Civ.C. § 2945 et seq. is liable to the homeowner for "actual damages," plus reasonable attorney fees and costs. [Civ.C. § 2945.6(a); see *Onofrio v. Rice* (1997) 55 CA4th 413, 421, 64 CR2d 74, 79—where foreclosure consultant purchased aggrieved homeowner's residence in foreclosure in violation of § 2945 et seq., "benefit of bargain" was proper measure of "actual damages" (i.e., difference between what defendant paid for the property and property's market value at that time)]

The court may also award appropriate equitable relief and, in its discretion, exemplary (punitive) damages. [Civ.C. § 2945.6(a)]

a) [6:546.5a] **Mandatory exemplary damages for certain violations:** For a violation of Civ.C. § 2945.4(a), (b) or (d), exemplary damages of at least three times the compensation received by the foreclosure consultant *must* be awarded in addition to any other award of actual or exemplary damages. [Civ.C. § 2945.6(a); see *Onofrio v. Rice* (1997) 55 CA4th 413, 423, 64 CR2d 74, 80—treble exemplary damages properly awarded]

Likewise, in addition to any other actual or exemplary damages award, the court "shall award" exemplary damages of at least three times the owner's actual damages for any violation of Civ.C. § 2945.4(c), (e) or (g). [Civ.C. § 2945.6(a)]

b) [6:546.6] **Four-year statute of limitations:** A Civ.C. § 2945.6 suit must be brought within four years from the date of the alleged violation. [Civ.C. § 2945.6(b)]

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c) [6:546.6a] **Other remedies preserved:** The Civ.C. § 2945.6 damages remedy does not preempt other rights and remedies an aggrieved homeowner may have under the law. [Civ.C. § 2945.6(b)]

2) [6:546.7] **Fines and imprisonment:** Additionally, the commission of any act proscribed by Civ.C. § 2945.4 "*shall be* punished" by a maximum $10,000 fine and/or imprisonment in county jail for up to one year, or in state prison … for *each* such violation. [Civ.C. § 2945.7—cumulative to any other remedies or penalties provided by law]

(e) [6:546.8] ***CAUTION—ATTORNEY ETHICS ALERT*:** In response to the residential mortgage crisis in California, some foreclosure consultants have attempted to avoid the statutory prohibition on collecting fees before any services are rendered by having an attorney work with them in foreclosure consultations. As a result, the State Bar Committee on Professional Responsibility and Conduct reiterated an earlier Ethics Alert to remind California lawyers of the rules that may apply in the event a foreclosure consultant or other nonlawyer requests assistance and/or refers potential distressed homeowner clients to the lawyer.

Specifically, California lawyers may *not*:

• Pay a referral or marketing fee to a foreclosure consultant or other person for referring distressed homeowners to the lawyer. [See CRPC 7.2(b)]

• Directly or indirectly split any attorney fees that the lawyer earns from a distressed homeowner client with the foreclosure consultant or any other nonlawyer. [See CRPC 7.2(b)]

• Aid a foreclosure consultant or anyone else in the unauthorized practice of law. For example, a lawyer may not form a partnership or joint venture with a foreclosure consultant or other nonlawyer if any of the business activities would involve providing legal services. And a lawyer may not, under the guise of serving as in-house counsel for a foreclosure consulting business, perform legal services for a distressed homeowner. [See CRPC 5.5(a)(2)]

• Contact in person, by telephone (or by real-time electronic contact) a distressed homeowner referred to the lawyer by a foreclosure consultant or someone else unless the lawyer has a family or prior professional relationship with the homeowner; nor may a lawyer direct another to do so on the lawyer's behalf. A lawyer, however, may write to a distressed homeowner who is a prospective client, as specified. [See CRPC 7.3]

• File a lawsuit (or motions in a lawsuit) without good cause and for the purpose of simply delaying or impeding a foreclosure sale. [See CRPC 3.1(a)]

• Intentionally or recklessly fail to perform legal services with competence (CRPC 1.1(a)). And the attorney should be wary of accepting fees for little or no work (See CRPC 1.5(a)).

Cross-refer: For a comprehensive treatment of attorney ethical obligations and governing rules of professional conduct, see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG).

(2) [6:547] **Home equity sales contracts:** A similar statutory scheme, known as the Home Equity Sales Contract Act, regulates purchasers of, and contracts to purchase, a "residence in foreclosure" (¶ *6:545*). [Civ.C. § 1695 et seq.] In addition to prescribing essential terms of the purchase and sale contract, these statutes give the homeowner a special right of cancellation. [Civ.C. §§ 1695.2, 1695.3, 1695.4, 1695.5, 1695.6; see *Hoffman v. Lloyd* (9th Cir. 2009) 572 F3d 999, 1000 (applying Calif. law)]

Equity purchasers who violate the Act are subject to civil liability (actual and exemplary damages, plus appropriate equitable relief), as well as fines and imprisonment. [See Civ.C. §§ 1695.7, 1695.8; *People v. Shetty* (2009) 174 CA4th 1488, 1491, 95 CR3d 355, 357—Act criminalizes violations involving fraud and deceit]

Cross-refer: The Home Equity Sales Contract Act is treated in detail in *Ch. 4; see¶ 4:279.5 ff.*

e. [6:548] **Mortgage Forgiveness Debt Relief Act:** The Mortgage Forgiveness Debt Relief Act (Pub.L. 110-142, 121 Stat. 1803), signed into law December 20, 2007 in response to declining real estate values and crises in the mortgage markets, expired December 31, 2013. The Act excluded from gross income discharges of indebtedness on principal residences that occurred on or after January 1, 2007, and before January 1, 2014. The purpose was to relieve residential borrowers from what would otherwise be deemed taxable income upon foreclosure when the amount owed on their homes was greater than the property's value.

Congress has extended the exclusion for qualified principal residence indebtedness (QPRI) each year since the Act's expiration. The current exclusion applies for QPRI that was discharged before January 1, 2026. [IRC § 108(a)(1)(E)]

➪ [6:548.1] ***PRACTICE POINTER:*** Counsel should monitor closely all future legislative action for possible extension of the exclusion to discharges occurring on or after January 1, 2021.

Cross-refer: The Act is treated in greater detail in *Ch. 13; see¶ 13:399.18 ff.*

f. [6:549] **Buyer's Choice Act (sale of foreclosed property):** In response to potential unfairness occasioned by the resale of large numbers of foreclosed homes on the market, the Legislature enacted the Buyer's Choice Act (Civ.C. § 1103.20 et seq). The Act prohibits a lender under a deed of trust (or its agents, employees, etc.) from requiring, either directly or indirectly, as a condition to the sale of foreclosed residential real property that the buyer purchase title insurance covering the property from a particular title insurer. [See Civ.C. § 1103.22(a), (b)]

Cross-refer: The Act is discussed in greater detail at *¶ 3:59.5 ff.*

g. [6:549.1] **California's "First Look" program (sale of residential properties acquired via foreclosure by certain institutions):** Effective January 1, 2023, the Legislature granted a 30-day right of first offer to "prospective owner-occupants" and "affordable housing providers" seeking to purchase one to four unit California residential properties from "institutions" conducting large volume foreclosures (¶ 6:549.2 ff.). Consistent with the federal "First Look" program, the intention is to expand home ownership opportunities in California and strengthen neighborhoods and communities. [Civ.C. § 2924p]

(1) [6:549.2] **"Institutions":** "Institutions" subject to the "first look" rules include any person or entity that foreclosed on 175 or more residential properties containing one to four units in their immediately preceding annual reporting period. This is so provided the person or entity is (i) a federally or state charted depository institution; (ii) a person licensed under the California Financing Law (Fin.C. § 22000 et seq.) or the California Residential Mortgage Lending Act (Fin.C. § 50000 et seq.); or (iii) a person licensed under the California Real Estate Law (Bus & Prof.C. § 10000 et seq.). [Civ.C. § 2942p(b)(3)]

(2) [6:549.3] **"Eligible bidders":** Two types of "eligible bidders" have preemptive rights to bid on real property containing one to four residential dwelling units acquired by "institutions" (¶ 6:549.2) through foreclosure under a mortgage or trust deed or at a foreclosure sale. They are "prospective owner-occupants" (¶ 6:549.4) and "eligible bidders" (¶ 6:549.5). [Civ.C. § 2942p(b)(2)]

(a) [6:549.4] **"Prospective owner-occupants":** A "prospective owner-occupant" having a preemptive right to bid on real property is defined as a natural person who presents to a qualified institution (¶ 6:549.2) an affidavit or declaration under penalty of perjury certifying they will occupy the property as their primary residence within 60 days of the trustee's deed being recorded and will maintain their occupancy for at least one year. [Civ.C. § 2924p(b)(4)(A), (B)]

The above affidavit or declaration also must aver that the prospective owner-occupant is (i) not the mortgagor/trustor or the child, spouse, parent, employee, officer, or member of the mortgagor/trustor; (ii) not the grantor of a living trust named in the property title when the notice of default was recorded; (iii) not a person with an ownership interest in the mortgagor (unless the mortgager is a publicly traded company); and (iv) not purchasing the property as the agent of any other person or entity. [Civ.C. § 2924p(b)(4)(C), (D)]

Comment: The Legislature appears to have copied the definition of "prospective owner-occupant" from the post-sale bidding statute (i.e., by requiring an affirmation that the prospective owner-occupant will occupy the subject property within 60 days following recordation of the trustee's deed; *see*¶ 6:535.10c). However, institutions may not even list properties for sale that soon since a good deal of internal analysis and paperwork must be completed first. Thus, Civ.C. § 2924p's definition of "prospective owner occupant" appears to be an oversight that most likely will be corrected by the Legislature in a future session.

(b) [6:549.5] **Affordable housing providers:** Affordable housing providers also have a preemptive right to bid on real property containing one-to four residential units acquired by "institutions" (¶ 6:549.2) through foreclosure under a mortgage or trust deed or at a foreclosure sale. Affordable housing providers include (Civ.C. § 2924p(b)(2)(B)-(E)):

— Non-profit corporations based in California, whose board members all have their primary residence in California, and that have an IRS determination letter certifying they are tax-exempt and not a private foundation. In addition, the corporation's "primary activity" must be the development and preservation of affordable California rental or homeownership housing;

— Community land trusts based in California (see Rev. & Tax.C. § 402.1(a)(11)(C)(ii));

— Limited-equity housing cooperatives based in California (see Civ.C. § 817); *and*

— The state, Regents of the University of California, a county, city, district, public authority, or public agency, as well as any other California political subdivision or public corporation.

(3) [6:549.6] **"First Look" procedure:** For 30 days following the listing of property subject to California's "first look" program (¶ 6:549.1), the selling institution may only accept offers from "eligible bidders" (¶ 6:593.3 ff.). The institution must respond in writing to all timely offers from eligible bidders before considering any other offers. Nonetheless, there is no requirement that the institution *accept* an offer from an eligible bidder. [Civ.C. § 2924p(c)]

(4) [6:549.7] **"Bundled sales" prohibition:** Institutions may not conduct "bundled sales" (i.e., sales of two or more parcels that contain one to four residential dwelling units, at least two of which were acquired through foreclosure). [Civ.C. § 2924p(b)(1), (c)(5)]

4. [6:550] **"One Action" Rule/"Security First" Rule (CCP § 726):** "There can be but *one form* of action for the recovery of any debt or the enforcement of any right secured by mortgage upon real property …" [CCP § 726(a) (emphasis added); *Nungaray v. Litton Loan Servicing, LP* (2011) 200 CA4th 1499, 1505, 135 CR3d 442, 447]

That form of action is *foreclosure* of the security. [CCP § 726(a); *Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1236, 44 CR2d 352, 357; *C.J.A. Corp. v. Trans-Action Fin'l Corp.* (2001) 86 CA4th 664, 668, 103 CR2d 538, 541]

a. [6:550.1] **Dual purposes:** As construed by the courts, CCP § 726 serves dual purposes: It is both a "*security first*" and a "*one action"* rule. "It compels the secured creditor, in a single action, to exhaust his security judicially *before* he may obtain a monetary 'deficiency' judgment against the debtor." [*O'Neil v. General Security Corp.* (1992) 4 CA4th 587, 597, 5 CR2d 712, 716 (emphasis in original); see also *Coker v. JPMorgan Chase Bank, N.A.* (2016) 62 C4th 667, 690-691, 197 CR3d 131, 149; *Cadlerock Joint Venture, L.P. v. Lobel* (2012) 206 CA4th 1531, 1539, 143 CR3d 96, 101-102]

(1) [6:551] **"One action" rule:** The "one action" component of the rule avoids *multiplicity of suits* on a secured obligation (e.g., judicial foreclosure suit followed by action(s) for a deficiency judgment). Thus, a creditor seeking to recover a debt secured by real property is limited to *one "action."* [*Kirkpatrick v. Westamerica Bank* (1998) 65 CA4th 982, 986, 76 CR2d 876, 878; *National Enterprises, Inc. v. Woods* (2001) 94 CA4th 1217, 1232, 115 CR2d 37, 47—creditor holding multiple security for single debt must include *all* of security in single action]

(a) [6:551.1] **"Action":** The meaning of the term "action" for purposes of CCP § 726 is discussed at ¶ *6:554 ff.*

(b) [6:551.2] **When rule applies:** The restrictions of the "one action" rule are triggered no earlier than when the action is commenced, as opposed to when the deed of trust is made (and possibly later since the commencement of the action does not necessarily constitute an election of remedies; *see*¶ *6:513, 6:553.10*). [*National Enterprises, Inc. v. Woods* (2001) 94 CA4th 1217, 1238, 115 CR2d 37, 51—"one action" rule did not require one lawsuit by separate holders of first and second deeds of trust, even though both deeds were held by single creditor when created]

(c) [6:551.3] **Application to joint obligors:** All obligors on the same debt arising from the same transaction are entitled to the protections of the "one action" rule, *including* those obligors who did not provide the security. [*Paykar Const., Inc. v. Spilat Const. Corp.* (2001) 92 CA4th 488, 496, 111 CR2d 863, 868—"one action" rule did not preclude action by plaintiff subcontractor against defendant contractor based on debt that was subject of prior judicial foreclosure action by plaintiff against property owners because defendant and property owners not jointly liable for debt]

(d) [6:551.4] **Compare—rights of sold-out junior lienholder:**CCP § 726 does not bar a junior lienholder from suing the obligor directly after the security has been extinguished by foreclosure of the senior lien. [*Brown v. Jensen* (1953) 41 C2d 193, 195, 259 P2d 425, 426; *Roseleaf Corp. v. Chierighino* (1963) 59 C2d 35, 38-41, 27 CR 873, 874-876; *see further discussion at*¶ *6:559 ff.*]

(e) [6:551.5] **Compare—debt structured into multiple promissory notes:** A single lender may structure a single debt into several promissory notes in order to preserve the right to bring multiple actions without violating CCP § 726. [*National Enterprises, Inc. v. Woods* (2001) 94 CA4th 1217, 1235, 115 CR2d 37, 49—no violation of "one action" rule where subject debts originated years apart]

(f) [6:551.6] **Compare—multiple final *determinations in single action:*** The purpose of the "one action" rule is to protect debtors from multiple collection *suits*, *not* to bar entry of *more than one* final *determination* in a single foreclosure action; i.e., a judicial decree of foreclosure does not bar a subsequent proceeding in the same action to adjudicate a

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deficiency judgment (where a deficiency judgment is otherwise allowed by statute) (¶ *6:578*). [*Kinsmith Fin'l Corp. v. Gilroy* (2003) 105 CA4th 447, 453-454, 129 CR2d 478, 483; *see also* ¶ *6:578.3*]

(g) [6:551.7] **Exception—fraud:** CCP § 726 itself contains an exception to the "one-action" rule: A lender may sue a borrower for fraudulently inducing the lender to make the loan *unless* the loan is secured by a single-family home actually occupied by the borrower and the loan is for $150,000 or less (adjusted annually for inflation). [CCP § 726(f), (g); see also *In re Montano* (9th Cir. BAP 2013) 501 BR 96, 109 (applying Calif. law)—fraud exception did not apply to $89,990 note that borrower used to purchase home even though he purportedly engaged in fraud]

(2) [6:552] **"Security first" rule:** The "security first" aspect of CCP § 726 compels the creditor to exhaust its security *before* suing on the underlying debt. [*Security Pac. Nat'l Bank v. Wozab* (1990) 51 C3d 991, 997-999, 275 CR 201, 204-205; see also *Thoryk v. San Diego Gas & Elec. Co.* (2014) 225 CA4th 386, 399, 170 CR3d 309, 317; *Kinsmith Fin'l Corp. v. Gilroy* (2003) 105 CA4th 447, 453, 129 CR2d 478, 483]

(a) [6:552.1] **Compare—worthless security:** Foreclosure is not required as the lender's first remedy where the encumbered property (security) has become valueless through no fault of the lender, rendering pursuit of a foreclosure action an idle act. [*Bank of America Nat'l Trust & Sav. Ass'n v. Graves* (1996) 51 CA4th 607, 611, 59 CR2d 288, 291; *C.J.A. Corp. v. Trans-Action Fin'l Corp.* (2001) 86 CA4th 664, 669, 103 CR2d 538, 541; see also *Cadlerock Joint Venture, L.P. v. Lobel* (2012) 206 CA4th 1531, 1539, 143 CR3d 96, 101-102—exception does not apply if "beneficiary himself" causes loss of security (e.g., by unilaterally divesting its security interest without debtor's consent); *see also* ¶ *6:559 ff.*]

b. [6:553] **Dual application:** If a creditor files suit on its secured debt without first pursuing foreclosure on the security, CCP § 726's protections can be invoked in two distinct ways:

(1) [6:553.1] **Affirmative defense:** First, the debtor may raise CCP § 726 as an *affirmative defense*, compelling the creditor to first exhaust the security before obtaining a deficiency judgment. [*Security Pac. Nat'l Bank v. Wozab* (1990) 51 C3d 991, 1004-1005, 275 CR 201, 209; see also *In re Prestige Ltd. Partnership-Concord* (9th Cir. 2000) 234 F3d 1108, 1114-1115 (applying Calif. law); *Scalese v. Wong* (2000) 84 CA4th 863, 869, 101 CR2d 40, 43; compare *Bank of America, N.A. v. Roberts* (2013) 217 CA4th 1386, 1396-1398, 159 CR3d 345, 353-355—lender not required to first pursue foreclosure in light of agreed short sale whereby borrower stipulated to remain personally liable on loan in exchange for lender consenting to release its lien]

(2) [6:553.2] **As sanction:** Alternatively, the debtor may waive the *affirmative defense*, allowing the lender's action on the debt to proceed to judgment. [*Paykar Const., Inc. v. Spilat Const. Corp.* (2001) 92 CA4th 488, 496, 111 CR2d 863, 868]

But the debtor then has the right to invoke CCP § 726 as a sanction, thereby barring the lender from further pursuing its security interest ("election of remedies," ¶ 6:553.3). [*Walker v. Community Bank* (1974) 10 C3d 729, 734, 111 CR 897, 900; *Scalese v. Wong* (2000) 84 CA4th 863, 869, 101 CR2d 40, 43; *In re Prestige Ltd. Partnership-Concord* (9th Cir. 2000) 234 F3d 1108, 1115]

(a) [6:553.3] **Election of remedies:** A lender who *elects a remedy* other than foreclosure *waives* the right to foreclose on the security, effectively *losing* its security interest (but *not* the underlying debt). [*Security Pac. Nat'l Bank v. Wozab* (1990) 51 C3d 991, 997, 1002, 275 CR 201, 204, 208; see *Scalese v. Wong* (2000) 84 CA4th 863, 869, 101 CR2d 40, 43; *In re Prestige Ltd. Partnership-Concord* (9th Cir. 2000) 234 F3d 1108, 1114-1117]

1) [6:553.3a] **Antideficiency provisions moot:** In effect, in this scenario, both sides have given up various of their respective rights: The lender waives for all time its right to have the property serve as security for the note. And the debtor has given up the right to have the security exhausted before becoming (potentially) personally liable for any shortfall. As a result, there can never be a foreclosure on the property and the antideficiency provisions (¶ *6:560 ff.*) never come into play. [*Scalese v. Wong* (2000) 84 CA4th 863, 870, 101 CR2d 40, 44; *In re Prestige Ltd. Partnership-Concord* (9th Cir. 2000) 234 F3d 1108, 1114-1117]

(b) [6:553.4] **Prejudgment attachment of unpledged assets as election of remedies:** A secured lender may elect to forgo the remedy of foreclosure when, after the borrower's default, the lender commences legal proceedings to obtain a prejudgment attachment order against the borrower's *unpledged property* (property other than the security), thereby effectively obtaining an *involuntary lien* on additional assets belonging to the borrower. By resorting to this procedure *before commencing a judicial foreclosure action*, the lender may lose its security interest. [See *Shin v. Sup.Ct. (Korea First Bank)* (1994) 26 CA4th 542, 548-549, 31 CR2d 587, 591-592—lender who first obtained prejudgment attachment

against defaulting debtor's unpledged Korean real property could not thereafter obtain judicial foreclosure; *Kirkpatrick v. Westamerica Bank* (1998) 65 CA4th 982, 990, 76 CR2d 876, 881]

1) [6:553.5] **Impact of CCP § 483.012:** Under CCP § 483.012, a secured creditor's resort to prejudgment attachment "shall *not* constitute an action for the recovery of a debt" in violation of the one action rule or security first rule *so long as the attachment is pursued in an action to foreclose a mortgage or deed of trust*. [See CCP § 483.012 (emphasis added), *discussed at¶ 6:555 ff.*]

Although not entirely clear, this statute probably does *not* overrule *Shin*, supra, … since the attachment in *Shin* was pursued in a *separate action before foreclosing* on the secured property (*¶ 6:555.4*). [See *Kirkpatrick v. Westamerica Bank* (1998) 65 CA4th 982, 990, 76 CR2d 876, 881 (postdating enactment of CCP § 483.012)—endorsing *Shin* without discussing CCP § 483.012; see also *In re Prestige Ltd. Partnership-Concord* (9th Cir. 1999) 164 F3d 1214, 1215—§ 483.012 applies *only* in actions to foreclose underlying security]

Cross-refer: Other forms of "action" within the meaning of the one action and security first rules are discussed at *¶ 6:554 ff.*

[6:553.6 - 6:553.9] ***Reserved.***

(c) [6:553.10] **No "election of remedies" absent final judgment:** Mere *commencement* of legal action does *not* constitute an election of remedies. A secured lender does not make an "election of remedies" for purposes of the one action and security first rules until there is a *final judgment*. [*Kirkpatrick v. Westamerica Bank* (1998) 65 CA4th 982, 990, 76 CR2d 876, 881; *C.J.A. Corp. v. Trans-Action Fin'l Corp.* (2001) 86 CA4th 664, 669, 103 CR2d 538, 542; see *National Enterprises, Inc. v. Woods* (2001) 94 CA4th 1217, 1237, 115 CR2d 37, 51]

• [6:553.10a] Thus, a *partial summary judgment* does not constitute an election of remedies; that would only occur at the point when the adjudicated claim is merged into a *judgment*. [*Kirkpatrick v. Westamerica Bank* (1998) 65 CA4th 982, 990, 76 CR2d 876, 881—no election of remedies where creditor amended complaint to seek foreclosure after adverse partial summary judgment entered on creditor's claim for breach of implied covenant]

• [6:553.10b] Similarly, the *dismissal* of a creditor's foreclosure action does not constitute an election of remedies precluding the creditor form bringing a subsequent foreclosure action on the same debt. [*Griffin v. Compere* (1952) 114 CA2d 246, 246, 250 P2d 1, 2]

(d) [6:553.11] **No modification of final judgment to switch remedies:** Having knowingly and unequivocally pursued a judicial foreclosure action to final judgment, the lender is estopped to change its remedy by a postjudgment modification authorizing a money judgment for the debt instead. [*C.J.A. Corp. v. Trans-Action Fin'l Corp.* (2001) 86 CA4th 664, 669-671, 103 CR2d 538, 542-543]

Allowing modification of a foreclosure judgment would be unfair and prejudicial to the debtor by summarily taking away their rights to a fair value hearing and to redeem the property (CCP § 726); the debtor would also be prejudiced to the extent they expended attorney fees and costs in defending the judicial foreclosure action. Moreover, allowing modification of a final judgment to obtain a completely different remedy "does an injustice to the strong policy favoring finality of actions." [*C.J.A. Corp. v. Trans-Action Fin'l Corp.*, supra, 86 CA4th at 671, 103 CR2d at 543—creditor's attempt to modify foreclosure judgment into money judgment 15 months after entry of judgment rejected]

c. [6:554] **"Action":** The CCP § 726 "one action" and "security first" rules have generated many complex issues. One of the most difficult issues concerns the definition of "action" within the meaning of the statute—i.e., when the creditor's pursuit of a particular remedy may be deemed an "action" in violation of the rules.

"Action" is defined under CCP § 22 as "an ordinary proceeding in a court of justice by which one party prosecutes another for the declaration, enforcement, or protection of a right, the redress or prevention of a wrong, or the punishment of a public offense." [CCP § 22; *Kirkpatrick v. Westamerica Bank* (1998) 65 CA4th 982, 989, 76 CR2d 876, 880 & fn. 4]

In operation the "one action rule" applies to *any proceeding or action* by the lender "for recovery of the debt, or enforcement of any right, secured by a mortgage or deed of trust." [*Shin v. Sup.Ct. (Korea First Bank)* (1994) 26 CA4th 542, 545, 31 CR2d 587, 589]

Clearly, a secured lender violates the "one action" and "security first" rules by recovering a personal money judgment against the debtor without first foreclosing all of its security. That "action" triggers the *sanction* of CCP § 726 (*¶ 6:553.2*)

and thereby waives further recourse against the security. [*Shin v. Sup.Ct. (Korea First Bank)*, supra, 26 CA4th at 547, 31 CR2d at 590] Resort to other remedies, however, does not necessarily waive the right to foreclose:

(1) [6:554.1] **Nonjudicial foreclosure:** A *nonjudicial* foreclosure is not an "action" within the meaning of CCP § 726. Thus, a nonjudicial foreclosure will not itself preclude the lender from pursuing a subsequent "action" for recovery of the secured debt. [See *Walker v. Community Bank* (1974) 10 C3d 729, 736, 111 CR 897, 901; *Birman v. Loeb* (1998) 64 CA4th 502, 509, 75 CR2d 294, 299; and *Resolution Trust Corp. v. Bayside Developers* (9th Cir. 1994) 43 F3d 1230, 1243 (construing Calif. law)]

Compare—antideficiency law: But CCP § 580d (¶ *6:570*) would bar a deficiency judgment after the nonjudicial foreclosure sale. [See *Black Sky Capital, LLC v. Cobb* (2019) 7 C5th 156, 158, 246 CR3d 583, 585; *Walker v. Community Bank*, supra, 10 C3d at 736, 111 CR at 901-902]

[6:554.2 - 6:554.4] ***Reserved.***

(2) Setoffs

(a) [6:554.5] **Bank's setoff of funds in debtor's general account:** Generally, an *extrajudicial* setoff is not an "action" within the meaning of CCP § 726. [*Security Pac. Nat'l Bank v. Wozab* (1990) 51 C3d 991, 998, 275 CR 201, 205—nonjudicial setoff cannot be an "action" as defined by CCP § 22]

For example, a bank's (creditor's) unilateral setoff against its debtor's general deposit accounts in partial payment of a debt secured by the debtor-depositor's real property does not violate the one action rule … because it is not an "ordinary proceeding in a court of justice" (CCP § 22, ¶ *6:554*). [*Security Pac. Nat'l Bank v. Wozab*, supra, 51 C3d at 998, 275 CR at 205]

Nonetheless, the setoff *violates the CCP § 726 security first rule*. Having failed to foreclose its real property security interest before taking the setoff, the bank triggers the *sanction* of § 726 and is deemed to have waived its security interest in the depositor-debtor's real property. [*Security Pac. Nat'l Bank v. Wozab*, supra, 51 C3d at 999-1002, 275 CR at 205-207]

1) [6:554.5a] **Compare—voluntary payments made pursuant to "Loan Workout Plan":**CCP § 726 did *not* preclude foreclosure on a residence where the lender accepted "trial period payments" and postponed the foreclosure sale pursuant to the debtors' Loan Workout Plan, which was preliminary to a possible loan modification that never materialized due to the debtors' failure to fulfill certain other conditions:

"The one-form-of action and security-first rules do not apply under the circumstances here … [The debtors] voluntarily paid monthly payments during the Plan period in hopes of obtaining a loan modification after the [loan servicer and lender] reviewed their financial information and declaration of hardship. In exchange, [the loan servicer and lender] suspended further foreclosure proceedings for approximately six months. *We do not consider the payments a set-off manifesting an election to not foreclose pursuant to the one-form-of-action rule of section 726*." [*Nungaray v. Litton Loan Servicing, LP* (2011) 200 CA4th 1499, 1505-1506, 135 CR3d 442, 447-448 (emphasis added); see also *Mehta v. Wells Fargo Bank, N.A.* (SD CA 2010) 737 F.Supp.2d 1185, 1202 (applying Calif. law)—money paid by debtor pursuant to forbearance agreement was not a set-off and therefore not a basis for invoking CCP § 726's one-form-of-action and "security-first" rules (lender did not pursue debtor's assets or otherwise attempt to pursue debtor personally prior to foreclosure)]

(b) [6:554.6] **Distinguish—equitable setoff:** On the other hand, a setoff asserted in a *judicial* proceeding *is* an action within the meaning of CCP § 726. [*Security Pac. Nat'l Bank v. Wozab* (1990) 51 C3d 991, 999, 275 CR 201, 206, fn. 7; see *Birman v. Loeb* (1998) 64 CA4th 502, 509, 75 CR2d 294, 299]

Even so, asserting an equitable right of setoff does not violate § 726 so long as it is the *only* action brought by the creditor against the debtor. [*Birman v. Loeb*, supra, 64 CA4th at 509, 75 CR2d at 299]

But the equitable setoff may still be deemed the "functional equivalent" of a "deficiency judgment" and thus barred by the antideficiency laws if it is sought after a nonjudicial foreclosure; *see*¶ *6:561.2*.

(3) [6:555] **Prejudgment attachment:** Subject to CCP § 580b (no deficiency judgment on a purchase money loan, ¶ *6:563*) and CCP § 580d (no deficiency judgment after nonjudicial foreclosure, ¶ *6:570*), in an action to foreclose a mortgage or deed of trust on real property (or an estate for years therein), pursuit of any attachment remedy under CCP § 481.010 et

seq. "shall *not constitute an action* for the recovery of a debt" within the meaning of CCP § 726(a) "or a failure to comply with any other statutory or judicial requirement to proceed first against security." [CCP § 483.012 (emphasis added)]

Thus, a secured creditor's resort to prejudgment attachment in a foreclosure action will not bar the creditor from foreclosing against the security. [CCP § 483.012]

(a) [6:555.1] **Limited to judicial foreclosure actions:** CCP § 483.012 expressly limits its application to "an action to *foreclose a mortgage or deed of trust*." Thus, an attachment obtained *outside* the judicial foreclosure process apparently *does* constitute an "action" for CCP § 726 purposes. [*In re Prestige Ltd. Partnership-Concord* (9th Cir. 1999) 164 F3d 1214, 1215 (construing CCP § 483.012)—in guaranty action, creditor's attachment of guarantor's unpledged property waived its real property security interest]

(b) [6:555.2] **Comment:** Because of this limitation, CCP § 483.012 probably does *not* displace prior case law under which a lender was deemed to have violated the CCP § 726 one action rule by obtaining a prejudgment attachment order against the borrower's unpledged real property *before* pursuing an action to foreclose its security interest. [See *Shin v. Sup.Ct. (Korea First Bank)* (1994) 26 CA4th 542, 548-549, 31 CR2d 587, 591-592 (predating CCP § 483.012), *discussed at* ¶ *6:553.4*]

"Since an attachment of property other than trust property constitutes an election to forgo the remedy of enforcement of the security interest the result in *Shin* is correct." [See *Kirkpatrick v. Westamerica Bank* (1998) 65 CA4th 982, 990, 76 CR2d 876, 881 (postdating § 483.012 but not addressing the statute)]

(4) [6:556] **Authorized enforcement of assignment of rents/profits:** Pursuit of a remedy authorized by Civ.C. § 2938(c) to enforce an assignment of rents, issues and profits (*see* ¶ *6:433.2*) is *not* an "action" in violation of CCP § 726 and does not otherwise create a bar to an action against the security. [Civ.C. § 2938(e)(2) & (3)]

(a) [6:556.1] **Petitioning for receiver:** Thus, e.g., a lender-assignee does not violate CCP § 726 by petitioning for a court-appointed receiver to enforce the assignment (authorized by Civ.C. § 2938(c)(1)). "[T]he appointment of a receiver is not an action to *collect the debt*, but merely an action to protect and preserve the lender's security." [*Resolution Trust Corp. v. Bayside Developers* (ND CA 1993) 817 F.Supp. 822, 828, fn. 4 (emphasis in original), aff'd (9th Cir. 1994) 43 F3d 1230]

(b) [6:556.2] **Enforcing securing interest:** Enforcing the security interest in associated rents, issues or profits is not a lawsuit to enforce the primary debt which would allow the lender to execute against the debtor's general assets—i.e., the lender does not thereby obtain a personal money judgment in violation of the one action rule. [*Resolution Trust Corp. v. Bayside Developers* (9th Cir. 1994) 43 F3d 1230, 1240-1241]

Nor does the lender thereby violate the security first rule. The rents, issues and profits constitute *additional collateral*; thus, the lender has not collected from the debtor's noncollateral general assets before being paid with collateral (the secured real property). Moreover, there is no rule in California requiring the lender to look to its primary security first. [*Resolution Trust Corp. v. Bayside Developers*, supra, 43 F3d at 1241-1242—lender financing construction of townhouse development did not forfeit foreclosure right by first applying proceeds from receivership sale of completed units and model furniture to debt since they were part of lender's security]

(5) [6:557] **Erroneous claim to hazard insurance proceeds:** The lender's erroneous claim to proceeds of hazard insurance on the secured property and wrongful refusal to endorse the proceeds to the borrower is neither an "action" triggering a CCP § 726 election of remedies nor a violation of the § 726 security first rule. Simply resisting the borrower's efforts to take control of insurance proceeds does not constitute an attempt by the lender to set off the borrower's personal funds against the secured debt or otherwise to obtain the borrower's noncollateral general assets. Nor does it amount to an affirmative attempt to recover a debt or enforce a right. [*Ziello v. Sup.Ct. (First Fed'l Bank of Calif.)* (1995) 36 CA4th 321, 331, 42 CR2d 251, 257]

(6) [6:558] **Recourse to letter of credit:** By statute, there is *no* violation of the one action rule (or the security first rule) when a lender who holds both a deed of trust and a letter of credit as security for the obligation draws on, receives payment on, or makes a demand for payment under the letter of credit. Whether done *before or after* judicial or nonjudicial foreclosure of the deed of trust, the secured lender's action on the letter of credit is *not* an "action" within the meaning of CCP § 726(a) (nor is it a deficiency judgment within the meaning of CCP §§ 580a, 580b, 580d or 726(b), or otherwise in violation of CCP §§ 580a, 580b, 580d or 726). [CCP § 580.5(b); *Western Sec. Bank, N.A. v. Sup.Ct. (Beverly Hills Business Bank)* (1997) 15 C4th 232, 238, 252-253, 62 CR2d 243, 246, 256]

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(a) [6:558.1] **Limitation—certain letters of credit not enforceable:** Though outside the scope of the one action and security first rules, certain letters of credit given in a loan transaction are *not enforceable*:

No party may enforce a letter of credit given in a loan transaction in which (i) the customer is a natural person; (ii) the letter of credit is issued to the beneficiary to *avoid a default* of the existing loan; *and* (iii) the existing loan is *secured by a purchase money deed of trust or purchase money mortgage* on *one-to-four unit residential real property* occupied in whole or in part by the customer (or intended to be so occupied) at the time the existing loan was made. [CCP § 580.7]

[6:558.2 - 6:558.4] ***Reserved.***

(7) [6:558.5] **Court proceeding to enforce lender's right of hazardous materials inspection:** Under specified circumstances, a secured lender has the statutory right to enter and inspect the real property security for suspected hazardous substance contamination (¶ *6:629 ff.*); and, if necessary, may commence an action to enforce that right (¶ *6:633*). The lender's commencement of such litigation is *not* an "action" within the meaning of the CCP § 726(a) one action rule. [Civ.C. § 2929.5(d); CCP § 564(d); see *Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1248, 44 CR2d 352, 366, fn. 10]

(8) [6:558.6] **Secured creditor's receipt of cash collateral protection payments in bankruptcy:** A secured creditor does not violate CCP § 726 by accepting *court-ordered* cash collateral adequate protection payments in a Chapter 11 bankruptcy (see 11 USC §§ 361, 363). Section 726 is triggered by a *creditor's* action, not a debtor's action; and by passively accepting the cash collateral payments, the creditor has neither initiated an action to recover its secured debt, obtained a personal money judgment against the debtor, nor attempted to collect its debt from the debtor's noncollateral general assets. Consequently, this scenario does not result in a waiver of the creditor's real property security. [*In re Sunnymead Shopping Center Co.* (9th Cir. BAP 1995) 178 BR 809, 817]

[6:558.7 - 6:558.9] ***Reserved.***

d. [6:558.10] **Waiver by guarantor:** The benefits of CCP § 726*cannot* be waived by the principal obligor (¶ *6:562*) but *can* be waived by a *guarantor* on the obligation (¶ *6:598 ff.*).

5. [6:559] **Rights of Sold-Out Junior Lienholder:** A sold-out junior lienholder is free to sue the obligor directly after the security has been extinguished by foreclosure of the senior lien (i.e., where a senior foreclosure sale "wipes out" all junior liens) without regard to the "one action rule" (CCP § 726; ¶ 6:551), the nonjudicial sale deficiency prohibition (CCP § 580d; ¶ 6:570) or the "fair value" deficiency limitation (CCP §§ 580a, 726; ¶ 6:577). [See *Black Sky Capital, LLC v. Cobb* (2019) 7 C5th 156, 160-161, 246 CR3d 583, 587; *Bank of America Nat'l Trust & Sav. Ass'n v. Graves* (1996) 51 CA4th 607, 613, 59 CR2d 288, 292; *CadlerockJoint Venture, L.P. v. Lobel* (2012) 206 CA4th 1531, 1546-1547, 143 CR3d 96, 107-108]

Rationale: The purpose of CCP § 580d is to ensure parity between nonjudicial and judicial remedies and to prevent double recovery by the creditor. [*Black Sky Capital, LLC v. Cobb* (2019) 7 C5th 156, 160-161, 246 CR3d 583, 586-587] Also, the junior lienholder's right to recover should not be controlled "by the whim of the senior." [*Black Sky Capital, LLC v. Cobb*, supra, 7 C5th at 161, 246 CR3d at 587; see also *Roseleaf Corp. v. Chierighino* (1963) 59 C2d 35, 44, 27 CR 873, 878; *National Enterprises, Inc. v. Woods* (2001) 94 CA4th 1217, 1234, 115 CR2d 37, 49]

a. [6:559.1] **Notwithstanding junior's aborted nonjudicial foreclosure:** The result is the same even if the sold-out junior lienholder commenced foreclosure proceedings by recording a notice of default and notice of trustee's sale before the senior commenced its foreclosure proceedings, but postponed its foreclosure sale to allow the senior to complete its foreclosure sale first. Mere *commencement* of nonjudicial foreclosure proceedings is not an election of remedies (¶ *6:553.10*). [*Bank of America Nat'l Trust & Sav. Ass'n v. Graves* (1996) 51 CA4th 607, 614-615, 59 CR2d 288, 293]

b. [6:559.2] ***Single lender holds senior and junior liens:*** The sold-out junior lienholder exception (¶ 6:559, 6:570.1) may apply even where a *single lender* holds both the junior and senior liens. This is so provided the lender did *not* structure what was functionally a single loan into two separate notes (i.e., "intentional loan-splitting") in order to increase its recovery. "Where, as here, there is no allegation of evasive loan splitting or recovery in excess of what junior lienholder would be able to recover, we see no reason to depart from a straightforward reading of section 580d." [See *Black Sky Capital, LLC v. Cobb* (2019) 7 C5th 156, 164-165, 246 CR3d 583, 590-591 (disapproving prior inconsistent authority)—because no sale occurred under trust deed securing junior note, CCP § 580d did not preclude single lender holding both senior and junior liens from pursuing deficiency judgment on junior note]

c. [6:559.3] **Lender assigns/sells liens to separate creditors:** Where a single lender holding both the senior and junior liens *sells or assigns* the liens to independent parties, the buyer/assignee of the junior lien ordinarily is protected by the sold-out junior lienholder exception: i.e., CCP § 726 does *not* prohibit the junior lienholder from bringing a subsequent action, *provided* there is no evidence of a scheme between the lienholders to circumvent the "one action" rule. [*National Enterprises, Inc. v. Woods* (2001) 94 CA4th 1217, 1221, 115 CR2d 37, 38—treating two separate debts once held by single creditor as one debt is inconsistent with plain language and underlying purpose of § 726, and would have adverse effect on transfers to secondary mortgage market]

d. [6:559.4] **Limitation—junior "purchase-money loans":** The sold-out junior lienholder exception does not apply if the junior loan was a "purchase money loan" (¶ 6:563). Indeed, "[t]here is no question that a junior lienholder whose loan is used to purchase a parcel of property and secured by that property has no legal right to *enforce* its debt against the borrower personally if the sale price at a foreclosure on that property initiated by any other lienholder who lent money for the purchase price is insufficient to pay off the debt." [See *Alborzian v. JPMorgan Chase Bank, N.A.* (2015) 235 CA4th 29, 35, 185 CR3d 84, 89 (emphasis added) (*discussed further at ¶ 6:563 ff.*)]

e. [6:559.5] **Limitation—prior nonjudicial foreclosure of one of several secured properties on same debt:** Nor does the sold-out junior lienholder exception apply where a single debt is secured by several pieces of property and the creditor has proceeded *nonjudicially* against its other security. By electing to collect the debt through nonjudicial foreclosure, the creditor has chosen to forgo *all judicial remedies*. [*Marriage of Oropallo* (1998) 68 CA4th 997, 1005-1006, 80 CR2d 669, 674-675—after nonjudicial foreclosure on several properties securing single debt, creditor could not invoke "sold out junior lienholder" exception and proceed to sue obligor directly]

f. [6:559.6] **Effect in bankruptcy:** Sold-out junior trust deed holders who sue on the debt *step outside of the foreclosure process*. Thus, a subsequent judgment on the debt obtained by a sold-out junior lienholder is *not* a "judgment arising out of a mortgage foreclosure" for purposes of 11 USC § 522(f)(2)(C) (excepting judicial liens arising from foreclosure from usual homestead exemption). [*In re Been* (9th Cir. 1998) 153 F3d 1034, 1036]

g. [6:559.7] **Compare—"revival" of extinguished junior liens:** A junior lien extinguished by the foreclosure of a senior lien may *reattach* to the property, as a "function of equity," if the original owner (debtor) reacquires the property. Under such circumstances, the "revived" junior lien effectively becomes an "*equitable encumbrance*," subordinate to the new deed of trust given to reacquire the property and/or any other simultaneously-created and recorded *legal* liens. [*DMC, Inc. v. Downey Sav. & Loan Ass'n* (2002) 99 CA4th 190, 199-200, 120 CR2d 761, 768]

Thus, e.g., when an original owner repurchases property after a trustee's sale and thereby revives a junior deed of trust, the junior trust deed remains second to a purchase-money deed of trust that replaced the original senior lien. [*DMC, Inc. v. Downey Sav. & Loan Ass'n*, supra, 99 CA4th at 199, 120 CR2d at 768—"After agreeing to take a junior lien on the property, it would defy reason and equity to elevate the junior lien above its bargained-for position"]

6. Antideficiency Laws

a. [6:560] **In general:** The "one action" and "security first" rules discussed at ¶ 6:550 ff. are features of California's broader "antideficiency laws." The antideficiency laws (CCP §§ 580a, 580b, 580d and 726) are detailed and quite complex; and, in many contexts, their application is still evolving.

The purposes behind the antideficiency provisions are to *prevent* (1) a multiplicity of actions, (2) an overvaluation of the security, (3) aggravation of an economic recession that would likely result if debtors lost their property and were also burdened with personal liability, and (4) creditors from making an unreasonably low bid at the foreclosure sale, acquiring the security below its value, and then recovering a personal judgment against the debtor. [*Thoryk v. San Diego Gas & Elec. Co.* (2014) 225 CA4th 386, 398, 170 CR3d 309, 316; *California Bank & Trust v. Lawlor* (2013) 222 CA4th 625, 632, 166 CR3d 38, 43; see also *In re Prestige Ltd. Partnership-Concord* (9th Cir. 2000) 234 F3d 1108, 1115 (applying Calif. law)]

(Only a small portion of California's antideficiency laws affect purchase and sale transactions. The sections at ¶ 6:561 ff. address those provisions.)

➪ [6:560.1] ***TACTICAL CONSIDERATIONS:*** The antideficiency laws raise differing concerns for buyers and sellers:

- Sellers should be concerned with the antideficiency laws only if (i) the transaction will involve seller financing; or (ii) the buyer will be taking over the seller's existing financing (*¶ 6:310 ff.*).

- On the other hand, *buyers* should always be concerned whether their particular kind of financing will be subject to antideficiency protection because the result directly affects the extent to which they can be exposed to *personal liability* on the loan obligation above and beyond the security given.

(1) [6:561] **No deficiency judgment in certain circumstances:** In certain circumstances, foreclosure of the security is a lender's *exclusive* remedy—i.e., despite properly pursuing foreclosure as the first remedy ("security first" rule), *no deficiency judgment* can be obtained:

- *Purchase money loan antideficiency rule:*CCP § 580b bars a deficiency judgment in purchase money loan transactions (*see¶ 6:563*).

- *Nonjudicial foreclosure antideficiency rule:*CCP § 580d bars a deficiency judgment after nonjudicial foreclosure (*see¶ 6:570 ff.*).

- *Short sale transaction antideficiency rule:*CCP § 580e bars a deficiency judgment in short sale transactions involving residential one-to-four unit properties (*see¶ 6:571 ff.*).

(a) [6:561.1] **"Deficiency judgment":** A "deficiency judgment" is a *personal money judgment* against the debtor for the difference between the price realized for the secured property at a foreclosure sale and the outstanding debt (in some cases, reduced by the "fair value" limitation, *see¶ 6:577*). [CCP §§ 580a, 726(b); *Cornelison v. Kornbluth* (1975) 15 C3d 590, 603, 125 CR 557, 566; see *Dreyfuss v. Union Bank of Calif.* (2000) 24 C4th 400, 407, 101 CR2d 29, 34]

1) [6:561.2] **"Functional equivalent" of deficiency judgment also proscribed:** Certain actions by a secured creditor do not literally seek to impose personal liability against the debtor and thus do not seek a "deficiency judgment" per se.

Nonetheless, such actions will be barred as if they were a proscribed "deficiency judgment" if they violate the policy considerations underlying the antideficiency judgment statutes and therefore amount to the "functional equivalent" of a deficiency judgment. [See *Birman v. Loeb* (1998) 64 CA4th 502, 511, 75 CR2d 294, 300, and cases cited therein]

For example, allowing the creditor an "equitable setoff" of its independent obligation to the debtor against the debtor's deficiency liability to the creditor arising from an inadequately secured real property purchase money loan would be the functional equivalent of a proscribed deficiency judgment … because it would contravene the economic policies underlying the CCP § 580b antideficiency bar. [*Birman v. Loeb*, supra, 64 CA4th at 513-514, 75 CR2d at 301-302; see also *Thoryk v. San Diego Gas & Elec. Co.* (2014) 225 CA4th 386, 405, 170 CR3d 309, 322—lender's postforeclosure lien on borrower's claim against third party tortfeasors violated antideficiency laws because it was "measured by, and interrelated to, the remaining deficiency on the note, but [the] loan documents did not create additional available security for the same obligation"; *and further discussion at¶ 6:567 ff.*]

2) [6:561.3] **Serial foreclosures not deficiency judgments:** A lender's resort to any and all *security* on a debt is not an attempt to secure a personal judgment against the debtor and does not implicate the antideficiency provisions. I.e., no deficiency judgment is involved when the lender conducts a nonjudicial foreclosure of one property and then proceeds with serial foreclosure sales of the remaining properties securing the same defaulted loan. [*Dreyfuss v. Union Bank of Calif.* (2000) 24 C4th 400, 407-409, 101 CR2d 29, 34-35; *see also¶ 6:561.15 ff. & 6:570.2*]

3) [6:561.4] **Attorney fees award to lender in action challenging foreclosure not a deficiency judgment:** A lender's prevailing party attorney fees award (pursuant to provision in the loan documents) in an action successfully challenging a nonjudicial foreclosure sale is not a deficiency judgment against the borrower.

The award "is neither measured by, nor interrelated to, a deficiency" on the loan. [*Jones v. Union Bank of Calif.* (2005) 127 CA4th 542, 546-547, 25 CR3d 783, 787-788—immaterial whether lender's action seeks to enjoin foreclosure or set aside completed trustee's sale; compare *Thoryk v. San Diego Gas & Elec. Co.* (2014) 225 CA4th 386, 404, 170 CR3d 309, 321—lender's attorney fee claim pursuant to note and junior deed of trust unenforceable following foreclosure because debtor-creditor relationship was extinguished and no additional collateral beyond real property security was available]

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(b) [6:561.5] **Compare—tort actions:** The antideficiency statutes apply to actions *on the note* (i.e., a contract suit to recover the difference between the secured obligation and the value of the security realized, or that could be realized, in a foreclosure sale). Lenders are not precluded by the antideficiency statutes from pursuing *tort actions* against the debtor for damages resulting from the debtor's tortious conduct (e.g., action for waste, conversion, fraud, etc.); this is so even though the amount of tort damages received may be similar to what would be recovered in an action on the note. [See *Evans v. California Trailer Court, Inc.* (1994) 28 CA4th 540, 552-553, 33 CR2d 646, 652 (disapproved on other grounds by *Black Sky Capital v. Cobb* (2019) 7 C5th 156, 165, 246 CR3d 583, 591)—lender's postforeclosure tort claims alleging impairment of security by debtor's commission of "bad faith" waste, conversion and fraud not barred by antideficiency rules; *Webber v. Inland Empire Investments, Inc.* (1999) 74 CA4th 884, 903, 88 CR2d 594, 606; compare *Lawler v. Jacobs* (2000) 83 CA4th 723, 737-738, 100 CR2d 52, 62-63—fraud action for nonperformance of invalid waiver of CCP § 580b antideficiency provision (¶ *6:568*) rejected]

1) [6:561.5a] **"Bad faith waste":** The antideficiency statutes do not protect trustors/debtors from liability for "bad faith waste" resulting from their failure to properly maintain the secured property. [*Cornelison v. Kornbluth* (1975) 15 C3d 590, 603-604, 125 CR 557, 566-567—"bad faith waste" includes reckless, intentional or malicious despoiling of property (not neglect due to owner's financial inability to properly maintain property); see also *Fait v. New Faze Develop., Inc.* (2012) 207 CA4th 284, 294, 143 CR3d 382, 388—any waste not committed solely or primarily because of economic pressures or market depression qualifies as "bad faith" waste (¶ *6:561.5d*); *Nippon Credit Bank, Ltd. v. 1333 North Calif. Boulevard* (2001) 86 CA4th 486, 494-496, 103 CR2d 421, 425-427—failure to pay property taxes may be deemed "bad faith waste" (¶ *6:535.2*)]

a) [6:561.5b] **Elements:** The following elements may support an action for "bad faith waste":

— Creditor/beneficiary has a lien encumbering the subject property;

— Trustor/debtor has or had possession of the property; and

— Waste was committed on the property in *bad faith*, impairing its value. [See *Cornelison v. Kornbluth* (1975) 15 C3d 590, 597-598, 125 CR 557, 562-563 & fns. 2, 3]

b) [6:561.5c] **Measure of damages:** The measure of damages for bad faith waste is the amount of the security's impairment—i.e., "the amount by which the value of the security is less than the outstanding indebtedness and is thereby rendered inadequate." [*Cornelison v. Kornbluth* (1975) 15 C3d 590, 606, 125 CR 557, 568]

c) [6:561.5d] **Defenses:** Defenses to a bad faith waste action include financial difficulties, depressed conditions in the general real estate market and full credit bids at foreclosure proceedings (¶ *6:561.7*). [See *In re Mills* (9th Cir. 1988) 841 F2d 902, 905 (financial difficulties defense); *Hickman v. Mulder* (1976) 58 CA3d 900, 909, 130 CR 304, 310 (decline in real estate values defense); and *Cornelison v. Kornbluth* (1975) 15 C3d 590, 606-608, 125 CR 557, 568-570 (full credit bid defense; *see*¶ *6:535.3 ff., 6:561.7*)]

Compare: It is no defense to an action for waste to simply claim that a building's demolition was part of a good faith attempt to improve the property. "The impairment of security that results from the destruction of the building is actionable waste, notwithstanding the antideficiency statutes, unless the destruction itself was somehow caused by the economic pressures of a depressed economy." [*Fait v. New Faze Develop., Inc.* (2012) 207 CA4th 284, 289, 143 CR3d 382, 384]

2) [6:561.6] **Third party torts distinguished:** The borrower does not lose antideficiency protection, and can raise the antideficiency rule as a defense, when the tortious conduct in issue was perpetrated by a *third party.* [See *Webber v. Inland Empire Investments, Inc.* (1999) 74 CA4th 884, 916-917, 88 CR2d 594, 615-616 (involving "sham" foreclosure allegedly orchestrated by borrower that wiped out plaintiff's purchase money lien)—borrower entitled to raise antideficiency rule as defense since court found third party, not borrower, engaged in the tortious conduct; compare *Thoryk v. San Diego Gas & Elec. Co.* (2014) 225 CA4th 386, 399, 170 CR3d 309, 317—lender's separate tort action against third party electric company for impairment of security (fire damage) fell outside scope of antideficiency law, making it an "appropriate means" by which lender could pursue "its own remedies"]

3) [6:561.7] **Bar under full credit bid rule distinguished:** Notwithstanding inapplicability of the antideficiency rule to tort claims, lenders who make a *full credit bid* (¶ *6:535.1*) at a *nonjudicial* foreclosure sale generally may *not* pursue

tort claims against obligors or third parties. Having obtained property with a market value equal to the value of the debt and the expenses of collection, the lender cannot thereafter complain of being damaged. *See discussion at¶ 6:535.3 ff.*

[6:561.8 - 6:561.9] ***Reserved.***

(c) [6:561.10] **Compare—lender's right to recover amount mistakenly omitted from payoff demand statement:** An obligor is entitled to rely on the lender's "payoff demand statement" as establishing the full amount necessary to satisfy the secured obligation. I.e., payment of the specified amount gives the obligor-trustor a right to release of the lien and reconveyance of the trust deed (¶ *6:406*). [Civ.C. §§ 2941(b)(1), 2943(d)(1)]

If the statement mistakenly understates the amount due on the secured loan, the balance continues to be recoverable by the lender as an unsecured (personal) obligation (up to the value of the property). This is not a violation of the antideficiency statutes. [Civ.C. § 2943(d)(3); *Ghirardo v. Antonioli* (1996) 14 C4th 39, 43, 57 CR2d 687, 689 (same where payoff demand statement and reconveyance predated enactment of § 2943(d)(3))]

Rationale

• [6:561.11] The lender's remedy is in the nature of *equitable relief on an unjust enrichment* theory, to prevent the obligor from receiving a windfall and escaping the obligation of satisfying a loan in full when the deed of trust is retired in error. [*Ghirardo v. Antonioli* (1996) 14 C4th 39, 43, 57 CR2d 687, 694]

• [6:561.12] Moreover, allowing the lender to pursue the obligor for the balance does "not contradict the policy of requiring the creditor to rely upon the property to secure the debt … because any unjust enrichment recovery could not exceed the property value." In other words, because the lender's recovery from the obligor is limited to the amount of the debt covered by the value of the property, it is *not the same as a deficiency* judgment. [*Ghirardo v. Antonioli* (1996) 14 C4th 39, 53, 57 CR2d 687, 695]

Cross-refer: For further discussion of payoff demand statements, *see¶ 4:304.1 ff.*

[6:561.13 - 6:561.14] ***Reserved.***

(d) [6:561.15] **Compare—recourse against multiple security instruments:** A lender's foreclosure under a deed of trust does not preclude subsequent recourse under an assignment of rents or other security instrument given to collateralize the same debt. [*Hodges v. Mark* (1996) 49 CA4th 651, 656, 56 CR2d 700, 703; *see also¶ 6:568.6*]

On the other hand, when the antideficiency laws apply to the transaction, a lender holding multiple security instruments on the same obligation (e.g., securing the payment of a combined purchase price for real and personal property) cannot obtain a *personal money judgment* after foreclosing under one of the security instruments. [*Sherwood-Trimble Med. Group v. 10001 Venice Blvd. Partnership* (1999) 75 CA4th 872, 877, 89 CR2d 533, 536; *and see further discussion at¶ 6:564.15 ff.*]

1) [6:561.16] **"Mixed collateral":** Where a single debt is secured by both real and *personal* property, special "mixed collateral" rules apply. [*Florio v. Lau* (1998) 68 CA4th 637, 644-645, 80 CR2d 409, 413-414]

Cases allowing nonjudicially foreclosing lenders (¶ *6:561.18*) to resort to the "mixed" or "additional" security involve certain types of valuable property mentioned or incorporated in the mortgage documents. [See *Thoryk v. San Diego Gas & Elec. Co.* (2014) 225 CA4th 386, 405, 170 CR3d 309, 321 (finding general references in trust deed to personal property, etc. "too general to amount to sufficiently specific designations of existing 'additional' security")]

a) [6:561.17] **Purpose:** The "Mixed Collateral Statute" (Comm'l C. § 9604) is intended to minimize the burdens on creditors secured by personal property when the creditor has also accepted security interests in real property. [*Florio v. Lau* (1998) 68 CA4th 637, 641, 80 CR2d 409, 411]

b) [6:561.18] **Foreclosure options:** Under the Mixed Collateral Statute, secured creditors may sell closely-related real and personal property as a single unit in a "unified sale." In such cases, the foreclosure is governed entirely by statutes applicable to real property collateral (e.g., CCP §§ 726, 580a, 580b & 580d). [*Florio v. Lau* (1998) 68 CA4th 637, 642, 80 CR2d 409, 411-412; see *Sherwood-Trimble Med. Group v. 10001 Venice Blvd. Partnership* (1999) 75 CA4th 872, 877, 89 CR2d 533, 535-536—"[m]erely by acquiring the real property security interest, the

creditor subjects himself and the single obligation secured by both real and personal property to the full panoply of one-action, antideficiency, fair value, and reinstatement provisions" of Calif. statutes (internal quotes and original emphasis omitted)]

Alternatively, the creditor may proceed separately against the real and personal property collateral. In such cases, the real property rules are applied only to the secured real property; the more flexible personal property foreclosure rules are applied to the personal property. [See *Oxford Street Properties, LLC v. Rehabilitation Assocs., LLC* (2012) 206 CA4th 296, 304, 141 CR3d 704, 709, fn. 4—CCP § 726 (one action rule) does not apply to personal property component of mixed collateral where personal property foreclosed in *nonunified* sale; *Florio v. Lau*, supra, 68 CA4th at 642-643, 80 CR2d at 412—CCP § 726 3-month limit on deficiency judgments not applicable to personal property; *see also*¶ *6:576.1*]

c) [6:561.19] **"Fair value" limitation in mixed collateral cases:***See*¶ *6:577.2.*

(2) Waiver limitations

(a) [6:562] **Antideficiency protections *nonwaivable by borrower:*** The benefits of the antideficiency judgment legislation *may not be waived by the debtor* at the time the loan is made or renewed. Such a waiver "shall be void and of no effect." [Civ.C. § 2953—applicable to CCP §§ 580a & 726; *Valinda Builders, Inc. v. Bissner* (1964) 230 CA2d 106, 112, 40 CR 735, 738-739—debtor's waiver agreement "contrary to public policy, void and ineffectual for any purpose"; compare *Nungaray v. Litton Loan Servicing, LP* (2011) 200 CA4th 1499, 1506, 135 CR3d 442, 448—Civ.C. § 2953 does *not* preclude agreements between borrowers and lenders regarding forbearance of foreclosure to negotiate loan modifications]

1) [6:562.1] **Analogous "purchase money" waiver limitation:** Although CCP § 580b ("purchase money" antideficiency statute) is not expressly included within the ambit of Civ.C. § 2953 (¶ *6:562*), an analogous protection has been fashioned by case law. [*DeBerard Properties, Ltd. v. Lim* (1999) 20 C4th 659, 670-671, 85 CR2d 292, 299; *California Bank & Trust v. Lawlor* (2013) 222 CA4th 625, 632, 166 CR3d 38, 43; *see*¶ *6:568 ff.*]

2) [6:562.2] **Distinguish—waiver by choice of law provision:** A choice of law provision in the note or trust deed may have the effect of a proscribed waiver when the chosen state does not have comparable antideficiency judgment laws. Nonetheless, if the choice of law provision is otherwise enforceable (*see*¶ *6:273*), the debtor properly may be subjected to a deficiency judgment under the chosen state's law … without regard to California's proscription against advance waivers. [See *Guardian Sav. & Loan Ass'n v. MD Assocs.* (1998) 64 CA4th 309, 323, 75 CR2d 151, 160 (enforcing promissory note provision adopting Texas law which, unlike Calif., did not prohibit deficiency judgment after foreclosure of purchase money security interest)]

[6:562.3 - 6:562.4] ***Reserved.***

(b) [6:562.5] **Guarantor waivers:** Unlike the principal debtor, a *guarantor* on the obligation *can* waive antideficiency protection; *see*¶ *6:598 ff.*

1) [6:562.6] **Compare—purported "guaranty" from borrower:** Lenders sometimes obtain a separate "guaranty" from the borrower in the *misguided belief* the guaranty will supersede nonwaivability of the antideficiency laws. A purported guaranty made by a *principal obligor* of a secured obligation is *unenforceable* … because a principal obligor cannot guarantee its own debt. [See *Valinda Builders, Inc. v. Bissner* (1964) 230 CA2d 106, 111, 40 CR 735, 738; and discussion of "sham" guaranties at ¶ *6:595 ff.*]

(c) [6:562.7] **Indemnitor waivers:** Like guarantors, *indemnitors* can waive antideficiency protections unless the indemnitor is "substantially the same" as the principal debtor. *See*¶ *6:605.*

b. [6:563] **"Purchase money loan" antideficiency rule (CCP § 580b):** Except as otherwise provided by statute (¶ *6:563.2 ff.*), no deficiency is owed by or may be collected from, and no deficiency judgment can be obtained against, the principal obligor after *any* sale (whether judicial, nonjudicial or short) under a "purchase money" loan. [CCP § 580b(a); *Coker v. JPMorgan Chase Bank, N.A.* (2016) 62 C4th 667, 676, 197 CR3d 131, 137; see also *Alborzian v. JPMorgan Chase Bank, N.A.* (2015) 235 CA4th 29, 35, 185 CR3d 84, 89—while CCP § 580b prohibits *any* collection of post-12/31/12 legally *unenforceable* debts, it does not absolutely bar lienholders from trying to get borrowers to voluntarily pay off pre-1/1/13

loan balances (¶ 6:563.3); *Scalese v. Wong* (2000) 84 CA4th 863, 868, 101 CR2d 40, 42—§ 580b protection applies to *any* purchase loan, even if for five-unit apartment building]

The purpose of § 580b is to place the risk of inadequate security on the purchase money lender/seller. The lender is thus discouraged from overvaluing the security. Similarly, if inadequacy of the security results from general market decline, the statute prevents aggravation of the downturn that would result if defaulting purchasers were burdened with large personal liability. Section 580b compels the purchase money lender to assume the risk that the security is inadequate. [See *Coker v. JPMorgan Chase Bank, N.A.*, supra, 62 C4th at 674, 197 CR3d at 135; *Cornelison v. Kornbluth* (1975) 15 C3d 590, 601-602, 125 CR 557, 565; see also *Alborzian v. JPMorgan Chase Bank, N.A.*, supra, 235 CA4th at 36, 185 CR3d at 90]

➪ [6:563.1] ***PRACTICE POINTER:*** Borrower's counsel should approach this area with caution. It is not always a simple task to determine whether CCP § 580b applies. Failure to raise § 580b as an affirmative defense could result in malpractice liability. [See *Crookall v. Davis, Punelli, Keathley & Willard* (1998) 65 CA4th 1048, 1067-1068, 77 CR2d 250, 262]

(1) [6:563.2] **Applicable to post-12/31/12 loans, refinances and other credit transactions:** The CCP § 580b antideficiency rule applies to post-12/31/12 loans, refinances and other credit transactions used to refinance purchase money loans, as defined, as well as subsequent refinances of purchase money loans. [See CCP § 580b(b)]

Lender/creditor advances of new principal that are not applied to an obligation owed or to be owed under the purchase money loan, and to fees, costs or other related refinance expenses, are exceptions to the above rule. [See CCP § 580b(b)]

(a) [6:563.3] **Compare—attempts to collect pre-1/1/13 legally unenforceable debts; unlawful debt collection practices apply:** For loans executed before 1/1/13, the lienholder is not absolutely barred from trying to get a borrower to pay off the loan balance voluntarily. Nonetheless, the lienholder remains liable under any other law it violates in the course of doing so. For example, the lienholder may run afoul of the federal Fair Debt Collection Practices Act (15 USC § 1692 et seq.), the Rosenthal Fair Debt Collection Practices Act (Civ.C. § 1788 et seq.) and the Unfair Competition Law (Bus. & Prof.C. § 17200 et seq.). [See *Alborzian v. JPMorgan Chase Bank, N.A.* (2015) 235 CA4th 29, 33-36, 185 CR3d 84, 87-90—if sold-out junior lienholder's collection efforts inaccurately implied its debt was still enforceable following foreclosure, borrower could sue lienholder under federal FDCPA, and lienholder or its debt collector under state FDCPA and UCL]

Cross-refer: For a detailed treatment of the federal and state FDCPAs, see Ahart, *Cal. Prac. Guide: Enforcing Judgments & Debts* (TRG), Ch. 2.

(2) [6:563.4] **Inapplicable to guarantors, pledgors or other sureties:** The liability that guarantors, pledgors or other sureties may have with respect to deficiencies is unaffected by CCP § 580b. [See CCP § 580b(c); *and ¶ 6:568.5 & 6:598 ff.*]

(3) [6:563.5] **Obligations constituting "purchase money" loans:** The facts and circumstances existing when the debt is created determine whether it is a "purchase money" loan. Thus, once determined to be a "purchase money" loan, the obligation ordinarily retains that character after subsequent transactions (*but see ¶ 6:568.3*). [*DMC, Inc. v. Downey Sav. & Loan Ass'n* (2002) 99 CA4th 190, 194, 120 CR2d 761, 764-765 (*see ¶ 6:565.1*)]

There are two kinds of purchase money loans subject to CCP § 580b antideficiency protection:

(a) [6:564] **Seller financing:** A *seller-financed* loan for *any kind* of real property (whether commercial or residential) is a "purchase money" loan protected by CCP § 580b. [CCP § 580b; see *Enloe v. Kelso* (2013) 217 CA4th 877, 881, 158 CR3d 881, 884 (noting transaction's timing does not change its character)—trust deed given to sellers *after escrow closed* to secure part of purchase price deemed § 580b purchase money obligation; see also *Jones v. Wagner* (2001) 90 CA4th 466, 480, 108 CR2d 669, 680—promissory note secured by trust deed *not*§ 580b purchase money obligation since note given to *partner* with whom property purchased rather than seller of property]

A secured loan on *commercial* property (which includes residential property consisting of more than four units; *see¶ 6:565*) can only be a "purchase money" transaction if it is seller financed. If the lender is *a third party*—i.e., essentially a "stranger" to the transaction—§ 580b, by its terms, does not apply. [*Conley v. Matthes* (1997) 56 CA4th 1453, 1462, 66 CR2d 518, 524]

1) [6:564.1] **Determining "seller" status:** Occasionally, there may be a threshold issue whether the lender is in fact a "seller" for purposes of CCP § 580b or, instead, a third party "stranger" to the transaction.

a) [6:564.2] **Liberal approach:** Courts generally interpret the term "seller" (or "vendor") broadly when doing so will further the purposes of CCP § 580b. Thus, a "seller" under § 580b "need not have virtual identity with the actual seller of the property." [*Conley v. Matthes* (1997) 56 CA4th 1453, 1462, 66 CR2d 518, 524; see also

Sherwood-Trimble Med. Group v. 10001 Venice Blvd. Partnership (1999) 75 CA4th 872, 876, 89 CR2d 533, 535—personal property seller in combined real and personal property purchase money sale transaction deemed "vendor" subject to § 580b]

b) [6:564.3] **Relevant factors:** The "critical factors" in determining the lienholder's status as a "seller" are the lienholder's *participation in the sale* and whether the financing they provided was *necessary to consummation of the sale*. [*Conley v. Matthes* (1997) 56 CA4th 1453, 1462, 66 CR2d 518, 524]

c) [6:564.4] **Application:** Applying the approach set forth at ¶ 6:564.2 ff., "vendor" status triggering CCP § 580b protection was found where:

• [6:564.5] An original purchase money loan was refinanced to facilitate a sale of the secured property, and the first trust deed holder in the refinancing then took back a second trust deed. Although not the legal owner of the property at the time, the lienholder was a "vendor" for CCP § 580b purposes because his participation and financing were necessary to the sale. [*Shepherd v. Robinson* (1981) 128 CA3d 615, 623, 180 CR 342, 345 (disapproved on other grounds by *DeBerard Properties, Ltd. v. Lim* (1999) 20 C4th 659, 671, 85 CR2d 292, 299-300)]

• [6:564.6] A co-owner seller assisted the buyer/borrower in obtaining third party financing for the first trust deeds on two properties, and then loaned the buyer $80,000, taking back a second trust deed on the first property, so that the buyer could complete the purchase of the second property. The co-owner seller's "nexus" to the transaction precluded a finding he was not a "vendor" for CCP § 580b purposes. "[T]he only reasonable inference we can draw from [seller's] loan of $80,000 is that [seller] did intend to finance the purchase of the property. Therefore, [he] is a vendor." [*Conley v. Matthes* (1997) 56 CA4th 1453, 1462, 66 CR2d 518, 524]

• [6:564.7] A settlement agreement between the buyers and seller of real property that merely modified the terms of the buyer's promissory note secured by a second trust deed in favor of the seller did not render the antideficiency statute inapplicable when the buyers defaulted on the note and the seller sued to enforce the settlement agreement. This was so even though the underlying security had become valueless after a sale under the senior trust deed.

> "Section 580b applies to the Promissory Note because [the seller] retained an interest in the property being sold with the ability to foreclose on it upon nonpayment by the [buyers]—albeit with lower priority than the first deed of trust. Because the property being purchased was used as security, this clearly falls within the definition of a 'deed of trust … given to the vendor to secure payment of the balance of the purchase price' to which section 580b applies … Because the Settlement Agreement was an explicit modification of obligations already owed under the Promissory Note and because of the policy reasons for interpreting section 580b broadly, [seller's] remedy is limited to foreclosure of the Promissory Note's security. As the security has been exhausted for the foreclosure of the senior lien, [seller] has no further remedy against the [buyers] …" [See *Weinstein v. Rocha* (2012) 208 CA4th 92, 97-99, 145 CR3d 93, 96-97]

[6:564.8] A broker who accepted a note secured by a second deed of trust as payment of his commission "intended to and did partially finance the purchase," subjecting him to the CCP § 580b antideficiency rule. [*Bargioni v. Hill* (1963) 59 C2d 121, 123-124, 28 CR 321, 322]

[6:564.9 - 6:564.14] ***Reserved.***

2) [6:564.15] **Application to mixed collateral sellers:** Whenever a deed of trust is given to the seller to secure payment of the real property purchase price, the transaction is a "purchase money" loan subject to CCP § 580b*even though* the seller *also* takes back a *personal property security interest* to secure the purchase of personal property sold with the real property *as part of the same obligation*. [*Sherwood-Trimble Med. Group v. 10001 Venice Blvd. Partnership* (1999) 75 CA4th 872, 878-879, 89 CR2d 533, 536-537]

a) [6:564.16] **Separate real property and personal property sellers given single (combined) note:** The purchase money antideficiency rule even applied where the real property and personal property sellers were different individuals, but both the real property and personal property (a medical practice) were sold collectively as a unit and a *single promissory note* (secured by a deed of trust on the real property and a personal property security agreement) was given to the sellers. When the note was later amended and restated to name the personal property seller as the

sole payee, that seller was barred by CCP § 580b from seeking a deficiency judgment. [*Sherwood-Trimble Med. Group v. 10001 Venice Blvd. Partnership* (1999) 75 CA4th 872, 882, 89 CR2d 533, 539]

➪ [6:564.17] ***PRACTICE POINTER:*** The problem that occurred in *Sherwood-Trimble*, supra, commonly arises where a personal property business is sold along with the real property on which the business is situated in a single purchase money transaction. The personal property seller can avoid application of the CCP § 580b bar by insisting on selling the personal property separately—e.g., in a concurrent escrow contingent on closing of the real property sale. [See *Sherwood-Trimble Med. Group v. 10001 Venice Blvd. Partnership* (1999) 75 CA4th 872, 879, 89 CR2d 533, 537—having failed to insist on selling its medical practice separately from the real property, seller "made its bed and must lie in it"]

[6:564.18 - 6:564.24] ***Reserved.***

3) [6:564.25] **Compare—trust deed given on unrelated property:** The CCP § 580b deficiency judgment bar ordinarily applies only where the foreclosure is under a trust deed on the *purchased property*. When the trust deed is recorded against an entirely different, unrelated property, an action on the note does *not* seek a deficiency judgment within the terms of § 580b. [*Kurtz v. Calvo* (1999) 75 CA4th 191, 194, 89 CR2d 99, 101]

The result may be otherwise where, as in *Conley*, supra, two closely-related sales essentially constitute one transaction so that a trust deed on one property securing the sale price of the other property may be deemed subject to § 580b (*see*¶ *6:564.6*). But that is not the case where the secured property was acquired by the buyers years before they bought the second property and the properties were completely unrelated so that the two sales could not be said to constitute essentially one transaction. [*Kurtz v. Calvo*, supra, 75 CA4th at 194, 89 CR2d at 101]

(b) [6:565] **Certain residential property loans:** The CCP § 580b antideficiency rule also applies to a deed of trust or mortgage "on *a dwelling for not more than four families* given to a lender to secure repayment of a loan which was in fact used to pay all or part of the purchase price of that dwelling occupied, entirely or in part by the purchaser." [CCP § 580b (emphasis added)]

Thus, pursuant to this provision, a loan from any party—even a *third party* loan—is "purchase money" so long as (i) the loan proceeds are used to *purchase a residential dwelling of four units or less*; and (ii) at least *one of the units is owner occupied*. [CCP § 580b]

1) [6:565.1] **Property repurchase:** The fact that the deed of trust is given in connection with the *repurchase* of residential property does not affect the "purchase money" nature of the loan. [See *DMC, Inc. v. Downey Sav. & Loan Ass'n* (2002) 99 CA4th 190, 194, 120 CR2d 761, 764—borrower's new loan to repurchase property foreclosed on by previous lender was "purchase money"]

(4) [6:566] **Also protects buyers of property encumbered by prior purchase money loan:** Although once removed from the seller-financed transaction, one who buys property encumbered by a prior purchase money deed of trust (whether taking "subject to" or assuming the existing purchase money loan) is also protected by the CCP § 580b antideficiency rule. [*Frangipani v. Boecker* (1998) 64 CA4th 860, 864, 75 CR2d 407, 409]

[6:566.1 - 6:566.4] ***Reserved.***

(5) [6:566.5] **Foreclosure not required to trigger § 580b protection:** CCP § 580b antideficiency protection is not limited to situations where the underlying trust deed is foreclosed. Otherwise, § 580b would be rendered meaningless; i.e., the seller/lender would never foreclose and would never be concerned that the fair value of the secured property was the sole means of recovering on the loan. [*Frangipani v. Boecker* (1998) 64 CA4th 860, 864-865, 75 CR2d 407, 410]

(a) [6:566.6] **Example:** Buyer assumed an existing purchase money loan. When he defaulted on the payments, Sellers gave the original trust deed beneficiary a $10,000 promissory note to cancel the foreclosure in order to protect their own credit. Sellers then sued Buyer for the $10,000.

CCP § 580b barred Sellers' action. "[A]warding [Sellers] damages for breach of [Buyer's] alleged agreement to honor his assumption of the [purchase money loan] is in the nature of a deficiency judgment and is barred by section 580b." [*Frangipani v. Boecker* (1998) 64 CA4th 860, 865, 75 CR2d 407, 410-411—sellers' agreement to pay lender to cancel foreclosure was a "voluntary act for their own benefit" since, pursuant to § 580b, neither they nor buyer had a legal obligation to pay any deficiency upon foreclosure]

(6) [6:567] **Equitable setoff as "deficiency judgment" barred by § 580b:** An equitable setoff does not technically constitute a "deficiency judgment" because (a) it does not impose a personal money judgment against the debtor; and (b) since it represents an independent obligation to the creditor, the amount of the setoff is not measured by the difference between the fair value of the secured property and the outstanding debt. Nonetheless, where an equitable setoff would violate CCP § 580b's underlying policy considerations (¶ 6:563), it will be treated as the *"functional equivalent" of a deficiency judgment* and thus be barred by § 580b in a purchase money loan transaction. [*Birman v. Loeb* (1998) 64 CA4th 502, 511, 75 CR2d 294, 300]

• [6:567.1] Buyer purchased a warehouse from Seller in a purchase money (seller-financed) transaction. Buyer later successfully sued Seller for fraudulent misrepresentation and failure to disclose in connection with the sale. In that action, the trial court reformed Buyer's note to Seller by reducing the amount of the loan obligation and awarded Buyer $300,000 in attorney fees and costs.

Buyer made no payments on the reformed note; and Seller never paid Buyer the court-awarded fees and costs.

Seller eventually commenced nonjudicial foreclosure proceedings and reacquired the property by a $2 million full credit bid; the fair market value of the warehouse was between $1.5 million and $2 million, but the balance due on the note exceeded $2 million. Seller sought to set off the $300,000 he owed Buyer against the deficiency, thereby relieving Seller of the $300,000 debt.

The attempted setoff was barred by CCP § 580b. Although allowing the setoff would not impose a personal money judgment against Buyer, it would violate the statute's underlying policies—significantly, placing the risk of inadequate security on the seller/lender. To allow the setoff would improperly shift the risk of inadequate security to Buyer. [*Birman v. Loeb* (1998) 64 CA4th 502, 513-514, 75 CR2d 294, 301-302]

(7) [6:568] **No waiver:**CCP § 580b's antideficiency protection may not be contractually waived either before *or after* a standard purchase money sale. [See *DeBerard Properties, Ltd. v. Lim* (1999) 20 C4th 659, 670-671, 85 CR2d 292, 299 (expressly disapproving prior cases holding § 580b may be waived following purchase money sale); *Coker v. JPMorgan Chase Bank, N.A.* (2016) 62 C4th 667, 686-687, 197 CR3d 131, 145-146 (citing *DeBerard*)—borrower cannot waive § 580b protections in exchange for lender approving short sale; *Lawler v. Jacobs* (2000) 83 CA4th 723, 736-737, 100 CR2d 52, 61-62—no "wiggle room" in statute to permit waiver; *Cadle Co. II v. Harvey* (2000) 83 CA4th 927, 934, 100 CR2d 150, 155—§ 580b protections cannot be waived in postorigination agreements changing terms of original loan]

(a) [6:568.1] **Exception—significant alteration of purchase money transaction:** The "no waiver" rule applies "only to the *standard* purchase money situation." A narrow exception has been recognized in circumstances involving a *variation* in the standard purchase money mortgage or deed of trust transaction. [*DeBerard Properties, Ltd. v. Lim* (1999) 20 C4th 659, 665, 85 CR2d 292, 295 (emphasis added); *Crookall v. Davis, Punelli, Keathley & Willard* (1998) 65 CA4th 1048, 1061, 77 CR2d 250, 257-258]

1) [6:568.2] **Two-prong approach:** Determining whether this exception applies involves a two-part inquiry:

— Whether the sale varies from a standard purchase money transaction; and

— If so, whether applying CCP § 580b's antideficiency protection comports with legislative intent (basically, to stabilize land values during economic downturns and discourage vendors from overvaluing the security, ¶ *6:563*). [*DeBerard Properties, Ltd. v. Lim* (1999) 20 C4th 659, 665, 85 CR2d 292, 295; *Lawler v. Jacobs* (2000) 83 CA4th 723, 733-734, 100 CR2d 52, 59-60]

The exception applies *only* if the answer to the first query is "yes" and the answer to the second is "no." [*DeBerard Properties, Ltd. v. Lim*, supra, 20 C4th at 665, 85 CR2d at 295; see *Coker v. JPMorgan Chase Bank, N.A.* (2016) 62 C4th 667, 692, 197 CR3d 131, 150—neither execution of short sale agreement nor borrower's CCP § 726 "security first" waiver destroyed purchase money character of borrower's residential mortgage; *Lawler v. Jacobs*, supra, 83 CA4th at 735, 100 CR2d at 60-61—exception inapplicable to purchase money transaction because none of "*DeBerard* touchstones" present; *Sherwood-Trimble Med. Group v. 10001 Venice Blvd. Partnership* (1999) 75 CA4th 872, 880, 89 CR2d 533, 538—exception inapplicable because "the transaction before us is not a variation on the standard purchase money deed of trust"]

2) [6:568.3] **Application—subordination of purchase money loan to construction loan:** A purchase money loan that is *subsequently subordinated to a construction loan* may lose its CCP § 580b antideficiency protection if all of the following factors are present:

• the subordination signals a *pronounced change* in the property's use;

• the *purchaser* is in a better position than the lender/seller to assess the property's *potential value* and understand the *risks* involved; *and*

• applying § 580b's protection would unfairly thrust the risk of the failure of the commercial development upon the lender/seller. [*DeBerard Properties, Ltd. v. Lim* (1999) 20 C4th 659, 666, 85 CR2d 292, 296; see *Spangler v. Memel* (1972) 7 C3d 605, 614, 102 CR 807, 814; see *In re Prestige Ltd. Partnership-Concord* (9th Cir. 2000) 234 F3d 1108, 1116-1117 (applying Calif. law)—changing business from "high-end" to "low-end" *not* pronounced change in property use; *and*¶ *6:453*]

3) [6:568.4] **Compare—unexercised subordination clause:** Even though the purchase money financing documentation contemplates subordination to a construction loan, CCP § 580b remains applicable, and a deficiency judgment is barred, if the subordination never actually occurs. "Until the subordination provision is exercised, jeopardy to the seller's security has not been aggravated. Thus, … the presence of an unexercised subordination provision does not take a purchase money loan outside section 580b protection." [*Webber v. Inland Empire Investments, Inc.* (1999) 74 CA4th 884, 915-916, 88 CR2d 594, 614-615 (internal quotes and citation omitted)]

(8) [6:568.5] **Compare—exposure for guarantors, pledgors or other sureties:** The CCP § 580b purchase money antideficiency rule protects the principal obligor. It does *not* affect the liability that *guarantors, pledgors or other sureties* might otherwise have with respect to the deficiency (CCP § 580b(c)). For example, a *guarantor*, under a properly-drafted guaranty, may *remain liable* for the deficiency. *See ¶ 6:598 ff.*

(9) [6:568.6] **Compare—recourse against additional security for severable portion of loan:** The CCP § 580b purchase money antideficiency rule does not preclude a lender from pursuing *additional security* when part of the purchase price is represented by a *separate promissory note*, secured by *separate* property. [*Hodges v. Mark* (1996) 49 CA4th 651, 655, 56 CR2d 700, 702—beneficiary may foreclose separate security instruments independently; *see further discussion at ¶ 6:561.15 ff.*]

[6:569] ***Reserved.***

c. [6:570] **Trustee's sale (nonjudicial foreclosure) anti-deficiency rule (CCP § 580d):** Except as otherwise provided by statute (¶ 6:570.4), no deficiency may be owed or collected, and no deficiency judgment may be obtained, when the secured property has been foreclosed by a trustee's private power of sale (nonjudicial foreclosure). Thus, a secured lender who elects the more expeditious nonjudicial foreclosure remedy forfeits the right to recover any deficiency that might otherwise be allowed under the law. [CCP § 580d; *Alliance Mortg. Co. v. Rothwell* (1995) 10 C4th 1226, 1236, 44 CR2d 352, 358; see also *Cadlerock Joint Venture, L.P. v. Lobel* (2012) 206 CA4th 1531, 1540, 143 CR3d 96, 102—§ 580d effectively limits right to obtain deficiency judgment to creditors who employ *judicial* foreclosure remedy]

Section 580d serves in part "to prevent creditors in private sales from buying in at deflated prices and realizing double recoveries by holding debtors for large deficiencies." [*Alliance Mortgage Co. v. Rothwell*, supra, 10 C4th at 1236, 44 CR2d at 358 (internal quotes and citation omitted)]

(1) [6:570.1] **Compare—rights of sold-out junior lienholder:** CCP § 580d does *not* bar a *junior lienholder* from suing the obligor directly after the security has been extinguished by foreclosure of the senior lien (i.e., where a senior lienholder's nonjudicial foreclosure sale "wipes out" all junior liens). [See *Black Sky Capital, LLC v. Cobb* (2019) 7 C5th 156, 164-165, 246 CR3d 583, 590-591 (senior and junior liens secured by same property and held by same creditor)—junior lienholder who, in its capacity as senior lienholder conducted nonjudicial foreclosure sale after debtors defaulted on senior loan, not precluded from seeking deficiency judgment against same debtors after they defaulted on junior loan (¶ 6:559.2); see also *Bank of America Nat'l Trust & Sav. Ass'n v. Graves* (1996) 51 CA4th 607, 611-613, 59 CR2d 288, 290-292]

(2) [6:570.2] **Serial nonjudicial foreclosures of multiple security for single debt allowed:** A lender who forecloses on one of several pieces of property securing a single debt may continue to exhaust the additional security through

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nonjudicial foreclosures without violating the antideficiency statutes. No personal judgment against the debtor, and hence no "deficiency judgment," is involved when the lender resorts only to its security—whether concurrently or serially. [*Dreyfuss v. Union Bank of Calif.* (2000) 24 C4th 400, 407-409, 101 CR2d 29, 34-35; *Marriage of Oropallo* (1998) 68 CA4th 997, 1005-1006, 80 CR2d 669, 674-675]

However, having elected to collect the debt by nonjudicial foreclosure, CCP § 580d precludes the creditor from subsequently seeking a *personal money judgment* on the additional collateral. [*Marriage of Oropallo*, supra, 68 CA4th at 1005-1006, 80 CR2d at 674-675—after foreclosing nonjudicially on several properties securing single debt, creditor could not invoke "sold out junior lienholder" exception in connection with other property securing same debt, and thereby attempt to sue obligor directly]

(3) [6:570.3] **Election of remedies:** A lender does not "finally" elect its foreclosure remedies (so as to preclude the right to seek a deficiency judgment following *judicial* foreclosure) unless and until the private trustee's sale is completed. *See*¶ *6:513*.

(4) [6:570.4] **Compare—exposure for guarantors, pledgors or other sureties:** The CCP § 580d antideficiency rule does not affect the liability that *guarantors, pledgors or other sureties* might otherwise have with respect to the deficiency (CCP § 580d(b)). For example, a properly-drafted guaranty may effectively *waive* a guarantor's antideficiency protection. *See*¶ 6:598 ff.

(5) [6:570.5] **Liens given to secure bond payments excluded:**CCP § 580d does not apply to a trust deed or other lien given to secure the payment of bonds or other evidence of indebtedness authorized, or permitted to be issued, by the Commissioner of Financial Protection and Innovation, or that is made by a public utility subject to the Public Utilities Act. [CCP § 580d(c)]

d. [6:571] **Short sale transaction antideficiency rule (CCP § 580e):** The short sale transaction antideficiency rule is meant to protect distressed homeowners obligated under *non-purchase money recourse loans* when the fair market value of their property is less than the balance owed under the trust deed. This legislation makes sure "these homeowners do not incur a higher dollar amount of liability after a short sale than they would otherwise have after a foreclosure sale." [See CCP § 580e, Hist. & Stat. Notes (explaining CCP § 580e applies to individual, *not* commercial, loan transactions)]

(1) [6:571.1] **Notes secured *solely by trust deeds for residential one-to-four unit properties:*** No deficiency may be owed or collected, and no deficiency judgment may be rendered, upon a note secured solely by a trust deed for a dwelling of not more than four units if the trustor, with the trust deed holder's written consent, sells the dwelling for less than the remaining amount of indebtedness due at the time of sale, provided (a) title has been voluntarily transferred to a buyer by grant deed or another document that has been recorded; and (b) the sale proceeds are tendered as agreed. [CCP § 580e(a)(1); see also *Bank of America, N.A. v. Roberts* (2013) 217 CA4th 1386, 1393-1394, 159 CR3d 345, 351-352]

(a) [6:571.1a] **No retroactive application:** In its original form, CCP § 580e's short sale antideficiency protection applied only to a *first* trust deed. However, in response to the foreclosure crisis, the Legislature in 2011 amended § 580e by extending its coverage to *any* trust deed, including junior lienholders, provided the trust deed's holder consented to the short sale and received the proceeds of the sale as agreed. As amended, § 580e applies *only* to short sales occurring on or after its effective date. [See *Bank of America, N.A. v. Roberts* (2013) 217 CA4th 1386, 1393-1394, 159 CR3d 345, 351-352—amendment extending § 580e's protection to notes secured by *any* trust deed did not apply retroactively to short sale that occurred before amendment's effective date and was agreed to under law in effect at that time]

(2) [6:571.2] **Notes *not secured solely by trust deeds for residential one-to-four unit properties:*** When the note is *not secured solely* by a trust deed for a dwelling of not more than four units, a deficiency judgment upon the note is still prohibited. However, following the short sale, in accordance with the holder's written consent, the voluntary transfer of title to the buyer and the tender of the sale proceeds, as well as the rights, remedies and obligations of any holder, beneficiary, trustor, obligor, obligee or guarantor vis-à-vis the note and with respect to any other property that secures the note, must be treated and determined as if the dwelling had been sold through foreclosure under a power of sale, as specified. [CCP § 580e(a)(2)]

(3) [6:571.3] **No additional compensation:** The note holder may not require the trustor or maker of the note to pay any additional compensation, aside from the sale proceeds, in exchange for its written consent to the short sale. [CCP § 580e(b)]

(4) [6:571.4] **Damages for fraud or waste committed by trustor/third party:** Notwithstanding the broad protection afforded homeowners under CCP § 580e, the statute does *not* limit a trust deed holder's ability to "seek damages and use

existing rights and remedies against the trustor … or any third party" if the trustor or third party commits fraud with respect to the sale of or waste to the secured property. [CCP § 580e(c)]

(5) [6:571.5] **Commercial loan transactions and liens given to secure bond payments excluded:** CCP § 580e does not apply if the trustor is a corporation, limited liability company, limited partnership or political subdivision. Again, the statute's purpose is to protect "distressed homeowners" (¶ *6:571*). [CCP § 580e(d)(1)]

Similarly, CCP § 580e does not apply to any trust deed or other lien given to secure the payment of bonds or other evidence of indebtedness authorized, or permitted to be issued, by the Commissioner of Financial Protection and Innovation, or that is made by a public utility subject to the Public Utilities Act. [CCP § 580e(d)(2)]

(6) [6:571.6] **Protection not waivable:** Any purported waiver of CCP § 580e(a)-(b) (¶ *6:571.1, 6:571.2, 6:571.3*) "shall be void and against public policy." [CCP § 580e(e)]

[6:572 - 6:573] ***Reserved.***

7. [6:574] **Obtaining Deficiency Judgment:** In circumstances where a deficiency judgment is permissible, there are additional rules to consider:

a. Procedural matters

(1) [6:575] **Governing law:** CCP § 726 regulates the manner in which a lender must proceed to enforce its debt after obtaining a *judicial* foreclosure of the security. [*Paykar Const., Inc. v. Spilat Const. Corp.* (2001) 92 CA4th 488, 496, 111 CR2d 863, 868—creditor entitled to deficiency judgment after judicial foreclosure only as provided by CCP § 726; *Florio v. Lau* (1998) 68 CA4th 637, 647, 80 CR2d 409, 415, fn. 4]

CCP § 580a, on the other hand, governs when the secured property has been foreclosed by a *trustee's private power of sale* (nonjudicial foreclosure). [*Marriage of Oropallo* (1998) 68 CA4th 997, 1003, 80 CR2d 669, 672-673]

(a) [6:575.1] **Comment:** As a practical matter, CCP § 580a has been rendered nearly obsolete with the enactment of CCP § 580d (barring deficiency judgments after nonjudicial foreclosure, ¶ *6:570*). [See *Marriage of Oropallo* (1998) 68 CA4th 997, 1003, 80 CR2d 669, 672-673]

(2) [6:576] **Three-month deadline:** Applications for deficiency judgments and fair value determinations (¶ *6:577*) must be filed within *three months* from the date of the *foreclosure sale*—i.e., the date when the highest bid is received at the auction, *not* when the certificate of sale is recorded. [CCP §§ 580a (nonjudicial foreclosures) & 726(b) (judicial foreclosures); *Paykar Const., Inc. v. Bedrosian* (1999) 71 CA4th 803, 808, 84 CR2d 135, 138]

The three-month deadline operates as a statute of limitations: i.e., unless the application is filed within the three-month period, no money judgment for a deficiency can be obtained. [*Life Savings Bank v. Wilhelm* (2000) 84 CA4th 174, 178, 100 CR2d 657, 660—creditor could not seek CCP § 473 relief to file tardy application; see *Paykar Const., Inc. v. Spilat Const. Corp.*, supra, 92 CA4th at 497, 111 CR2d at 869]

(a) [6:576.1] **Compare—"mixed collateral" cases:** CCP § 726's three-month time limit does *not* apply to personal property in a mixed collateral situation (i.e., where a single obligation is secured by a combination of real and personal property) unless it is sold in a unified sale (¶ *6:561.18*). Under the "Mixed Collateral Statute" (Comm'l C. § 9604), real property limitations "do not in any way" apply to obligations secured by personal property sold separately. [Comm'l C. § 9604(a)(2)(A); see also *Oxford Street Properties, LLC v. Rehabilitation Assocs., LLC* (2012) 206 CA4th 296, 304, 141 CR3d 704, 709, fn. 4; *Florio v. Lau* (1998) 68 CA4th 637, 652-653, 80 CR2d 409, 418—more flexible personal property rules govern]

b. [6:577] **"Fair value" deficiency limitations:** The "fair market value" deficiency rules (CCP §§ 580a (applicable to nonjudicial foreclosures) & 726 (applicable to judicial foreclosures)) limit deficiency judgments to the difference between the *fair market value* of the property at the time of the sale and the *outstanding debt*. [CCP § 726; *Cornelison v. Kornbluth* (1975) 15 C3d 590, 600-601, 125 CR 557, 564-565; *Talbott v. Hustwit* (2008) 164 CA4th 148, 151, 78 CR3d 703, 705]

(1) [6:577.1] **Compare—"sold out" junior lienholders:** The "fair value" rules do not apply to a sold-out junior lienholder. [See *Bank of America Nat'l Trust & Sav. Ass'n v. Graves* (1996) 51 CA4th 607, 612, 59 CR2d 288, 291; *and further discussion at* ¶ *6:559 ff.*]

(2) [6:577.2] **Application to mixed collateral:** Apparently clearing up an ambiguity under prior law, amendments to the Mixed Collateral Statute indicate that the "fair value" limitation applies to deficiency judgments following foreclosure in mixed collateral situations where the mixed collateral is sold as a unit (*¶ 6:561.18*). [See Comm'l C. § 9604(a)(2)(A) & (8); *Florio v. Lau* (1998) 68 CA4th 637, 644-645, 80 CR2d 409, 413-414 (predating eff. date of Comm'l C. amendments) —assuming, but expressly not deciding, that fair value limit applied to mixed collateral]

[6:577.3] ***Reserved.***

(a) [6:577.4] **Compare—personal property:** The fair value limitation does *not* apply to deficiency judgments following the foreclosure of secured *personal property*. [*Florio v. Lau* (1998) 68 CA4th 637, 652-653, 80 CR2d 409, 418-419]

(3) [6:578] **Judicial foreclosures (CCP § 726):**CCP § 726's "fair value" limitation on deficiency judgments applies to judicial foreclosures:

In the event a deficiency is neither waived by the creditor nor prohibited by CCP § 580b and it is decreed that defendant (obligor) is personally liable for the debt, upon plaintiff's (lender's) application filed within three months of the date of the foreclosure sale (*¶ 6:576*) "and after a hearing thereon at which the court shall take evidence and … either party may present evidence as to the *fair value* of the real property … sold as of the date of sale," the court shall render a money judgment against the defendant for the amount by which the outstanding debt (including interest and costs of levy and sale and of the action) "*exceeds the fair value* of the real property … sold as of the date of sale." [CCP § 726(b) (emphasis added); see *O'Neil v. General Sec. Corp.* (1992) 4 CA4th 587, 603, 5 CR2d 712, 720; see also *Paykar Const., Inc. v. Spilat Const. Corp.* (2001) 92 CA4th 488, 496, 111 CR2d 863, 868]

(a) [6:578.1] **"Fair value" determination:** "Fair value" for purposes of CCP § 726 is the "*fair market value*" of the property (i.e., the highest price a willing buyer would pay to a willing seller) as of the date of foreclosure, *without reduction* for the adverse impact of the foreclosure or the one-year right of redemption that would temporarily lower the market value of the property. [*San Paolo U.S. Holding Co., Inc. v. 816 South Figueroa Co.* (1998) 62 CA4th 1010, 1026, 73 CR2d 272, 280; see also *Kinsmith Fin'l Corp. v. Gilroy* (2003) 105 CA4th 447, 455, 129 CR2d 478, 484; *Luther Burbank Sav. & Loan Ass'n v. Community Const., Inc.* (1998) 64 CA4th 652, 657-658, 75 CR2d 367, 370]

1) [6:578.2] **Adjustment for other encumbrances:** A court's assessment of fair value for CCP § 726 purposes begins with *competent evidence* (typically appraisals, *¶ 6:665 ff.*) showing the likely sales price the property would command in the open market if *entirely unencumbered*. The court then considers *external* factors (unrelated to the foreclosure process) that reduce the amount a willing purchaser in an open market would pay a lender for the property. [*Luther Burbank Sav. & Loan Ass'n v. Community Const., Inc.* (1998) 64 CA4th 652, 658, 75 CR2d 367, 370]

Next, having determined a reasonable *unencumbered value*, the court must consider the amount by which any encumbrances (other than the foreclosed trust deed) might reasonably affect the property's actual sales price. Any such encumbrance unpaid by the borrower at the time of foreclosure is properly *excluded* in calculating "fair value." The foreclosing lender "gets nothing in return for that portion of the property's value attributable to this encumbrance and passes that debt onto the foreclosure sale purchaser." [*Luther Burbank Sav. & Loan Ass'n v. Community Const., Inc.*, supra, 64 CA4th at 658-659, 75 CR2d at 370-371—county *tax lien* on foreclosed property properly subtracted from property's unencumbered value to determine its "fair value" for deficiency judgment purposes]

2) [6:578.3] **Effect on finality of foreclosure decree:** A judicial decree of foreclosure conclusively establishes the borrower's liability for the defaulted loans. Thus, it is *final and appealable* even though the court retains jurisdiction to hear and determine the borrower's liability for any deficiency remaining after the foreclosure. [*Citicorp Real Estate, Inc. v. Smith* (9th Cir. 1998) 155 F3d 1097, 1101 (applying Calif. law); *Kinsmith Fin'l Corp. v. Gilroy* (2003) 105 CA4th 447, 452-453, 129 CR2d 478, 481-482]

In addition, any claims precluding judicial foreclosure may be *barred* if not raised *before* entry of the foreclosure decree. [*Albano v. Norwest Fin'l Hawaii, Inc.* (9th Cir. 2001) 244 F3d 1061, 1063-1064 (applying Hawaii law) —once state court action proceeded to final decree of foreclosure, any right debtors had to rescind mortgage transaction based on truth-in-lending law vanished]

(4) [6:579] **Nonjudicial foreclosures (CCP § 580a):**CCP § 580a, applicable to nonjudicial foreclosures, limits a secured lender's right to recover a deficiency judgment to the amount by which the secured obligation *exceeds the fair market value*

of the property as of the date of the foreclosure sale (plus interest thereon from the date of sale) … except that in no event may the deficiency judgment (exclusive of interest after the date of sale) exceed the difference between the amount for which the property was sold and the entire amount of the secured obligation. [CCP § 580a]

Any such action to recover a deficiency judgment must be brought within *three months* of the time of sale under the trust deed. [CCP § 580a; *see*¶ *6:576*]

(As noted, the § 580a fair value rule has, for all practical purposes, become obsolete because of the CCP § 580d antideficiency judgment rule, ¶ *6:570*.)

(a) [6:579.1] **Compare—no fair value limitation on serial foreclosures:** Because no deficiency judgment is involved when a lender serially forecloses on multiple items of collateral securing the same debt (¶ *6:561.3, 6:570.2*), the debtor has no right to a fair value hearing before each successive foreclosure sale. This is so even if the lender is the successful bidder at the trustee sales. Simply stated, the antideficiency laws do not apply in this scenario. [*Dreyfuss v. Union Bank of Calif.* (2000) 24 C4th 400, 409-412, 101 CR2d 29, 35-37]

1) [6:579.2] **Debtor has no alternative set-aside rights:** Nor can a debtor who believes the lender did not credit the fair value of property recovered in prior foreclosure sales realize the equivalent of a fair value hearing by obtaining a set-aside of a subsequent trustee's sale or restitution of an unjust recovery.

"A properly conducted [trustee's] sale does not require judicial oversight and constitutes a final adjudication of the rights of the creditor and debtor … Applying the fair market value provisions of [the antideficiency law] … by eliminating the finality of nonjudicial foreclosure and requiring judicial oversight, would derogate the legislative goal of providing a quick, inexpensive, and efficient remedy." [*Dreyfuss v. Union Bank of Calif.* (2000) 24 C4th 400, 411-412, 101 CR2d 29, 37 (internal quotes and citation omitted)]

(b) [6:579.3] **CCP § 580a protections inapplicable to guarantors:** The CCP § 580a deficiency judgment protections afforded principal obligors (¶ *6:579*) have no application in actions against guarantors. [*Bank of America Nat'l Trust & Sav. Ass'n v. Hunter* (1937) 8 C2d 592, 598, 67 P2d 99, 102; *Mariners Sav. & Loan Ass'n v. Neil* (1971) 22 CA3d 232, 234, 99 CR 238, 240; see *Talbott v. Hustwit* (2008) 164 CA4th 148, 151-152, 78 CR3d 703, 705-706—deficiency judgment against guarantors for difference between foreclosure credit bid and unpaid loan balance proper even though rendered without regard to whether property's fair market value exceeded total amount owed]

[6:579.4 - 6:579.9] ***Reserved.***

c. [6:579.10] **Enforcing deficiency judgment; time limit:** Deficiency judgments are subject to the provisions of the Enforcement of Judgments Law limiting the period of enforceability of a money judgment (CCP § 683.010 et seq.). The time limit on enforcement (generally 10 years unless the judgment is properly renewed before then, see CCP §§ 683.020, 683.110-683.220) begins to run from the date of entry of the deficiency judgment, *not* the earlier date of the foreclosure decree. [*Kinsmith Fin'l Corp. v. Gilroy* (2003) 105 CA4th 447, 454, 129 CR2d 478, 483-484—deficiency judgment enforceable even though more than 10 years passed since issuance of foreclosure decree; compare *Starcevic v. Pentech Fin'l Services, Inc.* (2021) 66 CA5th 365, 380-381, 280 CR3d 764, 775—failure to renew judgment automatically extinguished judgment creditor's priority lien]

Cross-refer: For a comprehensive treatment of the Enforcement of Judgments Law, see Ahart, *Cal. Prac. Guide: Enforcing Judgments & Debts* (TRG).

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Cal. Prac. Guide Real Prop. Trans. Ch. 6-J

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Chapter 6. Financing and Appraisals

J. Guaranty of the Obligation

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1. [6:580] **Lender's Purpose:** There are two reasons why a lender might want the borrower's obligations guarantied by another party:

• The borrower's credit might simply be insufficient to meet the lender's standards.

• A properly-drafted guaranty can give the lender *deficiency judgment* recourse against a third party when the borrower (principal obligor) is protected by California's antideficiency laws (¶ *6:560 ff., 6:598 ff.*).

2. [6:581] **Governing Law:** The rights and obligations of lenders and guarantors are governed by Civ.C. § 2787 et seq. regarding “suretyships.” The principal provisions are overviewed at ¶ 6:582 ff.

a. [6:582] **“Guarantors” and “sureties” treated the same:** The distinction between “sureties” and “guarantors” was statutorily abolished in 1939. Both terms have the same meaning under California statutory and case law; specifically, a guarantor, like a surety, is “one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor.” [Civ.C. § 2787; *Central Building, LLC v. Cooper* (2005) 127 CA4th 1053, 1058, 26 CR3d 212, 216; see also *Gramercy Investment Trust v. Lakemont Homes Nevada, Inc.* (2011) 198 CA4th 903, 911, 130 CR3d 496, 502—guarantor promises to answer for debt or perform obligation of another if that person fails to pay or perform; *Talbott v. Hustwit* (2008) 164 CA4th 148, 151, 78 CR3d 703, 705—guaranty gives rise to separate and independent obligation from that which binds principal debtor]

A guarantor's rights are based on suretyship law. [Civ.C. § 2787; *Conner v. Conner* (1999) 76 CA4th 646, 650, 90 CR2d 687, 689; see also *Bank of America, N.A. v. Stonehaven Manor, LLC* (2010) 186 CA4th 719, 723, 113 CR3d 57, 60—under suretyship law, guarantor is entitled to benefit of every security held by creditor]

➪ [6:582.1] ***PRACTICE POINTER:*** When researching the applicable law, counsel should keep in mind that California Code references to “sureties” apply equally to guarantors; and be careful about relying on pre-1939 cases involving “guarantors.” [See Civ.C. § 2787—“Guaranties of collection and continuing guaranties are forms of suretyship obligations, and except in so far as necessary in order to give effect to provisions specially relating thereto, shall be subject to all provisions of law relating to suretyships in general”]

(1) [6:582.2] **Trustor as guarantor:** A property owner sometimes executes a deed of trust encumbering their interest in the property to secure *another party's* obligation but does not execute the underlying note or other obligation. Because guarantors include those who hypothecate their property as security for the debt of another (Civ.C. § 2787, ¶ *6:582*), a trustor under a deed of trust can be a guarantor. [*Mead v. Sanwa Bank Calif.* (1998) 61 CA4th 561, 568, 71 CR2d 625, 629]

When the trustor allegedly has taken inconsistent positions as to its status as “principal” or “guarantor,” the following rule applies: If the creditor knows that its obligors have agreed between themselves that one will be the principal and

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the other will be the surety, the latter is bound to the creditor as a *surety* only, even though they appear from the written instruments to be a principal. [*Mead v. Sanwa Bank Calif.*, supra, 61 CA4th at 571, 71 CR2d at 631]

[6:582.3 - 6:582.4] ***Reserved.***

(2) [6:582.5] **Compare—letters of credit:** A "letter of credit" within the meaning of Comm'l C. § 5103(1)(a) is *not* a form of suretyship obligation. [See Civ.C. § 2787]

➪ [6:582.6] ***PRACTICE POINTER:*** When a borrower's credit does not meet a lender's standards, the lender often prefers "credit enhancement" in the form of a letter of credit rather than a guaranty. Again, a letter of credit is *not* a form of suretyship; therefore, it is *not* subject to California's antideficiency provisions or, in the case of a related borrower and guarantor, a "sham guaranty" defense (*see ¶ 6:595 ff.*). An additional advantage is that the lender generally may draw on the letter of credit even if the borrower files for bankruptcy.

b. [6:583] **Writing generally required to create guaranty:** Except as provided in Civ.C. § 2794 (obligations not required to be in writing), a guaranty obligation must be *in writing* and be *signed* by the guarantor. [Civ.C. § 2793; *see Form 6:L*]

Like any contract, however, a guaranty agreement may incorporate another contract (typically, the underlying obligation that is the subject of the guaranty) … in which case, the two documents are read and construed together as a whole according to the intention of the parties. [*Central Building, LLC v. Cooper* (2005) 127 CA4th 1053, 1058, 26 CR3d 212, 216]

c. [6:584] **Unconditional unless otherwise specified:** A guaranty is deemed *unconditional unless* its terms express a condition precedent to the guarantor's liability. [Civ.C. § 2806]

[6:584.1 - 6:584.3] ***Reserved.***

d. [6:584.4] **Limited vs. continuing guaranty:** A guaranty agreement may be "limited" or "continuing." [*Central Building, LLC v. Cooper* (2005) 127 CA4th 1053, 1059, 26 CR3d 212, 216]

• [6:584.4a] A *limited guaranty* restricts the guarantor's obligations to a specific amount or certain terms of the underlying agreement and/or operates only for a specifically-defined period (i.e., the guarantor's obligations terminate upon expiration of the specified period—e.g., when the note is paid off). [See *Central Building, LLC v. Cooper* (2005) 127 CA4th 1053, 1060, 26 CR3d 212, 217]

• [6:584.4b] A *continuing guaranty* operates with respect to the principal obligor's present liability *and future liabilities* under successive transactions continuing the original liability or renewing it (e.g., as when a loan is renewed). [Civ.C. § 2814; *Central Building, LLC v. Cooper* (2005) 127 CA4th 1053, 1059, 26 CR3d 212, 217]

A continuing guaranty may be *revoked* by the guarantor at any time as to future transactions, "unless there is a continuing consideration" therefor that is not renounced by the guarantor. [Civ.C. § 2815] However, the right of revocation, like other statutory rights and defenses, may be waived by the guarantor, thereby making the continuing guaranty irrevocable. [See *Central Building, LLC v. Cooper*, supra, 127 CA4th at 1059, 26 CR3d at 217 (irrevocable continuing guaranty)]

e. [6:584.5] **Extent of liability:** Generally, a guarantor's liability can be no larger in amount or more burdensome in any other respect than the underlying principal obligation; and, to the extent it exceeds the principal obligation, the guaranty will be reduced accordingly. In determining whether the guaranty imposes a greater or more burdensome obligation, courts focus on the scope of the principal's liability at the time the guaranty is executed. [Civ.C. § 2809; *River Bank America v. Diller* (1995) 38 CA4th 1400, 1410-1411, 45 CR2d 790, 794-795]

(1) [6:584.6] **Waivable:** Nonetheless, Civ.C. § 2809 is a *waivable* defense and, in fact, can be waived even by vague language in the guaranty agreement. The issue turns on whether the agreement, construed as a whole, shows the guarantor's understanding that its obligations under the guaranty are completely separate and independent from the principal's obligation and unaffected by whatever action the lender may take against the primary obligor. [*Bloom v. Bender* (1957) 48 C2d 793, 804, 313 P2d 568, 575; see *River Bank America v. Diller* (1995) 38 CA4th 1400, 1413-1419, 45 CR2d 790, 796-800]

For example, a defense based on Civ.C. § 2809 was effectively waived by provisions in a guaranty (i) making the guaranty separate from the obligations guarantied, (ii) permitting the lender to proceed directly against the guarantors, and (iii) providing that receipt of foreclosure proceeds will not terminate the guarantors' liability. [*River Bank America v. Diller*, supra, 38 CA4th at 1415-1416, 45 CR2d at 798]

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f. [6:585] **Default triggers liability:** A guarantor becomes liable on the guarantied obligation upon the principal obligor's default and without prior demand or notice. [Civ.C. § 2807; see also Civ.C. § 2808 re conditional guaranties]

g. [6:586] **Exoneration by subsequent alteration of principal obligation:** A guarantor is *exonerated* from the guarantied obligation (except to the extent they may be indemnified by the principal obligor) if the lender (creditor) *alters the underlying obligation "in any respect" without the guarantor's consent* or in any way *impairs or suspends* its remedies against the principal obligor. [Civ.C. § 2819; *R.P. Richards, Inc. v. Chartered Const. Corp.* (2000) 83 CA4th 146, 154, 99 CR2d 425, 431; *Conner v. Conner* (1999) 76 CA4th 646, 650, 90 CR2d 687, 689 & fn. 3]

Civ.C. § 2819 applies, however, only where there is a *material* alteration of the principal obligation in a manner not originally contemplated by the guarantor, *irrespective* of whether the alteration is prejudicial to the guarantor. [*R.P. Richards, Inc. v. Chartered Const. Corp.*, supra, 83 CA4th at 154, 99 CR2d at 431]

(1) Exceptions

(a) [6:587] **Acceptance of part performance:** The lender's agreement to accept from the principal obligor an amount less than the balance owed on the original obligation, without the guarantor's consent and without any other change to the underlying agreement between lender and principal obligor, *shall not exonerate* the guarantor for the lesser sum agreed upon by the lender and principal obligor. [See Civ.C. §§ 2819 & 2822(b)]

(b) [6:588] **Indemnification by principal:** A guarantor who has been *indemnified* by the principal is liable to the lender to the extent of the indemnity even though the lender may have modified the principal obligation or released the principal without the guarantor's consent. [Civ.C. § 2824]

[6:588.1 - 6:588.4] ***Reserved.***

➪ [6:588.5] ***PRACTICE POINTER—ADVANCE CONSENT AND WAIVER BY GUARANTOR*****:** Inadvertent exoneration from alteration of the principal obligation can be avoided by careful drafting of the guaranty. Provisions giving the guarantor's *advance consent* to subsequent modifications (guaranteeing the principal obligation as so modified) and *waiving* the guarantor's statutory rights under Civ.C. § 2819 are enforceable. [See *Central Building, LLC v. Cooper* (2005) 127 CA4th 1053, 1060-1061, 26 CR3d 212, 218-219 (guaranty agreement expressly authorized alteration or modification "without consent or notice to Guarantors" and stated "this Guaranty shall thereupon and thereafter guarantee the Performance as so changed, modified, altered or assigned")]

(2) [6:589] **Guaranty not restored by rescission of agreement altering obligation:** The guaranty of an *exonerated* guarantor is *not restored* by the lender's rescission of an agreement altering the principal obligation or impairing the lender's remedy. [Civ.C. § 2821]

[6:589.1 - 6:589.4] ***Reserved.***

h. [6:589.5] **Exoneration by termination of principal's liability on grounds** ***other than principal's "personal disability":*** A guarantor is also exonerated if the principal's liability ceases on grounds *other* than the principal's "mere personal disability," *unless* the guarantor assumed liability with knowledge of the existence of the defense. [Civ.C. § 2810; *R.P. Richards, Inc. v. Chartered Const. Corp.* (2000) 83 CA4th 146, 155, 99 CR2d 425, 431]

"Personal disabilities" that ordinarily do *not* exonerate the guarantor include the principal's death or bankruptcy. [*R.P. Richards, Inc. v. Chartered Const. Corp.*, supra, 83 CA4th at 155, 99 CR2d at 431]

i. [6:590] **No exoneration by lender's delay in proceeding against principal:** The lender's delay in proceeding against the principal obligor (or in enforcing any other remedy) does *not itself* exonerate the guarantor. [Civ.C. § 2823]

j. [6:591] **No exoneration by principal's discharge by operation of law:** A guarantor is *not* exonerated by a discharge of the principal by operation of law "without the intervention or omission" of the lender. [Civ.C. § 2825; *R.P. Richards, Inc. v. Chartered Const. Corp.* (2000) 83 CA4th 146, 155, 99 CR2d 425, 431]

[6:592 - 6:594] ***Reserved.***

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3. [6:595] **"True" vs. "Supposed" Guarantors:** A "true guarantor" is one who is *not already liable* on the guarantied obligation. [See Civ.C. § 2787; *Cadle Co. II v. Harvey* (2000) 83 CA4th 927, 932, 100 CR2d 150, 154]

a. [6:595.1] **Test:** It is a question of fact whether a person is a "true guarantor" or a principal obligor "in guarantor's disguise." [*River Bank America v. Diller* (1995) 38 CA4th 1400, 1422, 45 CR2d 790, 802]

(1) [6:595.2] **"Sham" notwithstanding different individuals/entities:** That the principal obligor and guarantor are not literally the same individual or entity is not dispositive of the issue. "The correct inquiry … is whether the purported debtor is anything other than an *instrumentality* used by the individuals who guaranteed the debtor's obligation, and whether such instrumentality actually removed the individuals from their status and obligations as debtors … Put another way, are the supposed guarantors nothing more than the principal obligors under another name?" [*River Bank America v. Diller* (1995) 38 CA4th 1400, 1422-1423, 45 CR2d 790, 802 (emphasis in original; internal quotes and citation omitted); see *Talbott v. Hustwit* (2008) 164 CA4th 148, 152, 78 CR3d 703, 706; *Cadle Co. II v. Harvey* (2000) 83 CA4th 927, 932-933, 100 CR2d 150, 154]

• [6:595.3] For example, guarantors who are general partners of a primary obligor partnership are themselves principal obligors. [*Union Bank v. Dorn* (1967) 254 CA2d 157, 158-159, 61 CR 893, 894; *Westinghouse Credit Corp. v. Barton* (CD CA 1992) 789 F.Supp. 1043, 1045]

• [6:595.4] Likewise, where a corporation is the nominal primary obligor and the debt is guarantied by its officers and shareholders, the guarantors may be considered the primary obligors. This is true even though the officers and shareholders are not directly obligated on the corporation's debt. [*River Bank America v. Diller* (1995) 38 CA4th 1400, 1423-1424, 45 CR2d 790, 803]

• [6:595.5] In determining whether a purported corporate guarantor actually is the principal obligor, courts may apply the alter ego doctrine (or the "single business enterprise" theory, a variant of the alter ego doctrine applicable to sister companies). Key factors are "(1) that there be such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist and (2) that, if the acts are treated as those of the corporation alone, an inequitable result will follow." [See *LSREF2 Clover Property 4, LLC v. Festival Retail Fund 1, LP* (2016) 3 CA5th 1067, 1081, 208 CR3d 200, 212 (internal quotes omitted)—guarantor that created special purpose entities to acquire and finance real estate could not invoke alter ego principles to escape its guaranty (¶ 6:595.6)]

• [6:595.5a] *Compare:* Trustors who guarantee loans made to their own trusts may structure the trusts so as to *separate* themselves from the trusts' debts (e.g., by using limited liability companies as trustees and naming themselves secondary beneficiaries). Such arrangements effectively remove the trustors from "their status and obligations as debtors," rendering them "true guarantors." [See *Talbott v. Hustwit* (2008) 164 CA4th 148, 153, 78 CR3d 703, 707]

• [6:595.5b] Real estate developers who guarantee business loans to their own limited liability companies and limited partnerships may be "true guarantors," *not* primary obligors, if they do not personally enter into the subject loan agreements or execute the underlying promissory notes. Moreover, the legal status of both entities provides legal separation between the companies as primary obligors and the developers as guarantors. [See *LSREF2 Clover Property 4, LLC v. Festival Retail Fund 1, LP* (2016) 3 CA5th 1067, 1071-1073, 1077-1079, 208 CR3d 200, 203-205, 208-210—no sham guaranty where guarantor itself designed ownership structure in advance of loan and guaranteed only 6% of obligation; *California Bank & Trust v. Lawlor* (2013) 222 CA4th 625, 632, 166 CR3d 38, 43—lender could recover outstanding loans from developers despite their "sham guaranty" claims]

• [6:595.5c] And individuals who elect to borrow through a shell entity for tax purposes may not assert an antideficiency defense to their guaranties where there is adequate legal separation between the borrower and the guarantors. "Where individuals purposefully take advantage of the benefits of borrowing through a corporate entity, they must also assume the risks that come with it." [*CADC/RAD Venture 2011-1 LLC v. Bradley* (2015) 235 CA4th 775, 792, 185 CR3d 684, 697]

(2) [6:595.6] **Subterfuge for avoiding antideficiency legislation indicates "sham":** Courts are especially likely to conclude purported guarantors are really primary obligors on the debt where the entire loan transaction has been structured to subvert the purpose of the antideficiency laws; i.e., courts look to whether the purpose and effect of the loan/guaranty agreements is to recover deficiencies in violation of CCP § 580d (¶ 6:570). [*River Bank America v. Diller* (1995) 38 CA4th 1400, 1423, 45 CR2d 790, 803]

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Conversely, a guarantor may *not* employ a sham guaranty defense to avail itself inequitably of the antideficiency protections: "[The guarantor] may have insulated itself from potential claims on the property by legally separating itself from [the borrower] and the owner of the property, but by doing so, [the guarantor] could not also claim the benefit of the antideficiency protections." [*LSREF2 Clover Property 4, LLC v. Festival Retail Fund 1, LP* (2016) 3 CA5th 1067, 1082, 208 CR3d 200, 213 (declining to apply alter ego theory to pierce corporate structure created by guarantor and invalidate guaranty); see also *CADC/RAD Venture 2011-1 LLC v. Bradley* (2015) 235 CA4th 775, 792, 185 CR3d 684, 697—no sham guaranty where guarantors, not lender, opted to borrow through separate entity for their own purposes; *and see* ¶ *6:598 ff.* re guarantor waiver of antideficiency protection]

(3) [6:595.7] **Compare—trustor as guarantor:** As previously discussed, one who executes a trust deed to secure the obligation of another can be a guarantor rather than the principal obligor. *See* ¶ *6:582.2*.

b. Consequences of sham guaranty

(1) [6:596] **Purported guaranty of no legal effect:** A principal obligor cannot "guaranty" its own debt. Consequently, any such purported guaranty will be superfluous and unenforceable; i.e., such "sham guaranties" are of *no legal effect*. [*Valinda Builders, Inc. v. Bissner* (1964) 230 CA2d 106, 112, 40 CR 735, 738; see also *River Bank America v. Diller* (1995) 38 CA4th 1400, 1420, 45 CR2d 790, 801; *Jack Erickson & Assocs. v. Hesselgesser* (1996) 50 CA4th 182, 187-188, 57 CR2d 591, 594]

(2) [6:597] **Purported guaranty ineffective to avoid antideficiency protection:** Most importantly, a supposed guaranty by the principal obligor is *ineffective* to circumvent the obligor's statutory antideficiency protection. [*River Bank America v. Diller* (1995) 38 CA4th 1400, 1420, 45 CR2d 790, 801; *Cadle Co. II v. Harvey* (2000) 83 CA4th 927, 933, 100 CR2d 150, 154-155; but see also *Jack Erickson & Assocs. v. Hesselgesser* (1996) 50 CA4th 182, 188, 57 CR2d 591, 594—principal obligor/purported guarantor waived CCP § 580b antideficiency protection when senior purchase money lienholder agreed to *subordinate* to subsequent construction loan (¶ *6:453*)]

4. [6:598] **Guarantor Waiver of Antideficiency Protection:** Generally, guarantors can waive the benefits of California antideficiency laws. [Civ.C. § 2856] Thus, while a borrower might be protected from deficiency judgment liability (¶ *6:560 ff.*), the guarantor will not necessarily enjoy the same protection. [*Cadle Co. II v. Harvey* (2000) 83 CA4th 927, 932, 100 CR2d 150, 154; see also *Gramercy Investment Trust v. Lakemont Homes Nevada, Inc.* (2011) 198 CA4th 903, 911, 130 CR3d 496, 502—guarantor's express waiver of antideficiency protections resulted in estoppel to assert same; *Gray1 CPB, LLC v. Kolokotronis* (2011) 202 CA4th 480, 482, 135 CR3d 448, 449—continuing guaranty under which guarantor, among other things, unconditionally agreed to pay amount equal to borrower's debt was "in form and substance" a guaranty, rendering guarantor's antideficiency protection waiver valid (guaranty's isolated references mirroring demand note language insufficient to transform agreement's essence)]

Nonetheless, as developed at ¶ 6:600 ff., there are limitations on an effective guarantor waiver.

a. [6:599] **Background—guarantor's "*Gradsky* defense":** Normally, a guarantor who is called upon to pay the principal obligor's debt becomes *subrogated* to the same rights against the debtor that the original lender had. The guarantor effectively "steps into the shoes" of the lender and can obtain no greater rights than the lender had. Thus, a lender who elects the remedy of *nonjudicial foreclosure* cannot obtain a deficiency judgment against the principal obligor and, in turn, effectively *destroys the guarantor's subrogation rights* against the principal obligor; the guarantor (now standing in the lender's shoes) has no further rights against the principal obligor.

Because only the lender has the option of preserving its rights *and* preserving the guarantor's subrogation rights (by electing judicial foreclosure), the lender is *estopped* to pursue the guarantor for a deficiency when it elects a remedy that destroys the guarantor's subrogation rights … *unless* the guarantor has effectively *waived* this estoppel (so-called "*Gradsky*") defense. [*Union Bank v. Gradsky* (1968) 265 CA2d 40, 43-47, 71 CR 64, 69-70; see *Cathay Bank v. Lee* (1993) 14 CA4th 1533, 1535, 18 CR2d 420, 421, fn. 3; *Trust One Mortg. Corp. v. Invest America Mortg. Corp.* (2005) 134 CA4th 1302, 1311-1312, 37 CR3d 83, 90]

b. [6:600] **Requirements for effective waiver:** Waivers of the "*Gradsky* defense" in secured real property transactions traditionally have received close judicial scrutiny so as to protect the guarantor from the inequity that otherwise would occur

when the lender elects nonjudicial foreclosure. However, the applicable law is in a transitional stage, moving from one-time very rigid requirements (*¶ 6:602 ff.*) to a more lenient statutory approach (*¶ 6:601 ff.*).

(1) [6:600.1] **Governing law based on date waiver executed:** The validity of a guarantor's *Gradsky* defense waiver "shall be determined by the application of the law that existed on the date that the waiver was executed." [Civ.C. § 2856(f)]

As discussed at ¶ 6:601 ff., the validity of waivers executed on and after *January 1, 1997* is determined under the version of Civ.C. § 2856 added to the Civil Code effective January 1, 1997 (Stats. 1996, Ch. 1013) (*¶ 6:601 ff.*). Waivers executed before 1997 are governed by the former version of § 2856 (*¶ 6:601.3*) and more stringent prior case law (*¶ 6:602 ff.*).

(2) [6:600.2] **Clear statement of intent required:** The law has remained consistent on the point that an effective guarantor waiver of antideficiency protection must *express the guarantor's intent* to do so. Court's will "not strain" to imply a waiver from ambiguous language. [See Civ.C. § 2856(b)—"contractual provision that *expresses an intent* to waive … [*Gradsky defense*] shall be effective"; *Union Bank v. Gradsky* (1968) 265 CA2d 40, 48, 71 CR 64, 70; see also *Gramercy Investment Trust v. Lakemont Homes Nevada, Inc.* (2011) 198 CA4th 903, 911, 130 CR3d 496, 503—waiver finding appropriate where waiver language evinces such intention, particularly when parties are sophisticated business persons with real estate development expertise]

(3) [6:601] **Post-1996 waivers:** With respect to post-1996 guaranties of loans *other than those secured by certain borrower-occupied residential property* (*see ¶ 6:604*), a contractual provision that *expresses an intent* to waive any or all of the rights and defenses set forth in Civ.C. § 2856(a) (¶ 6:601.1) "*shall be effective* to waive those rights and defenses *without regard to the inclusion of any particular language or phrases*" in the waiver "*or any references to statutory provisions or judicial decisions*." [Civ.C. § 2856(b) (emphasis added); see also Stats. 1996, Ch. 1013, § 3—"It is the intent of the Legislature that the types of waivers described in … [Civ.C. § 2856] do not violate the public policy of this state"]

(a) [6:601.1] **Waivable rights and defenses:** The guarantor rights and defenses that may be waived pursuant to Civ.C. § 2856 include:

- Rights of subrogation, reimbursement, indemnification, and contribution "and any other rights and defenses that are or may become available to the guarantor … by reason of [Civil Code] Sections 2787 to 2855, inclusive" (Civ.C. § 2856(a)(1));

- Rights or defenses the guarantor may have by reason of the creditor's (lender's) election of remedies (Civ.C. § 2856(a)(2));

- Rights or defenses the guarantor may have because the principal's note or other obligation is secured by real property —including, but not limited to, rights or defenses based upon CCP §§ 580a, 580b, 580d or 726 (antideficiency laws) (Civ.C. § 2856(a)(3)). [*Gramercy Investment Trust v. Lakemont Homes Nevada, Inc.* (2011) 198 CA4th 903, 912, 130 CR3d 496, 503]

The Civ.C. § 2856(a)(2) and (3) rights/defenses essentially encompass the *Gradsky* defense.

1) [6:601.1a] **Compare—equitable defenses:** A guarantor's waiver of defenses is limited to legal and statutory defenses expressly set out in the agreement. Indeed, "[a] waiver of statutory defenses is not deemed to waive all defenses, especially *equitable defenses*, such as unclean hands, where to enforce the guaranty would allow a lender to profit by its own fraudulent conduct … Public policy requires us to read Civil Code section 2856 in a manner that prevents one party from capitalizing upon its own fraud or willful misconduct." [See *California Bank & Trust v. DelPonti* (2014) 232 CA4th 162, 166-168, 181 CR3d 216, 218-220 (applying rule of strict construction to contractual predefault waivers in case of first impression)—guarantors entitled to raise equitable defenses despite waiver provision where creditor willfully breached guaranty agreement]

(b) [6:601.2] **"Safe harbor" language for effective waiver of "*Gradsky* defense":** Without limiting the parties' right to use any other language to express an intent to waive the Civ.C. § 2856(a)(2) and (3) rights and defenses (i.e., the *Gradsky* defense), use of the following statutory language "*shall effectively waive*" those rights and defenses (Civ.C. § 2856(c) (emphasis added); *see also Form 6:L*):

> "The guarantor waives all rights and defenses that the guarantor may have because the debtor's debt is secured by real property. This means, among other things:

"(1) The creditor may collect from the guarantor without first foreclosing on any real or personal property collateral pledged by the debtor.

"(2) If the creditor forecloses on any real property collateral pledged by the debtor:

"(A) The amount of the debt may be reduced only by the price for which that collateral is sold at the foreclosure sale, even if the collateral is worth more than the sale price.

"(B) The creditor may collect from the guarantor even if the creditor, by foreclosing on the real property collateral, has destroyed any right the guarantor may have to collect from the debtor.

"This is an unconditional and irrevocable waiver of any rights and defenses the guarantor may have because the debtor's debt is secured by real property. These rights and defenses include, but are not limited to, any rights or defenses based upon Section 580a, 580b, 580d, or 726 of the Code of Civil Procedure." [Civ.C. § 2856(c)]

1) [6:601.3] **Alternative "safe harbor" language—validating post-1994 waivers:** Section 2856 also validates alternative "safe harbor" language taken from that version of the statute in effect between 1995 and the end of 1996 (former Civ.C. § 2856(b)).

Without limiting the parties' right to use any other language to express an intent to waive all guarantor rights and defenses by reason of the creditor's (lender's) election of remedies, the following provision "*shall be effective*" to waive all rights and defenses the guarantor may have by reason of the creditor's (lender's) *election of remedies* (Civ.C. § 2856(d) (emphasis added)):

"The guarantor waives all rights and defenses arising out of an election of remedies by the creditor, even though that election of remedies, such as a nonjudicial foreclosure with respect to security for a guaranteed obligation, has destroyed the guarantor's rights of subrogation and reimbursement against the principal by the operation of Section 580d of the Code of Civil Procedure or otherwise." [Civ.C. § 2856(d) (former Civ.C. § 2856(b))]

Pursuant to current Civ.C. § 2856(f) (¶ *6:600.1*), the above "safe harbor" language validates any waiver of the *Gradsky* defense executed on and after January 1, 1995. [See *Gramercy Investment Trust v. Lakemont Homes Nevada, Inc.* (2011) 198 CA4th 903, 912, 130 CR3d 496, 503—waiver finding appropriate where guarantor, in Civ.C. § 2856 recommended language, clearly and unequivocally waived all rights or defenses it had based on antideficiency statutes and creditor's election of remedies]

2) [6:601.4] **Exception for guaranties of certain residential secured loans:** *See ¶ 6:604*.

(4) [6:602] **Pre-1995 waivers—stricter *Cathay Bank* standards:** Civ.C. § 2856 (¶ 6:601.3) was enacted in response to case law that took a particularly stringent position with respect to the enforceability of a purported waiver of the *Gradsky* defense (*Cathay Bank v. Lee* (1993) 14 CA4th 1533, 1539-1540, 18 CR2d 420, 423-424). [See *Gramercy Investment Trust v. Lakemont Homes Nevada, Inc.* (2011) 198 CA4th 903, 911, 130 CR3d 496, 502—*Cathay Bank* imposed "stringent requirements" on wording and interpretation of guarantor's waiver of a defense arising from principal's rights under antideficiency statutes]

The *Cathay Bank* decision (¶ 6:602.1 ff.) continues to apply to guarantor waivers executed before 1995 (i.e., before the enactment of Civ.C. § 2856 in its former and current versions; cf. Civ.C. § 2856(f)); and it *may* still govern guarantor waivers with respect to certain residential property secured loans (*see ¶ 6:604*).

(a) [6:602.1] **Explanation of defense being waived:** According to *Cathay Bank* and its progeny, an effective waiver must not only expressly identify the rights being waived but *also* evidence the guarantor's *actual knowledge and awareness of what is being waived*—i.e., the waiver language must alert the guarantor to the *nature of the defense* at stake. [*Cathay Bank v. Lee* (1993) 14 CA4th 1533, 1539-1540, 18 CR2d 420, 423-424]

Specifically, an effective "explicit" waiver must tell the guarantor that "if the lender selects nonjudicial foreclosure, [the guarantor] will have a *defense* to a deficiency judgment, and it is *that defense* which the guarantor is now being asked to give up in advance." [*Cathay Bank v. Lee*, supra, 14 CA4th at 1538-1539, 18 CR2d at 423 (emphasis in original); see *Resolution Trust Corp. v. Titan Fin'l Corp.* (9th Cir. 1994) 22 F3d 923, 925]

1) [6:602.2] **Doubts resolved against waiver:** Further, under the stricter *Cathay Bank* approach, any ambiguity regarding the guarantor's *knowing* waiver of the *Gradsky* defense must be interpreted against the lender (drafter of the guaranty) and thus against an effective waiver. [*Cathay Bank v. Lee* (1993) 14 CA4th 1533, 1540-1541, 18 CR2d 420, 424]

2) Application

• [6:602.3] At least under *Cathay Bank*, language stating Guarantor "shall be liable to [Lender] for any deficiency resulting from the exercise by it of any such remedy, even though any rights which Guarantor may have against others might be … destroyed" is *not* an effective waiver. These words are *not sufficiently specific* about the *precise* rights being waived.

"To find a waiver of the *Gradsky* defense here one must go beyond the actual words and imply into them two more ideas, namely: (1) that the destruction of subrogation rights creates a defense to a deficiency judgment, and (2) the guarantor is now waiving that *specific* defense." [*Cathay Bank v. Lee* (1993) 14 CA4th 1533, 1539, 18 CR2d 420, 423 (emphasis in original)]

(b) [6:603] **Civ.C. § 2856 preemption re post-1994 waivers:** To the extent Civ.C. § 2856 applies—in *either* its former or current forms—the stricter *Cathay Bank* requirements are effectively *preempted*. [See *River Bank America v. Diller* (1995) 38 CA4th 1400, 1419, 45 CR2d 790, 800—"it is clear the Legislature enacted section 2856 to ameliorate the strict rule laid down in *Cathay Bank*"]

(c) [6:604] **Continued *Cathay Bank* viability with respect to certain residential secured loans?** The more lenient Civ.C. § 2856(b), (c), and (d) waiver provisions (including waiver of the *Gradsky* defense) expressly *do not apply* to a "guaranty or other type of suretyship obligation made in respect of a loan secured by a deed of trust or mortgage on a *dwelling of not more than four families* when the dwelling is *occupied*, entirely or in part, *by the borrower* and that loan was in fact used to pay all or part of the purchase price of that dwelling." [Civ.C. § 2856(e) (emphasis added)]

In an uncodified statement of intent, the Legislature declared that, by enacting Civ.C. § 2856(b), (c) and (d), it did not intend to address the legal requirements for guarantor waivers in connection with loan transactions described in Civ.C. § 2856(e); but that "[n]o inference of any kind should be drawn from the exclusion of these transactions" from Civ.C. § 2856(b), (c), and (d). [See Stats. 1996, Ch. 1013, § 3]

Thus, the Legislature has taken no position on the issue either way but, instead, deferred to the courts to decide whether *Cathay Bank* or some other standard should apply in these cases. See also Stats. 2013, Ch. 65, § 1, wherein the Legislature explicitly recognizes that the antideficiency protections of CCP §§ 580b and 580d do not impact existing law regarding the liability of guarantors, pledgors or other sureties with respect to deficiencies, nor existing law regarding other collateral pledged to secure obligations that are the subject of deficiencies (¶ *6:563 and 6:563.2*).

c. [6:605] **Application to indemnity agreements:** The *Gradsky* defense (¶ *6:599*) also applies to an *indemnity agreement* when the indemnitor and principal obligor are "*substantially the same*." In such a case, the agreement is the same as a guaranty and, without an effective waiver (¶ *6:600 ff.*), constitutes an invalid attempt to circumvent the antideficiency laws. [See *Trust One Mortg. Corp. v. Invest America Mortg. Corp.* (2005) 134 CA4th 1302, 1310-1313, 37 CR3d 83, 90-92 (collecting cases) (emphasis added)—agreement between lender and mortgage broker whereby lender funded secured loans brokered by broker and broker agreed to indemnify lender for losses incurred as result of borrowers' defaults *not* subject to *Gradsky* defense (i.e., antideficiency law did not bar enforcement of indemnity agreement) because broker (indemnitor) was unrelated to borrowers —not "a principal obligor in guarantor's guise"]

d. [6:606] **Compare—guarantor as secured debtor:** Guarantors may lawfully waive antideficiency protection (the "*Gradsky* defense," ¶ 6:599 ff.) *only* as to the underlying secured obligation which they guaranty. On the other hand, guarantors who *pledge real property* as security for *their* guaranty are themselves *principal obligors* entitled to the antideficiency protections of CCP §§ 580d and 726 with respect to a foreclosure on the property pledged to secure the guaranty.

5. [6:607] **Guarantor as Foreclosing Creditor:** A borrower (principal obligor) has the protection of antideficiency legislation with respect to claims by either the guarantor or the lender. However, the guarantor might be able to purchase the loan from the lender and thereafter pursue a *judicial* foreclosure. If the loan is not otherwise nonrecourse (¶ *6:402*), the guarantor would then stand in the lender's shoes and could obtain a deficiency judgment against the borrower following the judicial foreclosure.

6. [6:608] **Drafting Effective Guaranties:** To protect the lender, a guaranty should, at a minimum, cover the issues addressed at ¶ 6:609 ff.

• ***FORM:*** Guaranty, *see Form 6:L*.

a. [6:609] **Scope of guaranty:** The precise scope of the obligation guarantied by the guarantor should be described.

➪ [6:610] ***PRACTICE POINTER:*** A guaranty of *all* of the borrower's obligations should explicitly state it extends to all obligations, whether principal, interest, collection costs or otherwise.

If, however, the amount guarantied is *less* than the borrower's full obligation, the parties should be particularly careful in describing the limitations on the scope of the guaranty.

b. [6:611] **Modifications, renewals and extensions of loan:** The guaranty should state whether it will continue after any modification, renewal or extension of the loan.

➪ [6:612] ***PRACTICE POINTER:*** It is always advisable for a lender to obtain the guarantor's written consent to any modification of the guarantied obligation (*see* ¶ *6:586* re exoneration by alteration of principal obligation). In particular, the guarantor should always obtain a separate, additional guaranty if the loan amount is ever increased. This is because an increase in the loan amount is not necessarily a "modification" of the loan but, rather, the creation of an additional, new debt.

c. [6:613] **Guarantor's liability after exoneration of borrower or other guarantors:** Well-drafted guaranties typically state each guarantor remains liable even if (1) the borrower or other guarantors are not pursued by the lender; and (2) the lender has compromised or released any claim against the borrower or other guarantors. In other words, the guaranty remains valid even if, at any time, the guarantor's liability to the lender is greater than that of the borrower or some other guarantor.

d. [6:614] **Waivers by guarantor:** The guarantor is usually required to waive various defenses and rights, including: applicable statutes of limitations; certain defenses to which the borrower might be entitled; defenses based on the lender's election of remedies ("*Gradsky* defense"); antideficiency protections; the lender's release of the borrower or any other guarantor; the lender's delay in exercising its remedies, etc. [See *Bank of America, N.A. v. Stonehaven Manor, LLC* (2010) 186 CA4th 719, 723-724, 113 CR3d 57, 60—property of two guarantors was subject to attachment upon debtor's default (both guarantors contractually waived their right under suretyship law to benefit of real property security pledged by borrower and third guarantor)]

Waiver provisions should be stated *explicitly* and, to ensure they will be given effect, should use the Civ.C. § 2856 "safe harbor" language (*see* ¶ *6:601.2, 6:601.3*). (Guarantor waivers in connection with loans secured by borrower-occupied residential (one-to-four unit) property arguably should be more extensive, adhering to *Cathay Bank's* stricter standards; *see* ¶ *6:602 ff., 6:604*.)

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[6:615 - 6:619] ***Reserved.***

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Cal. Prac. Guide Real Prop. Trans. Ch. 6-K

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 6. Financing and Appraisals

K. Environmental Indemnities

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1. [6:620] **Necessity for From Lender's Perspective:** Lenders have wisely developed a heightened sensitivity to environmental issues out of concern they might become subject to third party claims either before or after they foreclose. This concern is particularly acute in light of California antideficiency laws, which might cut off the lender's rights against a borrower relating to environmental contamination of the encumbered property.

Therefore, in commercial and multi-unit residential loan transactions, lenders typically require the borrower to execute a separate environmental indemnity agreement under which the borrower agrees to indemnify the lender for various environmental liabilities relating to the secured property.

Cross-refer: Environmental indemnities are also discussed in *Ch. 5* in connection with the allocation of environmental (cleanup) liability risks in a real property purchase and sale transaction; *see ¶ 5:230 ff.* Additionally, keep in mind that lenders are protected from CERCLA and State Superfund liability (i.e., they are not deemed "owners" or "operators" of a contaminated property) under specified conditions; *see ¶ 5:84 ff.*

2. [6:621] **Nature of Borrower's Indemnity:** Lenders typically require one of two kinds of an environmental indemnity: Either an *unsecured* environmental indemnity; or a *secured* environmental indemnity, which becomes *unsecured* upon a foreclosure of the deed of trust.

3. [6:622] **Antideficiency Protection?** There is yet no known case law addressing whether an environmental indemnity obligation might be subject to the protection of California's antideficiency laws.

[6:623] ***Reserved.***

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4. [6:624] **Lender's Statutory Rights:** Lenders are afforded certain statutory rights and protections with respect to environmental matters.

a. [6:625] **Waiver of lien:** A secured lender may elect to waive its lien on "environmentally impaired" property (see CCP § 726.5(e)(3)) and exercise the rights and remedies of an *unsecured creditor* by proceeding against the borrower's other assets. [CCP § 726.5(a) (applicable only to secured real property loans made, renewed or modified on or after January 1, 1992; see CCP § 726.5(g))]

(1) [6:626] **Limitation—culpable borrower:** However, a lender may make this election *only* if the borrower is culpable in either causing, contributing to, or not informing the lender of the environmental impairment. [See CCP § 726.5(d)]

b. [6:627] **Breach of contract remedy:** "Notwithstanding any other provision of law," secured lenders may bring a breach of contract action against the borrower for breach of any environmental agreement made by the borrower relating to the real property security. This cause of action does *not* invoke the protections of California antideficiency laws. [CCP § 736(a) (applicable only to environmental provisions contracted in conjunction with loans made, renewed or modified on or after January 1, 1992; see CCP § 736(e))]

(1) [6:628] **Limitation on recoverable damages:** However, the damages recoverable in a CCP § 736 action are subject to several statutory limitations. [See CCP § 736(b)] And *no* such damages are recoverable if:

- the original principal loan amount did not exceed $200,000;
- the lender agreed in writing to accept the real property security on the basis of a completed environmental site assessment "and other relevant information from the borrower";
- the borrower did not permit, cause or contribute to the release or threatened release of hazardous substances; *and*
- the deed of trust covering the secured property has not been discharged, reconveyed or foreclosed upon. [See CCP § 736(c)]

c. [6:629] **Lender's right of entry and inspection:** Secured lenders have a statutory right to enter and inspect their real property security for the purpose of determining the "existence, location, nature, and magnitude of any past or present release or threatened release of any hazardous substance into, onto, beneath, or from the real property security …" [Civ.C. § 2929.5(a)]

(1) [6:630] **Conditions on entry/inspection rights:** The right of entry and inspection is *conditioned* upon the occurrence of *either* of the following:

- The lender's "reasonable belief" of a past or present hazardous substance release or threatened release not previously disclosed in writing to the lender in conjunction with the making, renewal or modification of its secured loan (Civ.C. § 2929.5(a)(1)); *or*
- The commencement of nonjudicial or judicial foreclosure proceedings against the real property security (Civ.C. § 2929.5(a)(2)).

(2) [6:631] **Prior notice:** Except in emergencies or when the borrower (or a tenant of the property) has abandoned the premises, and unless it is "impracticable" to do so, the lender must give the borrower (or tenant of the property) "reasonable notice" (generally, at least 24 hours' notice) of the intent to enter and may enter only during the borrower's (or tenant's) normal business hours. [Civ.C. § 2929.5(b); CCP § 564(c)]

(3) [6:632] **Consequential damages reimbursement:** The lender must reimburse the borrower for the cost of repairing any physical injury to the secured property caused by the entry and inspection. [Civ.C. § 2929.5(c)]

(4) [6:633] **Court action to enforce entry/inspection rights; appointment of receiver:** If the borrower (or tenant of the property) refuses the lender the right of entry and inspection, or if the lender is otherwise unable to enforce its inspection rights without breaching the peace, the lender may commence an action for an order compelling compliance. [Civ.C. § 2929.5(d)] Incident thereto, the court may *appoint a receiver* to facilitate enforcement of the lender's Civ.C. § 2929.5 rights. [CCP § 564(c)]

(a) [6:634] **Not subject to "one action" rule:** Neither a Civ.C. § 2929.5 enforcement action nor the appointment of a receiver pursuant to CCP § 564 constitutes an "action" within the meaning of the CCP § 726(a) "one action rule" (¶ *6:551*). [Civ.C. § 2929.5(d); CCP § 564(d)]

[6:635 - 6:649] ***Reserved.***

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California Practice Guide: Real Property Transactions | September 2024 Update
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Chapter 6. Financing and Appraisals

L. Real Estate Appraisals

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1. General Considerations

a. [6:650] **Definition:** Other than in connection with loans by "federally-regulated financial institutions" (which are subject to the Real Estate Appraisers' and Licensing Certification Law, *see ¶ 6:690*), the term "appraisal" has no specific legal definition.

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Broadly, a real estate appraisal is merely someone's opinion as to the monetary value of a property. While that valuation opinion might be based on a standardized methodology, it is only an opinion, not a scientific fact or legal conclusion.

Indeed, unless the appraisal is made in connection with a "federally-related transaction" (*¶ 6:690 ff.*), anyone can call oneself a real estate "appraiser." Therefore, the term "real estate appraisal" has traditionally meant anything from an informal valuation opinion (with little or no supporting research or data) to the opinion of a highly experienced valuation professional based on extensive research consistent with the standards and practices of a professional real estate appraisers association.

b. [6:651] **"Appraised value":** In lay parlance, the "appraised value" of a piece of real property is generally thought to be its "fair market value"—i.e., the price at which a willing seller would sell and a willing buyer would buy in an arm's length transaction. However, depending upon the purpose of the appraisal and the valuation methodology used, a property's "fair market value" may or may not be the same as its "appraised value":

(1) [6:652] **Appraised value as affected by purpose of appraisal:** The valuation of a property can dramatically change with the purpose for which the appraisal is made. For example, appraisals for the identical property (or property interest) may yield entirely different results when made for purposes of determining (a) a compensation award in an eminent domain proceeding, or (b) gift and estate tax, or (c) the value of collateral for a lender's secured financing.

(2) [6:653] **Appraised value as affected by method of appraisal:** The particular appraisal methodology or "approach" utilized in a given transaction can produce different valuations for the same property (or property interest). For example, the appraised value of a single family residence based on a comparison with sale prices for comparable homes might be different from the appraised value of the identical residence based on its "replacement cost" (*see ¶ 6:665 ff.* re real estate appraisal "approaches").

c. [6:654] **Appraisal purposes:** The general purpose of a real estate appraisal is to value a particular interest in real property. Typically, the appraised interest is a fee or leasehold; however, other interests—such as an option to purchase or an easement —can also be the subject of a real estate appraisal.

More specifically, there are several fundamental purposes for an appraisal:

(1) [6:655] **Determining purchase/sale price:** A seller might need an appraisal to determine the property's fair market purchase and sale price.

(2) [6:656] **Determining value for secured loan or credit bidding at foreclosure:** Lenders conduct appraisals to ascertain the value of the property that will serve as security for a particular loan.

Also, in contemplation of making a full credit bid at a foreclosure sale of the secured property, lenders usually conduct appraisals to ensure the property is worth at least as much as the principal obligation. (The lender's purchase by full credit extinguishes its lien and the underlying debt, and ordinarily bars it from pursuing other remedies based on impairment of the security; *see ¶ 6:535.1 ff.*)

(3) [6:657] **Determining compensation in eminent domain proceeding:** In eminent domain proceedings, an appraisal may be the yardstick by which appropriate compensation for the acquired parcel or interest is measured.

(4) [6:658] **Determining valuation for tax purposes:** A taxpayer may need to determine the value of property for a variety of tax purposes (property tax, gift/estate tax, allocation of the purchase price between land and improvements, etc.). The property valuation established by the tax assessor for purposes of calculating property tax is referred to as the "assessed value." A taxpayer wishing to appeal the assessed or taxable value of property may submit evidence of a lower value, including an appraisal, to the taxing authority.

(5) [6:658.1] **Determining basis for canceling PMI:** "Private mortgage insurance" (PMI) often is required as a condition of a loan secured by a deed of trust or mortgage on real property. A borrower may be able to cancel PMI based upon various factors, including a current appraisal of the property. [See generally, Civ.C. § 2954.12(a), (b) (conditions for canceling PMI on post-12/31/97 loans, exclusive of loans made by or sold to institutional third parties such as Fannie Mae, Freddie Mac or Ginnie Mac)]

[6:659] **Comment:** In terms of sheer volume, the great majority of appraisals are prepared for lenders who contemplate making a loan that is to be secured by the property appraised. Indeed, every institutional lender (and every prudent private lender) will require some form of appraisal in order to determine whether the value of the security will support the loan. (*See ¶ 6:109 ff.* re lenders' "loan-to-value" requirements.) For this reason, the remaining sections of this Chapter focus primarily on appraisals prepared by real property secured lenders.

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d. [6:660] **Professional real estate appraiser organizations:** Numerous national professional real estate appraiser organizations provide certification functions. Appraisers who wish to be certified by these organizations must satisfy specified education and experience requirements. Member appraisers must also follow the organization's guidelines and standards in preparing their appraisals.

Perhaps the three best known professional real estate appraiser organizations are the *American Institute of Real Estate Appraisers* (whose members' appraisals are known as "MAI appraisals"), the *Society of Real Estate Appraisers* and the *Appraisal Foundation*.

[6:661 - 6:664] ***Reserved.***

2. [6:665] **Basic Real Property Appraisal Approaches:** There are three basic methods (or "approaches") to the appraisal of real property: the sales comparison approach, the cost approach, and the income capitalization approach. The particular approach used by an appraiser will depend on the purpose of the appraisal and, of course, on the preference of the party who commissions the appraisal.

The various appraisal methods take different factors into consideration; consequently, as discussed, the "appraised value" of a property (or interest therein) yielded under one approach will not necessarily be the same value yielded under another approach.

a. [6:666] **Sales comparison approach:** Residential real property most commonly is appraised by the "sales comparison approach." This method assumes there is a direct correlation between the market value of a property and the price of comparable properties that have recently sold.

(1) [6:667] **Comparison factors:** The typical factors for comparison are:

• the real property rights conveyed;

• financing terms;

• conditions of sale;

• date of sale;

• location of the property; and

• specific physical characteristics of the property (e.g., lot size, number of rooms, age of structure, quality of construction materials, unique design features, etc.).

(2) [6:668] **Preferred method for single-family residences:** Although the sales comparison approach may be used for appraising almost every kind of real property, it has its greatest applicability to single-family residences. This is chiefly because a single-family residence appraisal based on the sales comparison approach is relatively easy to do and there is often a sizable pool of comparable properties that have recently sold.

The "income capitalization approach" (*¶ 6:674*) is not particularly appropriate for appraising single-family residences because they rarely produce income and, even if they do, the income is not necessarily comparable to other residential properties. The "cost approach" (*¶ 6:670*) is equally inappropriate for single-family residences because it is not a reliable method for valuing older residential properties which may need significant repairs.

➪ [6:669] ***PRACTICE POINTER:*** Despite its general acceptance for residential property valuations, a sales comparison approach may not necessarily be suitable to a given case. In particular, it may be unreliable if there are not sufficient comparable sales within a recent time period. It may also be unreliable if market conditions change dramatically. For example, a sudden change in interest rates or tax laws, or a recent natural disaster (e.g., flood, earthquake or hurricane), can make a valuation that was valid when made unreliable one month later.

b. [6:670] **Cost approach:** Like the sales comparison approach, the "cost approach" to valuation is also based on comparability. However, the comparison is between the value of the completed project (which is being appraised) and the cost to develop a comparable project. In other words, the appraiser estimates the cost to *replace* the subject project.

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(1) [6:671] **Methodology:** The appraiser first calculates the cost of reproducing the subject project by (a) determining the value of the land and then (b) adding the cost of reproducing the building and other improvements with a comparable design and comparable materials.

From that total cost, the appraiser must factor in a depreciation adjustment to reflect the age and depreciation of the existing project.

(2) [6:672] **Applicable properties:** The cost approach is most applicable in appraising *new or relatively newly-constructed projects*, but is more problematic to apply to older properties (because it is sometimes difficult to assess the degree of depreciation in older properties). The cost approach is particularly valuable when the sales comparison approach would be unreliable because either the subject property is unique or there is not a pool of recent sales sufficient to justify a valuation based on sales comparisons.

➪ [6:673] ***PRACTICE POINTER:*** As a practical matter, the cost approach is more likely to be used when assessing issues relating to property damage insurance. Because it is fairly unrelated to the "market value" of a property, the cost approach is rarely used by lenders (or, for that matter, by buyers or sellers).

c. [6:674] **Income capitalization approach:** The "income capitalization approach" is used to appraise income-producing property; it is based on the premise that the value of a property is directly related to the ability of the property to generate revenues. Therefore, value is fundamentally determined by assessing the property's estimated future income stream.

The income capitalization approach includes some of the factors considered in the sales comparison and cost approaches, but is perhaps the most complex method of valuing a property. It is usually most appropriate when valuing a commercial (or other income-producing) building, an interest in an entity that owns a real estate project, participation mortgages, master leaseholds, subleasehold estates, or like real property interests.

3. [6:675] **Selecting an Appraiser—Checklist:** If the appraisal is commissioned in connection with a secured loan application, the borrower typically has no voice in selecting the appraiser. However, a buyer or seller looking to commission an appraisal for any other purpose should consider the following factors in assessing a particular appraiser's suitability:

• What is the appraiser's education and general experience level?

• Does the appraiser have substantial experience in appraising *similar* kinds of properties?

• Is the appraiser experienced in valuing properties in the subject property's geographic locale? (Knowledge of local market conditions, zoning laws, etc. is important.)

• Is the appraiser a member of a respected *professional appraisal association?* (*See ¶ 6:660*.) If so, the appraiser will be able to certify that the appraisal meets generally-accepted standards in the industry. (For example, a member of the American Institute of Real Estate Appraisers can issue an "MAI appraisal," which is one of the most highly regarded kinds of real estate appraisals.)

• If the appraisal is being prepared in connection with litigation (e.g., to obtain evidence of fair market value for use in a breach of contract suit between buyer and seller), does the appraiser have sufficient knowledge, skill and expertise to be a convincing expert witness?

(Also, if the appraisal is commissioned in connection with litigation, any potential conflict of interest between the appraiser and any party to the lawsuit should be considered before retaining the appraiser.)

➪ [6:676] ***PRACTICE POINTER:*** The completed appraisal is likely to be formalized by the appraiser's *written report* (*see ¶ 6:677 ff.*). When the appraisal is being prepared in connection with *litigation*, the report is likely to be a *discoverable* document (because relevant to the subject matter, see CCP § 2017). If discoverability is a concern, it may be advisable to have the *attorney* (rather than the party personally) *hire the appraiser*, thereby making the report subject to *work product protection* (see CCP § 2018; and detailed discussion in Weil & Brown et al., *Cal. Prac. Guide: Civ. Pro. Before Trial* (TRG), Ch. 8C).

4. [6:677] **Appraiser's Report:** A completed appraisal can be as informal as an oral report or a brief letter. Typically, however, appraisers prepare a written report that contains most (if not all) of the following information:

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a. [6:678] **Property identification:** An identification of the real property (and the interest being appraised), including a legal description of the land and a description of the improvements thereon.
b. [6:679] **Dates:** The date of valuation of the property and the date the appraisal was completed.
c. [6:680] **Appraisal approach:** The particular appraisal methodology used (e.g., sales comparison approach, cost approach, income capitalization approach) and a brief discussion of that methodology.
d. [6:681] **Assumptions and conditions:** Specific factual and legal assumptions made in the valuation process and so-called “limiting conditions.” (Limiting conditions might include such things as a statement that no survey was made; or that no analysis of subsurface mineral, oil and gas rights was considered.)
e. [6:682] **Personal property:** An indication of any personal property that is (or is not) included in the appraisal.
f. [6:683] **Misc. background information:** Miscellaneous background material, such as a statement as to how value is estimated; the appraiser's definition of the “appraisal” (or of “value”); and the purpose of the appraisal.
g. [6:684] **Supporting data:** Depending on the type of appraisal, the report will include various data that support the appraiser's valuation. This may include photographs of the property (and comparable properties); maps and charts; a preliminary title report; a history of the property; market studies; abstracts of leases; building specifications; income and expense data; cost estimates; sales and listings for comparable properties; real property taxes and assessments; plans and elevations of buildings; a plot plan; and area data (which may include information relating to public transportation, proximity to schools, parks and social services, population trends, vacancy and rent levels, new construction activities, adequacy of on-site and off-site parking and other beneficial or detrimental influences).
h. [6:685] **Appraiser's qualifications:** If the appraisal has been prepared in accordance with the standards of a professional appraisers association, the report will so indicate (and also include a reference to the association's standards and practices).
i. [6:686] **Appraised value:** The appraised value might be stated in a specific dollar amount or a range of values.
j. [6:687] **Borrower's right to receive copy of appraisal:** If the borrower is required to pay for the appraisal, the report should indicate that the lender or broker must provide the borrower with a copy of the appraisal upon request (*see ¶ 6:692*).

[6:688 - 6:689] ***Reserved.***

5. Appraiser Licensing Requirements

a. [6:690] **California Licensing Law:** California has enacted the “Real Estate Appraisers' Licensing and Certification Law” (Bus. & Prof.C. § 11300 et seq.), which requires real estate appraisers who engage in “federally-related real estate appraisal activity” to be licensed by the California Bureau of Real Estate Appraisers. [Bus. & Prof.C. § 11320]

Indeed, no person other than a state-licensed real estate appraiser may assume or use that title (or any other title likely to create the impression of state licensure as a real estate appraiser in California). And, while nonlicensed persons may *assist* in preparing an appraisal in federally-related transactions under specified conditions (see Bus. & Prof.C. § 11324), only a duly-licensed appraiser may sign an appraisal in a federally-related transaction. [Bus. & Prof.C. § 11321(b)]

(1) [6:691] **Limited application—federally-related loan transactions only:** The purpose of the California Real Estate Appraisers' Licensing and Certification Law is to control abuses in the preparation of real estate appraisals in connection with *loans issued by federally-regulated financial institutions*. Thus, the statutory scheme applies only to appraisals “on real estate or real property in a federally related transaction.” [Bus. & Prof.C. § 11302(s)]

A “federally-related transaction” means “any real estate-related financial transaction that a federal financial institutions regulatory agency engages in, contracts for or regulates and that requires the services of a state licensed real estate appraiser regulated by [Bus. & Prof.C. § 11300 et seq.].” It also includes any transaction identified as such by a federal financial institutions regulatory agency. [Bus. & Prof.C. § 11302(t)] In other words, the appraiser must be licensed under California law only if the appraisal is prepared in connection with a *loan from a federally-regulated financial institution*.

(2) [6:692] **Licensing requirements and administration:** Under the statutory scheme, the Governor of California appoints a Chief of the Bureau of Real Estate Appraisers and, together, they administer the licensing and certification program for real estate appraisers. [Bus. & Prof.C. § 11310]

At a minimum, licensed appraisers must satisfy criteria established by the Appraiser Qualification Board of the Appraisal Foundation or the Appraisal Subcommittee. [Bus. & Prof.C. § 11314; *and see ¶ 6:694*]

A license issued with an effective date of January 1, 2000 or later is valid for two years unless otherwise extended or limited by the Director. [Bus. & Prof.C. § 11341]

Beginning January 1, 2023, applicants must complete at least one hour of instruction in cultural competency (as defined). [Bus. & Prof.C. § 11340(e)]

To renew an appraiser's license the applicant must demonstrate "continuing fitness" to hold a license and, beginning January 1, 2023, complete at least two hours of elimination of bias training. [Bus. & Prof.C § 11360(a), (b)]

In addition, the law contemplates compliance with continuing education requirements (to be reported on the basis of four-year continuing education cycles). Thus, every four years, licensees must complete at least four hours of appraisal-related statutory and regulatory law. Moreover, beginning January 1, 2023, they must complete at least one hour of cultural competency training every four years. [See Bus. & Prof.C. § 11360(a), (b), (c), (e) (defining "cultural competency")]

If the borrower is required to pay for the appraisal, the law also requires the lender or broker to provide the borrower with a copy of the appraisal upon the borrower's request. [See Bus. & Prof.C. § 11423(b), (d)—lender must give loan applicant written notice of right to request copy of appraisal as statutorily specified; see also Bus. & Prof.C. § 10241.3—licensed broker must provide copy of appraisal to both borrower and lender at or before loan transaction's closing]

[6:692.1 - 6:692.4] ***Reserved.***

(3) [6:692.5] **Compensation limitation:** Appraisers required to be licensed under the Real Estate Appraisers' Licensing and Certification Law are prohibited from basing the amount of their compensation on the value they ultimately ascribe to the subject real property: "No licensee shall engage in any appraisal activity if [their] compensation is dependent on or affected by the value conclusion generated by the appraisal." [Bus. & Prof.C. § 11323]

(4) Enforcement

(a) Administrative orders and fines

1) [6:693] **Up to $10,000 fine for each violation:** A licensee, license applicant, person who acts in a capacity requiring a real estate appraiser license, course provider or applicant for course provider accreditation, or person or entity acting in a capacity requiring course provider accreditation, can be cited for violations of Bus. & Prof.C. § 11300 et seq. and assessed administrative fines (maximum $10,000 per violation). [Bus. & Prof.C. § 11315(a) & (e)]

Failure to pay the fine or penalty (or a required installment on the fine or penalty) by the date due will result in disciplinary action. The violator will also be charged interest and a penalty of 10% of the fine (or installment amount). Additional disciplinary action will be taken if the fine (or a required installment on the fine) is not paid within 30 days of the date ordered in the citation (unless the citation is being appealed). [See Bus. & Prof.C. § 11315(g)]

Further, the full amount of the unpaid balance of the fine will be added to any license renewal fee. [Bus. & Prof.C. § 11315(g)]

Any fine or interest thereon not paid within 30 days of a final citation or order constitutes a "valid and enforceable civil judgment." [See Bus. & Prof.C. § 11315(g)]

2) [6:693.1] **Abatement and continuing education:** The citation may also order abatement of the violation within a specified reasonable time. And, "if appropriate," the citation may order the violator to enroll in and successfully complete additional basic or continuing education courses. Failure to satisfactorily complete or timely report the education course by the date specified in the citation "shall result in the automatic suspension of the licensee's real estate appraisal license as of that date." [Bus. & Prof.C. § 11315(d)(2)(D)]

Moreover, no license may be renewed prior to satisfactory completion of the education course specified in the citation unless the citation provides for a completion date after the license renewal date. [Bus. & Prof.C. § 11315(d)(2)(D)]

(b) [6:693.2] **Criminal penalties:** Additionally, a willful violation of § 11320 (prohibition against engaging in a federally-related real estate appraisal activity without a license or misrepresenting licensed status) is punishable by imprisonment in state prison, or in county prison for up to one year, and/or a maximum $10,000 fine. [Bus. & Prof.C. § 11320]

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(c) [6:693.3] **Disciplinary proceedings:** The expiration, suspension, cancellation, forfeiture or surrender of a license or registration certificate may not, during any period in which it can be renewed, restored, reissued or reinstated, prevent the Bureau of Real Estate Appraisers from (i) instituting or continuing disciplinary proceedings against the licensee or registrant; or (ii) entering an order suspending or revoking the license or registration certificate, or otherwise taking disciplinary action against the licensee or registrant. [Bus. & Prof.C. § 11315.3]

[6:693.4] ***Reserved.***

(5) [6:693.5] **Compare—registration of appraisal management companies:** Appraisal management companies, as defined, also are subject to the Real Estate Appraiser's Licensing and Certification Law (¶ 6:690 ff.) and must be registered with the Bureau of Real Estate Appraisers. [See Bus. & Prof.C. §§ 11302(d), (h), (w) & 11320.5]

(The Bureau of Real Estate Appraisers is charged with adopting regulations governing the registration process for appraisal management companies, with minimum requirements, and establishing fees to cover the costs associated therewith; see Bus. & Prof.C. §§ 11345 & 11406.5.)

(a) [6:693.6] **Standards; administrative penalties:** As with individual licensees, appraisal management companies must meet certain standard business practices. The Bureau of Real Estate Appraisers has authority to issue citations or administrative penalties for violations of those standards (not to exceed $10,000 per violation). [See Bus. & Prof.C. §§ 11315.1 & 11345.3]

(b) [6:693.7] **Fingerprinting; background checks:** As with individual applicants, "each controlling person of each applicant for registration as an appraisal management company" must submit to the Department of Justice fingerprint images and information via LiveScan. Out-of-state applicants must include fingerprint cards with their application packages. [See Bus. & Prof.C. § 11343(a)]

(c) [6:693.8] **Unlawful influence of appraisers; prohibited acts; cross-registration violations:** *See ¶ 6:710 ff.*

(d) [6:693.9] **Federal preemption:** Any provision under the Real Estate Appraisers' Licensing and Certification Law relating to appraisal management companies is inoperative 60 days after the effective date of any federal law that mandates registration or licensing of them with an entity other than the applicable state regulatory authority. [Bus. & Prof.C. § 11346]

b. [6:694] **Federal law:** Federal law establishes the "Appraisal Subcommittee of the Federal Financial Institutions Examination Council" (12 USC § 3331 et seq.). Like the state law counterpart (¶ 6:690 ff.), this law is specifically directed at regulating real estate appraisers and appraisals in *federally-related loan transactions*.

The purpose of the federal law is expressly codified: "… to provide that Federal financial and public policy interests in real estate related transactions will be protected by requiring that real estate appraisals utilized in connection with federally-related transactions are performed in writing, in accordance with uniform standards, by individuals whose competency has been demonstrated and whose professional conduct will be subject to effective supervision." [12 USC § 3331; see *Groten v. State of Calif.* (9th Cir. 2001) 251 F3d 844, 848]

The law then goes on to provide for an Appraisal Subcommittee (under the authority of the Secretary of the Treasury) to carry out the purposes of the statute (12 USC §§ 3332 ff.); it also establishes various appraiser certification and licensing requirements and provides for the promulgation of appraisal standards (see 12 USC §§ 3336, 3340, 3345).

6. [6:695] **Appraiser Liability for Erroneous Valuations:** Appraisers who erroneously value a property may be liable to persons who suffer damages in *reliance upon* the valuation (e.g., lender finances a secured loan in reliance on adequacy of the secured property but subsequently discovers the property was overvalued and thus not sufficient recourse for the loan). [See *Neu-Visions Sports, Inc. v. Soren/McAdam/Bartells* (2000) 86 CA4th 303, 310, 103 CR2d 159, 163, fn. 3]

a. [6:696] **Theories of liability:** Like other professionals (attorneys, physicians, etc.), appraisers may be exposed to a variety of claims premised on distinct theories of liability—e.g., negligence in the performance of their duties, fraud/misrepresentation, breach of contract, etc.

(1) [6:697] **Professional negligence/duty of care:** Appraisers owe a duty to act with that degree of skill, prudence and diligence as real estate appraisers of ordinary skill and capacity commonly possess and exercise in the performance of the tasks they undertake. [See generally, *Smith v. Lewis* (1975) 13 C3d 349, 356, 188 CR 621, 625 (disapproved on other grounds by *Marriage of Brown* (1976) 15 C3d 838, 851, 126 CR 633, 641, fn. 14) (regarding professional's standard of

care); and *Budd v. Nixen* (1971) 6 C3d 195, 200, 98 CR 849, 852 (superseded by statute on other grounds as stated in *Adams v. Paul* (1995) 11 C4th 583, 595, 46 CR2d 594, 602, fn. 1, see J. Kennard concur.opn.) (elements of tort cause of action for professional negligence)] A breach of that standard of care in the performance of their duty may thus give rise to liability predicated on professional negligence.

(a) [6:698] **Threshold duty issue:** As in any negligence action, plaintiffs proceeding on a theory of professional negligence must meet the threshold burden of establishing that the defendant appraiser *owed them a duty of care* in making the appraisal. [*Nymark v. Heart Fed. Sav. & Loan Ass'n* (1991) 231 CA3d 1089, 1096, 283 CR 53, 56]

1) [6:699] **Lender's duty in appraisal process:** As a general rule, a *lender* owes *no* duty of care to its *borrower* in appraising the borrower's collateral to determine if it is adequate security for the loan. "[W]hen the [financial] institution's involvement in the loan transaction does not exceed the scope of its conventional role as a mere lender of money," the institution owes no duty of care to the borrower. [*Nymark v. Heart Fed. Sav. & Loan Ass'n* (1991) 231 CA3d 1089, 1096, 283 CR 53, 56; see also *Graham v. Bank of America, N.A.* (2014) 226 CA4th 594, 607, 172 CR3d 218, 229—appraisal ordinarily is intended for lender's benefit, not to ensure borrower made "a good bargain"; *Wagner v. Benson* (1980) 101 CA3d 27, 35, 161 CR 516, 521—"Liability to a borrower for negligence arises only when the lender actively participates in the financed enterprise beyond the domain of the usual money lender" (internal quotes omitted)]

• [6:700] A lender that conducts an appraisal of its borrower's property in the usual course and scope of its loan processing procedures acts to protect *its own* (the lender's) interest by satisfying itself that the property provides adequate security for the loan. Absent facts indicating the appraisal was intended to induce the borrower to enter into the loan transaction or to assure the borrower that their collateral was sound, the lender owes the borrower *no duty of care* in preparing the property appraisal and, thus, cannot incur professional negligence liability to the borrower for an erroneous appraisal. [*Nymark v. Heart Fed. Sav. & Loan Ass'n* (1991) 231 CA3d 1089, 1096-1097, 1099-1100, 283 CR 53, 57, 58-59—lender who prepared appraisal to determine adequacy of security for loan not liable to borrower who suffered loss in purported reliance on appraisal that erroneously indicated borrower's property was of "A+ quality" and structurally sound; see also *Graham v. Bank of America, N.A.* (2014) 226 CA4th 594, 606-607, 172 CR3d 218, 228-229 (borrower's action against lender for fraud dismissed)—statements in appraisal indicating, among other things, that FMV of borrower's home was "ever-increasing" and loan was "good" for borrower were not facts, but rather statements of opinion or predictions of future events made for lender's benefit, and thus not actionable; *Cansino v. Bank of America* (2014) 224 CA4th 1462, 1469, 169 CR3d 619, 626 (fact pattern similar to *Graham*)—appraisal's future appreciation representations were mere opinions, not actionable misrepresentations]

2) [6:701] **Appraiser's duty in loan financing process:** Similarly, an appraiser designated by a lender to value its borrower's collateral for financing purposes generally owes its duty of care *to the lender*, not to the borrower. Indeed, "[w]hether the lender conducts the appraisal in house or hires an outside appraiser, the considerations are the same. The appraisal ordered by the lender is for its own protections and the borrower has [their] own means of ascertaining the desirability of the property." [*Willemsen v. Mitrosilis* (2014) 230 CA4th 622, 629, 178 CR3d 735, 740 (noting borrower should know lender's appraisal is intended for lender's benefit, *not* to ensure success of borrower's investment); see also *Tindell v. Murphy* (2018) 22 CA5th 1239, 1253-1254, 232 CR3d 448, 459-460—lender's appraiser had no duty of care to borrowers for inaccurate property description as appraisal was intended to support lender's evaluation of collateral, *not* borrowers' decision whether to purchase property]

For example, an appraiser selected by the Veterans Administration to appraise property that is the subject of a veteran's application for a VA-guaranteed loan is *not* liable to the borrower for negligently undervaluing the property, as a result of which the borrower is rendered ineligible for a VA loan and must obtain conventional financing at a greater cost. [*Gay v. Broder* (1980) 109 CA3d 66, 75, 167 CR 123, 127]

The VA's statutory duty to appraise property that is the subject of a VA loan application (38 USC § 3710(b)(5)) is designed to protect the federal government from having to assume the responsibility of a guarantor because of inadequate security. Since the statute is directed at protecting the VA and not the loan applicant, the appraiser's duty of care extends *only to the VA*. Otherwise, "[c]oncern with the possibility of claims against him for refusing to set a value as high as the loan desired … would deter the appraiser from reporting to the [VA] his true opinion as to

value and tend to cause him to breach his duty to the federal government. The policy considerations against the imposition of liability in the instant case are manifest." [*Gay v. Broder*, supra, 109 CA3d at 75, 167 CR at 127]

(b) [6:702] **Accrual of cause of action:** A professional negligence action against an appraiser is subject to the CCP § 339(1) *two-year* statute of limitations. The two-year period commences to run upon accrual of the cause of action; and the cause of action does not accrue until plaintiff *both* (i) sustains damage *and* (ii) discovers, or should discover, the negligence. [See generally, *Budd v. Nixen* (1971) 6 C3d 195, 203, 98 CR 849, 854 (superseded by statute on other grounds as stated in *Adams v. Paul* (1995) 11 C4th 583, 595, 46 CR2d 594, 602, fn. 1, see J. Kennard concur.opn.); and *Slavin v. Trout* (1993) 18 CA4th 1536, 1539-1540, 23 CR2d 219, 222 (lender's professional negligence action against appraiser who overvalued secured property)]

Speculative harm or the threat of future harm is not sufficient to create a cause of action. Notwithstanding discovery of the defendant's negligence, the two-year statute of limitations does not commence until plaintiff suffers "*appreciable harm*" as a result of the professional negligence. [*Budd v. Nixen*, supra, 6 C3d at 200, 98 CR at 852; *Slavin v. Trout*, supra, 18 CA4th at 1540, 23 CR2d at 222]

1) [6:703] **Accrual triggered by recourse to security:** A secured lender does not suffer actual and appreciable harm from reliance on an overvalued appraisal *until resort to the inadequate security*. Thus, the lender's professional negligence cause of action against the appraiser does not accrue—and the limitations period does not commence to run—until the lender *acquires the property by foreclosure or power of sale* (regardless of the date of its borrower's default). [See *Slavin v. Trout* (1993) 18 CA4th 1536, 1542-1543, 23 CR2d 219, 223-224]

[6:704] ***Reserved.***

(2) [6:705] **Negligent misrepresentation:** Appraisers who erroneously value a property might be held liable on a theory of negligent misrepresentation. Appraisers clearly risk such liability to those with whom they *directly contract* to perform the appraisal, knowing they intend to rely on the appraisal report in conducting their affairs. In addition, however, appraisers may incur negligent misrepresentation liability to *third persons*.

(a) [6:705a] **Framework for liability to third parties:** An appraiser may be liable for negligent misrepresentation to third parties who *justifiably rely* on the appraisal report in a particular transaction or type of transaction which the *appraiser intended to influence*. [*Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 376, 11 CR2d 51, 53; *Mariani v. Price Waterhouse* (1999) 70 CA4th 685, 705, 82 CR2d 671, 683]

1) [6:705.1] **Knowledge of plaintiff's specific identity not required:** It need not be shown that the appraiser, when hired, knew the names or specific identities of the third parties. Liability may be imposed where the appraiser "knows with substantial certainty that plaintiff, *or the particular class of persons to which plaintiff belongs*, will rely on the representation in the course of the transaction." [*Soderberg v. McKinney* (1996) 44 CA4th 1760, 1768, 52 CR2d 635, 640, quoting *Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 414, 11 CR2d 51, 78 (emphasis added); see also Rest.2d Torts § 552, comm. "h"]

2) [6:705.2] **Knowledge of precise transaction not required:** Nor is it essential that the appraiser have contemplated the precise details of the transaction in which the appraiser's report ultimately will be used. Negligent misrepresentation liability may exist if the appraisal report was relied upon in the *type* of transaction the appraiser anticipated or in one substantially similar to it. [*Soderberg v. McKinney* (1996) 44 CA4th 1760, 1769, 52 CR2d 635, 641, citing *Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 392, 410, 11 CR2d 51, 64, 75; see also Rest.2d Torts § 552, comm. "j"]

3) [6:705.3] **Direct transmittal from appraiser to plaintiff not required:** Further, the appraiser need not be the one who transmitted their report to the third persons. Appraisers may be liable if they knew their *client* would forward the report to a particular *class* of persons. [*Soderberg v. McKinney* (1996) 44 CA4th 1760, 1771, 52 CR2d 635, 642, citing *Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 392-393, 414, 11 CR2d 51, 64, 78-79]

4) [6:705.4] **Compare—no liability if appraiser ignorant of appraisal's intended purpose/use:** On the other hand, there can be no appraiser liability to third persons where there is no evidence indicating the appraiser knew what purpose their report was intended to serve and thus no evidence that the appraiser knew any class of third persons would rely on it. Liability is "restricted to those to whom or for whom the misrepresentations were made." [*Soderberg v. McKinney* (1996) 44 CA4th 1760, 1770, 52 CR2d 635, 641, quoting *Bily v. Arthur Young & Co.* (1992) 3 C4th 370,

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408, 414-415, 11 CR2d 51, 74, 79—absent competent evidence that professional supplied report "with knowledge of the existence of a specific transaction or a well-defined type of transaction which the report was intended to influence, … summary adjudication [in favor of professional] will be appropriate because plaintiff will not, as a matter of law, fall within the class of intended beneficiaries"]

(b) [6:705.5] **Example:** Mortgage Broker solicited Third Party to invest in a second trust deed on residential property that had been valued at $670,000. Third Party verbally committed $50,000 pending receipt of an appraisal report. Mortgage Broker contracted with Appraiser to conduct the appraisal; Appraiser's report confirmed a $670,000 value and, in reliance thereon, Third Party invested the $50,000 and solicited others to contribute another $25,000. When Borrowers defaulted on the first and second deeds of trust, plaintiff investors learned the true value of the property was between $450,000 and $500,000, leaving insufficient equity to protect their investments. Their suit against Appraiser for negligent misrepresentation followed.

Summary judgment for Appraiser on the ground he did not know plaintiffs' names or specific identities until after they had relied on his report and invested in the loan (and thus owed them no duty of care) was reversed on appeal. Appraiser had performed some 200 appraisals for Mortgage Broker prior to this transaction and knew Mortgage Broker had always sent the appraisal reports to potential investors. Appraiser admittedly also knew Mortgage Broker was in the business of connecting potential borrowers using real property as security with investors who have ready cash.

"Based on this record, [Appraiser] did not establish as a matter of law that he believed the appraisal would be used solely by [Mortgage Broker]. Rather … [Appraiser] knew that a particular *group or class of persons* to which plaintiffs belonged—potential investors contacted by [Mortgage Broker]—would rely on his report in the course of a *specific type of transaction* he contemplated—investing in a deed of trust secured by the appraised property … [D]isputed issues of material fact concerning the intended beneficiaries of the appraisal and the circumstances of the transaction precluded summary adjudication [in Appraiser's favor on the negligent misrepresentation claim]." [*Soderberg v. McKinney* (1996) 44 CA4th 1760, 1771-1772, 52 CR2d 635, 642-643 (emphasis added)]

(c) [6:705.6] **Comment re prior case law:** Case law predating *Soderberg*, supra, states that, as a prerequisite to liability, the appraiser must have known the *specific individual investor*, and that no negligent misrepresentation liability can run to "unspecified strangers." [See *Christiansen v. Roddy* (1986) 186 CA3d 780, 786, 231 CR 72, 76]

However, *Christiansen* also predated *Bily*, wherein the Cal. Supreme Court clarified that a professional supplier of information need not know the third party's name or specific identity and that, for negligent misrepresentation liability purposes, it is sufficient that the third party belongs to a *particular group or class* which the information was intended to benefit (*Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 392-393, 11 CR2d 51, 64). Although the Cal. Supreme Court has not had occasion to overrule *Christiansen* (the *Bily* facts concerned accountants' liability), *Soderberg* notes there is no reason why *Bily* should not be extended to all groups of information-supplying professionals and, therefore, logically concludes that conflicting language in *Christiansen* "is no longer good law." [*Soderberg v. McKinney* (1996) 44 CA4th 1760, 1770, 52 CR2d 635, 641-642]

By the same token, the result in *Christiansen* probably would be the same even under the *Bily* standards:

• [6:705.7] Appraiser, hired by a mortgage company to value a borrower's proposed collateral for a loan but who grossly overvalued the property, could not be held liable on a theory of negligent misrepresentation to third party investors who "bought into" the loan on recommendation of an investment counselor who worked for the mortgage company. Appraiser performed his services for the *borrower* and the *mortgage company*—*not* for the third party investors; there was no evidence Appraiser knew his report would be used by third party investors (let alone these particular third party plaintiffs) and no indication he was aware that any of them were considering loaning money secured by the subject property until he was served in the lawsuit. [*Christiansen v. Roddy* (1986) 186 CA3d 780, 787-788, 231 CR 72, 77; see *Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 408, 11 CR2d 51, 74—citing *Christiansen* with approval for proposition that liability is limited to those to whom or for whom professional's misrepresentations were made]

(3) [6:706] **Mortgage loan broker's liability for appraiser's negligent valuation:** A mortgage loan broker owes a *fiduciary duty* of the "highest good faith" toward its principal and is charged with a duty of "fullest disclosure of all material facts concerning the transaction that might affect the principal's decision." This includes a duty to provide prospective lenders with an *estimate of the fair market value* of the secured property. [Bus. & Prof.C. § 10232.5(a)(2); see also Fin.C.

§ 50701(d) (same re residential mortgage lenders, ¶ *6:167.7*); *Wyatt v. Union Mortgage Co.* (1979) 24 C3d 773, 782, 157 CR 392, 397; *Barry v. Raskov* (1991) 232 CA3d 447, 455-457, 283 CR 463, 467-468]

(a) [6:706.1] **To whom duty owed:** A mortgage loan broker's fiduciary duties run both to the borrower *and* to *third party investors* who "buy into" the loan. [*Barry v. Raskov* (1991) 232 CA3d 447, 455, 283 CR 463, 467]

(b) [6:706.2] **Nondelegable duty:** Mortgage loan brokers (like any fiduciary) *cannot delegate* their fiduciary duties to someone else. "To hold otherwise would allow mortgage loan brokers to evade their responsibilities by simply allocating them among numerous unlicensed independent contractors … This would subvert the real estate law's purpose to upgrade the standards of the real estate profession, which includes mortgage loan brokers …, and to provide protection to the consuming public." [*Barry v. Raskov* (1991) 232 CA3d 447, 455-456, 283 CR 463, 467-468]

1) [6:706.3] **Use of licensed appraiser's report:** Notwithstanding their nondelegable fiduciary duty as set forth at ¶ 6:706 ff., brokers who engage the services of a licensed real estate appraiser for the loan transaction and deliver the resulting appraisal report to the prospective lender and borrower are, by statute, deemed to have *satisfied* their duty to provide an estimate of the fair market value of the property. A separate estimate of fair market value under Bus. & Prof.C. § 10232.5 need not be provided. [Bus. & Prof.C. § 10232.6(a)]

2) [6:706.4] **Negligence liability despite use of licensed appraiser's report:** Ordinarily, one who hires an independent contractor to perform the hirer's *nondelegable duty* is liable for the independent contractor's tortious acts or omissions in the discharge of that duty. This principle would ordinarily support a rule of vicarious liability for the negligence of an independent property appraiser employed by a mortgage loan broker to appraise property that will be used to secure a loan. [*Barry v. Raskov* (1991) 232 CA3d 447, 454-457, 283 CR 463, 466-468]

The vicarious liability rule has seemingly been changed by Bus. & Prof.C. § 10232.6(a), providing that mortgage loan brokers meet their obligation to provide lenders with a fair value estimate of the secured property by furnishing an appraisal prepared by a licensed appraiser (¶ 6:706.3). However, the statute also carves out circumstances wherein the loan broker may nonetheless incur liability based on a negligent independent appraisal:

a) [6:706.5] **Appraisal by broker's employee:** Bus. & Prof.C. § 10232.6 does *not* apply where the licensed appraiser is an *employee of the broker*. (This apparently recognizes that a loan broker may be held vicariously liable for its employee-appraiser's negligent appraisal under normal respondeat superior principles applicable in any employer-employee relationship.) [Bus. & Prof.C. § 10232.6(b)]

b) [6:706.6] **Negligent referral or inaccurate appraisal known to broker:** The broker's duty to disclose estimated fair market value "shall *not be deemed met*" where the broker *knew or should have known* the referral to the appraiser was negligently made or that the fair market value provided by the appraiser was inaccurate. [Bus. & Prof.C. § 10232.6(b) (emphasis added)]

c) [6:706.7] **Facts affecting value known to broker:** Brokers cannot hide behind a licensed appraiser's report to justify withholding *known facts* affecting the property's value. Nothing in Bus. & Prof.C. § 10232.6 relieves the broker "of any obligation or requirement to disclose what they know about the value of the property." [Bus. & Prof.C. § 10232.6(c)]

d) [6:706.8] **Real estate broker disclosure duties unaffected:** Bus. & Prof.C. § 10232.6 applies *only to loan transactions*. Despite a proper referral to a licensed appraiser and use of the appraiser's report in performing duties as a *mortgage loan broker*, real estate brokers remain subject to their ordinary duties of disclosure in purchase and sales transactions. [Bus. & Prof.C. § 10232.6(d)]

b. [6:707] **Measure of damages; punitive damages:** Appraiser liability predicated on *tort* causes of action (negligence, fraud, etc.) generally is subject to the Civ.C. § 3333 tort measure of damages ("except where otherwise expressly provided by this code, … the amount which will compensate for all the detriment proximately caused thereby, whether it could have been anticipated or not"). [See *Foggy v. Ralph F. Clark & Assocs., Inc.* (1987) 192 CA3d 1204, 1214-1217, 238 CR 130, 137-138—lenders who prevailed in action alleging negligence or fraud of real estate appraisers caused them to enter into loan agreement were entitled to all consequential damages (pursuant to Civ.C. § 3333), including expenses incurred in keeping first loan current, paying property taxes, and maintaining and insuring the property]

Moreover, where the liability rests on a tort theory (rather than breach of contract), *punitive damages* may be recoverable upon proof by "clear and convincing evidence" that the appraiser acted with "oppression, fraud or malice" (Civ.C. § 3294). [*Foggy v. Ralph F. Clark & Assocs., Inc.*, supra, 192 CA3d at 1214, 238 CR at 137—court erred in omitting requested

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punitives instruction since plaintiffs proceeded on *tort* (rather than contract) causes of action; compare *Barry v. Raskov* (1991) 232 CA3d 447, 457-458, 283 CR 463, 469—punitives instruction properly denied in action against mortgage loan broker for its appraiser's negligence because no "clear and convincing" evidence that appraiser (or any other employee of broker) was guilty of Civ.C. § 3294 "fraud" or that broker was aware of appraiser's "unfitness" or ratified his conduct as required by Civ.C. § 3294(b)]

[6:708 - 6:709] ***Reserved.***

7. [6:710] **Unlawful Influence of Property Valuations/Appraisals:** No person with an interest in a real estate transaction involving a valuation may "improperly influence, or attempt to improperly influence, the development, reporting, result, or review of that valuation, through coercion, extortion, bribery, intimidation, compensation, or instruction." [Civ.C. § 1090.5(a); see also Bus. & Prof.C. § 11345.4 (applying similar proscriptions to appraisal management companies attempting to improperly influence appraisals)]

A valuation is defined as "an estimate of the value of real property in written or electronic form, other than one produced solely by an automated valuation model or system." [Civ.C. § 1090.5(a)]

a. [6:710.1] **Prohibited acts:** Prohibited acts include, but are not limited to:

— Seeking to influence a valuation preparer to report a minimum or maximum value for specified property;

— Requesting a preliminary estimate or opinion of value prior to entering into a contract for valuation services;

— Conditioning a person's employment based on an expectation of the value conclusion they are likely to return;

— Conditioning a person's compensation on the value conclusion they return;

— Providing an anticipated, estimated, encouraged or desired valuation to a person prior to their completion of a valuation;

— Withholding/threatening to withhold timely payment to a valuation preparer or the person/entity that provides valuation management functions because they do not return a value at or above a certain amount;

— Implying to a valuation preparer that their current or future retention depends on their estimate of a real property's value;

— Excluding a valuation preparer from consideration for future engagement because they report a value that does not meet or exceed a predetermined threshold;

— Conditioning the compensation paid to a valuation preparer on consummation of the real estate transaction for which the valuation is prepared;

— Requesting the payment of compensation to achieve higher priority in the assignment of valuation business. [Civ.C. § 1090.5(a); see also Bus. & Prof.C. § 11345.4(a)-(f) (parallel statute applicable to appraisal management companies attempting to improperly influence appraisers)]

b. [6:711] **Cross-licensing/registration violations:** *Anyone* licensed or registered under *any* state licensing or registration law who violates Civ.C. § 1090.5 while performing that person's professional duties is deemed to have violated the specific law under which that person is licensed or registered. [Civ.C. § 1090.5(c)] (Apparently, therefore, the person in turn will be subject to the disciplinary provisions, license or registration suspension/revocation provisions, and penalty provisions of that particular licensing/registration law.)

c. [6:712] **Permitted activities:** Persons interested in a particular real estate transaction are *not* prohibited from doing any of the following:

— Asking a valuation preparer to consider additional, appropriate property information, including information about comparable properties;

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— Asking a valuation preparer to provide further detail, substantiation or explanation for the person's value conclusion;

— Asking a valuation preparer to correct errors in the valuation report;

— Obtaining multiple valuations for purposes of selecting the most reliable valuation;

— Withholding compensation due to breach of contract or substandard performance of services;

— Providing a copy of the sales contract in connection with a purchase transaction. [Civ.C. § 1090.5(b); see also Bus. & Prof.C. § 11345.4(g) (parallel statute applicable to appraisal management companies)]

[6:713 - 6:720] ***Reserved.***

8. [6:721] **Unlawful discrimination in performing appraisals:** It is unlawful for any person or entity whose business includes performing (or making available) residential real property appraisals to discriminate against any person because of their race, color, religion, sex, gender, gender identity, gender expression, sexual orientation, family status, source of income, disability, genetic information, veteran or military status, or national origin. [Gov.C. § 12955(i)(2)]

Likewise, licensed appraisers may not base their analysis or opinion of value on such attributes of either the present or prospective owners, occupants or neighbors of a subject property, or on any other basis prohibited by the federal Fair Housing Act. [Bus. & Prof.C. § 11424]

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Cal. Prac. Guide Real Prop. Trans. Form 6:A

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 6. Financing and Appraisals

Forms

[Form 6:A] Construction Loan Agreement

CONSTRUCTION LOAN AGREEMENT

1. **THIS AGREEMENT** is executed by the undersigned, hereinafter called "Borrower," for the purpose of obtaining a construction loan from ___________, hereinafter called "Lender," to be evidenced by a Note of Borrower in favor of Lender and secured by a Deed of Trust covering property referred to in the Loan Agreement dated _____ executed by Borrower, which is incorporated by referenced and made a part of this Agreement.

2. **LOAN:** Borrower and Lender agree that Lender shall make the loan to Borrower and Borrower shall accept the loan upon the terms, conditions, covenants, representations and warranties contained herein and agreements entered into in connection herewith. All funds disbursed hereunder shall be evidenced by the Note, bear interest at the rate specified in the Note and be secured by the Deed of Trust and the security agreements.

3. **LOAN PROCEEDS:** Upon recordation, Lender is authorized to:

3.1. Credit the loan to the loans in process account to be disbursed from that account in the manner and for the purposes provided in Exhibit "A," which exhibit is the method of disbursement, and subject to the limits set forth in paragraphs 6.1 and 6.2 hereof.

3.2. Make the initial disbursements in the manner and for the purposes provided by paragraph 6.1 directly to the parties to whom the respective payments are due.

4. **CONDITIONS PRECEDENT TO RECORDATION:** Prior to recordation the following conditions shall have been satisfied:

4.1. Lender shall have received:

4.1.1. Application For Loan in form and content as required by Lender.

4.1.2. The executed Deed of Trust and Note.

4.1.3. Executed security agreements.

4.1.4. The financial statements.

4.1.5. A copy of the plans and specifications.

4.1.6. A copy of the general contract.

4.1.7. A preliminary title report, issued by a title insurance company satisfactory to Lender (hereinafter "title insurer") showing the condition of title to the property with the property's legal description.

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4.1.8. Cost Breakdown dated and signed by General Contractor, if separate owner and separate contractor. If owner-builder, signed by owner.

4.2. If required by Lender, as indicated by an "X" in the box opposite the required item, Lender shall have received:

_ 4.2.1. Deposits of Borrower's fund in the amount of $________.

_ 4.2.2. Executed Guaranty.

_ 4.2.3. A current survey of the property, including dimensions, delineations and locations of all easements thereon, satisfactory to the title insurer if required by it.

_ 4.2.4. A performance, labor and material payment bond, naming Lender as co-obligee, in a penal sum equal to the amount of the general contract, or if none, then in such amounts as Lender may require in form and content meeting the statutory requirements of California law and with such sureties approved by Lender.

_ 4.2.5. Building permit and any other authorization, if any, which may be required from a governmental authority for the construction of the improvements.

_ 4.2.6. Subordination Agreements executed in recordable form acceptable to the title insurer.

_ 4.2.7. Soils report covering the property satisfactory to Lender.

_ 4.2.8. Copies of major subcontractors as designated by Lender.

_ 4.2.9. Assignment to Lender of the plans and specifications executed by the person or firm who owns them.

_ 4.2.10. Assignments by Borrower to Lender of all contracts and agreements with general contractor, subcontractors and materialmen, all of which are subject to written acceptance by Lender, exercisable at its option at any time after the occurrence of a default under the terms of this Agreement.

_ 4.2.11. Original insurance policy or certificates thereof for the insurance required by paragraph 8.10 hereof.

_ 4.2.12. UCC Financing Statement covering personal property, and/or Assignment of Sales Proceeds and Security Agreement.

_ 4.2.13. All leases (whether executed or proposed) affecting property, and any subordinations as required.

_ 4.2.14. An executed copy of the outside "fund control" agreement.

5. **CONDITIONS PRECEDENT TO DISBURSEMENT:**

5.1. Prior to initial disbursement the following conditions shall have been satisfied:

5.1.1. Recordation shall have occurred.

5.1.2. The title insurer shall have issued or agreed to issue the title insurance policy described in paragraph 8.3 hereof, naming Lender as insured to the full extent of the loan.

5.1.3. Where appropriate, UCC-1 Financing Statements as required by Lender shall have been filed in the office of the California Secretary of State describing the personal property.

5.1.4. Upon recordation, the loan shall be deemed disbursed and credited to the loan in process account. Borrower hereby irrevocably assigns and pledges to Lender all right, title and interest in and to the funds credited and to be credited to said account to additionally secure Borrower's performance of this Agreement and the obligations of Borrower under the terms of

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the Note, Deed of Trust and security agreements. Lender shall have the absolute obligation to disburse the construction funds to pay for the cost of construction of the project subject to the provisions of this Agreement.

5.2. As a prior condition to making disbursements, after the initial disbursement (except for the last disbursement) the following conditions shall have been satisfied:

ORIGINAL INSURANCE POLICY OR BINDER THEREOF FOR THE INSURANCE REQUIRED BY PARAGRAPH 8.10 HEREOF PRIOR TO ANY ONSITE DISBURSEMENTS. ANY OVERAGE TO BE USED AT THE OPTION OF THE LENDER FOR INTEREST, CONSTRUCTION PURPOSES, OR TO PRESERVE PRIORITY AND VALIDITY OF THE DEED OF TRUST.

5.2.1. No default shall exist under this Agreement, the Note, Deed of Trust or security agreements.

5.2.2. All the requirements for disbursement set forth in Section 6 through Section 8 shall have been satisfied. If Lender requests, it shall have received a list of names and address of all material dealers, laborers and subcontractors with whom agreements have been made by the general contractor and/or Borrower to deliver materials and/or perform work on the improvements. Such list shall include an estimate of the dollar value of the work and materials to be performed and/or delivered and if work is in progress, the amount still owing.

5.2.3. Upon completion of the foundations, title insurer has issued its foundation endorsement assuring Lender that the foundation is constructed wholly within the boundaries of the property and does not encroach on any easements.

5.2.4. The representations and warranties of Borrower made in Section 7 hereof shall be true and correct on and as of date of each disbursement with the same effect as if made on such date.

5.2.5. The improvements shall not have been materially injured or damaged by fire or other casualty unless Lender shall have received insurance proceeds sufficient in its judgment to effect the satisfactory restoration of the improvements and to permit the completion thereon within a reasonable time.

5.3. Prior to the final disbursement, at Lender's sole option, the conditions set forth in paragraph 5.2 shall be satisfied and in addition, the following conditions shall have been satisfied by Lender's receipt of:

5.3.1. Advice from Lender's inspection department to the effect that the improvements have been completed in accordance with the plans and specifications and in a workmanlike manner.

5.3.2. Evidence that Borrower has filed the Notice of Completion of the improvements necessary to establish commencement of the shortest statutory period for the filing of mechanic's and materialmen's liens.

5.3.3. The CLTA Form 101.6 endorsement issued by title insurer and/or such other endorsement to Lender's title insurance policy at Lender may require shall insure Lender that the improvements have been completed free of all mechanic's and materialmen's liens.

Subject to the provisions of this Agreement, the final disbursement shall be made only after Borrower has satisfied the conditions of paragraph 5.3 hereof and delivered or caused to be delivered to Lender in addition to those required under paragraph 8.3 hereof, such additional indorsements or such additional policies of title insurance with indorsements thereto as Lender may require, with a liability limit of not less than the principal amount of the Note, issued by the title insurer, with coverage and in form satisfactory to Lender, insuring Lender's interest under the Deed of Trust as a first lien on the property, excepting only such items as shall have been approved in writing by Lender. However, Lender may withhold the final disbursement until Borrower has furnished Lender with the written approval of such final disbursement by the title insurer and the surety on any bond required by Lender.

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5.3.4. Evidence of approval of completion of the improvements by governmental bodies, FHA, VA, HUD, or other guarantor or purchaser and tenants under major leases as such approvals are deemed appropriate by Lender.

5.3.5. If tenant improvements are to be installed by Borrower, Lender shall have segregated sufficient funds, in Lender's judgment, from the loans in process account to pay such tenant improvements.

6. **LOAN DISBURSEMENT:** Provided Borrower is not in default, the loan and Borrower's funds credited in the loans in process account including the proceeds of the noncash items referred to in paragraph 16.1 hereof shall be disbursed as follows:

6.1. Initial Disbursements: Immediately following recordation and upon satisfaction of the conditions of paragraph 5.1 hereof, Lender shall disburse the amounts necessary to pay all costs, charges and expenses incurred or to be incurred (as estimated and approved by Lender) in connection with the loan or payable pursuant to this Agreement, the Deed of Trust or security agreements, excluding direct costs of labor and materials related to the improvements, and including but not limited to loan fees (which are deemed earned at recordation and are not refundable in whole or in part), trustee's fees, service charges, title charges, tax and lien service charges, recordation fees, escrow fees, appraisal fees, real property taxes and assessments, insurance premiums, any amount required to pay existing encumbrances affecting the property and amounts required to complete the purchase of the property.

6.2. Subsequent Disbursements: Upon satisfaction of the conditions of paragraph 5.2 hereof, Lender shall disburse such sums as required for the payment of costs and expenses of construction of the improvements and costs incidental thereto which are described in the construction cost breakdown and interest payments as they become due under the loan if an interest reserve has been established. Such disbursements shall be made in accordance with the applicable provisions of Exhibit A. The disbursed funds shall be used for the payment of those items contemplated by the particular cost item or otherwise as approved by Lender. However, any funds remaining after the particular cost item is complete and paid shall constitute a cash reserve for payment of unforeseen contingencies and shall be disbursed in payment of such other items as Lender in its discretion deems appropriate which are not provided for herein or otherwise approved by Lender.

6.3. Disbursement of Borrower's Funds: Borrower's funds including the proceeds of the noncash items referred to in paragraph 16.1 hereof shall, at the option of Lender, be disbursed before the loan proceeds in the loan in process account are disbursed. Lender reserves the right to draw upon and convert into cash, at any time, all or any part of the noncash items referred to in paragraph 16.1 hereof in the event Lender in its sole judgment determines that to do so is necessary to protect the security for the loan.

6.4. Anything contained herein to the contrary notwithstanding, in the event the Deed of Trust is recorded after the work of construction has commenced, thus causing a potential loss of priority of said Deed of Trust with respect mechanic's or materialmen's liens hereafter claimed, or if possible loss of partial priority is apparent with respect to any disbursements to be made hereunder, Lender shall be obligated to disburse the construction fund only upon first having been furnished with title insurance coverage acceptable to Lender. Lender shall have the absolute obligation to disburse portions of the construction fund to the extent that such disbursements are covered by such title insurance, and provided neither Borrower nor general contractor is in default under the terms of this Agreement, the Note, the Deed of Trust or the security agreements.

6.4.1. Borrower agrees that regardless of the method of disbursement in effect hereunder Lender shall be furnished with CLTA Indorsement No. 102.5 or 102.7 by the title insurer as soon as the foundation has been completed. If, for any reason said indorsement is not available, Lender may withhold all undisbursed funds until the indorsement is issued. If the project to be constructed consists of separate structures, funds for payment for separate foundations shall be disbursed from time to time as foundations are completed. Such disbursements shall be made in conformance with Exhibit "A" and shall only be made after such completion is verified by Lender's inspections and the furnishing to Lender of CLTA Indorsement No. 102.5 or 102.7 issued by the title insurer as each increment of foundation is completed.

6.4.2. Final Disbursement.

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A. Subject to the provisions of subparagraph 6.4.2B below, if applicable, the remaining balance of the construction fund with the exception of any undisbursed funds retained for payment of interest shall be disbursed to pay final costs of construction. When the improvements have been substantially completed and Borrower or general contractor has deposited with Lender an affidavit stating that all bills for labor and/or materials used in or related to construction of the improvements have been paid or ordered to be paid as hereinbefore provided (and has submitted proof which, in the sole judgment of Lender, establishes that the amount available for construction has been used for the direct cost of completion of the improvements), any balance of the construction fund remaining after payment of construction costs in full shall either be applied as a credit to the loan balance, applied as additional interest reserve, or paid to Borrower or to the general contractor at the option of Lender.

B. [Disregard if not applicable.] Installation of carpet or tenant improvements provided for in the plans is not required for substantial completion. At the time for final disbursement under the provisions of paragraph 6.4.2A hereof, any balance of the amount allocated for carpets or tenant improvements as installed, provided that if installation of carpets and/or tenant improvements as to any part of the project is not completed within 90 days from the completion of such part, Lender, at its option, may apply and credit the amount withheld for such part to the loan balance. Delay or omission of installation shall not prevent or delay disbursement in accordance with the provisions of paragraph 6.4.2A, of such remaining balance.

6.5. Interest will be charged monthly on the first day of the month and shall be calculated on the aggregate amount of funds disbursed, with interest accruing from actual day of disbursement. Interest will be deducted from interest reserve account, if established, up to the amount of that account and shall be billed to Borrower thereafter. If no interest reserve is established, the interest billing shall be mailed to borrower directly and is due and payable upon receipt.

6.6. Disbursement Limit: Lender shall not be required to disburse an aggregate amount of the construction fund for labor furnished to and materials incorporated into the improvements during any stage of construction which exceeds the lesser of the value of such labor and materials or the amount allocated to that stage of construction. Lender shall not be required to disburse any amount which, in Lender's opinion, will reduce the loan in process account below that needed to pay for the labor and materials necessary to complete the improvements. If Borrower consists of more than one person or is a partnership or joint venture, Lender is authorized to make disbursements to any one of such persons or to any partner or joint venturer, at Lender's option.

6.7. At Lender's option, no disbursement shall be made to or for any city, county, public body or agency, irrigation, sewer or water district or company, gas and/or electric company, telephone company or any other person, entity or agency for the installation of any such utility or service unless and until the benefits of a corresponding reimbursement agreement shall have been assigned to Lender pursuant to the provisions of the Deed of Trust and such assignment has been accepted and approved by the reimbursing party. Such acceptance and approval shall include a statement by such party that the assignment is sufficient to entitle Lender to receive the monies deposited for such installation at the time or times and to the extent that Borrower would otherwise be entitled to reimbursement in the absence of such assignment.

7. **REPRESENTATIONS AND WARRANTIES OF BORROWER:** Borrower represents and warrants that:

7.1. If Corporation: If a corporation, it is duly organized and validly existing, in good standing under the laws of the state of its incorporation, is qualified to do business, and is in good standing in the state in which the property is situated with full power and authority to consummate the transactions contemplated hereby.

7.2. If Partnership: If a partnership, it is duly organized and validly existing.

7.3. If Trust: If a trust, it is duly organized and validly existing.

7.4. Plans, Defects: The plans are satisfactory to Borrower, have been approved by guarantor, and to the extent required by applicable law or any effective restrictive covenant, by all governmental authorities and the beneficiary of any such covenant respectively; the plans so approved have been initialed by Borrower and general contractor, if any; all construction, if any, heretofore performed within the perimeter of the property has been completed in accordance with the plans and any restrictive

covenants applicable thereto; there are no structural defects in the improvements, and no violation of any local requirement exists with respect thereto.

7.5. Financial Statements: The financial statements heretofore delivered to Lender are true and correct in all respects, have been prepared in accordance with generally accepted accounting principles, fairly present the respective financial conditions reflected therein since their respective dates and no additional borrowings have been made by Borrower since the date thereof other than the borrowing contemplated hereby or approved by Lender.

7.6. Litigation: There are no actions, suits or proceedings pending, or to the knowledge of Borrower threatened against or affecting it, the property or guarantor, or involving the validity or enforceability of the Deed of Trust or the priority of the lien thereof, at law or in equity, or before or by any governmental authority or local authority. To the Borrower's knowledge it is not in default with respect to any order, writ, injunction, decree or demand of any court or any governmental authority.

7.7. No Breach: The consummation of the transaction hereby contemplated and performance of this Agreement, Deed of Trust and the security agreements will not result in any breach of, or constitute a default under any mortgage, deed of trust, lease, bank loan or security agreement, corporate charter, bylaws or other instrument to which the Borrower is a party or by which it may be bound or affected.

7.8. Utilities: All utility services necessary for the construction of the improvements and the operation thereof for their intended purpose are either available at the boundaries of the property or all necessary steps have been taken by Borrower and local authority to assure the complete construction and installation thereof, including water supply, storm and sanitary sewer facilities, gas, electric and telephone facilities.

7.9. Certified Invoice: Each certified invoice shall be true and accurate and the submission of same or the receipt of the funds so requested shall constitute a reaffirmation of the representations, warranties and covenants contained herein.

7.10. Other Liens: It has made no contract or arrangement of any kind, the performance of which by the other party thereto would give rise to a lien on the property, except for its arrangements with Borrower's architect, the general contractor or the major subcontractors if there is no general contractor.

7.11. Title: Borrower's title to the property is not subject to a vendor's lien.

7.12. Major Leases: All major leases, if any, are in full force and effect, there are no defaults under any of the provisions thereof, and all conditions to the effectiveness thereof required to be satisfied as of the date thereof have been satisfied.

7.13. No Default: There is no default on the part of Borrower under this Agreement, Note or Deed of Trust, and no event has occurred and is continuing which with notice or the passage of time or either would constitute a default under any thereof.

7.14. CC&Rs, Zoning: It has examined, is familiar with, and the improvement will in all respects conform to and comply with all covenants, conditions, restrictions, reservations and zoning ordinances affecting the property.

7.15. Other Financing: It has not received any financing for either the acquisition of the property or the construction and installation of the improvements except as has been specifically disclosed to and approved by Lender prior to recordation.

8. **BORROWER'S COVENANTS:** Borrower covenants and agrees until the full and final payment of the loan, unless Lender waives compliance in writing, that it will:

8.1. Borrower's Funds: At the time and in the amounts required by Lender, deposit Borrower's funds in the loan in process account. Borrower's funds shall be disbursed from such account in the manner provided in paragraph 6 herein. Should it appear at any time that the total funds then held by Lender are insufficient, in Lender's reasonable judgment, to provide the financing for the completion of the improvements, Borrower, within ten (10) days following receipt of written demand by Lender for additional

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funds, shall pay to Lender an amount equal to such deficiency as expressed in said demand for deposit in the loan in process account.

8.2. Improvements Inspection: Permit Lender, or its representatives, (and Lender shall have the right) to enter upon the property, inspect the improvements and all materials to be used in the construction thereof and to examine the plans and all detailed plans and shop drawings which are or may be kept at the construction site and will cooperate and cause the general contractor or, if none, the major subcontractors, to cooperate with Lender. Inspection by Lender of construction shall be for the purposes of protecting the security of the Lender and such inspection is in no way to be construed as a representation by Lender that there is a compliance with the plans or that the construction is free from faulty material or workmanship. Lender is not required to make inspections of said improvements and any inspection that may be made of the proposed building by Lender is made solely for the benefit and protection of the Lender, and the contractors and owners will not rely thereon but will make their own inspections during the course of the construction and if any labor or materials used therein, or any part thereof is not satisfactory to them, or if the contract is not complied with in any respect, they will immediately notify the Lender in writing.

8.3. Title Insurance: Deliver or cause to be delivered at recordation or within a reasonable time thereafter an ALTA LP-10 policy of title insurance or its equivalent, with a liability limit of not less than the face amount of the Note, issued by a title insurer acceptable to Lender, insuring Lender's interest under the Deed of Trust as a valid first lien on the property. Said policy shall contain only such exceptions from its coverage as shall have been approved in writing by Lender. After recordation, Borrower shall, at its own cost and expense, maintain the Deed of Trust as a first lien on the property and deliver or cause to be delivered to Lender from time to time such indorsements to said policy as Lender deems necessary to insure the priority of the Deed of Trust as a first lien on the property. Borrower shall furnish to the title insurer surveys and any other information required to enable it to issue such indorsements and policies.

8.4. Leases: Deliver to Lender an executed counterpart of all leases of the property whether executed before or after the date hereof.

8.5. Change Orders: Not permit the performance of any work pursuant to any change order which will result in a change in the general contract price in excess of the change order amount unless it shall have received the specific approval of Lender to such change order and provided that the additional funds necessary to pay for such change order are deposited in the loan in process account. Lender is hereby authorized to and shall disburse said funds for the payment of such change order upon completion of such changes to Lender's satisfaction. Change orders for less than $300.00 do not require the Lender's approval and may be paid direct by the Owner to the Contractor.

8.6. General Contractor Covenant: Require covenants from the general contractor to the same effect as the covenant made by Borrower in the preceding paragraph hereof, and that general contractor will, upon request, deliver to Lender the names of all persons with whom general contractor has contracted or intends to contract for the construction of the improvements or for the furnishing of labor or materials therefor.

8.7. General Contract Only: Not execute any contract or become a party to any arrangement for the performance of work on the property except with the general contractor. If there is no general contractor, Borrower shall only contract with major subcontractors approved by Lender at Lender's option, for the performance of the work on the property.

8.8. Foundation Completion: Notify Lender immediately on completion of the foundation of the improvements.

8.9. Installation of Fixtures, Materials and Equipment: Not install materials, personal property, equipment or fixtures subject to any security agreement or other agreement or contract wherein the right is reserved to any person, firm or corporation to remove or repossess any such material, equipment or fixtures, or whereby title to any of the same is not completely vested in Borrower at time of installation without Lender's written consent.

8.10. Insurance: Prior to any disbursement hereunder, procure and deliver to Lender and thereafter maintain policy or policies of insurance in form and content and by an insurer satisfactory to Lender, including a clause giving Lender a minimum of ten (10) days' notice if such insurance is cancelled, as follows: (i) fire insurance in an amount not less than the face amount of the Note or the insurable value of the improvements, with the normal conditions including fire, extended coverage, vandalism,

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malicious mischief, course of construction endorsement and a loss payable endorsement naming Lender as Payee, (ii) liability insurance indicating coverage satisfactory to Lender, and (iii) worker's compensation insurance, issued to Borrower or to general contractor.

8.11. Maintain Records: Keep and maintain firm and accurate accounts and records of its operations according to generally accepted accounting principles and practices for this type of business.

8.12. Taxes: Pay and discharge all lawful claims, including taxes, assessments and governmental charges or levies imposed upon it or its income or profits or upon any properties belonging to it prior to the date upon which penalties attach thereto; provided that Borrower shall not be required to pay any such tax, assessment charge or levy, the payment of which is being contested in good faith and by proper proceedings.

8.13. No Conveyance or Encumbrances: Not convey or encumber the property in any way without the consent of Lender. All easements affecting the property shall be submitted to Lender for its approval prior to the execution thereof by Borrower, accompanied by a drawing or survey showing the location thereof.

8.14. Compliance with Government: Comply promptly with any governmental requirement of governmental authority.

8.15. Construction: Borrower agrees to commence or cause to be commenced construction of the improvements promptly after recordation and not before and also agrees that such construction will be continued diligently and in a workmanlike manner until completion, in accordance with the plans, including any specifications prescribed by Lender.

8.16. Information: Lender may assume that the statements, facts, information and representations contained in any affidavits, orders, receipts or other written instruments which are filed with Lender or exhibited to it are true and correct and may rely thereon without any investigation or inquiry and any payment made by Lender in reliance thereon shall conclusively be deemed to be in the discharge of Lender's obligations hereunder to the extent of all sums so paid.

8.17. Application of Disbursements: Receive the disbursements to be made hereunder as a trust fund for the purpose of paying the costs of construction of the improvements and will apply the same first to such payments before using any part thereof for any other purpose.

8.18. Approval: Borrower shall obtain and deliver to Lender evidence of the approval by the local board of fire underwriters or its equivalent and by all governmental authority of the improvements in their entirety for permanent occupancy to the extent any such approval is a condition of the lawful use and occupancy of the improvements.

8.19. Paid Vouchers: Deliver to Lender, on demand, any contracts, bills of sale, statements, receipted vouchers or agreements, under which Borrower claims title to any materials fixtures or articles incorporated in the improvements or subject to the lien of Lender.

8.20. Defect Corrections: Upon demand of Lender, correct any defect in the improvements or any departure from the plans not approved by Lender. The advance of any loan proceeds shall not constitute a waiver of Lender's rights to require compliance with this covenant with respect to any such defects or departures from the plans not theretofore discovered by, or called to the attention of Lender.

8.21. Preliminary Notices: Deliver to Lender copies of all Preliminary Notices and related documents served on Borrower pursuant to California Civil Code Sections 8034 and 8200 et seq. including all such notices and documents addressed to Lender or to “Construction Lender” and received by Borrower.

9. **DEFAULT:** The following shall constitute events of default hereunder (including, if Borrower consists of more than one person, the occurrence of any such events with respect to any one or more of said persons):

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9.1. Any default in the performance of any covenant, condition or agreement set forth herein, in the Deed of Trust, Note, security agreements or in any ground lease if the property is a leasehold estate.

9.2. Borrower or general contractor does not proceed continuously with the construction of the improvements or the construction of the improvements is otherwise discontinued for a period of 10 consecutive business days or more, for any reason.

9.3. Borrower voluntarily suspends the transaction of business or there is an attachment, execution or other judicial seizure of any portion of Borrower's assets and such seizure is not discharged within ten (10) days.

9.4. Borrower becomes insolvent or unable to pay its debts as they mature or makes an assignment for the benefit of creditors.

9.5. Borrower files or there is filed against Borrower a petition to have Borrower adjudicated a bankrupt (or a petition for reorganization or arrangement under any law relating to bankruptcy) unless, in the case of a petition filed against Borrower, the same is dismissed within ten (10) days.

9.6. Borrower applies for or consents to the appointment of a receiver, trustee, or conservator for any portion of Borrower's property or such appointment is made without Borrower's consent and is not vacated within ten (10) days.

9.7. Any representation by Borrower of any material fact proves to be false or misleading (whether occurring before or after the execution of this Agreement).

9.8. Any person obtains an order or decree in any court of competent jurisdiction enjoining the construction of the improvements or enjoining or prohibiting Borrower or Lender or either of them from performing this Agreement, and such proceedings are not discontinued and such decree is not vacated within ten (10) days after the granting thereof.

9.9. Borrower neglects, fails or refuses to keep in full force and effect any permit or approval with respect to the construction of the improvements.

9.10. If any bonded notice to withhold in connection with the loan is served on Lender pursuant to the provisions of Title 15, Division 3, Part 4 of the California Civil Code, and within five (5) days of the receipt of such notice the claim set forth therein is not discharged or, if the amount claimed is disputed in good faith by Borrower or general contractor, an appropriate counter bond or equivalent acceptable to Lender is not filed with Lender.

9.11. The imposition, voluntary or involuntary, of any lien or encumbrance upon the property without Lender's written consent or unless an adequate bond is provided and such lien is accordingly released within ten (10) days of the imposition of such lien.

10. **REMEDIES:** If any of the events of default set forth in paragraph 9 occur, then Lender, in addition to its other rights hereunder, may at its option without prior demand or notice:

10.1. Terminate the obligation of Lender to make disbursements hereunder.

10.2. Declare the Note immediately due and payable.

10.3. Notwithstanding the exercise of either or both of the remedies described in paragraph 10.1 and 10.2 hereof, Lender may make any disbursements after the happening of any one or more of said events of default without thereby waiving its right to demand payment of the Note and without liability for making any other or further disbursements.

10.4. Proceed as authorized by law to satisfy the indebtedness of Borrower to Lender and, in that regard, Lender shall be entitled to all of the rights, privileges and benefits contained in the Deed of Trust, security agreements or other loan documents.

10.5. Take possession of the property and perform any and all work and labor necessary to complete the improvements substantially in accordance with the plans in which event expenditures therefore shall be deemed an additional loan to Borrower, payable on demand bearing interest at the rate specified in the Note. In addition, Borrower shall pay Lender a fee of fifteen percent (15%)

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of the cost of such completion for supervision of construction. Such additional loan and the fee for supervision is secured by the Deed of Trust and security agreements.

10.6. Require Borrower to purchase the loan from Lender at a price equal to the outstanding loan balance plus accrued interest thereof and all costs and charges incurred by Lender in connection with the loan.

11. **POWER OF ATTORNEY:** In the event of default as defined in paragraph 9 hereof, Borrower hereby constitutes and appoints Lender its true and lawful attorney in fact with the power and authority including full power of substitution as follows:

11.1. To take possession of the property and complete the improvements.

11.2. To use any of Borrower's funds and any funds which may remain undisbursed under the loan for the purpose of completing the improvements and for other costs related thereto.

11.3. To make such additions and changes and corrections in the plans as may be necessary or desirable as Lender in its sole discretion deems proper to complete the improvements.

11.4. To employ such contractors, subcontractors and agents, architects and inspectors as are required to complete the improvements.

11.5. To employ watchmen to protect the property and improvements from injury.

11.6. To pay, settle or compromise all existing bills and claims against Borrower's funds or any funds which may remain undisbursed under the loan or as may be necessary or desirable, as Lender in its sole discretion deems proper, for the completion of the improvements or for protection or clearance of title to the property and personal property or for the Lender's interest with respect thereto.

11.7. To prosecute and defend all actions and proceedings in connection with the construction of the improvements.

11.8. As Lender in its sole discretion deems proper, to execute, acknowledge and deliver all instruments and documents in the name of Borrower which may be necessary or desirable to do and to do any and every act with respect to the construction of the improvements which Borrower might do on his own behalf. This power of attorney is a power coupled with an interest and cannot be revoked.

12. **DISCLAIMER:** WHETHER OR NOT LENDER ELECTS TO EMPLOY ANY OR ALL OF THE REMEDIES AVAILABLE TO IT IN THE EVENT OF DEFAULT, LENDER SHALL NOT BE LIABLE FOR THE CONSTRUCTION OF OR FAILURE TO CONSTRUCT OR COMPLETE OR PROTECT THE IMPROVEMENTS OR FOR PAYMENT OF ANY EXPENSE INCURRED IN CONNECTION WITH THE EXERCISE OF ANY REMEDY AVAILABLE TO LENDER OR FOR THE CONSTRUCTION OR COMPLETION OF THE IMPROVEMENTS OR FOR THE PERFORMANCE OR NONPERFORMANCE OF ANY OTHER OBLIGATION OF BORROWER.

13. **SIGNS:** Borrower hereby grants Lender the right to erect or cause to be erected Lender's sign or signs in size and location desired by Lender on the property so long as such signs do not interfere with the reasonable construction of the improvements. Borrower will and will cause general contractor and subcontractors to exercise due care to protect said sign or signs from damage.

14. **MISCELLANEOUS**

14.1. Limitation of Starts: In a tract development Lender may from time to time limit the number of construction starts, if, in its sole discretion, based on then current market conditions, it is determined that it is not economically feasible to proceed with a greater number of starts at that time. If, in the sole discretion of Lender, no further starts are authorized, Lender may discharge any and all of its obligations under this Agreement by crediting the balance of the construction fund to the loan thereby reducing the principal balance thereof by such amount. Any guaranty written in connection with the completion of the improvements shall be divisible and limited as to each phase as groups of starts are authorized. At such time as a new group of starts is authorized

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said guaranty shall cover that phase to the same extent and with the same effect as if a separate and distinct guaranty agreement were then executed at the inception of the construction of the new group starts. In the event no further starts are authorized by Lender, said guaranty agreement shall be limited strictly to the lien free completion of the construction of the previously authorized group(s) of starts.

14.2. Assignment of Sales Proceeds: If required by Lender, Borrower agrees to execute Lender's form entitled Assignment of Sales Proceeds and Security Agreement which irrevocably assigns, transfers, pledges and conveys to Lender all or part of the net proceeds of all escrows or other sales transactions accruing to Borrower from sales of all or any part of the property, as additional security for payment of the loan. The term “net proceeds” as used herein means all monies, trust deeds, notes, property and other consideration that normally would be disbursed or delivered to a seller from an escrow or otherwise, after deducting usual seller's closing costs and real estate commissions.

15. **GENERAL CONDITIONS:**

15.1. No Waiver: No delay or omission of Lender in exercising any right or power arising from any default by Borrower shall be construed as a waiver of such default or as an acquiescence therein, nor shall any single or partial exercise thereof preclude any further exercise thereof. Lender may, at its option, waive any of the conditions herein and any such waiver shall not be deemed a waiver of Lender's rights hereunder but shall be deemed to have been made in pursuance of this Agreement and not in modification thereof. No waiver of any event of default shall be construed to be a waiver of or acquiescence in or consent to any preceding or subsequent event of default.

15.2. No Third Party Benefits: This Agreement is made for the sole benefit of Borrower and Lender, their successors and assigns and no other person or persons shall have any rights or remedies under or by reason of this Agreement nor shall Lender owe any duty whatsoever to any claimant for labor performed or material furnished in connection with the construction of the improvements, to apply any undisbursed portion of the loan to the payment of any such claim or to exercise any right or power of Lender hereunder or arising from any default by Borrower.

15.3. Notice: All written notices or demands of any kind which Lender may be required or desires to serve upon Borrower or general contractor under the terms of this Agreement may be served upon Borrower or general contractor (as an alternative to personal service) by leaving a copy of such notice or demand addressed to Borrower or general contractor at the property, whereupon service shall be deemed complete, or by mailing a copy thereof by certified or registered mail, addressed to Borrower or general contractor at the property. In the case of service by mail it shall be deemed complete at the expiration of the second day after the date of mailing. If Borrower consists of more than one person, service of any notice or demand of any kind by Lender upon any one of said persons in the manner hereinabove provided shall be complete service upon all.

15.4. Death of Partner: If Borrower is organized as a partnership or joint venture, upon the death of any of the general partners or joint venturers comprising Borrower prior to the completion of the improvements or prior to the disbursement of the balance of loan proceeds, Lender may cease disbursements hereunder unless the partnership or joint venture agreement provides for and the partnership or joint venture in fact does continue after such death.

15.5. Entire Agreement: This Agreement constitutes the entire understanding between the parties and may not be modified, amended or terminated except by a written agreement signed by each of the parties hereto.

15.6. Documentation: In addition to the instruments and documents mentioned or referred to herein, Borrower will, at its own cost and expense, supply Lender with such other instruments, documents, information and data as may, in Lender's opinion, be reasonably necessary for the purposes hereof, all of which shall be in form and content acceptable to Lender.

15.7. Not Assignable: This Agreement may not be assigned by Borrower without prior written consent of Lender. Subject to the foregoing restriction, this Agreement shall inure to the benefit of Lender, its successors and assigns and binds Borrower, its heirs, executors, administrators, successors and assigns.

15.8. Time is of the Essence: Time is hereby declared to be of the essence of this Agreement and of every part hereof.

15.9. Supplement to Security Agreements: The provisions of this Agreement are not intended to supersede the provisions of the Deed of Trust or the security agreements but shall be construed as supplemental thereto.

15.10. Joint and Several Obligations: If Borrower consists of more than one person, the obligations of Borrower shall be the joint and several obligations of all such persons, and any married spouse who executes this Agreement agrees that recourse may be had against his/her separate property for satisfaction of his/her obligations hereunder. When the context and construction so require, all words used in the singular herein shall be deemed to have been used in the plural and the masculine shall include the feminine and neuter.

15.11. California Law: This Agreement shall be construed in accordance with the laws of the State of California.

15.12. Agency: Borrower hereby appoints and authorizes Lender, as its agent, to record any notices of completion, cessation of labor and other notices that Lender deems necessary to record to protect any interest of Lender under the provisions of this Agreement, the Note, the Deed of Trust or any of the security agreements. This agency is a power coupled with an interest and is not revocable.

15.13. Governmental Regulations: If payment of the indebtedness secured by the Deed of Trust is to be insured or guaranteed by any governmental agency, Borrower shall comply with all rules, regulations, requirements and statutes relating thereto or provided in any commitment issued by any such agency to insure or guarantee payment of such indebtedness.

15.14. Collection Costs: Borrower shall pay promptly to Lender without demand, with interest thereon from date of expenditure at the rate specified in the Note, reasonable attorney fees and costs and other expenses paid or incurred by Lender in enforcing or exercising its rights or remedies created by, connected with or provided in this Agreement, and payment thereof shall be secured by the Deed of Trust and each of the security agreements.

15.15. Survival: The representations, warranties and covenants herein shall survive the disbursement of the loan and shall remain in force and effect until the loan is paid in full.

15.16. Severability: Invalidation of any one or more of the provisions of this Agreement, the Deed of Trust or security agreements by judgment or court order shall in no way affect any of the other provisions thereof which shall remain in force and effect.

15.17. Pay-off of the loan prior to total disbursement: In the event the loan is paid in full prior to the disbursement of the Construction Fund and/or Interest Reserve the Lender may, at its option, retain and administer the remaining funds in accordance with the provisions of this Agreement and other loan documents until all obligations of the Lender are completed, or a fund control satisfactory to the Lender is substituted.

16. **TERMS USED IN THIS AGREEMENT:**

16.1. Borrower's Funds: The funds to be deposited by Borrower in the loan in process account subject to the prior written approval of Lender given prior to recordation. Borrower's funds may include, in lieu of cash, irrevocable letters of credit for the benefit of Lender, certificates of deposit or savings accounts duly assigned and pledged for direct costs of construction of the improvements.

16.2. Construction Fund: That portion of the loan and Borrower's funds, in cash, available for payment of items in the construction cost breakdown which does not include the initial disbursement or interest reserve.

16.3. Loans in Process Account: A special non-interest bearing account to which there shall be credited the loan proceeds upon recordation.

16.4. Guarantor: The Guarantor of Borrower's obligations in connection with the loan.

16.5. Loan: The face amount of the Note.

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16.6. Loan Fee: The fee paid by Borrower to Lender in connection with making the loan.

16.7. Request for Payment: Lender's form "Request for Payment of Construction Money" or its equivalent acceptable to Lender, containing a statement of Borrower setting forth the amount of progress payment(s) sought.

16.8. Change Orders: Any amendments or modifications to the general contract, any subcontract, or the plans and specifications.

16.9. Construction Cost Breakdown: A list of the individual component costs of constructing the improvements.

16.10. Financial Statements: Financial statements of Borrower and Guarantor and such other entity required by Lender including Operating Statements, Balance Sheets, and such other financial reports in such form and content as Lender may require.

16.11. General Contract: The contract between Borrower and general contractor for construction of the improvements.

16.12. Guaranty: The guaranty, if any, executed by the person or persons named herein as Guarantor, which guarantees the performance of Borrower's obligations specified herein, in form and content as required by Lender.

16.13. Initial Disbursement: Making of the payments upon recordation of costs, charges, expenses and items associated with the loan as set forth in paragraph 6.1.

16.14. Interest Reserve: That portion of the loan set aside by Lender and allocated for the payment of monthly, interest-only installments under the Note.

16.15. Note: The Note evidencing the loan, executed by Borrower as maker and payable to Lender or order in such form and content as required by Lender.

16.16. Personal Property: The property described in the security agreements and which collateral for the repayment of the loan.

16.17. Plans and Specifications: The final plans and specifications for the construction of the improvements and approved as required herein, including all amendments and modifications thereof made by approved change orders.

16.18. Property: That certain real property described in the Deed of Trust and on which the improvements are to be constructed.

16.19. Recordation: The act of recording the Deed of Trust in the official records of the county in which the property is situated.

16.20. Security Agreements: All agreements, other than the Deed of Trust, the performance hereunder and/or the repayment of the loan, interest, costs and charges associated therewith.

16.21. Tenant Improvements: That portion of the improvements which will be constructed to conform to the requirements of the initial tenants leased premises situated in the improvements.

16.22. Deed of Trust: The Deed of Trust executed by Borrower to Lender securing the Note, in such form and content as requested by Lender.

16.23. Improvements: All on-site and off-site improvements and fixtures to be constructed on the property in accordance with the plans and specifications.

16.24. Completion of Improvements: All on-site and off-site improvements and fixtures completed in accordance with plans and specifications to the satisfaction of the Lender and the satisfaction of the governing authority as evidenced by the "signing off" of the building permit on the final inspection, the issuance of a Certificate of Occupancy or any other document by which the governing authority acknowledges completion of the improvements.

16.25. Government Authority: Any government authority which has jurisdiction or control of the property, development thereof or construction thereon including the State of California, any political subdivision thereof, any city, county and any agency, department, commission, board, bureau or instrumentality of any of them.

IN WITNESS WHEREOF, the parties have executed this Agreement the day and year first above written.

___________, a ___________
By ___________
BORROWER:
___________, a ___________
By: ___________

(TO BE COMPLETED ONLY WHERE THERE IS NO CONTRACT BETWEEN THE CONTRACTOR AND OWNER, i.e., contractor is in the employ of owner on a salary basis.)

CONTRACTOR—The undersigned contractor hereby represents and warrants that it has initialed the plans, makes the covenants set forth in paragraphs 8.6 and 8.7 hereof and agrees that the disbursement schedule shall control notwithstanding the provisions of the employment or other contract.

CONTRACTOR
By ___________ License #___________
By ___________

(TO BE COMPLETED ONLY WHERE A GENERAL CONTRACT EXISTS BETWEEN A GENERAL CONTRACTOR AND AN OWNER AS SEPARATE PERSONS OR SEPARATE ENTITIES.)

___________, the undersigned, as the General Contractor for construction of the Improvements mentioned in the foregoing Construction Loan Agreement, hereby represents and warrants as follows:

1. That the undersigned has been furnished a copy of said Agreement and has read and understands its terms.

2. That the undersigned understands that the Lender, in making the loan mentioned in the Agreement, is relying on the faithful performance of the General Contract between the undersigned and Borrower, an executed copy of which has been deposited with Lender.

3. That the undersigned will commence construction of the proposed Improvements promptly after recording of the Lender's Deed of Trust and not before; will proceed with such construction diligently and in a workmanlike manner and will complete said Improvements in accordance with the Plans and Specifications referred to in the Agreement together with any specifications prescribed by the Lender and will comply with all requirements of each and every Governmental Authority having control and/or jurisdiction of the Project.

4. That there are no provisions in the Agreement which conflict with or which will interfere with performance of the General Contract by the undersigned and the disbursement provisions of the General Contract.

5. That the undersigned has initialed the Plans and Specifications and makes the covenants set forth in paragraphs 8.6 and 8.7 of the Agreement.

6. That the undersigned acknowledges that there is only $________ available under this loan for construction costs.

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7. That the undersigned agrees to the disbursement system as outlined in Exhibit A and will comply with the terms stated therein.

GENERAL CONTRACTOR
___________ License #___________

____

RELEASE PRICE AGREEMENT

DATED: LOAN NO. _____

This agreement is between ___________ (you/your) and ___________ (I, my)

You will issue a partial reconveyance on portions of the property secured by the deed of trust provided that:

1. I am not in default in any agreement under this loan at the time the partial reconveyance is issued.
2. For each property to be released, I have paid you the amount listed below in the Release Price column.
3. I have paid you accrued interest on the release price at the note rate up to and including the day the release price is paid.

You will apply the portion of the release price known as the Par Amount to decrease the principal balance of the note. You may, at your option, apply any amount in excess of the Par Amount to do any of the following: (1) decrease the principal balance, (2) increase the loan-in-process account, (3) increase the interest retention account, or (4) pay any accrued interest, late charges, trustee fees, and any other costs incurred in the administration of this loan.

For each lot or unit released, I will pay you a partial reconveyance fee which will be your standard fee in effect at the time the partial reconveyance is issued.

Any partial release of the property used as security will not affect my liability for the balance of the note and the provisions of the deed of trust.

LOT/UNIT	VALUE	PAR AMOUNT	RELEASE PRICE

EXHIBIT "A" (JOINT OR DUAL CHECKING ACCOUNT)

Date: ___________, ___ Loan No. ___________

A Bank checking account in the names of Borrower and/or general contractor shall be established in a form acceptable to Lender. To secure the payment of construction disbursements, Borrower and/or general contractor hereby grants to Lender a security interest in bank checking account referred to herein. Withdrawals from such account shall require the signatures of Lender and Borrower or general contractor. The Lender shall be delivered properly executed "Requests for Payment of Construction Money," supported by such invoices, lien waivers and payroll records and other documents as Lender may require. Request For Payment On Construction Money forms will be honored by Lender when they bear the signature of

___________ or ___________

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At the same time, Borrower and/or general contractor shall also deliver to Lender checks drawn on said account payable to the persons entitled to payment covering each item to be paid as so requested, together with stamped and addressed envelopes for mailing such checks to the payees therein named. Lender shall then review the documentation so submitted in support of the "Request for Payment" and inspect the property, at its option. Upon determining by such inspection that the work and/or materials represented by such Requests have been performed and/or delivered to the property and that such documentation conforms to the Request, Lender shall then deposit in the bank account a sum sufficient to cover the payments in amounts approved by Lender and shall countersign the checks submitted by Borrower and/or general contractor and mail them in the envelopes mentioned above. This method of disbursement shall continue until 90 percent of the Construction Funds has been disbursed.

The remaining 10 percent shall be retained by Lender, at its option, until completion of the improvements, the recording of a valid Notice of Completion and the delivery of a policy of title insurance in form and content and with indorsements attached satisfactory to Lender. Said remaining 10 percent shall be finally disbursed or credited in accordance with paragraph 6.4.2 hereof.

By: ___________
Title
ACCEPTED BY CONTRACTOR:

____

ASSIGNMENT OF CONSTRUCTION CONTRACTS AND PLANS AND SPECIFICATIONS

LOAN NUMBER: _____

THIS ASSIGNMENT OF PLANS AND SPECIFICATIONS (this "Assignment") is made as of ___________, by ___________ ("Borrower"), whose address is ___________ in favor of ___________ ("Lender"), the address of which is ___________, California _____.

RECITALS

A. **Loan.** Lender has agreed to make a loan to Borrower in the original principal sum of up to ___________ (the "Loan"), pursuant to and subject to the terms and conditions of a Construction Loan Agreement of even date herewith between Borrower and Lender (the "Construction Loan Agreement"), for the purpose of Borrower constructing certain improvements described in the Construction Loan Agreement (the "Improvements"), upon that certain real property owned by Borrower located in ___________ County, California, more particularly described in Exhibit "A" attached hereto (the "Property"). The Property, together with the Improvements, is referred to herein as "The Project."

B. **Loan Documents.** The Loan will be evidenced by a Promissory Note of even date herewith executed by Borrower in favor of Lender (the "Note"), and will be secured by a Deed of Trust, Assignment of Rents and Security Agreement of even date herewith executed by Borrower encumbering the Project (the "Deed of Trust"). This Assignment, the Note, the Deed of Trust, the Construction Loan Agreement and all other documents and instruments now or hereafter executed by Borrower in connection with or to evidence or secure payment of the Loan, including without limitation any security agreements, other assignments and other documents or instruments related thereto, will hereinafter be referred to collectively as the "Loan Documents."

AGREEMENT

NOW, THEREFORE, in consideration of Lender's agreement to make the Loan, Borrower agrees as follows:

1. **Assignment.** As security for the due and punctual payment and performance of all indebtedness and obligations now or hereinafter due from Borrower to Lender under the Loan Documents, as they may be modified, amended or supplemented

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from time to time, Borrower hereby assigns and transfers to Lender, and hereby grants to Lender a security interest in, all of Borrower's right, title and interest now owned or hereafter acquired in and to (a) all construction contracts between Borrower and other persons, and all general and supplemental conditions, amendments, modifications, additions and changes thereto, related to any part of the Project including without limitation those certain contracts between Borrower and other persons described in Exhibit “B” attached hereto, and (b) all other contracts, agreements, documents and instruments now existing or hereafter arising related to any part of the Project including without limitation any and all construction, architectural and engineering contracts, plans and specifications, drawings, surveys, bonds, permits, licenses and other governmental approvals. All of the foregoing contracts, agreements, plans, specifications, documents and instruments will hereinafter be referred to collectively as the “Contracts and Documents.”

2. **Rights of Borrower.** This Assignment is an absolute assignment for security purposes, but until the occurrence of an event of default under any of the Loan Documents, Borrower shall retain the right to enforce the Contracts and Documents.

3. **Representations and Warranties of Borrower.** Borrower represents and warrants to Lender (a) that it has not assigned or granted a security interest in any of the Contracts and Documents to any person other than Lender, (b) that its interests therein are not subject to any lien, encumbrance, claim, set-off or deduction, (c) that it is not in default and that no event has occurred which with notice or lapse of time or both would constitute a default by Borrower under any of the Contracts and Documents, and (d) that none of the Contracts and Documents have been amended or modified except as set forth in Exhibit “C.”

4. **Covenants of Borrower.** Borrower covenants and agrees (a) that it will not further assign, encumber or suffer the assignment or encumbrance of any of the Contracts and Documents without the prior written consent of Lender, (b) that it will faithfully abide by, perform and discharge each and every obligation, covenant and agreement of Borrower under the Contracts and Documents, (c) that it will enforce or secure the performance of each and every obligation, covenant and agreement of the other parties to the Contracts and Documents, and (d) that it will not, without Lender's prior written consent, waive, modify, extend or in any way alter any of the terms of any of the Contracts and Documents or in any manner release or discharge any party thereto from the obligations, covenants and agreements of such party thereunder.

5. **Limitation of Lender's Obligation.** Nothing in this Assignment shall constitute an assumption of any obligation by Lender under any of the Contracts and Documents. Borrower shall continue to be liable for all obligations thereunder and hereby agrees to perform all such obligations, to comply with all terms and conditions of the Contracts and Documents, and to take such steps as may be necessary or appropriate to secure performance by all other parties thereto. Borrower shall defend, indemnify and hold Lender harmless from and against all losses, costs, liabilities and expenses, including without limitation attorneys' fees, arising from or related to any failure by Borrower to perform any obligation of Borrower under any of the Contracts and Documents.

6. **Cure by Lender.** At any time and from time to time, Lender shall have the right, but shall have no obligation, to take all actions that Lender may determine to be necessary or appropriate to cure any default under any of the Contracts and Documents and to protect the rights of Borrower or Lender thereunder, and may do so in Lender's name, in the name of Borrower or otherwise. If any such action taken by Lender shall prove to be inadequate or invalid in whole or in part, Lender shall incur no liability on account thereof, and Borrower hereby agrees to defend, indemnify and hold Lender harmless from and against all losses, costs, liabilities and expenses, including attorneys' fees, which Lender may incur or to which it may become subject in exercising any of its rights under this Assignment.

7. **Lender's Rights and Remedies.** Upon the occurrence of any event of default under any of the Loan Documents, irrespective of whether a notice of default has been given with respect to such event of default, and with or without bringing any action or proceeding, Lender may, at its option, succeed to and proceed to enforce all of the rights, interest and remedies of Borrower under the Contracts and Documents, amend, modify, cancel, terminate or replace the same, reassign Borrower's rights, title and interest therein to any other person, and exercise any and all other rights of Borrower under the Contracts and Documents, either in person or through an agent or receiver, without further notice to or consent by Borrower, and without regard to the adequacy of security for the indebtedness and obligations secured hereby or the availability of any other remedies. The exercise of any of the foregoing rights or remedies shall not cure or waive any default under any of the Loan Documents, nor waive, modify or affect any notice of default thereunder, nor invalidate any act done pursuant to any such notice. In addition to the rights and

remedies of Lender as set forth in this Assignment, Lender shall be entitled to the benefit of all other rights and remedies set forth in the Loan Documents, at law or in equity.

8. **Additional Instruments.** With respect to both existing and further Contracts and Documents, Borrower hereby agrees to execute and deliver such additional assignments and other documents as Lender may reasonably request in order to implement the purpose and intent of this Assignment.

9. **Miscellaneous.** This Assignment shall inure to the benefit of and be binding upon the parties hereto and their respective heirs, legal representatives, successors and assigns. In any action or proceeding arising from or related to this Assignment, including without limitation, arbitration, the prevailing party shall be entitled to recover its costs and attorneys' fees. The reference to "attorneys' fees" in this Paragraph and in all other places in this Assignment and the other Loan Documents shall include without limitation such amounts as may then be charged by Lender for legal services furnished by attorneys in the employ of Lender, at rates not exceeding those that would be charged by outside attorneys for comparable services. All exhibits referred to herein are attached to and hereby made a part of this Assignment. This Assignment shall be construed without regard to whether it was prepared or drafted by one party or the other or either of their attorneys. This Assignment shall be governed by the laws of the State of California except to the extent federal laws or regulations applicable to Lender conflict with applicable law in which case such federal law or regulation will control.

IN WITNESS WHEREOF, Borrower has executed this Agreement as of the date first above written.

BORROWER:

____
By: ___________
Title
[THE PROPERTY]

EXHIBIT "A"

[CONTRACTS]

EXHIBIT "B"

ARCHITECT'S OR ENGINEER'S CONSENT TO ASSIGNMENT

LOAN NUMBER: _____

THIS ARCHITECT'S OR ENGINEER'S CONSENT TO ASSIGNMENT (the "Consent") is made as of ___________ by ___________ (the "Architect or Engineer"), whose address is ___________ in favor of ___________, a ___________ ("Lender"), the address of which is ___________, California.

RECITALS

A. **Borrower; Contract;** Architect or Engineer and ___________ ("Borrower") are the parties to that certain Contract dated _____ (the "Contract").

B. **Assignment.** By that certain Assignment of Plans and Specifications dated ___________ (the "Assignment"), Borrower has assigned to Lender all of Borrower's right, title and interest in and to the Contract. Architect or Engineer has received a copy of and is familiar with the Assignment, the provisions of which are incorporated herein by this reference.

CONSENT

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NOW, THEREFORE, for good and valuable consideration, receipt of which is hereby acknowledged, Architect or Engineer agrees as follows:

1. **Consent to Assignment.** Pursuant to the Contract, Architect or Engineer has performed or supplied, or agreed to perform or supply, certain services, materials or documents in connection with the Property or the construction of the Improvements. Architect or Engineer hereby consents to the assignment thereof by Borrower to Lender as provided in the Assignment and this Consent.

2. **Borrower's Default Under Contract.** If Borrower defaults under the Contract, before exercising any remedy it may have under the Contract or otherwise, Architect or Engineer shall deliver to Lender at its address set forth above, by certified mail, postage prepaid, return receipt requested, written notice of such default, specifying the nature of the default and the steps necessary to cure the same. If Borrower fails to cure the default within the time permitted under the Contract, then Lender shall have an additional 30 days after the expiration of the time permitted under the Contract (but in no event less than an additional 30 days after Lender's receipt of said notice from Architect or Engineer) within which Lender shall have the right, but not the obligation, to cure such default, except that Architect or Engineer shall not be required to continue performance under the Contract for said additional period, unless and until Lender agrees to pay Architect or Engineer for the portion of the work, labor and materials rendered during the said period.

3. **Borrower's Default Under Loan Documents.** If Lender gives written notice to Architect or Engineer that Borrower has defaulted under the Loan Documents and requests that Architect or Engineer continue its performance under the Contract, Architect or Engineer shall thereafter perform for Lender under the Contract in accordance with its terms so long as Architect or Engineer shall be paid pursuant to the Contract for all work labor and materials rendered thereunder, including payment of any sums due to Architect or Engineer for work performed up to and including the date of Borrower's default.

4. **Performance for Lender.** If Lender (a) cures any default by Borrower pursuant to Paragraph 2 above, (b) gives written notice to Architect or Engineer that Borrower has defaulted under the Loan Documents pursuant to Paragraph 3 above, (c) becomes the owner of the Property, (d) undertakes to complete the construction of the Improvements, or (e) otherwise requires the performance of Architect's or Engineer's obligations under the Contract or the use of any plans and specifications, drawings, surveys or other materials or documents previously prepared or provided by Architect or Engineer pursuant to the Contract, then in any such event, so long as Architect or Engineer has received and continues to receive the compensation required under the Contract related thereto, Lender shall have the right to obtain performance from Architect or Engineer of all of these obligations under the Contract, and to use all such plans and specifications, drawings, surveys and other materials and documents, and the ideas, designs and concepts therein, in connection with the completion of Improvements, without the payment of any additional fees or charges to Architect or Engineer.

5. **Amendments and Change Orders.** Architect or Engineer agrees that it will not modify, amend, supplement or in any way join in the release or discharge of any of Architect's or Engineer's obligations under the Contract without the prior written consent of Lender, and that it will not perform any work pursuant to any change order or directive unless the same is issued and executed in accordance with the terms and conditions of the Contract.

6. **List of Subcontractors.** Upon the written request of Lender at any time and from time to time, Architect or Engineer shall furnish to Lender a current list of all persons with whom Architect or Engineer has entered into subcontracts or other agreements related to the rendering of work, labor or materials under the Contract, together with a statement as to the status of each such subcontractor or agreement, and the respective amounts, if any, owed by Architect or Engineer related thereto.

7. **Subordination of Liens.** Any liens, claims and security interests that Architect or Engineer may now or hereafter have related to the work described in the Contract, including without limitation choate liens, inchoate liens and mechanic's liens, are hereby subordinated to the liens, claims and security interest now existing or hereafter arising in favor of Lender securing the payment and performance of any or all indebtedness and obligations of Borrower to Lender arising from or related to the Loan. In

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furtherance thereof, Architect or Engineer hereby waives any and all rights that it may now or hereafter have to claim priority, directly or indirectly, in whole or in part, over the liens, claims and security interest of Lender under the Loan Documents.

8. **Representations and Warranties.** Architect or Engineer represents and warranties to Lender that (a) it is duly licensed to conduct its business in the jurisdiction contemplated by the Contract, and will at all times maintain its license in full force and effect throughout the term of the Loan, (b) the Contract has not been amended, modified or supplemented except as set forth in the Assignment, (c) the Contract constitutes a valid and binding obligation of Architect or Engineer and is enforceable in accordance with its terms, (d) there have been no prior assignments of the Contract, and (e) all covenants, conditions and agreements of Borrower and Architect or Engineer contained in the Contract have been performed as required therein, except for those that are not due to be performed until after the date hereof.

9. **Application of Funds.** Nothing herein imposes or shall be construed to impose upon Lender any duty to direct the application of any Loan funds, and Architect or Engineer acknowledges that Lender is not obligated under the Loan Documents to Architect or Engineer or any of its subcontractors, materialmen, suppliers or laborers.

10. **Acknowledgement of Inducement.** Architect or Engineer is executing this Consent to induce Lender to advance funds under the Loan Documents, and Architect and Engineer understands that Lender would not do so but for Architect's or Engineer's execution and delivery hereof.

IN WITNESS WHEREOF, Architect or Engineer have executed this Consent as of the date first above written.

ARCHITECT OR ENGINEER LICENSE #___________

____

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End of Document

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Cal. Prac. Guide Real Prop. Trans. Form 6:B

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 6. Financing and Appraisals

Forms

[Form 6:B] All-Inclusive Promissory Note

ALL-INCLUSIVE PROMISSORY NOTE
SECURED BY ALL-INCLUSIVE DEED OF TRUST

$________ ___________, California
___________, ___

In installments as herein stated, for value received, the undersigned ("Maker") promises to pay to ___________ ("Payee"), or order, at ___________, the principal sum of ___________ ($________), with ___________ (____%) per annum; interest only payable in monthly installments of $________ on the ___ day of each calendar month, beginning on the $________ day of ___________, and continuing until ___________, on which day the entire balance of the unpaid principal with unpaid interest due thereon shall be due and payable. Should interest not be so paid, it shall thereafter bear like interest as the principal.

The original principal amount of this Note includes the unpaid principal balance of the promissory note(s) (collectively hereinafter referred to as the "Underlying Note") secured by a Deed of Trust, more particularly described as follows:

(a) PROMISSORY NOTE:
Maker:
Payee:
Original Amount: $
(b) DEED OF TRUST:
Beneficiary:
Original Amount:
Recordation Date:
Instrument No.:
Place of Recordation:
(c) PROMISSORY NOTE:
Maker:
Payee:
Original Amount: $
(d) DEED OF TRUST:
Beneficiary:
Original Amount:
Recordation Date:
Instrument No.:
Place of Recordation:

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By Payee's acceptance of this Note, Payee covenants and agrees that, provided Maker is not delinquent or in default under the terms of this Note, Payee shall pay all installments of principal and interest which shall hereafter become due pursuant to the provisions of the Underlying Note as and when the same become due and payable. In the event Maker shall be delinquent or in default under the terms of this Note, Payee shall not be obligated to make any payments required by the terms of the Underlying Note until such delinquency or default is cured. In the event Payee fails to timely pay any installment of principal or interest on the Underlying Note at the time when Maker is not delinquent or in default hereunder, Maker may, at Maker's option, make such payments directly to the holder of such Underlying Note, in which event Maker shall be entitled to a credit against the next installment(s) of principal and interest due under the terms of this Note equal to the amount so paid and including, without limitation, any penalty, charge, and expense paid by Maker to the holder of the Underlying Note on account of Payee's failing to make such payment. The obligations of Payee hereunder shall terminate upon the earliest of (i) foreclosure of the lien of the All-inclusive Deed of Trust securing this Note or (ii) cancellation of this Note and reconveyance of the All-inclusive Deed of Trust securing same.

Should Maker be delinquent or in default under the terms of this Note and Payee consequently incurs any penalties, charges, or other expenses on account of the Underlying Note during the period of such delinquency or default, the amount of such penalties, charges, and expenses shall be immediately added to the principal amount of this Note and shall be immediately payable by Maker to Payee.

Notwithstanding anything to the contrary herein contained, the right of Maker to prepay all or any portion of the principal of this Note is limited to the same extent as any limitation exists in the right to prepay the principal of the Underlying Note. If any prepayments of principal of this Note shall, by reason of the application of any portion thereof by Payee to the prepayment of principal of the Underlying Note, constitute such prepayment for which the holders of the Underlying Note are entitled to receive a prepayment penalty or consideration, the amount of such prepayment penalty or consideration shall be paid by Maker to Payee upon demand, and any such amount shall not reduce the unpaid balance of principal or interest hereunder.

At any time when the total of the unpaid principal balance of this Note, accrued interest thereon, all other sums due pursuant to the terms hereof, and all sums advanced by Payee pursuant to the terms of the All-Inclusive Deed of Trust securing this Note, is equal to or less than the unpaid balance of principal and interest then due under the terms of the Underlying Note, Payee, at his option, shall cancel this Note and deliver same to Maker and execute a Request for Full Reconveyance of the Deed of Trust securing this Note.

Should default be made by Maker in payment of any installments of principal, interest, or any other sums due hereunder or in the All-Inclusive Deed of Trust securing this Note, the whole sum of principal and interest hereunder, shall become immediately due at the option of the holder of this Note.

Principal, interest and all other sums due hereunder are payable in lawful money of the United States.

Maker acknowledges that late payment to Payee will cause Payee to incur costs not contemplated by this loan. Such costs include, without limitation, processing and accounting charges. Therefore, if any installment is not received by Payee when due, Maker shall pay to Payee an additional sum of six percent (6%) of the overdue amount as a late charge. The parties agree that this late charge represents a reasonable sum considering all of these circumstances existing on the date of this Note and represents a fair and reasonable estimate of the costs that Payee will incur by reason of late payment. The parties further agree that proof of actual damages would be costly or inconvenient. Acceptance of any late charge shall not constitute a waiver of a

default with respect to the overdue amount, and shall not prevent Payee from exercising any of the other rights and remedies available to Payee.

In the event of any default by Maker under this Note, the All-Inclusive Deed of Trust securing this Note, Maker shall pay, in addition to all principal and interest, all reasonable costs and attorneys' fees necessary to collect the obligation evidenced by this Note and the All-Inclusive Deed of Trust, whether or not suit be filed; plus the aggregate of all amounts theretofore paid by Payee pursuant to the terms of the All-Inclusive Deed of Trust for taxes, assessments, insurance premiums, delinquency charges, foreclosure costs, and any other sums advanced by the beneficiary of the All-Inclusive Deed of Trust pursuant to the terms thereof, to the extent the same were not previously repaid by Maker to Payee; plus the costs of foreclosure under the All-Inclusive Deed of Trust; plus attorneys' fees and costs incurred by Payee in enforcing payment of this Note or the All-Inclusive Deed of Trust including, but not limited to, all reasonable costs and fees incurred in order to obtain relief from any Federal Bankruptcy Court stay enjoining foreclosure.

This Note is secured by an All-Inclusive Deed of Trust given to ___________, a California corporation, as Trustee.

"MAKER"
By: ___________
By: ___________

The undersigned hereby accepts the foregoing All-Inclusive Promissory Note and agrees to perform each and all of the terms thereof on the part of Payee to be performed. Executed as of the date and place first above written.

"PAYEE"
By: ___________

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Cal. Prac. Guide Real Prop. Trans. Form 6:C

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 6. Financing and Appraisals

Forms

[Form 6:C] All-Inclusive Deed of Trust

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Cal. Prac. Guide Real Prop. Trans. Form 6:D

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 6. Financing and Appraisals

Forms

[Form 6:D] Loan Commitment

___________,
____
____
___________, California _____
Attn: ___________

Project: ___________
____
____

Dear _____:

___________ Bank (“Lender”) offers to make an adjustable mortgage loan to ___________ (“Borrower”) secured by a First Deed of Trust on the above Project (“Project”) under the following terms and conditions:

TERMS:

Loan Amount:

The total amount Lender is willing to lend is $5,800,000.

Interest Rate:

The loan will accrue interest at the initial rate of 3.00% plus 3-month LIBOR (“Index”) as quoted in the Wall Street Journal on the first U.S. business day of each month. In the event this index is not published, a comparable index, selected by the lender, will be used.

Interest Rate Adjustment:

The interest rate will be subject to an adjustment every 90 days from the date of the first payment by adding 3.00% to the then existing Index value.

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Interest Rate Floor/Ceiling:

The interest rate will have no floor or ceiling.

Payments:

Payments will be made monthly and will be amortized over 30 years.

Payment Adjustments:

The payment amount will be adjusted every 90 days based on the then outstanding loan balance, at the adjusted interest rate, and reamortized accordingly. The exact notice provisions will be determined by Lender at its sole discretion and appropriately documented with the Borrower.

Loan Term:

One year.

Prepayment Fee:

The loan may be paid in full or in part without a prepayment charge.

Assumability:

None. There will be a "due-on-sale" clause.

Loan Fee:

$________

Commitment Fee:

$________

Guarantees:

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Personal guaranty by ___________.

CONDITIONS:

Liens:

All existing liens must be paid off.

Impounds:

So long as Borrower is not in default under the loan, Lender will not require an impound account for the payment of property taxes and fire and other hazard insurance premiums.

Additional Security:

Borrower will be required to sign a financing statement and a security agreement encumbering personal property as additional security for the loan.

Title Insurance:

Lender will obtain at Borrower's expense an American Land Title Association lender's policy of title insurance showing fee title to the Project vested in Borrower, and Lender's Deed of Trust in first lien position. The title company, form of policy, policy limit, and content of the policy, including exceptions to title, must be acceptable to Lender.

Property Insurance:

Prior to funding this loan Borrower shall provide the following minimum insurance coverages written in form and content and by an insurance company or companies acceptable to Lender:

a) "All Risk" (special form) Hazard Insurance pro-viding full replacement coverage on this project. A Lender's Loss Payable endorsement (438BFU) is to be attached in favor of Lender.

b) A Certificate of Insurance verifying that the Borrower has at least one million dollars ($1,000,000) combined single limit liability insurance.

c) Evidence of Rental Loss coverage in the amount of a twelve month projected loss.

d) Evidence of worker's compensation coverage.

Lender will not be required to make a loan on any portion of the security that is materially damaged or destroyed by fire, flood, theft, vandalism or other hazard until it has been reconstructed according to plans and specifications approved by Lender.

Environmental Clearance:

Borrower agrees to sign Lender's Environmental Indemnity document.

General Indemnification:

Notwithstanding anything contained herein, Borrower and its Guarantor and/or General Partners shall be personally liable to Lender for: (a) any damages suffered as a result of intentional or willful fraud, waste or misrepresentation by any General Partner or officer of Borrower; (b) any rental or other income arising with respect to the Project collected by Borrower after written notice that Borrower is in default to the full extent of the rental or other income retained and collected by Borrower after the giving of any such written notice (Borrower, may, however, apply income derived from the Project to the operating expenses directly relating to the Project without creating personal liability under the Loan); (c) the fair market value as of the time of the giving of any such written notice of any personal property or fixtures removed or disposed of by Borrower other than in accordance with the terms of the Loan Documents; (d) the misapplication of any proceeds, to the full extent of said misapplied proceeds, under any insurance policies or awards relating to condemnation or the exercise of the power of eminent domain or by reason of damage, loss or destruction of any portion of the Project; (e) violations of any legal requirements applicable to the Project, including, without limitation, applicable environmental laws, and/or the presence of hazardous waste or other similar substances on the Project; and (f) attorneys' fees and other costs incurred by Lender in collecting any of the foregoing.

Miscellaneous:

All papers signed and/or delivered in connection with obtaining and funding the loan must be satisfactory to Lender.

GENERAL PROVISIONS:

This commitment replaces all prior communications and agreements. Waivers and modifications to this letter must be in writing signed by Borrower and Lender.

Should any legal dispute arise, the prevailing party in any action or proceeding related to this commitment is entitled to reasonable costs and attorneys' fees.

This commitment will be interpreted according to California law. The loan must conform to all laws, regulations and rulings governing Lender, including those that may be enacted after the date of this letter.

TERMINATION:

Compliance:

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Borrower's failure to comply with any provision in this letter will allow Lender to terminate this commitment and to seek reimbursement for all fees and charges incurred by Lender up to and including the date of the termination. The disapproval by Lender of any of the items requiring the approval by Lender will terminate this commitment.

The disclosure of any information which in Lender's sole discretion would (i) make any certificate, etc., furnished to Lender hereunder false in any material respect, (ii) materially adversely change the anticipated cost of the Project or the financial condition of Borrower or any proposed guarantor, or (iii) otherwise impair the ability of Borrower or any of its guarantors to perform under the terms of this Commitment or the Loan contemplated hereunder, will terminate this commitment.

Assignment:

This commitment may not be assigned by Borrower, but Lender's obligations may be delegated to, and assumed by, any third party.

Default:

If Borrower or principal(s) of borrower defaults under any note or deed of trust pertaining to any loans that Borrower or principal(s) of Borrower may have or will have with Lender, Lender may terminate this commitment.

Insolvency/Bankruptcy:

Lender has the right to terminate this commitment if either of the following occurs:

a) Borrower (or the property which is the subject of this commitment letter), or any Guarantor or General Partner of Borrower becomes the subject of any bankruptcy, insolvency, or other similar proceeding or law now or hereafter in effect, or suffers the appointment of a receiver, liquidator, assignee, custodian, trustee, sequestrator (or similar official) and any such decree or order remains unstayed and in effect for a period of 60 consecutive days.

Time is of the Essence:

Time is of the essence in this commitment. Thirty days' notice must be provided of the date Borrower wants the loan to fund and record. If the loan is not funded, and the Deed of Trust securing the loan is not recorded by 4:00 p.m. on ______, this commitment will terminate unless earlier terminated as provided in this letter.

If the loan is not funded within 10 business days after the date Lender prepares loan documents, Lender may change the initial interest rate to reflect any adjustments to the then current Index value on the date new loan documents are prepared.

Extension Provision:

None; [or set forth terms of borrower's right to extend commitment].

To accept this offer, sign and return this letter to _____ ___________ Bank, ___________ ___________, California _____, together with the Commitment Fee of $________, on or before _____; otherwise this offer will terminate.

Sincerely,
___________ BANK
By: ___________
ACCEPTED BY: ___________

____
Date

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California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 6. Financing and Appraisals

Forms

[Form 6:E] Mortgage Loan Broker Agreement

EXCLUSIVE AUTHORIZATION AND FEE AGREEMENT

In consideration of the mutual promises, covenants and conditions contained herein ___________ (jointly, severally and collectively referred to as "Applicant") hereby employs ___________ ("Broker") as exclusive agent to obtain a commitment for a loan to be secured by mortgage, or deed of trust against the property hereinafter described, and Broker hereby accepts such employment on the following terms and conditions:

1. DESCRIPTION OF PROJECT: (hereinafter "the Property"):

2. DESCRIPTION OF LOAN COMMITMENT TO BE OBTAINED:

   Type of Loan: ___________

   Minimum Amount of Loan: ___________

   Maximum Commitment Fee Payable to Lender: ___________

   Other Terms: ___________

3. AMENDMENTS AND CHANGES: Applicant authorizes Broker to obtain such commitment conforming to the provisions of paragraph 2 above, or with such other terms as Applicant may hereafter approve, or with such other terms as may be contained in any amendment hereto or loan application hereafter executed by Applicant.

4. SERVICES: Broker shall diligently seek to (i) obtain such loan, (ii) negotiate the terms thereof on behalf of Applicant, and (iii) prepare in connection therewith (based upon information furnished and to be furnished by Applicant and information independently obtained by Broker) a loan package and/or brochure for submission to one or more prospective lenders in order to obtain such loan commitment. Broker shall have sole discretion as to which prospective lenders the loan package and/or brochure shall be submitted.

5. DOCUMENTATION AND QUALIFICATION OF APPLICANT: Applicant shall promptly furnish all documents and information required by Broker or prospective lender(s), which information shall be true and correct, and Applicant shall fully cooperate in efforts to facilitate procurement of the loan commitment. Applicant shall be solely responsible for, and Broker

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shall not be concerned with, matters relating to qualification of Applicant, vesting of title or other matters affecting recordation and closing of the financing transaction(s).

6. TERM OF AGREEMENT: The term of this Agreement shall be for a minimum period of 45 days commencing on the date of acceptance hereof by Broker as shown below. The term of this Agreement shall be extended thereafter until the earlier of (i) the expiration of 10 days' notice in writing from one party to the other of termination, or (ii) six months from the commencement date hereof; provided, that all periods of time specified herein shall be extended by the number of days elapsing between the date Broker or a prospective lender shall request documents or information from Applicant and the date Applicant shall furnish such documents or information in form satisfactory to the prospective lender.

7. COMMISSION TO BROKER: Applicant shall pay a commission to Broker, at _____, California, in a sum equal to _____ (____%) of the principal amount of the loan commitment described herein. The commission shall be deemed earned by Broker upon receipt by Applicant of a loan commitment. Such commission shall be due and payable out of the first funding of loan proceeds. The loan commitment will be one of the following:

a. in accordance with the terms set forth above in paragraphs 2 and 3, above; or,

b. on such other terms acceptable to or accepted by Applicant; or,

c. issued or approved during the term hereof by a lender to whom an application was submitted by or on behalf of Applicant without Broker involvement, knowledge, consent or participation; or,

d. issued or approved after the term hereof by a lender to whom the application was submitted during the term hereof and which is accepted or approved by Applicant, regardless of whether such application was submitted by Broker, Applicant or any other person, firm or entity; or,

e. accepted by Applicant within 12 months from the termination of this Agreement, from one or more lenders to whom a loan package or brochure was submitted during the term hereof; provided, however, that within 30 days from the termination of this Agreement Broker must provide Applicant in writing the names of such prospective lenders to whom the loan package or brochure has been submitted.

Sale, lease, transfer, or conveyance of the Property, or any interest therein, by Applicant shall not relieve, discharge, or excuse Applicant from payment of commissions otherwise due and payable hereunder. If Applicant shall enter into a joint venture, partnership, or other collaborative arrangement with any lender or prospective lender to whom the loan package has been submitted by Broker, then Broker shall be entitled to a fee in accordance with its general and usual compensation arrangement for such transaction(s).

8. CONTINUING RELATIONSHIP: From and after the date a loan or commitment is approved or issued, or a loan commitment is accepted by Applicant, as provided herein, and continuing for a period of 36 months, if the lending institution approving or making the loan or loan commitment shall make, issue or approve any loan or loans to Applicant for purposes of refinancing or increasing the loan concerning the Property herein, Applicant shall pay to Broker one percent (1%) of the principal amount of said loan or loans. In the case of a loan to refinance or increase the amount of the loan described herein on the Property described herein said percentage shall be applied only to the difference in the principal amount of such loan immediately prior to such refinancing and the principal amount immediately thereafter.

9. INSTRUCTION FOR PAYMENT, ESCROW DEMAND: Applicant authorizes Broker to deliver this authorization or a copy thereof to any lender making said loan commitment or any person, firm or entity holding proceeds from the sale of the Property and hereby directs the lender or such other entity to pay said commission to Broker. Broker's rights to collect the commission in this manner shall not be consider exclusive, nor shall it be construed to prohibit collection of the commission in any other proper manner, and Broker shall at all times retain the right to pursue collection of such commissions by any means provided by law.

10. LEGAL ACTION: Any legal action to enforce any provision of this Agreement shall be commenced in a court of competent jurisdiction in the County of _____, State of California. The prevailing party in such legal action shall be entitled to reasonable attorneys' fees, costs incurred, and any other relief to which such party may be entitled.

11. WARRANTY OR AUTHORITY: The undersigned, individually and on behalf of Applicant, warrant that they have full power and authority to enter into and execute this Agreement; that all necessary formalities have been complied with; and, that the terms, covenants, promises, conditions, representations and warranties herein shall be binding on Applicant. Each of the undersigned, jointly, severally, individually, and on behalf Applicant and any other entity owned or controlled by them, agree to be bound by the terms and conditions of this Agreement and guarantee performance thereof by Applicant to the same extent as if each of them were the Applicant.

12. SIGNS: From the time the loan commitment is obtained to the time construction of the Property is completed, Applicant authorizes Broker to place signs on the Property containing the Broker logo and the statement "Financing Arranged By _____" (or similar language), and to place an announcement relating to the transaction in trade publications, newspapers, and such other public or private media as deemed necessary and appropriate by Broker.

13. ENFORCEABILITY: This Agreement shall be binding upon and inure to the benefit of the heirs, successors and assigns of the parties and shall be interpreted and governed by the laws of the State of California. If any court should find any provision hereof unenforceable, the remaining provisions shall remain in full force and effect to the fullest extent permitted by law.

14. DEFINITIONS: "Commitment" and "Loan Commitment", as used herein, refer to, mean, and include not only formal loan commitments, but also approval of the loan by loan committee or similar empowered body as well as the drafting and preparation by the lender in form for signature of documents reflecting the approval by such lender of a loan or loan commitment for which Applicant has made application, or such other usual and customary document issued by the lender that reflects the approval by the lender of the loan commitment for which Applicant has made application. The term "Applicant", as used herein, refers to, means, and includes, but is not limited to, the persons, firms and entities designed as "Applicant" hereinabove, and the heirs, successors, assigns, affiliates, subsidiaries, partners, joint venturers, and other persons, firms or entities affiliated with, related to, or substantially owned or controlled by the person, firm or entity designated herein as "Applicant".

15. MODIFICATION OF AGREEMENT: This Agreement contains the entire understanding and agreement of the parties and except as otherwise provided herein may be modified, altered, or changed only by an instrument in writing signed by the party to be charged.

THIS AGREEMENT HAS BEEN READ, UNDERSTOOD, AND EXECUTED this _____ day of _____, at _____, California and the undersigned have received a copy of this instrument.

____

(Applicant)

Accepted this _____ day of ___________.

BROKER
By: ___________

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California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 6. Financing and Appraisals

Forms

[Form 6:F] Promissory Note Secured by Deed of Trust (Simple)

NOTE SECURED BY DEED OF TRUST

$________,	_____, (City)	California,	_____ (Date)

In installments as herein stated, for value received, I promise to pay to ___________, or order, at ___________ the sum of ___________ DOLLARS, with interest from ___________ on unpaid principal at the rate of ___________ per cent per annum; principal and interest payable in installments of ___________ Dollars or more on the _____ day of each _____ month, beginning on the _____ day of ______________________________ and continuing until said principal and interest have been paid.

Each payment shall be credited first on interest then due and the remainder on principal; and interest shall thereupon cease upon the principal so credited. Should interest not be so paid it shall thereafter bear like interest as the principal, but such unpaid interest so compounded shall not exceed an amount equal to simple interest on the unpaid principal at the maximum rate permitted by law. Should default be made in payment of any installment of principal or interest when due the whole sum of principal and interest shall become immediately due at the option of the holder of this note. Principal and interest are payable in lawful money of the United States. If action be instituted on this note I promise to pay such sum as the Court may fix as attorney's fees. This note is secured by a DEED OF TRUST to ___________, as Trustee.

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Cal. Prac. Guide Real Prop. Trans. Form 6:G

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 6. Financing and Appraisals

Forms

[Form 6:G] Promissory Note Secured by Deed of Trust (Complex)

ADJUSTABLE RATE PROMISSORY NOTE
(SECURED BY DEED OF TRUST)

NOTICE TO BORROWER: THIS DOCUMENT CONTAINS PROVISIONS FOR A VARIABLE INTEREST RATE

$________ _____, California
____

FOR VALUE RECEIVED, ___________ ("Maker") promises to pay to ___________, or order ("Holder"), the principal sum of ___________ Dollars ($________), or so much thereof as may be advanced, together with interest on the unpaid principal from and after _____, ("Interest Commencement Date"), and all other sums as provided below.

1. ***Adjustable Interest Rate.*** Interest shall accrue on the unpaid principal at the Loan Rate (defined below). The Loan Rate shall be adjusted on the first day of the calendar month following the _____ month anniversary of the Interest Commencement Date and on each _____ month anniversary thereafter (the "Adjustment Dates"). "Loan Rate" is defined as and shall mean the interest rate which is _____ percent (____%) above the Prime Rate (defined below) in effect three (3) days prior to the date of the calculation of the Loan Rate. "Prime Rate" is defined as and shall mean the variable rate of interest per annum most recently announced by ___________ Bank, at its principal office in _____, _____ as its "prime rate," and which serves as a basis upon which effective rates of interest are calculated for loans making reference thereto. Interest shall be calculated on the basis of 1/360th of one year's interest at the applicable rate multiplied by the number of days for which interest is being calculated.

2. ***Payment of Principal and Interest.***

(a) Interest Due on Interest Commencement Date. On the Interest Commencement Date, Maker shall pay to Holder an amount equal to the interest which shall accrue on the unpaid principal from the Interest Commencement Date through the last day of the calendar month in which the Interest Commencement Date occurs.

(b) Monthly Installments of Principal and Interest. Commencing on ___ 1, ___, Maker shall pay to Holder installments of principal and accrued interest on the first (1st) day of each calendar month during the term of this Adjustable Rate Promissory Note (Secured By Deed of Trust) (this "Promissory Note"). The installments of principal and accrued interest shall be paid in arrears, and, therefore, the first installment of principal and accrued interest due pursuant to this Paragraph 2(b) shall be paid for the calendar month following the calendar month in which the Interest Commencement Date occurs. Each installment of principal and accrued interest shall be in an amount which would enable Maker to repay the entire unpaid principal and interest at the then current Loan Rate in equal monthly installments over a period of _____ years.

(c) General Terms. Maker acknowledges that because the monthly installments of principal and accrued interest due under this Promissory Note are based on an amortization period which is longer than the term of this Promissory Note, the principal balance due on the Maturity Date (defined below) will be substantial. Any accrued interest not paid when due shall, at Holder's sole option, be added to the principal owing hereunder and thereafter earn like interest of principal and accrued interest as principal and otherwise be treated as principal hereunder. Each monthly installment of principal and accrued interest paid by Maker shall be credited first to expenses incurred by Holder in connection with this Promissory Note and/or the Deed of Trust (defined below), then to accrued interest, and finally to unpaid principal.

3. ***Method of Payment.*** All payments of principal, interest and other sums due hereunder shall be paid in lawful money of the United States to Holder at the following address: ___________, California _____ (or at such other place, and to such other holder of this Promissory Note, as Holder may designate in writing from time to time).

4. ***Maturity Date.*** Except as otherwise provided below in this Promissory Note, the maturity date ("Maturity Date") of this Promissory Note shall be ___________. Therefore, on the Maturity Date, Maker shall pay Holder any and all unpaid principal, accrued and unpaid interest and any other sums due under this Promissory Note.

5. ***Promissory Note Secured By Deed of Trust.*** This Promissory Note is secured by a deed of trust ("Deed of Trust") made of even date herewith by and between Maker, as trustor, and Holder, as beneficiary, encumbering that certain real property commonly known as ___________, California (the "Property").

6. ***Default and Acceleration.*** A default shall be deemed to occur if Maker (a) fails to pay any sum due under this Promissory Note, (b) fails to comply with any nonmonetary covenant under this Promissory Note, (c) fails to pay any sum due under the Deed of Trust, or (d) fails to comply with any non-monetary covenant under the Deed of Trust and such failure to comply with any non-monetary covenant under the Deed of Trust continues for more than thirty (30) days. Notwithstanding anything herein to the contrary, upon the occurrence of a default, Holder may elect, in its sole discretion, to accelerate the Maturity Date and declare the entire unpaid principal, accrued interest and other sums to be immediately due and payable.

7. ***Late Charge.*** If Maker fails to pay any amount due hereunder (including, without limitation, any monthly installment or the final installment of principal and interest due on the Maturity Date) within fifteen (15) days following the due date, Maker shall pay a late charge of five percent (5%) of the amount past due. Maker acknowledges and agrees that it would be extremely difficult or impracticable to fix the actual damages resulting from Maker's failure to pay amounts when due, and therefore, Maker shall pay such late charges not as a penalty, but for the purpose of defraying the expenses incident to handling amounts past due. Such late charges represent the reasonable estimate of the loss that may be sustained by Holder due to the failure of Maker to timely pay amounts due hereunder. The late charges shall be payable by Maker without prejudice to the rights of Holder to collect any other amounts to be paid under this Promissory Note (including, without limitation, interest at the Default Rate pursuant to Paragraph 9, below) the Deed of Trust, or to accelerate all sums due hereunder pursuant to Paragraph 6, above.

8. ***Due-on-Sale.*** If Maker sells, conveys, assigns or otherwise transfers (a) all or any part of the Property, (b) any interest in the Property, or (c) all or substantially all of the beneficial interest of Maker (which shall include, without limitation, a sale or other transfer of fifty percent (50%) or more of the shares of Maker if Maker is a corporation, and a sale or other transfer of fifty percent (50%) or more of the general partners' interests in Maker if Maker is a partnership), whether any such sale, conveyance, assignment or other transfer occurs directly or indirectly, voluntarily or involuntarily or by operation of law, without the prior written consent of Holder (which may be withheld in Holder's sole and absolute discretion), then Holder may elect, in its sole and absolute discretion, to accelerate the Maturity Date and declare the entire unpaid principal, accrued interest and other sums due hereunder to be immediately due and payable.

9. ***Default Interest Rate.*** Notwithstanding anything in this Promissory Note to the contrary, after the Maturity Date (regardless of whether the Maturity Date occurs by reason of acceleration pursuant to Paragraph 6 or 8, above, or in the ordinary course), interest shall accrue on the unpaid principal at the interest rate (the "Default Rate") equal to the lesser of (a) _____ percent (____%) above the Loan Rate, or (b) the maximum interest rate permissible by law. If the Maturity Date is accelerated pursuant to Paragraph 6, above, the unpaid principal shall accrue interest at the Default Rate only until the default is cured and the Deed of

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Trust is reinstated. Maker acknowledges and agrees that it would be extremely difficult or impractical to fix the actual damages resulting from Maker's failure to pay the principal, accrued interest and other sums due on the Maturity Date, and therefore Maker shall pay interest at the Default Rate not as a penalty, but for purposes of defraying the expenses incident to handling the past due principal, accrued interest and other sums due under this Promissory Note. Interest at the Default Rate represents the reasonable estimate of the loss that may be sustained by Holder due to the failure of Maker to pay the principal, accrued interest and other sums due on the Maturity Date. Interest at the Default Rate shall be payable by Maker without prejudice to the rights of Holder to collect any other amounts to be paid under this Promissory Note (including, without limitation, late charges pursuant to Paragraph 7, above) or the Deed of Trust.

10*. *Waivers. Maker, without affecting Maker's liability, waives all defenses available to Maker of diligence, presentment, protest and demand, and also notice of protest, demand, nonpayment, dishonor and maturity and consents to any extension of the time or terms of payment hereof, any and all renewals or extensions of the terms hereof, any release of all or any part of the security given for this Promissory Note, any acceptance of additional security of any kind and any release of any party liable under this Promissory Note. Any such renewals or extensions may be made without notice to Maker.

11*. *Cost of Collection. Maker agrees to pay all costs of collection, all costs of suit, foreclosure or other enforcement of this Promissory Note and/or the Deed of Trust and all costs in the event Holder is made a party to any litigation (including, without limitation, appellate and bankruptcy proceedings) because of the existence of this Promissory Note. For the purpose of this provision, “costs” shall include all reasonable attorneys' fees and costs, consultants' fees, experts' fees and the like.

12*. *Compliance With Usury Laws. It is the intent of Maker and Holder in the execution of this Promissory Note and the Deed of Trust to contract in strict compliance with the usury laws of the State of California governing the loan evidenced by this Promissory Note. In furtherance thereof, Maker and Holder stipulate and agree that none of the terms and provisions contained in this Promissory Note or in the Deed of Trust shall ever be construed to create a contract in violation of the usury laws of the State of California. Maker or any other party now or hereafter becoming liable for the payment of this Promissory Note shall never be required to pay interest on this Promissory Note at a rate in excess of the maximum interest that may be lawfully charged under the laws of the State of California, and the provisions of this Paragraph shall control over all other provisions hereof and any other instrument executed in connection herewith which may be in apparent conflict herewith. In the event any holder of this Promissory Note shall collect monies which are deemed to constitute interest which would otherwise increase the effective interest rate on this Promissory Note to a rate in excess of that permitted to be charged by the laws of the State of California, all such sums deemed to constitute interest in excess of the maximum rate shall, at the option of Holder, be credited to the payment of principal or returned to Maker.

13*. *Miscellaneous.

(a) Assignment. Holder may, at its sole option, assign this Promissory Note and/or designate any other person or entity as the holder hereof.

(b) No Modifications or Amendments; No Waiver. Except as specified herein, this Promissory Note may not be amended, modified or changed, nor shall any waiver of the provisions hereof be effective, except only by an instrument in writing signed by the party against whom enforcement of any waiver, amendment, change, modification or discharge is sought. Additionally, a waiver of any provision in one event shall not be construed as a waiver of any other provision at any time, as a continuing waiver, or as a waiver of such provision on a subsequent event.

(c) Severability. Any provision of this Promissory Note which shall be held by a court of competent jurisdiction to be invalid, void or illegal shall in no way affect, impair or invalidate any other provision or term hereof, and such other provisions or terms shall remain in full force and effect.

(d) Successors and Assigns. Whenever used herein, the terms “Holder” and “Maker” shall be deemed to include their respective heirs, personal representatives, successors and assigns.

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(e) Choice of Law. This Promissory Note shall be subject to, governed by, construed, and enforced pursuant to the internal laws of the State of California applicable to instruments, persons and transactions having contacts and relationships solely within the State of California. In the event of any dispute or controversy arising under this Promissory Note, the parties mutually consent to the jurisdiction of the courts of the State of California.

(f) Remedies. The rights, powers and remedies of Holder permitted by law or contract or as set forth herein or in the Deed of Trust shall be cumulative and concurrent, and may be pursued singly, successively or together against Maker or the Property, in the sole discretion of Holder, and such rights, powers and remedies shall not be exhausted by any exercise thereof but may be exercised as often as occasion therefor shall occur. Additionally, the failure to exercise any such rights, powers and remedies or the acceptance by Holder of any payment hereunder which is less than payment in full shall not constitute a waiver of the right to exercise any of Holder's rights, powers or remedies at that time or any subsequent time.

(g) Notice. All notices to Maker shall be in writing and shall be given to Maker at the address set forth below by: (i) personal service (including service by overnight courier service regularly providing proof of delivery), or (ii) registered or certified, first class mail, return receipt requested. All notices by personal service shall be deemed given upon receipt, and all notices by registered or certified, first class mail, return receipt requested, shall be deemed given three (3) days after deposit in the U.S. Mail.

14. ***Prepayment of Promissory Note.*** Maker shall not have any right to prepay this Promissory Note except as set forth below in this Paragraph 14. Maker shall have the right to prepay this Promissory Note, in whole or in part, on any Adjustment Date by giving Holder thirty (30) days prior written notice (which notice shall include the amount to be prepaid). If Maker so prepays the Promissory Note, in whole or in part, on an Adjustment Date, Maker shall not be required to pay any prepayment premium therefor. Maker shall have the right to prepay this Promissory Note, in whole or in part, on a day other than an Adjustment Date upon (a) giving Maker thirty (30) days prior written notice (which notice shall include the amount to be prepaid), and (b) paying to Holder a prepayment premium equal to ___________. Any partial prepayment shall be applied to the principal installments due hereunder in their inverse order of maturity. MAKER ACKNOWLEDGES AND AGREES THAT MAKER HAS NO RIGHT TO PREPAY THIS PROMISSORY NOTE EXCEPT AS PROVIDED IN THIS PARAGRAPH 14. MAKER FURTHER ACKNOWLEDGES AND AGREES THAT IF THE MATURITY DATE IS ACCELERATED BY HOLDER PURSUANT TO PARAGRAPH 6 OR 8, ABOVE, AND MAKER OR ANY THIRD PERSON (INCLUDING, WITHOUT LIMITATION, A JUNIOR LIENHOLDER OF THE PROPERTY) THEREAFTER SEEKS TO PAY OFF SUCH ACCELERATED INDEBTEDNESS OR PURCHASE THE PROPERTY AT A FORECLOSURE SALE (WHETHER JUDICIAL OR NON-JUDICIAL), SUCH PAYOFF OR PURCHASE SHALL CONSTITUTE A PREPAYMENT HEREUNDER AND THE PREPAYMENT PREMIUM SET FORTH ABOVE SHALL BE DUE IN THE EVENT PREPAYMENT OCCURS ON A DATE OTHER THAN AN ADJUSTMENT DATE. BY INITIALING BELOW MAKER SPECIFICALLY ACKNOWLEDGES AND AGREES THAT MAKER SHALL PAY THE PREPAYMENT PREMIUM, EVEN IN THE CASE WHERE HOLDER HAS ACCELERATED THE MATURITY DATE PURSUANT TO PARAGRAPH 6 OR PARAGRAPH 8, ABOVE; THAT THE CALCULATION OF THE PREPAYMENT PREMIUM IS FAIR AND REASONABLE TO COMPENSATE HOLDER FOR THE LOSS WHICH HOLDER MAY INCUR AS A RESULT OF PREPAYMENT OF THIS PROMISSORY NOTE; THAT MAKER WAIVES ANY RIGHT MAKER MAY HAVE OR CLAIM TO HAVE UNDER CALIFORNIA CIVIL CODE SECTION 2954.10 OR ANY SUCCESSOR STATUTE; AND THAT HOLDER HAS MADE THE LOAN EVIDENCED BY THIS PROMISSORY NOTE IN RELIANCE ON THE AGREEMENTS AND WAIVERS OF MAKER IN THIS PARAGRAPH 14 AND HOLDER WOULD NOT HAVE MADE THE LOAN WITHOUT SUCH AGREEMENTS AND WAIVERS.

MAKER'S INITIALS: _____

"MAKER"

....

By: ....

Its: ....

Address: ....

....

....

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Cal. Prac. Guide Real Prop. Trans. Form 6:H

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 6. Financing and Appraisals

Forms

[Form 6:H] Deed of Trust (Simple)

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Cal. Prac. Guide Real Prop. Trans. Form 6:I

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 6. Financing and Appraisals

Forms

[Form 6:I] Deed of Trust (Complex)

The following is an extensive form of Deed of Trust. However, in certain instances counsel may find it advisable to use the simple form of Deeds of Trust (Form 6:H), but add an Addendum containing selected provisions from the following complex form of Deed of Trust.

RECORDING REQUESTED BY
AND WHEN RECORDED MAIL TO
NAME
ADDRESS
CITY &
STATE
____
DEED OF TRUST, ASSIGNMENT OF RENTS AND SECURITY AGREEMENT
(SECURING PROMISSORY NOTE)

This **DEED OF TRUST, ASSIGNMENT OF RENTS AND SECURITY AGREEMENT** ("Deed of Trust") is made as of the ___ day of _____, by ________________________ ("Trustor"), whose address is ______________________________, to ______________________ ("Trustee"), whose address is ______________________________, for the benefit of ___________ ("Beneficiary"), whose address is ___________ California _____.

1. GRANTING CLAUSE.

1.1. Trust Estate. For good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, Trustor hereby irrevocably grants, sells, transfers and assigns to Trustee, in trust, with power of sale, for the benefit and security of Beneficiary, all of Trustor's right, title and interest in and to all real and personal property, tangible and intangible, described below in Sections 1.1(a) through (g) (hereinafter collectively referred to as the "Trust Estate"): (a) all that certain real property (the "Property") located in the City of ___________, County of ___________, State of California, commonly known as ___________, as more particularly described in Exhibit "A" attached hereto and made a part hereof; (b) all right, title, estate and interest of Trustor in and to all options to purchase or lease the Trust Estate or any part thereof or interest therein, and any greater estate in the Trust Estate now owned or hereafter acquired by Trustor; (c) all right, title, estate and interest of every kind and nature, at law or in equity, which Trustor now has or may hereafter acquire in the Trust Estate; (d) all rights, rights-of-way, easements, licenses, profits, privileges, tenements, hereditaments and appurtenances, now or hereafter in any way appertaining and belonging to or used in connection with the Trust Estate and any part thereof, or as a means of access thereto, including, but not limited to, any claim at law or in equity, and any after acquired title and reversion in or to each and every part of all

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streets, roads, highways and alleys adjacent to and adjoining the Trust Estate; (e) all buildings, structures and improvements now or hereafter located on or at the Trust Estate, including, without limitation, all of the property owned by Trustor which is described in Exhibit "B" attached hereto and made a part hereof and any other property now or hereafter affixed or attached to such buildings, structures or improvements (collectively, the "Improvements"); (f) all of the property owned by Trustor which is described in Exhibit "B" (to the extent such property constitutes personal property under the California Commercial Code), and all replacements, additions, substitutions and proceeds thereof, now or hereafter owned by Trustor or in which Trustor now or hereafter has any rights and which is now or hereafter located on or at, or affixed or attached to, or used in connection with the ownership, operation, management, maintenance or repair of the Trust Estate (collectively, the "Personal Property"); and (g) all other claims and demands which Trustor now has or may hereafter acquire in the Trust Estate, including, without limitation, all claims or demands to all proceeds of all insurance now or hereafter in effect with respect to the Trust Estate, the Improvements or the Personal Property, all awards made for the taking by condemnation or the power of eminent domain, or by any proceeding or purchase in lieu thereof, of the Trust Estate, or any part thereof, or any damage or injury thereto, all awards resulting from a change of grade of streets, and all awards for severance damages.

1.2. ***Assignment of Leases, Rents and Profits.*** Trustor hereby assigns and transfers to Beneficiary, absolutely and unconditionally, all of Trustor's right, title and interest in and to the following property: (a) any and all leases and occupancy agreements now existing or hereafter entered into affecting all or any part of the Trust Estate, together with all benefits and advantages to be derived therefrom, and all rights and benefits now or hereafter accruing to Trustor under any and all guarantees of the obligations of any tenant thereunder, all as the same may be amended, extended, renewed or modified from time to time (collectively, the "Leases"); provided, however, that such grant is subject to the provisions of Section 3, below; and (b) all rents, royalties, profits, revenues, incomes and other benefits of and from the Leases and the Trust Estate whether now due, past due or to become due, including without limitation, all prepaid rents, reserve accounts, security and other deposits (the "Rents and Profits"); provided, however, that such grant is subject to the provisions of Section 3, below.

FOR THE PURPOSE OF SECURING, in such order of priority as Beneficiary may in its sole discretion determine:

(1) Payment of the indebtedness evidenced by the promissory note made of even date herewith by Trustor to Beneficiary in the original principal sum of ___________ ($________), and any renewals, extensions or modifications thereof (the "Note"); (2) Payment of all indebtedness arising under this Deed of Trust, including sums advanced by Beneficiary or Trustee, with interest thereon at the same rate set forth in the Note which is applicable to the principal (the "Advance Interest Rate"); (3) Payment of all other sums, with interest thereon, which may hereafter be loaned to Trustor, or its successors or assigns, by Beneficiary, when evidenced by another promissory note (or modification to the Note) reciting that it is secured by this Deed of Trust; and (4) Performance and discharge of all obligations, covenants and agreements of Trustor in this Deed of Trust, the Note, and any other instrument securing the Note (including, without limitation, any environmental indemnity executed to secure the Note), and all modifications, amendments, replacements, extensions, renewals and substitutions of any and all such documents. The Note, this Deed of Trust, and all other instruments given to evidence or further secure the payment and performance of any indebtedness or obligation secured hereby (including, without limitation, any environmental indemnity made by Trustor in favor of Beneficiary) are hereinafter collectively referred to as the "Loan Documents." All that which is described in the foregoing paragraphs (1) through (3) and the monetary components of the obligations described in paragraph (4) is collectively referred to herein as the "Indebtedness."

TO PROTECT THE SECURITY OF THIS DEED OF TRUST, TRUSTOR HEREBY COVENANTS AND AGREES AS FOLLOWS:

2. COVENANTS AND AGREEMENTS OF TRUSTOR.

2.1. ***Trustor's Covenants.***

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(a) Trustor shall pay when due, in the manner specified herein or in any other Loan Document, all components of the Indebtedness. (b) Trustor covenants that it has good and marketable title to the fee simple interest in the Property; that is, Trustor has full power and authority to convey the Trust Estate as provided in this Deed of Trust and the other Loan Documents and that neither the entry nor the performance of this Deed of Trust and the other Loan Documents has resulted or will result in any violation of, or be in conflict with, or result in the creation of any deed of trust, lien, encumbrance or charge (other than those created by the execution and delivery of, or permitted by, this Deed of Trust or any other Loan Document) upon any of Trustor's properties or assets, or constitute a default under any deed of trust, indenture, contract, agreement, instrument, franchise, permit, judgment, order, statute, rule or regulation applicable to Trustor. (c) Trustor shall, at its sole cost: keep and maintain the Trust Estate, including all landscaping, sidewalks, curbs, roads, parking areas and abutting grounds, in good condition and repair and shall make all reasonable or necessary repairs to the Trust Estate, whether interior or exterior, structural or nonstructural, ordinary or extraordinary, or foreseen or unforeseen; not remove, demolish or substantially alter any of the Improvements without Beneficiary's prior written consent (except to the extent required by applicable law and then only upon giving Beneficiary prior written notice); complete promptly and in a good and workmanlike manner any building or other improvement which is constructed on the Trust Estate, and promptly restore and repair, in like manner, to the equivalent of its original condition, any building or other improvement which is damaged or destroyed thereon; obtain Beneficiary's prior written consent to any contracts with any general contractors, architects, engineers or other similar consultants for the Trust Estate; and not permit or commit any waste or deterioration of the Trust Estate. (d) Trustor shall comply with all federal, state and local restrictions, covenants, conditions, laws, ordinances, building codes, regulations, rules, requirements, directions, orders and notices of every kind relating to or affecting the Trust Estate or the business being conducted thereon whether by Trustor or by any occupant thereof. (e) Trustor shall pay when due all utility assessments and charges for gas, electricity, fuel, water, steam, sewer, drainage, refuse disposal, telephone and other services furnished to the Trust Estate and all other assessments and charges of a similar nature, whether public or private, affecting the Trust Estate. (f) Trustor shall appear in, contest and defend any action or proceeding purporting to affect the Trust Estate, the security of this Deed of Trust or the rights or powers of Beneficiary or Trustee under this Deed of Trust, and Trustor shall pay all costs (including, without limitation, attorneys' fees and costs) incurred by Beneficiary or Trustee in connection with such action or proceeding. (g) Unless required by applicable law, Trustor shall not allow changes in the use of the Trust Estate from the use being made as of the date of this Deed of Trust, and Trustor shall not initiate or acquiesce in any change in the zoning classification of the Property without Beneficiary's prior written consent. (h) Trustor shall faithfully perform each and every monetary and nonmonetary covenant to be performed by Trustor under any lien or encumbrance upon or affecting the Trust Estate, including, without limitation, mortgages, deeds of trust, leases, declaration of covenants, easements, conditions and restrictions and other agreements which affect the Trust Estate, and a breach of or a default under any such lien or encumbrance shall constitute an Event of Default under this Deed of Trust. (i) Trustor shall pay all filing, registration, recording, documentary stamp tax and other fees, taxes, assessments and charges in connection with the preparation, execution, delivery and enforcement of the Note, this Deed of Trust, the other Loan Documents and subsequent Loan Documents.

2.2. <u>Hazardous Substances.</u>

(a) As used in this Section 2.2, the following terms shall have the meanings set forth below: (i) "Environmental Laws" means and includes any law, ordinance, regulation or requirement now or hereinafter in effect relating to land use, air, soil, surface water, groundwater (including the protection, cleanup, removal, remediation or damage thereof), human health and safety or any other environmental matter, including, without limitation, the following laws as the same may be amended from time to time: Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), 42 U.S.C. § 9601, et seq.; Federal Resource Conservation and Recovery Act, 42 U.S.C. § 6901, et seq.; Clean Water Act, 33 U.S.C. § 1251, et seq.; Toxic Substances Control Act, 15 U.S.C. § 2601, et seq.; Refuse Act, 33 U.S.C. § 407; Occupational Safety and Health Act, 29 U.S.C. § 651, et seq.; Clean Air Act, 42 U.S.C. § 7401, et seq.; Hazardous Waste Control Act, California Health and Safety Code sections 25100, et seq.; Hazardous Substance Account Act, California Health and Safety Code sections 78000, et seq.; Hazardous Substance Cleanup Bond Act of 1984, California Health and Safety Code sections 25385, et seq., and related statutes including sections 25356.1-25356.4 of the California Health and Safety Code; Porter-Cologne Water Quality Control

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Act, California Water Code sections 13000, et seq.; Safe Drinking Water and Toxic Enforcement Act of 1986 ("Proposition 65"), California Health and Safety Code sections 25249.5, et seq.; California Health and Safety Code sections 25220, et seq., 25280, et seq., 78700; California Civil Code section 3483; and California Code of Civil Procedure section 736. (ii) "Hazardous Substances" shall mean any hazardous or toxic substances, materials or wastes, pollutants or contaminants defined, listed or regulated by the Environmental Laws or any other federal, state or local law, regulation, order or common law decision.

(b) Trustor hereby represents and warrants to Beneficiary that neither Trustor, nor any agent, affiliate, tenant, partner or joint venturer of Trustor has actual knowledge or notice of the actual, alleged or threatened presence or release of Hazardous Substances in, on, around or potentially affecting any part of the Trust Estate or the soil, groundwater or soil vapor on or under the Trust Estate, except as has been expressly disclosed to Beneficiary in writing. Trustor has used its best efforts to investigate the presence of Hazardous Substances in, on, around or potentially affecting any part of the Trust Estate, and any potential environmental liability with respect to the Trust Estate for noncompliance with the Environmental Laws. Trustor shall perform regular environmental audits to determine if any Hazardous Substances are in, on, around or potentially affecting any part of the Trust Estate and investigate any potential environmental liability with respect to the Trust Estate for noncompliance with the Environmental Laws. Trustor has complied, and shall comply and cause all occupants of the Trust Estate to comply, with all Environmental Laws, including those requiring disclosures to prospective and actual buyers of all or any portion of the Trust Estate. Trustor also has complied and shall comply with the recommendations of any qualified environmental engineer or other expert which apply or pertain to the Trust Estate. Trustor shall promptly notify Beneficiary if it knows, suspects or believes there may be any Hazardous Substance in, around or potentially affecting the Trust Estate or the soil, groundwater or soil vapor on or under the Trust Estate, or that Trustor or the Trust Estate may be subject to any threatened or pending investigation by any governmental agency under any Environmental Laws.

(c) Beneficiary shall have the right at any reasonable time to enter and visit the Trust Estate for the purposes of observing the Trust Estate, taking and removing soil or groundwater samples, and conducting tests on any part of the Trust Estate. Beneficiary has no duty, however, to visit or observe the Trust Estate or to conduct tests, and no site visit, observation or testing by Beneficiary shall impose any liability on Beneficiary. In no event shall any site visit, observation or testing by Beneficiary be a representation that Hazardous Substances are or are not present in, on, under or around the Trust Estate, or that there has been or shall be compliance with any Environmental Laws. Neither Trustor nor any other party is entitled to rely on any site visit, observation or testing by Beneficiary. Beneficiary owes no duty of care to protect Trustor or any other party against, or to inform Trustor or any other party of, any Hazardous Substances or any other adverse condition affecting the Trust Estate. Beneficiary shall not be obligated to disclose to Trustor or any other party any report or findings made as a result of, or in connection with, any site visit, observation or testing by Beneficiary. Beneficiary shall make reasonable efforts to avoid interfering with Trustor's use of the Trust Estate in exercising any rights provided in this Section 2.2(c).

(d) In the event any or all of the representations contained in subsection (b), above, are or become untrue or Trustor defaults in or fails to perform or observe any of its obligations under this Section 2.2, Beneficiary, at its option, and without prior notice to or the right to cure by Trustor, may: (i) declare the Indebtedness immediately due and payable; (ii) require Trustor to promptly perform, at Trustor's sole cost and in accordance with applicable law, all Remedial Work (defined below) desired by Beneficiary; and (iii) cause a person other than Trustor to perform the Remedial Work, at Trustor's sole cost.

(e) All monitoring and investigation of site conditions, cleanup, containment, removal, restoration or other remedial work for the Trust Estate which is required by the Environmental Laws or reasonably requested by Beneficiary pursuant to this Section 2.2 is hereinafter referred to as the "Remedial Work." All Remedial Work shall be conducted: (i) in a diligent and timely manner by licensed contractors acting under the supervision of a consulting environmental engineer; (ii) pursuant to a detailed written plan approved by any public or private agencies or persons with the legal or contractual right to such approval; (iii) with such insurance coverage pertaining to liabilities arising out of the Remedial Work as is customarily maintained with respect to such activities; and (iv) only following receipt of any required permits, licenses, or approvals. The selection of the Remedial Work contractors and consulting environmental engineer, the contracts entered into with such parties, all disclosures to or agreements with any public or private agencies or parties relating to the Remedial Work and the written plan for the Remedial Work shall be subject to Beneficiary's prior written approval. In addition, Trustor shall submit to Beneficiary, promptly upon receipt or

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preparation, copies of any and all reports, studies, analyses, correspondence, governmental comments or approvals prepared or received by Trustor in connection with any Remedial Work. All costs and expenses of such Remedial Work shall be paid by Trustor, including, without limitation, the cost of the Remedial Work contractors and the consulting and environmental engineers, taxes and penalties assessed in connection with the Remedial Work and Beneficiary's reasonable fees and costs incurred in connection with monitoring and reviewing the Remedial Work. In the event Trustor shall fail to commence or cause to be commenced in a timely manner or fail diligently to prosecute the completion of such Remedial Work, Beneficiary may, but shall not be required to, cause such Remedial Work to be performed, and all costs incurred in connection therewith, together with interest at the Advance Interest Rate, shall be reimbursed by Trustor upon demand and shall be secured by this Deed of Trust.

2.3. Required Insurance.

(a) Trustor shall at all times provide and keep in force the following policies of insurance: (i) insurance covering the Improvements (exclusive of the excavations, grading, filling and foundations of buildings below the lowest basement floor) and Personal Property against all risks of physical loss (including, without limitation, fire, lightning, windstorm, hail, explosion, vandalism and civil unrest) in an amount not less than the full replacement cost of the Improvements and Personal Property (without deduction for depreciation); (ii) comprehensive public liability insurance covering Trustor against any and all liability in connection with the Trust Estate, the adjoining streets and sidewalks (including, but not limited to, construction operations coverage if any construction of new Improvements occurs following the execution of this Deed of Trust); (iii) if requested by Beneficiary, business interruption insurance and loss of “rental value” insurance in such amounts as are reasonably required by Beneficiary; (iv) during the course of any construction or repair of the Improvements, builder's risk completed value insurance against all risks of physical loss, including collapse and transit coverage, covering the total value of the work performed, plus equipment, supplies and materials; (v) boiler and machinery insurance covering pressure vessels, air tanks, boilers, machinery, pressure piping, heating, ventilation and air conditioning equipment, and elevator and escalator equipment, provided the Improvements contain equipment of such nature, and insurance against loss of occupancy or use arising from any breakdown of any such items, in such amounts as are reasonably required by Beneficiary; (vi) upon Beneficiary's written request, insurance against loss or damage by earthquake; (vii) flood insurance if all or any part of the Trust Estate is now or hereafter located in a special flood hazard area, as defined in the Flood Disaster Protection Act of 1973, as now in force or as hereafter amended, or any successor thereto or regulations thereunder, in compliance with all requirements of the National Flood Insurance Programs as applicable to the Trust Estate, in an amount approved by Beneficiary and by an insurance company or companies or governmental agency or instrumentality approved by Beneficiary; (viii) upon Beneficiary's written request, insurance against environmental impairment liability, as well as an environmental cleanup bond, valued at the principal sum of the Indebtedness; (ix) workers' compensation coverage and employee automobile coverage in an amount and form required by California law; and (x) Such other policies of insurance as may from time to time be reasonably required by Beneficiary. All policies of insurance required by this Deed of Trust shall contain an endorsement or agreement by the insurer that any loss shall be payable in accordance with the terms of such policy notwithstanding any act, omission or negligence of Trustor which might otherwise result in forfeiture of such insurance, and an endorsement that the insurer waives all rights of setoff, counterclaims or deductions against Trustor.

(b) All policies of insurance shall be issued by companies and in amounts reasonably satisfactory to Beneficiary. All liability policies (including those listed in clauses (a)(ii), (vii) and (ix), above) shall list Beneficiary as an additional insured, and all property policies (including those listed in clauses (a)(i), (iii), (iv), (v), (vi) and (vii), above) shall list Beneficiary as mortgagee and shall have attached thereto a lender's loss payable endorsement for the benefit of Beneficiary in form satisfactory to Beneficiary. Trustor shall furnish Beneficiary with an original of all policies of insurance required by this Deed of Trust. If Beneficiary consents to Trustor providing any of the required insurance through blanket policies carried by Trustor and covering more than one property, Trustor shall furnish Beneficiary with a certified copy of each such policy and a certificate of insurance for each such policy setting forth the coverage as to the Trust Estate, the limits of liability as to the Trust Estate, the name of the carrier, the policy number and the expiration date. At least thirty (30) days prior to the expiration of each insurance policy, Trustor shall furnish Beneficiary with evidence satisfactory to Beneficiary of the payment of the premium and arrangements for the reissuance of the policy continuing insurance in force as required by this Deed of Trust. All such policies shall contain a provision that such policies shall not be canceled or materially amended (which includes any reduction in the scope or limits of

coverage), without at least thirty (30) days prior written notice to Beneficiary. If Trustor fails to provide, keep in force or deliver to Beneficiary the policies of insurance required by this Deed of Trust, Beneficiary may procure such insurance, and Trustor shall pay all premiums thereon promptly upon demand by Beneficiary, and until such payment is made by Trustor the amount of all such premiums, together with interest thereon at the Advance Interest Rate, shall be secured by this Deed of Trust.

(c) In the event of foreclosure of this Deed of Trust or other transfer of title or assignment of the Trust Estate in extinguishment, in whole or in part, of the Indebtedness, all right, title and interest of Trustor in and to all policies of insurance required by this Deed of Trust shall inure to the benefit of and pass to the successor in interest to Trustor, or the purchaser or grantee of the Trust Estate. In the event that prior to any such transfer of title, any claim under any casualty insurance policy has not been paid and distributed in accordance with the terms of this Deed of Trust, but such claim is paid after any such transfer of title, then, to the extent the Indebtedness was not fully discharged in conjunction with such transfer of title, the subject insurance proceeds shall belong to and be paid to Beneficiary. Trustor hereby assigns, transfers and sets over to Beneficiary all of its respective right, title, and interest in and to any such insurance proceeds. The balance of any such insurance proceeds, if any, shall belong to Trustor. Notwithstanding the above, Trustor shall retain an interest in the insurance policies required by this Deed of Trust during any redemption period.

***2.4*. *Insurance Proceeds*.**

(a) Following the occurrence of any casualty to the Trust Estate, Trustor shall give prompt written notice thereof to Beneficiary (but in no event shall Trustor give any such notice later than three (3) days following the date of the occurrence of the casualty). (b) In the event of any damage to or destruction of the Trust Estate, all proceeds of insurance shall be payable to Beneficiary, and Trustor hereby authorizes and directs any and all insurance companies to make payment of such proceeds directly to Beneficiary. Beneficiary is hereby authorized and empowered by Trustor to settle, adjust and compromise all claims for loss, damage or destruction under any policy of insurance. (c) In the event of any such damage or destruction, Beneficiary shall have the right, in its sole discretion, to apply all or any part of the insurance proceeds to (i) the Indebtedness (in such order as Beneficiary may determine), (ii) the restoration and/or replacement of the Trust Estate, or (iii) Trustor. (d) If the insurance proceeds are applied by Beneficiary to the restoration and/or replacement of the Trust Estate, Trustor shall restore, repair and replace the Trust Estate as nearly as possible to its value, condition and character immediately prior to such damage or destruction. Beneficiary shall have the right, at Beneficiary's option, to establish disbursement procedures and to condition disbursement of the insurance proceeds on Beneficiary's approval (in its sole discretion) of architects' and/or engineers' plans and specifications, contractors' cost estimates, architects' certificates, waivers of liens, sworn statements of contractors, mechanics and materialmen, and such other evidence of costs, completion of construction, application of payments, and satisfaction of liens as Beneficiary may require. (e) Except to the extent that insurance proceeds are received by Beneficiary and applied to the Indebtedness, nothing herein shall excuse Trustor from repairing or maintaining the Trust Estate as provided in Section 2.1, above, or restoring and/or replacing all damage to or destruction of the Trust Estate, regardless of whether insurance proceeds are available or sufficient in amount, and the application or release by Beneficiary of any insurance proceeds shall not cure or waive any default or notice of default under this Deed of Trust.

***2.5*. *Indemnification; Subrogation; Waiver of Offset*.**

(a) If Beneficiary is made a party to any action, cause of action, litigation or other proceeding (“action”) concerning this Deed of Trust or the Trust Estate or any part thereof or interest therein, or the use or occupancy thereof, then Trustor shall indemnify, protect, defend and hold harmless Beneficiary from and against any and all claims, demands, liability, losses, damages, costs and expenses (including attorneys' fees and costs) by reason of such action, whether or not any such action is prosecuted to judgment. If Beneficiary commences an action against Trustor to enforce this Deed of Trust or because of the breach by Trustor of this Deed of Trust, or for the recovery of the Indebtedness or any part thereof, Trustor shall pay Beneficiary's attorneys' fees and costs, and the right to such attorneys' fees and costs, shall be deemed to have accrued on the commencement of such action and shall be enforceable whether or not such action is prosecuted to judgment. If Trustor breaches any covenant or agreement in this Deed of Trust, Beneficiary may employ attorneys to protect its rights hereunder and, in the event of such employment

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following any breach by Trustor, Trustor shall pay Beneficiary's attorneys' fees and costs, whether or not an action is actually commenced against Trustor by reason of the breach.

(b) Trustor waives any and all right to claim or recover against Beneficiary, its directors, officers, employees, agents and representatives, for loss of or damage to Trustor, the Trust Estate, Trustor's property or the property of others under Trustor's control from any cause insured against or required to be insured against by this Deed of Trust.

(c) All sums payable by Trustor pursuant to this Deed of Trust shall be paid without notice, demand, counterclaim, setoff, deduction or defense and without abatement, suspension, deferment, diminution or reduction, and the obligations and liabilities of Trustor hereunder shall in no way be released, discharged or otherwise affected (except as expressly provided herein) by reason of: (i) any damage to or destruction or any condemnation or similar taking of the Trust Estate or any part thereof; (ii) any restriction or prevention of or interference with any use of the Trust Estate or any part thereof; (iii) any title defect or encumbrance or any eviction from the Trust Estate or any part thereof by title paramount or otherwise; (iv) any bankruptcy, insolvency, reorganization, composition, adjustment, dissolution, liquidation or other like proceeding relating to Trustor or Beneficiary, or any action taken with respect to this Deed of Trust by any trustee or receiver of Trustor or Beneficiary, or by any court, in any such proceeding; (v) any claim which Trustor has or might have against Beneficiary; (vi) any default or failure on the part of Beneficiary to perform or comply with any of the terms hereof or of any other agreement with Trustor; or (vii) any other occurrence whatsoever, whether similar or dissimilar to the foregoing, whether or not Trustor shall have notice or knowledge of any of the foregoing. Except as expressly provided herein, Trustor waives all rights now or hereafter conferred by statute or otherwise to any abatement, suspension, deferment, diminution or reduction of any sum secured by this Deed of Trust and payable by Trustor.

***2.6*. *Taxes, Assessments and Impositions*.**

(a) Trustor agrees to pay prior to the date when due all general, special and supplemental real property taxes and assessments, and all other taxes, assessments, fees, levies and charges of every kind and nature whatsoever, including, without limitation, all nongovernmental levies and assessments such as maintenance charges, owner association dues and charges, and assessments, fees, levies and charges resulting from covenants, conditions and restrictions affecting the Trust Estate, which are assessed against or imposed upon the Trust Estate, or become due and payable with respect to the Trust Estate, or which create or are secured by a lien upon the Trust Estate (all of such taxes, assessments, fees, levies and charges are hereinafter collectively referred to as “Impositions”). In the event Trustor fails to pay any Imposition as required by this Deed of Trust, Beneficiary may pay such Imposition, and Trustor shall pay the amount thereof to Beneficiary promptly upon demand by Beneficiary, and until such payment is made by Trustor the amount of such Imposition, together with interest thereon at the Advance Interest Rate, shall be secured by this Deed of Trust. Subject to the provisions of Section 2.6(c), below, Trustor shall provide to Beneficiary, within thirty (30) days following the date an Imposition is due, receipts evidencing the payment of such Imposition. Subject to the provisions of Section 2.6(c), below, Trustor shall provide to Beneficiary, within thirty (30) days following the date an Imposition is due, receipts evidencing the payment of such Imposition. If requested by Beneficiary, Trustor shall (at Trustor's cost) cause to be provided to Beneficiary a tax reporting service covering the Trust Estate of the type and duration and with a company satisfactory to Beneficiary.

(b) If at any time there is assessed or imposed any tax, assessment, levy or fee on Beneficiary and measured by or based in whole or in part on this Deed of Trust, the amount of the Indebtedness or upon the Trust Estate, then all such taxes, assessments, levies and fees shall be deemed to be included within the term “Impositions” as defined in subparagraph (a) of this Section 2.6 and Trustor shall pay and discharge the same as provided with respect to the payment of Impositions or, if it is unlawful for Trustor to pay any such tax, assessment, levy or fee, at the option of Beneficiary, the Indebtedness shall immediately become due and payable. If requested by Beneficiary, Trustor shall (at Trustor's cost) cause to be provided to Beneficiary a tax reporting service covering the Trust Estate of the type and duration and with a company satisfactory to Beneficiary.

(c) Trustor shall have the right before any delinquency occurs to contest in good faith the amount or validity of any Imposition by appropriate legal proceedings; provided, any such contest by Trustor shall not in any way release, modify or extend Trustee's obligation to pay an Imposition at the time and in the manner provided in this Section 2.9 unless Trustor gives prior written

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notice to Beneficiary of Trustor's intent to contest the Imposition, and, at Beneficiary's sole option, (i) Trustor demonstrates to Beneficiary's satisfaction that the contest proceedings shall conclusively operate to prevent the sale of the Trust Estate or to stay payment of the Imposition prior to final determination of the proceedings, (ii) Trustor furnishes a good and sufficient bond or other security for payment as requested by and satisfactory to Beneficiary, or (iii) Trustor furnishes a good and sufficient bond or undertaking as may be required or permitted by law to accomplish a stay of payment of the Imposition. At the conclusion of such proceedings, Trustor shall pay the Imposition as determined in such proceedings.

2.7. ***Impound Payments.*** At the request of Beneficiary, Trustor shall deposit with Beneficiary, in monthly installments in advance on the first day of each month, an amount sufficient, as estimated by Beneficiary in its sole discretion, to pay (a) all Impositions next due on the Trust Estate, and (b) all insurance premiums next due on all policies of insurance required by this Deed of Trust. In such event, Trustor agrees, upon Beneficiary's request, to cause all bills, statements and other documents relating to Impositions and the insurance premiums to be mailed directly to Beneficiary. Upon receipt of such bills, statements and other documents, and provided Trustor has deposited sufficient funds with Beneficiary, Beneficiary shall pay the amounts due thereunder from the funds deposited with Beneficiary. If at any time and for any reason the funds deposited with Beneficiary are or will be insufficient to pay the Impositions and insurance premiums as may then or subsequently be due, Beneficiary may notify Trustor and Trustor shall immediately deposit an amount equal to the deficiency with Beneficiary. If at any time the funds deposited with Beneficiary exceed the amount deemed necessary by Beneficiary to pay such Impositions and insurance premiums as may then or subsequently be due, such excess shall be credited to Trustor on the next monthly installment or installments of such Impositions and insurance premiums (unless Trustor is in default of this Deed of Trust or another Loan Document, in which event any such excess shall be applied to reduce the Indebtedness in such order as Beneficiary shall elect). Upon payment in full of the Indebtedness, Beneficiary shall promptly refund to Trustor any funds held by Beneficiary for the payment of Impositions and insurance premiums. Trustor grants to Beneficiary a security interest in all funds deposited with Beneficiary for the payment of Impositions and insurance premiums, and such funds are pledged by Trustor to Beneficiary for the purpose of securing the Indebtedness. Nothing herein shall cause Beneficiary to be deemed a trustee of such funds or to be obligated to pay any amounts in excess of the amount of funds deposited with Beneficiary. Beneficiary may commingle such deposits with its own funds and Trustor shall not be entitled to any interest on the funds deposited with Beneficiary.

2.8. ***Eminent Domain.***

(a) If the Trust Estate, or any part thereof or interest therein, is taken or damaged by reason of any public improvement, condemnation proceeding, exercise of the power of eminent domain, or conveyance in lieu of condemnation (hereinafter collectively referred to as a “taking”), or if Trustor receives any notice or other information regarding any such taking, Trustor shall give prompt written notice thereof to Beneficiary.

(b) Beneficiary shall have the right to receive all compensation, awards, damages, proceeds and other payments for any such taking, and shall be entitled to commence, appear in and prosecute in its own name any action or proceeding at Trustor's sole cost. Beneficiary shall also have the right to make any compromise or settlement in connection with any such taking at Trustor's sole cost. Trustor hereby absolutely and unconditionally assigns to Beneficiary all such compensation, awards, damages, proceeds and other payments awarded to Trustor (the “Proceeds”) and Trustor agrees to execute all further assignments of the Proceeds which are requested by Beneficiary.

(c) In the event the Trust Estate, or any part thereof or interest therein, is taken, Beneficiary shall have the right, in its sole discretion, to apply all or any part of the Proceeds, after deducting therefrom all costs incurred by Beneficiary in connection with the Proceeds (including, without limitation, attorneys' fees and costs), to (i) the Indebtedness (in such order as Beneficiary may determine), (ii) the restoration and replacement of the Trust Estate, or (iii) Trustor.

(d) If the Proceeds are applied by Beneficiary to the restoration and replacement of the Trust Estate, Trustor shall restore, repair and replace the Trust Estate as nearly as possible to its value, condition and character immediately prior to the taking. Beneficiary shall have the right, at Beneficiary's option, to establish disbursement procedures and to condition disbursement of the Proceeds on Beneficiary's approval of architects' and/or engineers' plans and specifications contractors' cost estimates,

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architects' certificates, waivers of liens, sworn statements of contractors, mechanics and materialmen, and such other evidence of costs, completion of construction, application of payments, and satisfaction of liens as Beneficiary may require.

(e) Except to the extent that the Proceeds are received by Beneficiary and applied to the Indebtedness, nothing herein shall excuse Trustor from repairing or maintaining the Trust Estate as provided in Section 2.1 or restoring all damage to the Trust Estate, regardless of whether Proceeds are available or sufficient in amount, and the application or release by Beneficiary of any Proceeds shall not cure or waive any default or notice of default under this Deed of Trust.

2.9. ***Financial Statements and Records.*** Trustor shall deliver to Beneficiary: (a) copies of operating statements, balance sheets, statements of changes in financial positions, tax returns and such other financial statements and reports in such form and content as Beneficiary may require of Trustor, the Trust Estate and any guarantor or the Indebtedness on or before ninety (90) days following the end of the fiscal year of Trustor; (b) copies of any interim operating statements, balance sheets, statements of changes in financial positions, tax returns and such other financial statements and reports in such form and content as Beneficiary may reasonably require of Trustor, the Trust Estate and any guarantor of the Indebtedness on or before the fifteenth (15th) business day following Beneficiary's written demand; and (c) any other report Beneficiary may reasonably require from time to time regarding Trustor, the Trust Estate and any guarantor of the Indebtedness. The foregoing operating statements, balance sheets and statements of changes in financial positions, tax returns and other financial statements and reports shall be prepared in accordance with generally accepted accounting principles and shall be certified as to accuracy by an independent certified public accountant or representative of Trustor acceptable to Beneficiary. Trustor authorizes Beneficiary, at any time, prior to payment in full of the Indebtedness, or within one year following foreclosure of the Trust Estate, to obtain any information that Beneficiary may reasonably require, including credit information from other sources (such as credit reporting agencies), concerning Trustor, the Trust Estate and any guarantor of the Indebtedness. Trustor shall also be required to furnish to Beneficiary at any time upon the request of Beneficiary, a rent roll for the Trust Estate, certified as to accuracy by Trustor, including for each unit of rentable space the identity of the tenant or a statement that such space is vacant, the net rentable area, the lease expiration date, the rent payable and the rent and any security or other deposit actually paid. Trustor shall keep and maintain at all times at the Trust Estate, or such other place as Beneficiary may approve in writing, complete and accurate books of account and records adequate to reflect correctly the results of the operation of the Trust Estate and copies of all written contracts, leases and other documents which affect the Trust Estate. Such books, records, contracts, leases and other documents shall be subject to examination, inspection and copying at any reasonable time by Beneficiary.

2.10. ***Sale or Encumbrance of Trust Estate.*** If Trustor sells, conveys, assigns or otherwise transfers (hereinafter collectively referred to as a “Sale”) or further pledges, mortgages or otherwise encumbers (hereinafter collectively referred to and an “Encumbrance”) all or any part of the Trust Estate or any interest in the Trust Estate, whether any such Sale or Encumbrance occurs directly or indirectly, voluntarily or involuntarily, or by operation of law, without the prior written consent of Beneficiary (which may be withheld in Beneficiary's sole and absolute discretion) the entire Indebtedness shall become immediately due and payable at the election of Beneficiary, without notice to Trustor. For purposes of this Deed of Trust, a transfer of the interests in Trustor, whether direct or indirect or in one or more transactions, shall be deemed a transfer of Trustor's interest in the Trust Estate (and, therefore, a “Sale” for purposes of this Section 2.10).

2.11. ***Inspections.*** Beneficiary, its agents and representatives are authorized to enter the Trust Estate at any reasonable time, and from time to time, for the purpose of inspecting the Trust Estate and performing any of the acts Beneficiary is authorized to perform under this Deed of Trust and any other Loan Document.

2.12. ***Preservation of Lien Priority by Trustor.*** (a) This Deed of Trust is and shall continue to be a valid lien upon the Trust Estate subject only to the liens, charges and encumbrances approved by Beneficiary in writing, and Trustor shall not, directly or indirectly, create or permit to be created against the Trust Estate, or any portion thereof, any lien, charge or encumbrance prior to, subordinate to, or on a parity with the lien of this Deed of Trust without Beneficiary's prior written consent; Trustor acknowledges and agrees that Beneficiary may withhold consent to any subordinate financing secured by the Trust Estate which Beneficiary, in its business judgment, deems to be detrimental to Beneficiary. (b) All property of every kind acquired by Trustor after the date hereof which, by the terms hereof, is required or intended to be subjected to the lien of this Deed of Trust shall, immediately upon the acquisition thereof and without any further conveyance, assignment or transfer, become subject to the

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lien of this Deed of Trust. (c) In order to more effectively evidence or confirm the lien of this Deed of Trust on the Trust Estate (including all property acquired after the date hereof which is subject to the lien of this Deed of Trust), Trustor shall, at its sole cost, do, execute, acknowledge and deliver all such further acts, conveyances, deeds of trust, assignments, notices of assignments and further instruments required by Beneficiary, including, without limitation, security agreements, financing statements, continuation statements and other instruments requested by Beneficiary. (d) If any action or proceeding is instituted (i) which could materially affect Trustor's ability to perform its obligations under any of the Loan Documents, (ii) to evict Trustor, (iii) to recover possession of the Trust Estate, or (iv) for any other purpose which affects the Trust Estate, the lien of this Deed of Trust or Beneficiary's rights hereunder, Trustor shall, immediately upon service thereof on or by Trustor, deliver to Beneficiary a true copy of each petition, summons, complaint, notice of motion, order to show cause and all other processes, pleadings and papers, however designated, served in such action or proceeding.

2.13*. *Liens. Trustor shall pay, at Trustor's sole cost, as and when payment is due, all lawful claims and demands of mechanics, materialmen, laborers and others which, if unpaid, might result in, or permit the creation of, a lien on the Trust Estate, the Leases, Rents or Profits, and Trustor shall do or cause to be done everything necessary so that the lien and security interest hereof shall be fully preserved; provided, however, that if applicable law empowers Trustor to discharge of record any mechanic's, laborer's, materialman's or other lien against the Trust Estate by posting a bond or other security, Trustor shall not have to make such payment if Trustor posts such bond or other security within the time prescribed by law so as not to place the Trust Estate in jeopardy of a lien or forfeiture. Trustor shall have the right to contest in good faith the amount or validity of any such lawful claims and demands of mechanics, materialmen, laborers and others by appropriate legal proceeding if Trustor gives Beneficiary prior written notice and procures a bond or anything else required by and satisfactory to Beneficiary (in Beneficiary's sole discretion). If at any time payment of any obligation imposed upon Trustor herein shall become necessary to prevent the delivery of a tax deed conveying the Trust Estate or any portion thereof because of non-payment, or if the Beneficiary or Trustee shall incur any civil or criminal liability as a result of such non-payment, then Beneficiary may pay the same in sufficient time to prevent the delivery of such tax deed or the incurrence of civil or criminal liability, and any expense incurred by Beneficiary in connection therewith shall be payable by Trustor upon demand, together with interest at the Advance Interest Rate, and shall be secured by this Deed of Trust.

2.14*. *Beneficiary's Powers. Without affecting the liability of any other person liable for the Indebtedness, and without affecting the lien of this Deed of Trust upon any portion of the Trust Estate not then released as security for the Note or any other Loan Document, Beneficiary may, from time to time and without notice: (a) release any person so liable; (b) extend the maturity or alter any of the terms of the Indebtedness; (c) grant other indulgences; (d) release or reconvey any parcel, portion or all of the Trust Estate; (e) take or release any other security for the Indebtedness; (f) make any arrangements with debtors in relation to the Indebtedness; and (g) advance additional funds to protect the security of this Deed of Trust and pay or discharge the obligations of Trustor hereunder or under any other Loan Document, and all amounts so advanced, together with interest at the Advance Interest Rate, shall be paid by Trustor to Beneficiary on demand and shall be secured by this Deed of Trust.

2.15*. *Cross Default Effect of Further Security Instruments. The Indebtedness may be secured by additional assignments of Trustor's interest in the Leases, security agreements, financing statements, deeds of trust, letters of credit, collateral assignments, pledges, or other security instruments. Any default under the provisions of any such additional security instruments that is not remedied within any applicable cure period shall be an Event of Default under this Deed of Trust, and Beneficiary may, at its option, effect a sale or foreclosure of any one or more of said security instruments either prior or subsequent to, joined or otherwise contemporaneous with, any sale or foreclosure with respect to this Deed of Trust, and may apply the proceeds received therefrom to the Indebtedness without waiving or affecting the status of any default or any right or power (whether contained in this Deed of Trust or any other security instrument).

3. ASSIGNMENT OF LEASES, RENTS AND PROFITS.

3.1*. *Assignment. Pursuant to Section 1.2, above, Trustor has absolutely, presently, and unconditionally assigned, transferred, conveyed and set over to Beneficiary all of Trustor's right, title and interest in and to the Leases, Rents and Profits to be applied by Beneficiary to the Indebtedness (the “Assignment”). This Assignment shall be fully operative without any further action on the part of Trustor or Beneficiary and Beneficiary shall be entitled, at its option, to all Rents and Profits whether or not Beneficiary

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takes possession of the Trust Estate. Trustor hereby further grants to Beneficiary the right to (a) enter and take possession of the Trust Estate for the purposes of collecting the Rents and Profits, (b) dispossess by the usual summary proceedings of any tenant defaulting in the payment thereof to Beneficiary, (c) let the Trust Estate or any part thereof, and (d) apply the Rents and Profits, after payment of all necessary charges and expenses (including attorneys' fees and costs) to the Indebtedness. This Assignment shall continue in effect until the Indebtedness is paid in full. The execution of this Deed of Trust constitutes Trustor's irrevocable consent to Beneficiary's entry and taking possession of the Trust Estate pursuant to this Assignment, whether or not sale or foreclosure has been instituted. Neither the exercise of any rights under this Assignment by Beneficiary nor the application of the Rents and Profits to the Indebtedness shall cure or waive an Event of Default or notice of default, and shall be cumulative with all other rights and remedies of Beneficiary.

3.2. ***Trustee's License.*** Notwithstanding anything in Section 3.1, above, to the contrary, as long as an Event of Default (described below) has not occurred, Trustor shall have a license to collect and receive all Rents and Profits. Upon the occurrence of an Event of Default, such license shall be deemed automatically revoked, without regard to the adequacy of Beneficiary's security and without notice to or demand upon Trustor, and any Rents and Profits received thereafter by Trustor shall be immediately turned over to Beneficiary. Upon the occurrence of an Event of Default, Trustor agrees to deliver the original copies of all Leases to Beneficiary. Trustor hereby irrevocably appoints Beneficiary its true and lawful attorney-in-fact to enforce in Trustor's name or Beneficiary's name or otherwise all rights of Trustor in the instruments, including without limitation, checks and money orders, tendered as payments of Rents and Profits and to do any and all things necessary and proper to carry out the purposes of this Assignment.

3.3. ***Trustor's Covenants.*** Trustor shall not: (i) execute an assignment of the rents or any part thereof from the Trust Estate; (ii) except where the lessee is in default thereunder, terminate or consent to the cancellation or surrender of any Lease having an unexpired term of two (2) years or more unless, promptly after the cancellation or surrender of any Lease, a new Lease is entered into with a new lessee satisfactory to Beneficiary and on terms at least as favorable to the lessor thereunder as were the terms of the Lease so terminated or canceled; (iii) modify any Lease or give consent to any assignment or subletting without Beneficiary's prior written consent; (iv) accept prepayments of any installments of rent or additional rent to become due under the Leases, except prepayments in the nature of security for the performance of the lessee's obligations thereunder; or (v) in any other manner impair the value of the Trust Estate or the security of the Trustee or Beneficiary for the payment of the Indebtedness. Trustor shall not execute any Lease for all or a substantial portion of the Trust Estate except for actual occupancy by the lessee thereunder, and shall at all times promptly and faithfully perform, or cause to be performed, all of the covenants, conditions and agreements contained in all Leases now or hereafter existing, on the part of the lessor thereunder to be kept and performed. Trustor shall, from time to time upon request of Beneficiary, specifically assign to Beneficiary as additional security hereunder, by a written instrument approved by Beneficiary, all right, title and interest of Trustor in and to any and all Leases, together with all security therefor and all monies payable thereunder, subject to the Trustor's conditional license to collect the Rents. Trustor shall also execute and deliver to Beneficiary any notification, financing statement or other document reasonably required by Beneficiary to perfect the Assignment as to any of the Leases. Each Lease shall provide that, in the event of the enforcement by the Trustee or Beneficiary of the remedies provided for by law or by this Deed of Trust, any person succeeding to the interest of Trustor as a result of such enforcement shall not be bound by any payment of rent or additional rent for more than one month in advance, and that nothing in the Lease or Deed of Trust affects or impairs the rights of Beneficiary to terminate the Lease in connection with the Beneficiary's or Trustee's exercise of its remedies hereunder.

3.4. ***Foreclosure.*** Upon a sale of the Trust Estate pursuant to foreclosure of this Deed of Trust, all right, title and interest of Trustor in and to the Leases shall, by virtue of this Deed of Trust and the Assignment, automatically vest in and become the absolute property of the purchaser of the Trust Estate without any further act or assignment by Trustor. Trustor hereby irrevocably appoints Beneficiary and its successors and assigns, as its agent and attorney-in-fact, to execute all instruments of assignment or further assurances in favor of such purchaser of the Property as may be necessary or desirable for such purpose. Nothing contained herein shall prevent Beneficiary from terminating through foreclosure the Lease of any tenant subordinate to this Deed of Trust.

4. SECURITY AGREEMENT.

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4.1. ***Creation of Security Interest.*** Trustor hereby grants to Beneficiary a security interest in the Personal Property for the purpose of securing the Indebtedness.

4.2. ***Warranties, Representations and Covenants of Trustor.*** Trustor hereby warrants, represents and covenants as follows: (a) except for the security interest granted hereby, Trustor is, and as to portions of the Personal Property to be acquired after the date hereof will be, the sole owner of the Personal Property, free from any lien, security interest, encumbrance or adverse claim of any kind whatsoever, and Trustor shall indemnify, protect, defend, and hold harmless Beneficiary and the Personal Property against all claims and demands of all persons and entities at any time claiming the Personal Property or any part thereof or any interest therein; (b) Trustor shall promptly notify Beneficiary of any attachment or other legal process levied against any of the Personal Property and any information received by Trustor relative to the Personal Property, Trustor's debtors or other persons obligated in connection therewith, which may in any way affect the value of the Personal Property or the rights and remedies of Beneficiary in respect thereto; (c) Trustor shall not lease, sell, convey or in any manner transfer the Personal Property without the prior written consent of Beneficiary; (d) the Personal Property is not, and shall not be, used or bought for personal, family or household purposes; (e) the Personal Property shall be kept on or at the Property and Trustor shall not remove the Personal Property from the Property without the prior written consent of Beneficiary, except for such portions or items of Personal Property as are consumed or worn out in ordinary usage, all of which Trustor shall promptly replace with new items of equal or better quality; (f) Trustor maintains a place of business in the State of California and Trustor shall immediately notify Beneficiary in writing of any change in its place of business; (g) at the request of Beneficiary, Trustor shall join Beneficiary in executing financing statements and continuations and amendments thereof pursuant to the California Commercial Code in form satisfactory to Beneficiary, and Trustor shall pay the cost of filing the same in all public offices wherever filing is deemed by Beneficiary to be necessary or desirable; (h) all covenants and agreements of Trustor in this Deed of Trust relating to the Trust Estate shall be deemed to apply to the Personal Property whether or not expressly referred to herein; (i) Trustor shall permit representatives of Beneficiary to inspect the Personal Property and Trustor's books and records relating to the Personal Property and make copies thereof and arrange for verification of the amount of Personal Property under procedures acceptable to Beneficiary at Trustor's cost; and (j) Trustor shall maintain, preserve and protect all Personal Property, keep all Personal Property in good condition and repair and prevent any waste or unusual depreciation thereof; and (k) until Beneficiary exercises its right to collect proceeds of the Personal Property pursuant to this Section 4, Trustor shall collect with diligence any and all proceeds of the Personal Property (which shall be held in trust for Beneficiary), and upon written request by Beneficiary, Trustor shall keep all such proceeds collected separate from all other funds so as to be capable of identification as to the property of Beneficiary and shall deliver such collections to Beneficiary at such time as Beneficiary may request and in the identical form received, properly endorsed or assigned when required to enable Beneficiary to complete collection thereof.

4.3. ***Beneficiary's Rights as a Secured Party.*** With respect to the security interest granted to Beneficiary in this Section 4, Beneficiary shall have all the rights and remedies granted to a secured party under Division 9 of the California Commercial Code, as well as all other rights and remedies available at law or in equity. Trustor shall, upon the demand of Beneficiary, assemble all of such Personal Property and make it available to Beneficiary at the Trust Estate, which is hereby agreed to be reasonably convenient to Beneficiary, Trustee and Trustor. Any sale proceeds which are applied against the principal component of the Indebtedness shall, to the extent not repaying the entire Indebtedness, be applied to principal in the reverse order of maturity.

4.4. ***Beneficiary's Collection of Proceeds.*** Beneficiary may at any time, without prior notice to Trustor, collect proceeds of the Personal Property and may give notice of assignment to any and all of Trustor's debtors, and Trustor hereby irrevocably appoints Beneficiary its true and lawful attorney-in-fact to enforce in Trustor's name or in Beneficiary's name or otherwise all rights of Trustor in the Personal Property and to do any and all things necessary and proper to carry out the purposes hereof; provided, however, Trustor shall have the right to collect, retain, use and enjoy such proceeds subject to the terms of the Loan Documents prior to the occurrence of any Event of Default. It is recognized that the power of attorney granted herein is coupled with an interest and shall not be revocable and Beneficiary shall have the right to exercise this power of attorney upon any Event of Default. Beneficiary shall notify Trustor of any action taken by Beneficiary pursuant to this provision, but Beneficiary's failure to do so shall not invalidate any such act, affect any of Trustor's obligations to Beneficiary or give rise to any right, claim or defense on the part of Trustor.

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4.5. ***Fixture Filing.*** The Personal Property in which Beneficiary has a security interest includes goods which are or may become fixtures on the Property. This Deed of Trust is intended to serve as a fixture filing pursuant to the terms of sections 9313 and 9402 of the California Commercial Code. This filing is to be recorded in the real estate records of the county in which the Property is located. Trustor warrants and agrees that there is no financing statement covering the Trust Estate or any part thereof on file in any public office.

5. REMEDIES UPON DEFAULT.

5.1. ***Events of Default.*** In addition to any Event of Default under any other Section of this Deed of Trust, the occurrence of any of the following events shall be an Event of Default under this Deed of Trust: (a) Trustor's failure to pay any of the following sums on the date that such sums are required to be paid: (1) any regular installment of interest and/or principal due under the Note; (2) any other payment of interest and/or principal due under the Note (whether at any stated maturity or by acceleration or otherwise); or (3) any other sums required to be paid by Trustor pursuant to the Note, this Deed of Trust or any other Loan Document. (b) Trustor's failure to perform when due any covenant, condition or agreement of Trustor in this Deed of Trust, or any other Loan Document. (c) Trustor (or any guarantor of the Indebtedness) files a voluntary petition in bankruptcy or is adjudicated a bankrupt or insolvent, or files any petition or answer seeking or acquiescing in any reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under any present or future federal, state or other statute, law or regulation relating to bankruptcy, insolvency or other relief for debtors, or seeks or consents to or acquiesces in the appointment of any trustee, receiver, custodian, liquidator or similar official for Trustor or the Trust Estate, or makes any general assignment for the benefit of creditors, or admits in writing its inability to pay its debts generally as they become due. (d) An order for relief or any other order, judgment or decree is entered approving a petition filed against Trustor (or any guarantor of the Indebtedness) seeking any reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under any present or future federal, state or other statute, law or regulation relating to bankruptcy, insolvency or other relief for debtors, and such order, judgment or decree remains unvacated and unstayed for an aggregate of thirty (30) days (whether or not consecutive) from the first date of entry thereof, or any trustee, receiver, custodian, liquidator or similar official of Trustor (or guarantor of the Indebtedness) or of all or any part of the Trust Estate or any interest therein is appointed without the consent or acquiescence of Trustor (or guarantor of the Indebtedness) and such appointment is not vacated and not stayed for an aggregate of thirty (30) days (whether or not consecutive) from the first date of entry thereof. (e) A writ of execution or attachment or any similar process is issued or levied against all or any part of the Trust Estate or any interest therein, or any judgment is entered against Trustor which becomes a lien on the Trust Estate or any part thereof or interest therein, and such execution, attachment or similar process or judgment is not released, vacated or stayed within thirty (30) days after its issuance, levy or entry. (f) Any or all of the representations or warranties made by Trustor in the Note, this Deed of Trust or any other Loan Document proves to be untrue, which adversely affects Beneficiary's security hereunder. (g) Any Sale or Encumbrance in violation of Section 2.10. (h) Any other default under or breach of any provision of the Note, this Deed of Trust or any other Loan Document (including, without limitation, any environmental indemnity executed to secure the Indebtedness.

5.2. ***Remedies.*** Upon the occurrence of any Event of Default, Trustee and Beneficiary, effective as of the date of the occurrence of any Event of Default, shall have any and all of the following rights and remedies which may be exercised individually, collectively or cumulatively:

(a) Beneficiary may declare all the Indebtedness immediately due and payable by delivery to Trustee of written declaration of default and demand for sale and written notice of default and of election to cause the Trust Estate to be sold, which notice Trustee shall cause to be duly filed for record. Beneficiary also shall deposit with Trustee this Deed of Trust, the Note and all documents evidencing expenditures secured hereby.

After the lapse of such time as may then be required by law following the recordation of said notice of default, and notice of sale having been given as then required by law, Trustee, without demand on Trustor, shall sell the Trust Estate at the time and place fixed by it in said notice of sale, either as a whole or in separate parcels, and in such order as it may determine, at public auction to the highest bidder for cash and lawful money of the United States, payable at time of sale. If the Trust Estate consists of more than one legal parcel, Beneficiary may designate the order in which such parcels shall be sold or offered for sale, subject,

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however, to any unqualified statutory right which Trustor may have to direct such order. In addition, if the Trust Estate consists of more than one legal parcel, Beneficiary may require that such parcels be sold at separate sales held at separate times, subject, however, to any unqualified statutory right which Trustor may have to direct the manner of the sale of such parcels. Trustee may postpone sale of all or any portion of the Trust Estate by public announcement at such time and place of sale, and from time to time thereafter may postpone such sale by public announcement at the time and place fixed by the preceding postponement. After making such sale, Trustee shall deliver to the purchaser or purchasers its deed or deeds conveying the Trust Estate so sold, but without any covenant or warranty, express or implied. The recitals in such deed of any matters or facts shall be conclusive proofs of the truthfulness thereof. Any person, including Trustor, Trustee or Beneficiary may purchase at such sale.

After deducting all costs, fees and expenses of Trustee and of the trust created by this Deed of Trust, including cost of evidence of title in connection with sale, Trustee shall apply the proceeds of sale to payment of: (i) all sums expended in connection with such sale, together with reasonable expenses of the trust created hereby, not then repaid, with accrued interest at the amount allowed by law in effect at the date hereof; (ii) all other sums advanced or expended by Beneficiary and secured hereby; (iii) the Indebtedness remaining unpaid; and (iv) the remainder, if any, to the person or persons legally entitled thereto.

The power of sale under this Deed of Trust shall not be exhausted by any one or more sales (or attempts to sell) as to all or any portion of the Trust Estate remaining unsold, but shall continue unimpaired until all of the Trust Estate has been sold by exercise of the power of sale in this Deed of Trust and all Indebtedness has been paid and discharged in full.

(b) Beneficiary may at any time, without notice, in person, by agent or by a court appointed receiver, and without regard to the adequacy of any security for the Indebtedness, enter upon and take possession of the Trust Estate or any part thereof, in Beneficiary's own name sue for or otherwise collect such Rents and Profits, including those past due and unpaid, and apply the same, less costs and expenses of operation and collection, including reasonable attorneys' fees, to any Indebtedness, in such order as Beneficiary may determine. The entering upon and taking possession of the Trust Estate, the collection of such Rents and Profits and the application thereof as aforesaid, shall not cure or waive any default or notice of default hereunder or invalidate any act on or pursuant to such notice.

Beneficiary may also at any time, without notice, in person, by agent, or by a court appointed receiver, and without regard to the adequacy of any security for the Indebtedness, enter upon, possess, manage, operate, dispose of and contract to dispose of the Trust Estate or any part thereof; take custody of all accounts; negotiate with governmental authorities with respect to the Trust Estate's environmental compliance and remedial measures; take any action necessary to enforce compliance with the Environmental Laws (defined above), including but not limited to spending Rents and Profits and/or other benefits arising from the Trust Estate to cause compliance with Environmental Laws; make, terminate, enforce or modify real or personal property leases, contracts, and agreements for occupancy and/or use of the Trust Estate upon such terms and conditions as Beneficiary deems proper; contract for goods and services, hire agents, employees and counsel, make repairs, alterations and improvements to the Trust Estate which are necessary, in Beneficiary's judgment, to protect or enhance the security of this Deed of Trust; appear in and defend any action or proceeding affecting the Trust Estate or other security hereof or the rights and powers of Beneficiary or Trustee; incur the risks and obligations ordinarily incurred by owners of property (without any personal obligation on the part of Beneficiary or the receiver); and/or take any and all other actions which may be necessary or desirable to comply with Trustor's obligations hereunder and under the other Loan Documents. All sums expended by Beneficiary or Trustee in exercising any of the foregoing shall be secured by this Deed of Trust and shall be immediately due and payable without demand or notice, with interest from the date of expenditure at the Advance Interest Rate. All sums realized by Beneficiary under this Section 5.4(b), less all costs and expenses incurred under this Section 5.4(b) (including, without limitation, attorneys' fees and costs), and less such sums as Beneficiary deems appropriate as a reserve to meet future expenses under this Section 5.4(b), shall be applied to the Indebtedness in such order as Beneficiary shall determine in its sole discretion. Neither application of said sums to the Indebtedness, nor any other acts taken by Beneficiary under this Section 5.4(b), shall constitute a waiver of any Event of Default or notice of default, or nullify the effect of any such notice of default. Beneficiary may take any action or proceeding

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hereunder without regard to the existence of a declaration that the Indebtedness secured hereby has been declared immediately due and payable or the filing of a notice of default and/or a notice of sale.

(c) Beneficiary shall have the right to commence an action to foreclose this Deed of Trust, appoint a receiver, and specifically enforce any of the covenants contained in this Deed of Trust or any other Loan Document. If an Event of Default under this Deed of Trust occurs, and as long as any such Event of Default exists, Beneficiary, as a matter of right and without notice to Trustor or anyone claiming under Trustor, and without regard to the adequacy of the security or the then value of the Trust Estate or the interest of Trustor therein, shall have the right to have a receiver of the Trust Estate appointed by any court having jurisdiction, and Trustor hereby irrevocably consents to such appointment. Any such receiver shall have all the usual powers and duties of receivers in like or similar cases and all the powers of Beneficiary in case of entry as provided in Section 5.2(b) and shall continue as such and exercise all such powers until the date of confirmation of sale of the Trust Estate unless such receivership is sooner terminated.

(d) Beneficiary shall have the right to exercise and enforce any or all of the rights and remedies available to a secured party under the Uniform Commercial Code of California, including, without limitation, those rights and remedies set forth in Section 4 of this Deed of Trust, or the right to sell the Personal Property or any part thereof, or any further or additional or substitute of the Personal Property, at one or more times, and from time to time at public sale or sales or private sale or sales, on such terms as cash or credit, or partly for cash and partly on credit, as Beneficiary may deem proper. At any such sale or sales, Beneficiary shall have the right to become the purchaser, free and clear of any and all claims and rights of equity or redemption in Trustor, all of which are hereby waived and released. Should any of the Personal Property be sold to any party other than Beneficiary, on credit or for future delivery, the Personal Property so sold may be retained by Beneficiary until the full sales price therefor is paid, and Beneficiary shall not be liable or responsible for the failure of such purchaser to pay for any Personal Property so sold but may, in such event resell such Personal Property. Trustor shall not be credited with the amount of any part of such purchase price, unless (and only to the extent) that such payment is actually received in cash. Notice of public sale, if given, shall be sufficiently given, for all purposes, if published not less than nor more than seven (7) days prior to any sale, in a newspaper of general circulation distributed in the city in which the Personal Property is located. The net proceeds of any sale of the Personal Property which may remain after the deduction of all costs, fees and expenses incurred in connection therewith (including, but not limited to, all advertising expenses, brokers' commissions, documentary stamp taxes, recording fees, foreclosure costs, and attorneys' fees and costs) shall be credited by Beneficiary against the Indebtedness. Any portion of the Personal Property which may remain unsold after the full payment of the Indebtedness shall be returned to the respective parties which delivered the same to Beneficiary. If at any time Trustor or any other parties shall become entitled to the return of any of the Personal Property, any transfer or assignment by Beneficiary shall be and shall recite that the same is made wholly without representation or warranty whatsoever by or recourse whatsoever against Beneficiary. Trustor recognizes that Beneficiary may not have the usual opportunity for an orderly liquidation of the Personal Property or part thereof, but may be compelled to resort to “private sale” of the Personal Property, at a price which may be less than any fair market price for the Personal Property at the time of its sale. Trustor specifically authorizes Beneficiary to sell at Beneficiary's election, any or all of the Personal Property at “private sale” at such price as may be negotiated directly between Beneficiary and the purchaser of the Personal Property, or any part thereof, whether or not the price may be less than the fair market price at the time of such sale. Trustor further acknowledges and agrees that, at Beneficiary's election, the Personal Property may be sold, pursuant to the California Commercial Code, concurrent with the sale of the Trust Estate.

(e) Beneficiary or its agents, acting by themselves or through a court appointed receiver, may, with or without notice, and without releasing Trustor from any obligation hereunder, for the purpose of curing any default of Trustor or otherwise in connection therewith, enter upon the Trust Estate or any part thereof and perform such acts and do such things as Beneficiary deems necessary or desirable to inspect, investigate, assess and protect the security of this Deed of Trust, including, without limitation: (i) obtain a court order to enforce Beneficiary's right to enter and inspect the Trust Estate under California Civil Code Section 2929.5 to determine whether there exists a release or threatened release of a Hazardous Substances onto the Trust Estate (which such determination by Beneficiary shall be deemed reasonable and conclusive as between the parties hereto); and (ii) have a receiver appointed under California Code of Civil Procedure Section 564 to enforce Beneficiary's right to enter and inspect

the Trust Estate for Hazardous Substances. All costs and expenses incurred by Beneficiary with respect to the audits, tests, inspections and examinations which Beneficiary or its agents or employees may conduct, including the fees of the engineers, laboratories, contractors, consultants and attorneys, shall be paid by Trustor. All costs and expenses incurred by Trustee and Beneficiary pursuant to this Section 5.4(e) (including, without limitation, court costs, consultant fees and attorneys' fees, whether incurred in litigation or not and whether before or after judgment) shall bear interest at the Advance Interest Rate from the date of expenditure and shall be secured by this Deed of Trust.

(f) Beneficiary may seek a judgment that Trustor has breached its covenants, representations, warranties and/or indemnities set forth in Section 2.2, above (or elsewhere in this Deed of Trust), in any separate environmental indemnity or other agreement relating to environmental matters, by commencing and maintaining an action for breach of contract pursuant to California Code of Civil Procedure Section 736, whether commenced prior to foreclosure of the Trust Estate or after foreclosure of the Trust Estate, and may further seek the recovery of any and all costs, damages, expenses, fees, penalties, fines, judgments, indemnification payments to third parties, and other out-of-pocket costs or expenses actually incurred by Beneficiary (collectively the “Environmental Costs”) or advanced by Beneficiary for the cleanup, remediation or other response action required by any Environmental Law, or which Beneficiary believes necessary to protect the Trust Estate, it being conclusively presumed between Beneficiary and Trustor that all such Environmental Costs incurred or advanced by Beneficiary relating to the cleanup, remediation or other response action of or to the Trust Estate were made by Beneficiary in good faith. All Environmental Costs incurred by Beneficiary under this Section 5.2(f) (including without limitation court costs, consultant fees and attorneys' fees, whether incurred in litigation or not and whether before or after judgment) shall bear interest at the Advance Interest Rate from the date of expenditure and shall be secured by this Deed of Trust until said sums have been paid. Beneficiary shall be entitled to bid at any foreclosure sale of the Trust Estate held under this Deed of Trust the amount of said Environmental Costs together with accrued interest thereon in addition to the amount of the other Indebtedness as a credit bid, but neither such credit bid nor the foreclosure and sale of the Trust Estate shall operate to invalidate or to discharge Trustor from its obligations under the terms of Section 5.2(f), any other portion of this Deed of Trust, any environmental indemnity or other agreement relating to the environmental condition of the Trust Estate. In addition, Beneficiary may, without notice, elect to waive its lien against the Trust Estate or any portion thereof, including fixtures or personal property, to the extent such Trust Estate is found to be environmentally impaired in accordance with California Code of Civil Procedure Section 726.5 and to exercise any and all rights and remedies of an unsecured creditor against Trustor and all of Trustor's assets and the Trust Estate for the recovery of any deficiency and Environmental Costs, including, but not limited to, seeking an attachment order under California Code of Civil Procedure Section 483.010. As between Beneficiary and Trustor, for purposes of California Code of Civil Procedure Section 726.5, Trustor shall have the burden of proving that Trustor or any related party (or any affiliate or agent of Trustor or any related party) was not in any way negligent in permitting the release or threatened release of the Hazardous Substance. TRUSTOR ACKNOWLEDGES AND AGREES THAT NOTWITHSTANDING ANY TERM OR PROVISION CONTAINED HEREIN OR IN THE OTHER LOAN DOCUMENTS, ALL ENVIRONMENTAL COSTS INCURRED PURSUANT TO THIS DEED OF TRUST AND ALL JUDGMENTS AND AWARDS ENTERED AGAINST TRUSTOR IN RESPECT OF OR PERTAINING TO THE PROVISIONS OF THIS SECTION 5.2(f), SHALL BE EXCEPTIONS TO ANY NONRECOURSE OR EXCULPATORY PROVISION OF THE LOAN DOCUMENTS, WHETHER SPECIFICALLY SET FORTH IN THE LOAN DOCUMENTS OR PROVIDED BY STATUTE, AND TRUSTOR SHALL BE FULLY AND PERSONALLY LIABLE FOR ALL SUCH ENVIRONMENTAL COSTS AND FOR ALL SUCH JUDGMENTS AND AWARDS ENTERED AGAINST TRUSTOR THEREUNDER, AND SUCH LIABILITY SHALL NOT BE LIMITED TO THE ORIGINAL PRINCIPAL AMOUNT OF THE INDEBTEDNESS. TRUSTOR'S OBLIGATIONS WITH RESPECT TO SUCH ENVIRONMENTAL COSTS AND JUDGMENTS AND AWARDS SHALL SURVIVE A FORECLOSURE, DEED IN LIEU OF FORECLOSURE, RELEASE, RECONVEYANCE OR ANY OTHER TRANSFER OF THE TRUST ESTATE OR THIS DEED OF TRUST. FOR THE PURPOSES OF ANY ACTION BROUGHT UNDER THIS SECTION 5.2(f), TRUSTOR HEREBY WAIVES THE DEFENSE OF LACHES AND ANY APPLICABLE STATUTE OF LIMITATIONS.

(g) Beneficiary shall have the right to full and complete access to the Trust Estate for the purpose of conducting any investigations, appraisals, studies or reports that Beneficiary may desire in its sole discretion, and the cost of any such investigations, appraisals,

studies and reports shall be paid by Trustor, together with interest at the Advance Interest Rate, and shall be secured by this Deed of Trust.

5.3. ***Remedies Not Exclusive.*** Every right, power and remedy granted to Trustee or Beneficiary in this Deed of Trust shall be cumulative and not exclusive, and in addition to all rights, powers and remedies granted at law or in equity or by statute, and each such right, power and remedy may be exercised from time to time and as often and in such order as may be deemed expedient by Trustee or Beneficiary, and the exercise of any such right, power or remedy shall not be deemed a waiver of the right to exercise, at the same time or thereafter, any other right, power or remedy.

5.4. ***Waiver of Rights.*** Upon the commencement of any action, suit or other legal proceeding by Beneficiary to obtain a judgment in connection with the Indebtedness or for the enforcement of this Deed of Trust or any other Loan Document, Trustor, to the fullest extent permitted by law, hereby waives every statute of limitations applicable at any time to any such action, suit, or proceeding. To the fullest extent permitted by applicable law, Trustor shall not at any time insist upon, plead or in any manner claim or take any benefit or advantage of, any stay or extension or moratorium law or law pertaining to the marshaling of assets, the administration of estates of decedents, any exemption from execution or sale of the Trust Estate or any part thereof, including exemption of homestead, wherever enacted, now or at any time hereafter in force, which may affect the covenants and terms of performance of this Deed of Trust. Trustor, to the fullest extent permissible, further waives its rights to claim, take, or insist upon any benefit or advantage of any law now or hereafter in force providing for the valuation or appraisal of the Trust Estate or any part thereof, prior to any sale or sales thereof which may be made pursuant to any provision herein, or pursuant to the decree, judgment or order of any court of competent jurisdiction (not including, however, appraisals incident to judicial foreclosures hereunder). Additionally, after any such sale or sales, Trustor shall not claim or exercise any right under any statute heretofore or hereafter enacted to redeem the Trust Estate so sold or any part thereof. Trustor hereby expressly waives, to the extent legally permissible, all benefit or advantage of any such law or laws, and covenants not to hinder, delay or impede the execution of every power as though no such law or laws had been made or enacted. Finally, Trustor, for itself and all who claim under it, specifically waives, to the extent that it lawfully may, all right to have the Trust Estate marshaled upon any sale or foreclosure hereunder.

5.5. ***Expenses.*** All expenses incurred by Beneficiary and Trustee in exercising any of their rights under this Section 5 of the Deed of Trust or in exercising any other rights available at law or in equity (including, without limitation, expenses incurred in retaking, holding, preparing for sale or selling the Trust Estate or any part thereof and Trustee's and attorneys' fees and costs) shall be borne solely by Trustor and shall, together with interest at the Advance Interest Rate, be secured by this Deed of Trust.

5.6. ***Order of Application.*** The purchase money or other proceeds of any foreclosure sale made under or by virtue of this Deed of Trust, together with all other sums which then may be held by Trustee or Beneficiary under this Deed of Trust, whether under the provisions of Section 5.4 or otherwise, shall be applied as follows: (a) first, to the payment of the costs and expenses of sale and any related judicial proceeding including, without limitation, reasonable compensation to Trustee and Beneficiary, their agents and counsel, all costs of publishing, recording, mailing and posting notices, the costs of any search and evidence of title procured in connection therewith and revenue stamps on any deed or instrument of conveyance, all expenses, liabilities and advances made or incurred by Trustee under this Deed of Trust, together with interest as provided herein and all taxes or assessments, except for any taxes, assessments or other charges subject to which the Trust Estate shall have been sold; (b) second, to the payment of any and all other sums expended under the provisions of this Deed of Trust not then repaid, and all other sums (other than sums described in clause (c), below) required to be paid by Trustor pursuant to any provisions of this Deed of Trust or any other Loan Document, including, without limitation, all expenses, liabilities and advances made or incurred by Beneficiary under this Deed of Trust or in connection with the enforcement thereof, together with interest thereon as set forth herein, with the specific exception of any sums which might otherwise be recoverable by Beneficiary under the provisions of California Code of Civil Procedure Section 736; (c) third, to the payment of the whole amount then due, owing or unpaid upon the Note for the principal, interest, other charges and any damages, and any other sums advanced by, or owed to, Beneficiary and secured hereby, with the exception of any sums which might otherwise be recoverable by Beneficiary under the provisions of California Code of Civil Procedure Section 736; (d) fourth, to any and all portions of the Indebtedness which

might otherwise be recoverable by Beneficiary under the provisions of California Code of Civil Procedure Section 736; and (e) fifth, the remainder, if any, to the persons legally entitled thereto.

6. MISCELLANEOUS.

6.1. Governing Law. This Deed of Trust shall be governed by and construed in accordance with the laws of the State of California without resort to choice of law principles.

6.2. Statements. Beneficiary shall, within ten (10) days after notice, furnish to Trustor a written statement setting forth the unpaid principal and interest due under the Note and any other component of the Indebtedness. Trustor agrees to pay Beneficiary for each such statement the maximum fee allowed by law or, if there is no maximum fee, such reasonable fee as is then charged by Beneficiary for such statement.

6.3. Reconveyance by Trustee. Upon written request of Beneficiary stating that the Indebtedness has been paid in full, and upon surrender of this Deed of Trust and the Note to Trustee for cancellation and retention, and upon payment by Trustor of Trustee's fees, Trustee shall reconvey to Trustor, or the person legally entitled thereto, without warranty, any portion of the Trust Estate then held hereunder. The recitals in such reconveyances of any matters or facts shall be conclusive proof of the truthfulness thereof.

6.4. Trustee. Trustee accepts this trust when this Deed of Trust, duly executed and acknowledged, is made a public record as provided by law. The trust hereby created shall be irrevocable by Trustor. Beneficiary may, from time to time, by a written instrument executed and acknowledged by Beneficiary and recorded in the county in which the Trust Estate is located, and by otherwise complying with applicable law, substitute a successor or successors to the Trustee named herein or acting hereunder. Trustee may resign at any time upon giving ten (10) days' notice in writing to Trustor and to Beneficiary. Trustor shall pay all costs, fees, and expenses of Trustee, its agents, and counsel in connection with the performance of its duties hereunder and shall pay all taxes (except federal and state income taxes) or other governmental charges or impositions imposed by any governmental authority on Trustee by reason of its interest in the Note, this Deed of Trust or any other Loan Document.

6.5. Further Assurances. Whenever reasonably requested by Beneficiary, Trustor shall promptly execute and deliver or cause to be executed and delivered all such other and further instruments, documents or assurances, and promptly do or cause to be done all such other and further things as may be necessary and reasonably required in order to further and more fully vest in Trustee or Beneficiary all rights, interest powers, benefits, privileges and advantages conferred or intended to be conferred by this Deed of Trust.

6.6. Notices. Whenever Beneficiary, Trustor or Trustee wishes to give any notice or demand with respect to this Deed of Trust, each such notice or demand shall be in writing and shall be given by personal service, certified or registered mail, return receipt requested, or Federal Express or other recognized overnight delivery service regularly providing proof of delivery, addressed to the address set forth at the beginning of this Deed of Trust. All such notices and demands shall be deemed given upon receipt. Any party may change its address for such notices by giving notice of such change to the other parties hereto.

6.7. Time. Time is of the essence in the performance of each and every obligation contained herein.

6.8. Successors and Assigns. This Deed of Trust inures to the benefit of and binds all parties hereto, their personal representatives, heirs, successors and assigns. The term Trustor includes both the original Trustor and any subsequent owner of the Trust Estate or any part thereof. The term Beneficiary shall mean the owner and holder of the Note whether or not named as Beneficiary herein.

6.9. Interpretation. The captions or headings at the beginning of each Section hereof are for the convenience of the parties and are not a part of this Deed of Trust. Whenever the context requires, the singular number includes the plural, and vice versa, and each gender includes each other gender.

6.10. Invalidity of Certain Provisions. If the lien of this Deed of Trust is invalid or unenforceable as to any part of the Indebtedness, or if such lien is invalid or unenforceable as to any part of the Trust Estate, the unsecured or partially secured portion of such

Indebtedness shall be completely paid prior to the payment of the remaining and secured or partially secured portion, and all payments made, whether voluntary or under foreclosure or other enforcement action or procedure, shall be considered to have been first paid on and applied to the full payment of that portion of the Indebtedness which is not secured or not fully secured by the lien of this Deed of Trust. The invalidity of any provision of this Deed of Trust shall not affect the remaining provisions of this Deed of Trust or any part thereof and this Deed of Trust shall be construed as if such invalid provision, if any, had not been inserted herein.

6.11*. *Subrogation. To the extent that proceeds of the Note or advances under this Deed of Trust are used to pay any outstanding lien, charge or prior encumbrance against the Trust Estate, such proceeds or advances have been or will be advanced by Beneficiary at Trustor's request and Beneficiary shall be subrogated to any and all rights and liens held by any owner or holder of such outstanding liens, charges and prior encumbrances, irrespective of whether such liens, charges or encumbrances are released.

6.12*. *No Waiver. The acceptance by Beneficiary of any sum after it is due shall not constitute a waiver of the right either to require prompt payment, when due, of all other sums hereby secured or to declare a default as herein provided. The acceptance by Beneficiary of any sum in an amount less than the sum then due shall be deemed an acceptance only of the sum so paid, and such acceptance of less than the full amount due shall not constitute a waiver of the obligation of Trustor to pay the entire sum then due. In addition, Trustor's failure to pay the entire sum then due shall be and continue to be a default notwithstanding acceptance of an amount which is less than the full amount due, and Beneficiary or Trustee shall, at all times thereafter and until the entire sum then due has been paid (and notwithstanding the acceptance by Beneficiary thereafter of further sums) be entitled to exercise all rights in this Deed of Trust conferred upon them upon the occurrence of a default, and the right to proceed with a sale under any notice of default, and election to sell, shall in no way be impaired, whether any of such amounts are received prior or subsequent to such notice. Consent by Beneficiary to any transaction or action of Trustor which is subject to consent or approval of Beneficiary hereunder shall not be deemed a waiver of the right to require such consent or approval to future or successive transactions or actions. This Deed of Trust cannot be waived, amended, modified, changed, discharged or terminated orally, but only by an instrument in writing signed by the party against whom enforcement of any waiver, amendment, modification, change, discharge or termination is sought.

6.13*. *Counterparts. This Deed of Trust may be executed in any number of counterparts and each of such counterparts shall for all purposes be deemed to be an original, and all such counterparts shall together constitute one and the same Deed of Trust.

IN WITNESS WHEREOF, Trustor has executed this Deed of Trust as of the date first above written.

	"TRUSTOR"
	....
[ADD NOTARY ACKNOWLEDGEMENT]	By: ....
	....
	Its: ....

EXHIBIT "A"

DESCRIPTION OF PROPERTY

EXHIBIT "B"

(1) All machinery, equipment, materials (including building materials and supplies), appliances and fixtures now or hereafter installed or placed on or in the Trust Estate or for the generation and distribution of air, water, heat, electricity, light, fuel or refrigeration or for ventilating or air conditioning purposes or for sanitary or drainage purposes or for the exclusion of vermin or insects or for the removal of dust, refuse or garbage, and all elevators, escalators, awnings, window shades, drapery rods and brackets, screens, floor coverings, incinerators, carpeting and all furniture, fixtures, and other property used in the operation or occupancy of the Trust Estate, together with all additions to, substitutions for, changes in or replacements of the whole or any

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part of any or all of said articles of property, and together with all property of the same character that Trustor may hereafter acquire at any time until the termination of this Deed of Trust and all proceeds received upon the sale, exchange, collection or other disposition of the foregoing.

(2) All intangible property and rights relating to the Trust Estate or the operation thereof, or used in connection therewith, including but not limited to all governmental permits relating to construction on said land.

(3) All reserves, deferred payments, deposits, refunds, cost savings and payments of any kind relating to the construction of any improvements on the Trust Estate.

(4) All water stock relating to the Trust Estate.

(5) All causes of action, claims, compensation and recoveries for any damage, condemnation or taking of the Trust Estate, or for any conveyance in lieu thereof, whether direct or consequential, or for any damage or injury to the Trust Estate, or for any loss or diminution in value of the Trust Estate.

(6) All plans and specifications prepared for construction of Improvements and all studies, data and drawings related thereto; and also all contracts and agreements of the Trustor relating to the aforesaid plans and specifications or to the aforesaid studies, data and drawings or to the construction of Improvements.

(7) All monies on deposit for the payment of real estate taxes or special assessments against the Trust Estate or for the payment of premiums on policies of insurance covering the Trust Estate.

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Cal. Prac. Guide Real Prop. Trans. Form 6:J

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 6. Financing and Appraisals

Forms

[Form 6:J] Subordination Agreement

RECORDING REQUESTED BY
AND WHEN RECORDED MAIL TO
NAME
ADDRESS
CITY &
STATE

____
SUBORDINATION AGREEMENT

NOTICE: THIS SUBORDINATION AGREEMENT RESULTS IN YOUR SECURITY INTEREST IN THE 1 PROPERTY BECOMING SUBJECT TO AND OF LOWER PRIORITY THAN THE LIEN OF SOME OTHER OR LATER SECURITY INSTRUMENT.

This AGREEMENT, made this _____ day of ___________ by ___________, owner of the real property described below (hereinafter referred to as "Owner"), and ___________, present owner and holder of the deed of trust and note first hereinafter described (hereinafter referred to as "Beneficiary");

WITNESSETH

THAT WHEREAS, ___________ did execute a deed of trust, dated ___________, to ___________, as trustee, covering:

to secure a note in the sum of $________, dated ___________, in favor of ___________, which deed of trust was recorded ___________, in book ___________ page _____/Instrument No. ___________, Official Records of said county; and

WHEREAS, Owner has executed, or is about to execute, a deed of trust and note in the sum of $________, dated ___________ in favor of ___________, (hereinafter referred to as "Lender"), payable with interest and upon the terms and conditions described therein, which deed of trust is to be recorded concurrently herewith; and

WHEREAS, it is a condition precedent to obtaining said loan that said deed of trust last above mentioned shall unconditionally be and remain at all times a lien or charge upon the real property hereinabove described, prior and superior to the lien or charge of the deed of trust first above mentioned; and

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WHEREAS, Lender is willing to make said loan provided the deed of trust securing the same is a lien or charge upon the described property prior and superior to the lien or charge of the deed of trust first above mentioned and provided that Beneficiary will specifically and unconditionally subordinate the lien or charge of the deed of trust first above mentioned to the lien or charge of the deed of trust in favor of Lender; and

WHEREAS, it is to the mutual benefit of the parties hereto that Lender make such loan to Owner; and Beneficiary is willing that the deed of trust securing the same shall, when recorded, constitute a lien or charge upon said real property which is unconditionally prior and superior to the lien or charge of the deed of trust first above mentioned.

NOW, THEREFORE, in consideration of the mutual benefits accruing to the parties hereto and other valuable consideration, the receipt and sufficiency of which consideration is hereby acknowledged, and in order to induce Lender to make the loan above referred to, it is hereby declared, understood and agreed as follows:

(1) That said deed of trust securing said note in favor of Lender, and any renewals or extensions thereof, shall unconditionally be and remain at all times a lien or charge on the property therein described, prior and superior to the lien or charge of the deed of trust first above mentioned.

(2) That Lender would not make its loan above described without this Subordination Agreement.

(3) That this Subordination Agreement shall be the whole and only agreement with regard to the subordination of the lien or charge of the deed of trust first above mentioned to the lien or charge of the deed of trust in favor of Lender above referred to and shall supersede and cancel, but only insofar as would affect the priority between the deeds of trust hereinbefore specifically described, any prior agreements as to such subordination including, but not limited to, those provisions, if any, contained in the deed of trust first above mentioned, which provided for the subordination of the lien or charge thereof to another deed or deeds of trust or to another mortgage or mortgages.

Beneficiary declares, agrees and acknowledges that

(a) Beneficiary consents to and approves (i) all provisions of the note and deed of trust in favor of Lender above referred to, and (ii) all agreements, including but not limited to any loan or escrow agreements, between Owner and Lender for the disbursement of the proceeds of Lender's loan;

(b) Lender in making disbursements pursuant to any such agreement is under no obligation or duty to, nor has Lender represented that it will, see to the application of such proceeds by the person or persons to whom Lender disburses such proceeds and any application or use of such proceeds for purposes other than those provided for in such agreement or agreements shall not defeat the subordination herein made in whole or in part;

(c) Beneficiary intentionally and unconditionally waives, relinquishes and subordinates the lien or charge of the deed of trust first above mentioned in favor of the lien or charge upon said land of the deed of trust in favor of Lender above referred to and understands that in reliance upon, and in consideration of, this part and parcel thereof, specific monetary and other obligations are being and will be entered into which would not be made or entered into but for said reliance upon this waiver, relinquishment and subordination; and

(d) An endorsement has been placed upon the note secured by the deed of trust first above mentioned that said deed of trust has by this instrument been subordinated to the lien or charge of the deed of trust in favor of Lender above referred to.

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NOTICE: THIS SUBORDINATION AGREEMENT CONTAINS A PROVISION WHICH ALLOWS THE PERSON OBLIGATED ON YOUR REAL PROPERTY SECURITY TO OBTAIN A LOAN OR A PORTION OF WHICH MAY BE EXPENDED FOR OTHER PURPOSES THAN IMPROVEMENT OF THE LAND

____________ Beneficiary	____________ Owner

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Cal. Prac. Guide Real Prop. Trans. Form 6:K

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 6. Financing and Appraisals

Forms

[Form 6:K] Personal Property Security Agreement

SECURITY AGREEMENT

THIS SECURITY AGREEMENT is made as of the ___ day of _____, by ___________, a ___________, whose address is ___________ (hereinafter called the "Debtor"), in favor of ___________ its successors and assigns, whose address is ___________, (hereinafter the "Secured Party").

1. RECITALS

1.1. The Debtor owes the Secured Party the sum of ___________ ($________), as evidenced by a Promissory Note Secured By Deed of Trust (hereinafter the "Note").

1.2. As security for the Note, Debtor has executed and delivered to the Secured Party a Deed of Trust with Assignment of Rents of even date herewith (the "Deed of Trust") encumbering the real property described on Exhibit "A," attached hereto and incorporated herein (hereinafter the "Real Property").

1.3. The making of said loan by Secured Party to Debtor is conditioned upon Debtor further securing the Note by giving to Secured Party a security interest in all of the property described on "Exhibit "B," attached hereto and incorporated herein. Such property includes, but is not limited to, whatever interest Debtor may have in all personal property which is now used upon (or may hereafter be appropriated for use on), and whatever interest Debtor may have in all personal property which is located on, the Real Property; all rights of Debtor under any policy or policies of insurance covering the property described on Exhibit "B," including but not limited to, all proceeds, loss payments, and premium refunds which may become payable with respect to such insurance policies; and any and all compensation, accounts, accounts receivable, fees, royalties, income, revenues, rights and benefits of any kind or nature generated by, from or in connection with, the ownership, use and/or operation of the Real Property, or any part thereof, whether such monies or right to monies arise by virtue of a contract, lease, license, concession agreement, or occupancy or other rental agreement, or any other contract or right under which Debtor is entitled to payment of monies; and various entitlements, permits, licenses, certificates, instruments and general intangibles of Debtor pertaining to the Real Property and its ownership, occupancy and/or use.

2. SECURITY INTEREST

2.1. In consideration of the aforesaid loan, Debtor hereby grants to Secured Party a security interest (hereinafter the "Security Interest") in the property described in Recital 1.3 above and on Exhibit "B" attached hereto and incorporated herein, including any and all replacements and proceeds of said property (hereinafter collectively referred to as the "Collateral").

2.2. This Security Agreement and the rights hereby granted shall secure the following (hereinafter sometimes collectively referred to as the "Obligations"):

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(a) The principal of, the interest on, and any other sums due under the Note including any renewals, extensions or modifications thereof;

(b) The statutory and other costs of all legal proceedings brought by the Secured Party to enforce the Note or the Deed of Trust, this Security Agreement (including, but not limited to, Secured Party's reasonable attorneys' fees in connection therewith), and all other costs and expenses paid or incurred by Secured Party in respect of or in connection with the Collateral, and any other sums that may become due and payable hereunder by Debtor; and

(c) The observance and performance by Debtor of all of the terms, provisions, covenants and obligations on its part to be observed or performed under the Deed of Trust, this Security Agreement and any other of the documents providing further security for the Note.

3. DEBTOR WARRANTS, COVENANTS AND AGREES

Debtor warrants, covenants and agrees that:

3.1. Although proceeds of Collateral are covered by this Security Agreement, this shall not be construed to mean that Secured Party consents to any sale of the Collateral.

3.2. Except for purposes of replacement and repair, Debtor will not remove those items of Collateral which constitute tangible personal property (or allow any such item to be removed), from the Real Property upon which it is currently located, without the prior written consent of Secured Party. Debtor will promptly give written notice to the Secured Party of any substantial change in the character of its business conducted on the Real Property and of the cessation of all or any part thereof and of any loss or damage by fire or other casualty to any substantial part of the Collateral.

3.3. Debtor will, at all reasonable times, allow Secured Party or its representatives free and complete access to all of Debtor's records which in any way relate to the Collateral, for such inspection and examination as Secured Party deems necessary. Debtor shall also upon request of Secured Party from time to time submit up-to-date schedules of the items comprising the Collateral in such detail as Secured Party shall require.

3.4. Debtor, at its sole cost and expense, will protect and defend this Security Agreement, all of the rights of Secured Party hereunder, and the Collateral against the claims and demands of all other parties.

3.5. Debtor will at all times keep and maintain and/or cause it tenants to keep and maintain those items of tangible personal property which are part of the Collateral in good order, repair and condition, and will promptly replace or cause its tenant to replace, any part thereof that from time to time may become obsolete, badly worn, or in a state of disrepair, or, if supplies, be consumed in the normal course of Debtor's business operations. Except as otherwise provided in Section 3.7 hereof, all such replacements shall be free of any other lien, security interest or encumbrance of any nature. Debtor may sell or dispose of, or suffer or allow its tenant to sell or dispose of, only that part of the Collateral that Debtor is obliged to replace, and unless Secured Party then agrees otherwise in writing, all proceeds from any sale or disposition in excess of the amount expended for such replacements shall promptly be paid over by Debtor to Secured Party to be applied against the sums secured hereby, whether or not such sums are then due and payable.

3.6. Secured Party or its representative may at any and all reasonable times inspect the Collateral and may enter upon any and all premises where the same is kept or might be located.

3.7. Debtor will not, without obtaining the prior written consent of Secured Party, transfer or permit any transfer of the Collateral or any part thereof to be made, or any interest therein to be created by way of a sale (except as permitted in Paragraph 3.5, above), or by way of a grant of a security interest, or by way of a levy or other judicial process.

3.8. Debtor will promptly notify Secured Party of any levy, distraint or other seizure by legal process or otherwise of any part of the Collateral, and of any threatened or filed claims or proceedings that might in any way affect or impair any of the rights of Secured Party under this Security Agreement.

3.9. Secured Party at all times shall have a perfected security interest in the Collateral which shall be prior to any other interests therein. Debtor has and will continue to have full title to the Collateral free from any liens, leases, encumbrances, judgments or other claims (except the lien created hereby or as otherwise permitted pursuant to Section 3.7 above) and Secured Party's security interest in the Collateral constitutes and will continue to constitute a first, prior and indefeasible security interest in favor of Secured Party. Debtor will do all acts and things, and will execute and file all instruments (including, but not limited to, security agreements, financing statements, continuation statements, etc.) reasonably requested by Secured Party to establish, maintain and continue the perfected security interest of Secured Party in the Collateral, and will promptly on demand, pay all costs and expenses of filing and recording, including the costs of any searches deemed necessary by Secured Party from time to time to establish and determine the validity and the continuing priority of the security interest of Secured Party, and also pay all other claims and charges that in the opinion of Secured Party might prejudice, imperil or otherwise affect the Collateral or its security interest therein.

3.10. Debtor at its expense will obtain and maintain in force, or shall cause its tenant to obtain and maintain in force, insurance policies covering losses or damage to those items of Collateral which constitute physical personal property. The insurance policies to be obtained by Debtor shall be in form and amounts acceptable to Secured Party. Secured Party hereby acknowledges and agrees that, once such policies reflect that Secured Party is the loss payee, the insurance policies of Debtor's tenant currently in effect will be in form and amounts acceptable to Secured Party. Secured Party is hereby irrevocably appointed Debtor's attorney-in-fact to endorse any check or draft that may be payable to Debtor, alone or jointly with other payees, so that Secured Party may collect the proceeds payable for any loss under such insurance. The proceeds of such insurance, less any costs and expenses incurred or paid by Secured Party in the collection thereof, shall be applied either toward the cost of the repair or replacement of the items damaged or destroyed, or on account of any sums secured hereby, whether or not then due or payable, in the same manner, and subject to the same terms and conditions, as set forth in the Deed of Trust.

3.11. Secured Party may, at its option, and without any obligation to do so, pay, perform and discharge any and all amounts, costs, expenses and liabilities herein agreed to be paid or performed by Debtor, and all amounts expended by Secured Party in so doing shall become part of the Obligations secured hereby, and shall be immediately due and payable by Debtor to Secured Party upon demand theretofore, and shall bear interest at the Default Interest Rate (as that term is defined in the Note) from the dates of such expenditures until paid.

3.12. Upon the request of Secured Party, Debtor will furnish within five (5) days thereafter to Secured Party, or to any proposed assignee of the Note, Deed of Trust, this Security Agreement, and any other security for the Note, a written statement in form satisfactory to Secured Party, duly acknowledged, certifying the amount of the principal and interest then owing under the Note, whether any claims, offsets or defenses exist there against or against this Security Agreement, or any of the terms and provisions of any other agreement of Debtor securing the Note. In connection with any assignment by Secured Party of the Note, Deed of Trust, this Security Agreement, and any other security for the Note, Debtor hereby agrees to cause the insurance policies required hereby and by the Deed of Trust to be carried by Debtor, to be endorsed in form satisfactory to Secured Party or to such assignee, with loss payable clauses in favor of such assignee, and to cause such endorsements to be delivered to Secured Party within ten (10) calendar days after request therefor by Secured Party.

4. EVENTS OF DEFAULT

The occurrence of any of the following events shall constitute, and is hereby defined to be, an “Event of Default”:

4.1. Debtor (i) breaches any of the representations and warranties set forth herein, in the Note or in any of the other agreements or (ii) commits a default in the performance of or compliance with any of the terms, covenants or conditions of this Security Agreement, and such default shall continue for more than ten (10) business days after the date that Debtor's performance

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hereunder was due; provided, however, that if Debtor shall commit a non-monetary breach or default of any provision of any one or more of the agreements executed by Debtor, including without limitation, this Agreement, it shall not constitute an Event of Default hereunder unless said non-monetary breach or default is not cured within thirty (30) calendar days after Secured Party has given notice thereof to Debtor, or if the non-monetary breach or default is of a type which is not capable of being cured within a thirty (30) calendar-day period, then it shall not constitute an Event of Default hereunder unless Debtor has failed to commence with due diligence and dispatch the cure of said breach or default within thirty (30) calendar days after Secured Party's notice to Debtor, or Debtor does not thereafter promptly prosecute the cure of such non-monetary breach or default to completion within sixty (60) calendar days after Secured Party's notice to Debtor of said breach or default; or

4.2. Any failure of Debtor to pay any installment of principal and/or interest or any other sum due under the Note, or under any other Obligations secured hereby, at the time such installment shall become due and payable which failure continues beyond any applicable grace period; or

4.3. The occurrence of any Event of Default under the Note, the Deed of Trust or any other agreement, which shall continue beyond any grace period which may be therein provided, or failure of Debtor to observe and perform all of the terms, provisions, covenants and agreements under any other agreements given in connection herewith within the grace periods therein provided; or

4.4. If any warranty, representation or statement contained in this Security Agreement made or furnished to Secured Party by or on behalf of Debtor, shall be or shall prove to have been false when made or furnished; or

4.5. Any material loss, material theft, substantial damage, or any destruction of or the attachment of an encumbrance to any of the Collateral (other than as permitted pursuant to Paragraph 3.7 above), or the voluntary or involuntary transfer of any of the Collateral (and said Collateral is not replaced, restored or returned within thirty (30) calendar days) or the transfer of possession thereof to anyone other than tenants approved by Secured Party of any portion of the Real Property, or the sale or creation of a security interest, lien, attachment, levy, garnishment, distraint, or other process of, in or upon any of the Collateral, and if such attachment or other similar process is not bonded or released within thirty (30) days after levy.

5. SECURED PARTY'S REMEDIES

Upon the occurrence of an Event of Default hereunder, Secured Party shall have the following rights and remedies; at any time after giving notice and after the expiration of the grace period provided herein:

5.1. Secured Party may, at its option, declare all sums due under the Note immediately due and payable and Debtor shall on demand by Secured Party deliver the Collateral to Secured Party. Secured Party may, without further notice or demand and without legal process, take possession of the Collateral wherever found and, for this purpose, may enter upon the Real Property or upon any other property occupied by or in the control of Debtor. Secured Party may require Debtor to assemble the Collateral and make it available to Secured Party at a place to be designated by Secured Party that is reasonably convenient to both parties. In taking possession of the Collateral, Secured Party may also take any and all of Debtor's documents, instruments, computer hardware and software, files and records, and any receptacles and cabinets containing the same, relating to the Collateral and Secured Party may use the supplies and space of Debtor at Debtor's place of business as may be necessary or appropriate properly to administer and control the Collateral.

5.2. Secured Party may pursue any legal remedy available to collect all sums secured hereby and to enforce its title in and right to possession of the Collateral, and to enforce any and all other rights or remedies available to it, and no such action shall operate as a waiver of any other right or remedy of Secured Party under the terms hereof, or under the laws of the State of California.

5.3. Secured Party may, at its option, treat the Collateral and the Real Property, as an entirety or as one parcel or security for the Note. Accordingly, Secured Party shall have the right and power, to the extent that it is lawful, to cause the Collateral to be sold at the same time and together with the Real Property secured by the Deed of Trust for one total bid or price at any judicial sale whereby the Deed of Trust is foreclosed.

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5.4. Secured Party, upon obtaining possession of the Collateral or any part thereof, may sell the same at public or private sale either with or without having such Collateral at the place of sale, and with notice to Debtor as provided in Paragraph 5.6 herein. The proceeds of such sale, after deducting therefrom all expenses of Secured Party in taking, storing, repairing and selling the Collateral (including reasonable attorneys' fees) shall be applied to the payment of any part or all of the Obligations and any other indebtedness or liability of Debtor to Secured Party in such order as Secured Party may determine, and any surplus thereafter remaining shall be paid to Debtor, or any other person that may be legally entitled thereto.

5.5. At any sale, public or private, of the Collateral or any part thereof, made in the enforcement of the rights and remedies hereunder of Secured Party, Secured Party may, so far as may be lawful, purchase any part or parts of the Collateral or all thereof offered at such sale.

5.6. Secured Party shall give Debtor reasonable notice of any sale or other disposition of the Collateral or any part thereof. Debtor agrees that notice and demand shall be conclusively deemed to be reasonable and effective if such notice is mailed by regular or certified mail postage prepaid to Debtor at the address above given, or at such other address as Debtor may designate hereafter by written notice to Secured Party, at least ten (10) calendar days prior to such sale or other disposition.

5.7. Secured Party shall give notice of an Event of Default hereunder to those parties and in the manner set forth in the Deed of Trust, and shall allow any applicable grace periods therein provided, if any, to expire prior to exercising any remedies for default hereunder.

5.8. Secured Party shall have all the rights and remedies afforded a secured party under the California Commercial Code and all other legal or equitable remedies provided by the laws of the United States and the State of California.

5.9. Debtor irrevocably appoints Secured Party its true and lawful attorney-in-fact, which appointment is coupled with an interest, for purposes of accomplishing any of the foregoing. Debtor further nominates and appoints Secured Party as attorney-in-fact to perform all acts and execute all documents deemed necessary by Secured Party in furtherance of the terms of this Agreement; except, however, for receiving notice on behalf of Debtor.

6. MISCELLANEOUS PROVISIONS

6.1. No Event of Default hereunder by Debtor shall be deemed to have been waived by Secured Party except by a writing to that effect signed on behalf of Secured Party by an officer thereof and no waiver of any such Event of Default shall operate as a waiver of any other Event of Default on a future occasion, or as a waiver of that Event of Default after written notice thereof and demand by Secured Party for strict performance of this Security Agreement. All rights, remedies and privileges of Secured Party hereunder shall be cumulative and not alternative, and shall, whether or not specifically so expressed, inure to the benefit of Secured Party, its successors and assigns, and all obligations of Debtor shall bind its successors and legal representative.

6.2. Until the occurrence of an Event of Default and expiration of any applicable grace period, Debtor may retain possession of the Collateral and may use it in any lawful manner not inconsistent with this Security Agreement or with the provisions of any policies of insurance thereon.

6.3. The terms hereof shall have the meanings set forth in and be construed under the California Commercial Code. Whenever possible each provision of this Security Agreement shall be interpreted in such manner as to be effective and valid under applicable law, but if any provision of this Security Agreement shall be prohibited by or invalid under applicable law, such provision shall be ineffective to the extent of such prohibition or invalidity, without invalidating the remainder of such provision or the remaining provisions of this Security Agreement.

6.4. No modification, rescission, waiver, release, alteration or amendment of any provision of this Security Agreement shall be made except by a written agreement subscribed by Debtor and a duly authorized officer of Secured Party.

6.5. This Security Agreement shall remain in full force and effect until all of the Obligations and any extensions or renewals thereof shall be paid in full.

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6.6. Secured Party and Debtor as used herein shall include the heirs, executors or administrators, or successors or assigns of those parties. The provisions of this Security Agreement shall apply to the parties according to the context hereof and without regard to the number or gender of words and expressions used herein.

6.7. This Security Agreement shall be governed by, and construed and enforced in accordance with, the laws of the State of California applicable to parties and transactions with contacts and relationships solely within the State of California and without reference to choice of law principles. Notice of acceptance of this Security Agreement by secured party is waived by debtor.

6.8. Should any party hereto retain counsel for the purpose of enforcing or preventing the breach of any provision hereof, including but not limited to instituting or defending any action or proceeding to enforce any provision hereof, for damages by reason of any alleged breach of any provision hereof, for a declaration of such party's rights or obligations hereunder or defense of any action to rescind or reform this Agreement, then if said matter is settled by judicial determination, the prevailing party shall be entitled to be reimbursed by the losing party for all costs and expenses incurred thereby including but not limited to reasonable attorneys', experts' and accountants' fees.

6.9. The undersigned parties signing as Debtor shall both be deemed a Debtor hereunder, and they shall be jointly, severally and individually liable for the obligations of Debtor hereunder.

IN WITNESS WHEREOF, this Security Agreement has been executed and delivered on behalf of and in the name of Debtor on the date indicated above.

....
By: ....
Its: ....
Address: ....
....
....
....

EXHIBIT “A”

LEGAL DESCRIPTION

EXHIBIT “B”

1. All machinery, equipment, materials (including building materials and supplies), appliances and fixtures now or hereafter installed or placed on or in the Property or for the generation and distribution of air, water, heat, electricity, light, fuel or refrigeration or for ventilating or air conditioning purposes or for sanitary or drainage purposes or for the exclusion of vermin or insects or for the removal of dust, refuse or garbage, and all elevators, escalators, awnings, window shades, drapery rods and brackets, screens, floor coverings, incinerators, carpeting and all furniture, fixtures, and other property used in the operation or occupancy of the Real Property, together with all additions to, substitutions for, changes in or replacements of the whole or any part of any or all of said articles of property, and together with all property of the same character that Debtor may hereafter acquire at any time until the termination of this Security Agreement all proceeds received upon the sale, exchange, collection or other disposition of the foregoing.

2. All causes of action, claims, compensation and recoveries for any damage, condemnation or taking of the Property, or for any conveyance in lieu thereof, whether direct or consequential, or for any damage or injury to the Property, or for any loss or diminution in value of the Property, together with all rights of the Debtor under any policy or policies of insurance covering the Property and all property described in this Exhibit “B”, and all proceeds, loss payments and premium refunds which may become payable with respect to such insurance policies, and all proceeds payable with respect to any taking under power of eminent domain.

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3. All plans and specifications prepared for construction of Improvements and all studies, data and drawings related thereto; and also all contracts and agreements of Debtor relating to the aforesaid plans and specifications or to the aforesaid studies, data and drawings or to the construction of Improvements.

4. All interest of Debtor in all goods, supplies, fixtures, furniture, furnishings and equipment which are now used upon (or may hereafter be appropriated for use on), or located on, the Property and all compensation, rents, revenues, income, issues, rights, benefits and profits due or to become due to Debtor from or pertaining thereto; each and every lease, license, rental or any other occupancy agreement relating to the Property, any and all funds, accounts, royalties, revenues, profits and income of any kind or nature due or to become due Debtor from or pertaining to the Property; all rights to the use of any trade name, trade mark or service mark now or hereafter associated with the business or businesses conducted on the Property (subject, however, to any franchise or license agreements relating thereto), together with all rights of Debtor under any policy or policies of insurance covering the Real Property and all property described in this Exhibit “B”, and all proceeds, loss payments and premium refunds which may become payable with respect to such insurance policies, all proceeds payable with respect to any taking under power of eminent domain.

5. All appurtenances to the Property and all rights, licenses, profits, liens, tenements, hereditaments, franchises and privileges of Debtor in and to any streets, roads or public places, easements or rights of way, relating to the Property.

6. All accounts, deposit accounts, funds, chattel paper, instruments, documents, general intangibles, or other rights to payment (collectively, “Rights to Payment”) which arise from or in connection with or are generated by reason of Debtor's ownership, use and/or occupancy of all or any portion of the Property, together with all renewals, and including all securities, guaranties, warranties, indemnity agreements, insurance policies, and other agreements pertaining to such Rights to Payment.

7. All monetary deposits which Debtor has been required to give to any public or private utility with respect to utility services furnished to the Property, instruments (including but not limited to any management contract for the operation of the facility located on the Property), documents, general intangibles and notes or chattel paper arising from or by virtue of any transactions related to the Property and all permits, licenses, franchises, certificates, and other rights and privileges obtained in connection with the Property, including any and all compensation, rents, revenues, income, issues, rights, benefits and profits due or to become due under all present and future oil, gas and mining leases on the Property or any part thereof, and all proceeds of the foregoing.

8. All general intangibles relating to the development, use, occupancy or operation of or construction on the Property, including but not limited to all governmental licenses, map rights, approvals and permits; all materials prepared for filing or filed with any public or quasi-public governmental entities or any public utilities, all Debtor's rights under any contract whether or not otherwise specifically assigned to Secured Party, and any and all permits, licenses, approvals and contracts relating to the Property.

9. All right, title and interest of Debtor in and to refundable or returnable fees, bonds, securities or other property held by any public or quasi-governmental entity, utility company or other entity which pertains to the Property.

10. After-acquired property which replaces the foregoing or is included within any of the foregoing descriptions.

11. The proceeds from all of the above.

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Cal. Prac. Guide Real Prop. Trans. Form 6:L

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 6. Financing and Appraisals

Forms

[Form 6:L] Guaranty

GUARANTY

FOR VALUABLE CONSIDERATION, receipt of which by the undersigned is acknowledged, and which is evidenced by various documents, including as applicable, a Promissory Note Secured by Deed of Trust ("Note") in the face amount of $________, a Deed of Trust, Security Agreement and Assignment of Rents and a Security Agreement, (all of even date herewith, and all jointly, and as applicable, severally, referred to as the "Loan Documents"); and to induce _____, _____ with offices at ___________ ("Lender") to make the loan described in the Loan Documents to or for the account of _____ ("Borrower") ("Loan"), which Loan Lender would not make but for this Guaranty, the undersigned (sometimes referred to herein as "Guarantors") irrevocably and unconditionally guarantees to Lender the full payment and prompt performance of each and every covenant, warranty, representation, provision, term and condition made or to be kept or performed by the Borrower and contained in the Loan Documents, and all liabilities, direct or contingent, joint, several, or independent arising in conjunction with said Loan Documents, including all liabilities of any assignee or successor in interest of Borrower, as performance becomes due, whether as installments, or whether at maturity, or earlier by reason of acceleration or otherwise, or whether extended, together with interest, attorneys' fees, and other costs and expenses which Borrower is obligated to pay under the terms and provisions of any Loan Document.

The undersigned hereby expressly waives the following, including, without limitation, any and all defenses, claims and set-offs of any kind or nature arising directly or indirectly as a result of any of the following: (i) acceptance or notice of the acceptance of this Guaranty; (ii) notice of the existence or creation of any Loan Documents; (iii) presentment, demand, notice of dishonor, protest, and all other notice whatsoever; (iv) the invalidity, irregularity, or unenforceability of the liabilities hereby guaranteed; (v) all diligence on the part of Lender in collection or protection of, or realization upon, any security for any of the liabilities or in enforcing any remedy available to it under any Loan Document; (vi) the right or power under any statute or rule of law, to demand, or otherwise require, that Lender take, initiate or pursue any action against the Borrower or against the property of the Borrower standing as security for the liabilities; (vii) any defense that may now or hereafter arise by reason of the incapacity, lack of authority, death or disability of Borrower, or any officer, partner or agent of Borrower, any co-guarantor, or any other person or entity or the failure of Lender to file or enforce a claim against the estate (either in administration, bankruptcy, or any other proceeding) of Borrower or any other person or entity; (viii) any duty on the part of Lender to disclose to the undersigned any facts it may now or hereafter know regarding the Borrower; (ix) the defense of the statute of limitations in any action hereunder or for the collection of the indebtedness or the performance of any obligation hereby guaranteed; (x) any delay on the part of Lender in exercising any of its rights under this Guaranty, or otherwise; (xi) until the obligations hereby guaranteed are satisfied in full, any right of subrogation to Lender against Borrower and any rights to enforce any remedy which Lender may have against Borrower and any rights to participate in any security for the Note or Loan Documents; and (xii) any defense based upon an election of remedies by Lender which destroys or otherwise impairs any subrogation rights of the undersigned or the right of the undersigned to proceed against Borrower for reimbursement, and/or any other rights of the undersigned to proceed against Borrower, against any other guarantor, or against any other person or security, including, without limitation,

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any defense based upon an election of remedies by Lender under the provisions of Section 580d and 726 of the California Code of Civil Procedure and/or any similar law of California or of any other jurisdiction; (xiv) any right to assert against Lender any defense (legal or equitable), set-off, counterclaim, and/or claim which the undersigned may now or at any time hereafter have against Borrower and/or any other party liable to Lender in any way or manner.

Without in any way limiting the foregoing, or any other provision in this Guaranty, the undersigned Guarantors agree as follows. Guarantors agree that nothing contained in this Guaranty shall prevent Lender from suing on the Note or from exercising any rights available to it under the Note or under any of the Loan Documents, and that the exercise of any of these rights shall not constitute a legal or equitable discharge of Guarantors. Guarantors understand that the exercise by the Lender of certain rights and remedies contained in the Loan Documents may affect or eliminate Guarantors' right of subrogation against Borrower and that Guarantors may therefore succeed to a partially or totally nonreimbursable liability hereunder. Nevertheless, Guarantors hereby authorize and empower Lender to exercise, in its sole discretion, any rights and remedies, or any combination of rights and remedies that may then be available, since it is the intent and purpose of Guarantors that the obligations hereunder shall be absolute, independent, and unconditional under any and all circumstances. Without limiting the generality of the foregoing, Guarantors expressly waive any and all benefits under California Civil Code Sections 2809, 2810, 2819, 2845, 2849, 2850, and 2855, and California Code of Civil Procedure Sections 580a, 580b, 580d and 726. Guarantors understand that each have a defense to a deficiency judgment under California Code of Civil Procedure Section 580d should the Lender elect to pursue nonjudicial foreclosure remedies, and each Guarantor expressly waives any and all benefits of any defense to a deficiency judgment should Lender elect to exercise its nonjudicial foreclosure remedies (including waiver of any Guarantor's defense under Section 580d).

[NOTE: The lender may wish to use either of the following paragraphs (quoting from Civil Code § 2856) in lieu of, or in addition to, the waivers set forth in the preceding paragraph:

"Guarantor waives all rights and defenses arising out of an election of remedies by the creditor, even though that election of remedies, such as a nonjudicial foreclosure with respect to security for a guaranteed obligation, has destroyed the guarantor's rights of subrogation and reimbursement against the principal by the operation of Section 580d of the Code of Civil Procedure or otherwise."

OR

"Guarantor waives all rights and defenses that the guarantor may have because the debtor's debt is secured by real property. This means, among other things: (1) The creditor may collect from the guarantor without first foreclosing on any real or personal property collateral pledged by the debtor. (2) If the creditor forecloses on any real property collateral pledged by the debtor: (A) The amount of the debt may be reduced only by the price for which that collateral is sold at the foreclosure sale, even if the collateral is worth more than the sale price. (B) The creditor may collect from the guarantor even if the creditor, by foreclosing on the real property collateral, has destroyed any right the guarantor may have to collect from the debtor. This is an unconditional and irrevocable waiver of any rights and defenses the guarantor may have because the debtor's debt is secured by real property. These rights and defenses include, but are not limited to, any rights or defenses based upon Sections 580a, 580b, 580d or 726 of the Code of Civil Procedure."]

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In addition to but not in limitation of the preceding, the undersigned agrees that Lender may, at any time and from time to time (more than once), without the consent of, or notice or responsibility to the undersigned, and without impairing or releasing any obligations or liability of the undersigned, upon or without any terms or conditions and in whole or in part: (i) change the manner, place or terms of payment, or change or extend the time of payment of, renew, reamortize or accelerate any liability of Borrower hereby guaranteed; (ii) alter, change, amend or modify any liability of Borrower hereby guaranteed and the terms and provisions of any documents evidencing or securing said liability, including without limitation, to increase or decrease the principal sum thereof or rate of interest thereon and to defer any installment payments of principal or interest and charge interest on the payments deferred at rates acceptable to Lender; (iii) sell, exchange, release, surrender, realize upon or otherwise deal with, in any manner and in any order, any property by whomsoever at any time pledged or mortgaged to secure or howsoever securing the liabilities hereby guaranteed, or any liabilities including those hereby guaranteed, whether incurred directly or indirectly in respect thereof, or offset there against; (iv) exercise or refrain from exercising any rights against Borrower or others, including the undersigned or otherwise in any way act or refrain from acting; (v) settle or compromise any liabilities hereby guaranteed or any liabilities due to Lender, incurred directly or indirectly, and subordinate the payment of all or any part thereof to the payment of any liabilities which may be due to Lender or others; (vi) apply any sums by whomsoever paid or howsoever realized to any liability or liabilities of Borrower to Lender, regardless of what liability or liabilities of Borrower to Lender remain unpaid; (vii) release any guarantor or endorser of the Note or Loan Documents; and (viii) accept a conveyance or conveyances of all or part of the property encumbered by the Loan Documents as partial satisfaction of the liability due under the Loan Documents and proceed against the undersigned for the balance due after said conveyance or conveyances. The undersigned agrees that Lender may do any or all of the foregoing in such manner, upon such terms, and at such times as Lender, in its sole discretion, deems advisable, without, in any way or respect, impairing, affecting, reducing or releasing the undersigned from the undersigned's undertakings hereunder, and the undersigned hereby consents to each and all of the foregoing acts, events and/or occurrences. This Guaranty shall apply to any liability of Borrower hereby guaranteed, or any other liabilities, incurred directly or indirectly as the result of any change, extension, renewal, increase, reamortization, amendment, modification or alteration of the Loan Documents in any manner.

Notwithstanding any foreclosure of the lien of the deed of trust or security agreement with respect to any or all real or personal property secured thereby, whether by the exercise of the power of sale contained herein, by an action for judicial foreclosure, or by an acceptance of a deed in lieu of foreclosure, each Guarantor shall remain bound under this Guaranty on the indebtedness that is the subject of the Note and all instruments securing said Note and shall be liable to Lender for any part of the indebtedness remaining unpaid after any foreclosure.

The provisions of this Guaranty shall extend and be applicable to all renewals, amendments, extensions, consolidations and modifications of the Note and Loan Documents, and shall continue unabated notwithstanding the failure of Lender to give the undersigned notice of any of the preceding. Any and all references herein to the Note and Loan Documents shall be deemed to include any such renewals, extensions, amendments, consolidations or modifications thereof.

In the event Borrower fails to perform its covenants, agreements and undertakings as provided in any of the Loan Documents, including its covenant to make payment as and when due, the undersigned shall immediately upon the written demand of Lender promptly and with due diligence, do and perform for the benefit of Lender, all of such covenants, agreements and undertakings, including the covenant to make payment as and when due, as if it constituted the direct and primary obligations of the undersigned.

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The obligations of the undersigned are independent of the obligations of Borrower or one another, and a separate action or actions for payment of any installment, payment upon maturity or upon acceleration, damages, or performance may be brought and prosecuted against the undersigned or any one of them, whether or not (i) an action is brought against the Borrower or the security for Borrower's obligation; (ii) Borrower is joined in any such action or actions; (iii) notice is given or demand is made upon Borrower; (iv) remedies are exhausted against the Borrower or the security for Borrower's obligation under the Loan Documents; and (v) any payment by Borrower to Lender is held to constitute a preference in any bankruptcy of Borrower or if for any reason Lender is required to refund such payment or pay such amount to Borrower or someone else.

The undersigned hereby authorizes and empowers Lender, at its sole discretion, and without notice to the undersigned, to exercise any right or remedy which Lender may have, as to any security, whether real, personal, or intangible, including, but not limited to, commencement of judicial foreclosure, exercise of rights of power of sale, acceptance of a deed or assignment in lieu of foreclosure, appointment of a receiver to collect, or direct collection of, rents and profits, exercise of remedies against personal property, or enforcement of any assignment of leases. If the indebtedness guaranteed hereby is partially paid for any reason, this Guaranty shall nevertheless remain in full force and effect, and the undersigned shall remain liable for the entire unpaid balance of the indebtedness guaranteed hereby.

The undersigned hereby subordinates any and all indebtedness of Borrower now or hereafter owed to the undersigned, or any of them, to all indebtedness of Borrower to Lender, and agrees with Lender that the undersigned shall not demand or accept any payment of principal or interest from Borrower, shall not claim any offset or other reduction of the undersigned's obligations hereunder because of any such indebtedness and shall not take any action to obtain any of the security described in and encumbered by the Loan Documents.

This Guaranty is an irrevocably absolute, continuing guaranty of payment and not a guaranty of collection. If this Guaranty is executed by more than one signer, all agreements and promises herein contained shall be construed, and are hereby declared to be, joint and several in each and every particular, and shall be fully binding upon and enforceable against either, any, or all of such signers, and neither the death, bankruptcy, insolvency, release of or revocation by one or more signers shall affect or release the liability of any other signer, either as to indebtedness then existing or thereafter incurred. The death of any of the undersigned shall not revoke this Guaranty as to such decedent unless and until written notice thereof is actually received by Lender and until all indebtedness then existing is fully paid and discharged.

The undersigned shall pay to Lender all attorneys' fees and costs incurred by Lender in seeking to enforce any of the liabilities or obligations of the undersigned under this Guaranty.

Nothing contained in this Guaranty shall prevent Lender from bringing any action or exercising any rights against any security or against the undersigned personally, or against any property of the undersigned, within any other state. Initiating such proceeding or taking such action in any other state shall in no event constitute a waiver of the agreement contained herein that the law of the State of California shall govern the rights and obligations of the undersigned and Lender hereunder or of the submission herein made by the undersigned to personal jurisdiction within the State of California. The aforesaid means of obtaining jurisdiction and perfecting service of process are not intended to be exclusive but are cumulative and in addition to all other means of obtaining personal jurisdiction and perfecting service of process now or hereafter provided by the laws of the State of California.

This Guaranty shall be construed in accordance with the laws of the State of California, and such laws shall govern the interpretation, construction and enforcement hereof. Wherever possible each provision of this Guaranty shall be interpreted in such a manner as to be effective and valid under applicable law, but if any provision of this Guaranty, or application thereof, shall be prohibited by or be invalid under such law, such provision or application, as the case may be, shall be ineffective to

the extent of such prohibition or invalidity, without invalidating the remainder of such provision or other applications or the remaining provisions of this Guaranty.

Except as otherwise provided herein, any and all notices, elections, demands, requests and responses thereto permitted or required to be given under this Guaranty shall be in writing, shall be deemed properly given and shall be effective upon either (i) three (3) days after their deposit in the United States mail postage prepaid, (ii) two (2) days after their deposit in a nationally recognized overnight courier service, or (iii) on the day of their personal delivery if delivered to the undersigned at the address designated below or at such other address as is specified in writing by any party to the others, provided that no change of address by the undersigned shall be effective unless the undersigned first serves notice of such change of address on Lender in writing by certified mail with return receipt requested, retaining a copy of such receipt in its files. Personal delivery to a party or to any officer, agent or employee at such address shall constitute receipt. Rejection or other refusal to accept or inability to deliver because of changed address of which no notice has been received shall also constitute receipt. Any such notice, election, demand, request or response, if given to Lender or the undersigned, shall be addressed as follows:

LENDER	**GUARANTORS**
....	....
....	....
....	....
	....
	....
	....

Time is of the essence in this Guaranty. All prior understandings, discussions and agreements are merged in the governing terms of this Guaranty, which is a complete and final written expression of the parties hereto. The undersigned acknowledge that the undersigned, and each of them, are not relying upon any oral representations and that this Guaranty is intended to be a legal and binding document. This Guaranty may not be changed orally, and no obligation of the undersigned can be released or waived by Lender or any officer or agent of Lender, except by a writing signed by a duly authorized officer of Lender. This Guaranty shall be irrevocable by the undersigned until all indebtedness guaranteed hereby has been completely repaid and all obligations and undertakings of the Borrower under, by reason of or pursuant to the Loan Documents have been completely performed.

This Guaranty and each of its provisions shall be binding upon the undersigned and upon the heirs, legal representatives, successors and assigns of the undersigned, and of each of them, respectively, and shall inure to the benefit of Lender, its successors and assigns. Lender shall be entitled to assign this Guaranty and all of its rights, privileges and remedies hereunder without notice to or consent of the undersigned, and such assignee shall be entitled to the benefits of this Guaranty and to exercise all such rights, interests and remedies as fully as Lender.

The term “undersigned” as used herein shall mean the entity or person executing this Guaranty, or any one or more of them. Anyone signing this Guaranty shall be bound hereby, whether or not anyone else signs this Guaranty at any time.

This Guaranty shall continue in full force and effect until all obligations of Borrower under the Loan Documents are fully paid, performed and discharged and Lender gives the undersigned written notice of that fact. The obligations of Borrower under the Loan Documents shall not be considered fully paid, performed and discharged unless and until all payments by Borrower to Lender are no longer subject to any right on the part of any person whomsoever, including, without limitation, Borrower, Borrower as a debtor-in-possession, and/or any trustee in bankruptcy, to set aside such payments or seek to recoup the amount of such payments, or any part thereof. The foregoing shall include, by way of example and not by way of limitation, all rights

to recover preferences voidable under Title 11 of the United States Code. In the event that any such payments by Borrower to Lender are set aside after the making thereof, in whole or in part, or settled without litigation, to the extent of such settlement, all of which is within Lender's sole discretion, the undersigned shall be liable for the full amount Lender is required to repay plus costs, interest, attorneys' fees and any and all expenses which Lender paid or incurred in connection therewith.

In the event that any bankruptcy, insolvency, receivership or similar proceeding is instituted by or against the undersigned and/or Borrower, or in the event that either the undersigned or Borrower becomes insolvent, makes an assignment for the benefit of creditors, or attempts to effect a composition with creditors, then, at Lender's election, without notice or demand, the obligations of the undersigned created hereunder shall become due, payable and enforceable against the undersigned whether or not the obligations of Borrower under the Loan Documents are then due and payable.

Notwithstanding any modification, discharge or extension of any obligations or liabilities under the Loan Documents or any amendment, modification, stay or cure of Lender's rights under the Loan Documents which may occur in any bankruptcy or reorganization case or proceeding concerning the Borrower, whether permanent or temporary, and whether assented to by Lender, the undersigned hereby agrees that it shall be obligated hereunder to perform in accordance with the terms of the Loan Documents and this Guaranty as originally written and not as so amended, modified, stayed or cured.

The undersigned understands and acknowledges that by virtue of this Guaranty, it has specifically assumed any and all risks of a bankruptcy or reorganization case or proceeding with respect to the Borrower. As an example and not by way of limitation, a subsequent modification of the Note in any reorganization case concerning the Borrower shall not affect the obligation of the undersigned to pay the Note in accordance with its original terms.

The undersigned represents and warrants to Lender that the undersigned has received, or will receive, direct or indirect benefit from the making of this Guaranty and the extension of the Loan or credit to Borrower as set forth in the Loan Documents.

THE UNDERSIGNED WAIVES THE RIGHT TO TRIAL BY JURY IN ANY AND EVERY ACTION OR PROCEEDING OF ANY KIND OR NATURE UNDER OR BY REASON OF OR RELATING IN ANY WAY TO THIS GUARANTY, THE LOAN DOCUMENTS OR ANY OF THE MATTERS AND THINGS REFERRED TO HEREIN.

IN WITNESS WHEREOF, the undersigned have executed this as of the date set forth below.

Dated:___________

GUARANTORS

___________	___________
___________	___________

CONSENT OF SPOUSE

The undersigned are the spouses, respectively, of _____ (all of whom are the Guarantors under the foregoing Guaranty). The undersigned each hereby certifies, represents and agrees that (i) they have read and understand the foregoing Guaranty; (ii) they consent to the terms of the Guaranty and their respective spouses execution, delivery and performance thereunder; and (iii) that Lender may have recourse against the community property interest of the undersigned in community assets. Notwithstanding

the foregoing, the undersigned shall not in any way be individually liable under the aforementioned Guaranty, nor shall Lender have the right of recourse against any of undersigned's separate property.

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Cal. Prac. Guide Real Prop. Trans. Ch. 7-A

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 7. Ground Leaseholds

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1. [7:1] **Overview:** The term "ground lease" is somewhat of a misnomer. "Ground lease" is simply a euphemism for a long-term lease, often involving vacant land upon which the tenant is permitted (or required) to build improvements. A "ground lease" has no defined legal significance and could just as easily be (and often is) denominated a "lease," "land lease" or any other designation indicating a leasehold. Thus, a ground lease involves all of the legal and practical issues associated with most any lease.

Apart from the concerns normally associated with the acquisition of a fee interest (*Ch. 4*), the purchase and sale of a "ground leasehold" presents some of the most sophisticated leasing issues. However, because of its extended term, the parties in many ways functionally treat the ownership and sale of a ground leasehold as they would the ownership and transfer of a fee interest. Therefore, in negotiations for the purchase and sale of a ground leasehold, counsel and client must analyze and weave together both leasehold and fee interest issues. As will be seen, the basic form of a purchase and sale agreement for the transfer of a ground leasehold interest should essentially be the same as for the purchase and sale of a fee interest, discussed in *Ch. 4*. Likewise, an escrow should be employed as it would when transferring a fee (*discussed in Ch. 4*).

Ground leaseholds exist in connection with every kind of real property: e.g., office, industrial, retail and residential developments. (However, in residential projects, the development is usually a common interest subdivision—such as a condominium or planned unit development.) Regardless of the type of property involved, the issues for the parties and their counsel are almost always the same.

(**Scope Note:** This Chapter focuses on the *transfer* of a tenant's interest in a ground lease; it does not deal with the creation of a ground lease or the ongoing landlord-tenant relationship. For a comprehensive treatment of the creation and termination of tenancies, and landlord-tenant rights and obligations during a tenancy, see Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG).)

• ***FORM:*** A sample ground lease is reproduced at the close of this Chapter as *Form 7:A*.

2. [7:2] **Distinguishing Features:** Ground leases are distinguishable from other leasehold interests in various fundamental characteristics. These are among the more salient distinguishing features:

a. [7:3] **Extensive term:** Perhaps the most obvious difference between a ground lease and other leases is the duration of the term. The term of a ground lease is typically very long—35, 50 or 99 years.

(1) [7:4] **Statutory limits on duration of certain kinds of leases:** However, the Civil Code restricts the term of certain leases.

(a) Examples

1) [7:5] **Municipal property:** Property owned, managed or controlled by a municipality (or department or board thereof) ordinarily cannot be leased for a term greater than 55 years (Civ.C. § 718); but the term can be extended for up to 99 years if the municipality follows specified statutory procedures (Civ.C. § 719).

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2) [7:6] **Municipal mineral leases:** Property owned by a municipality may not be subject to a mineral lease exceeding 35 years. [Civ.C. § 718]

3) [7:7] **Municipal tideland or submerged land leases:** Any lease of tidelands or submerged lands *granted to any city* by the State of California may not exceed 66 years. Likewise, tidelands or submerged lands owned or controlled *by a city* may not be leased for a period exceeding 66 years. [Civ.C. § 718]

4) [7:8] **Nonmunicipal mineral, oil and gas leases:** Mineral, oil and gas leases on nonmunicipal property may not exceed 99 years. [Civ.C. § 718f]

5) [7:9] **Agricultural property:** A lease for "agricultural or horticultural purposes" cannot exceed 51 years. [Civ.C. § 717]

6) [7:10] **Town or city lots:** The lease of any town or city lot is limited to a maximum 99-year term (this restriction typically applies to commercial, including retail, property). [Civ.C. § 718; see *Shaver v. Clanton* (1994) 26 CA4th 568, 576, 31 CR2d 595, 599-600]

7) [7:10.1] **State park land:** The Department of Parks and Recreation may lease state park system property for any "compatible" use up to a maximum 10-year term (longer terms must be approved by the Joint Legislative Budget Committee, as statutorily prescribed). [See Pub.Res.C. § 5003.17]

(b) [7:11] **Options to renew included:** The statutory limits set forth at ¶ 7:4 ff. apply to the lease term as initially stated in the ground lease *and as extended* by the grant of *options to renew*. Thus, even though the original lease term is within the applicable statutory limit, the lease violates the applicable statute if it provides for options (or perpetual options) by which it *could be* extended beyond the authorized term. [*Shaver v. Clanton* (1994) 26 CA4th 568, 575-576, 31 CR2d 595, 599-600—shopping center lease that provided for original 10-year term but was amended to provide for perpetual five-year options to renew violated Civ.C. § 718; *Epstein v. Zahloute* (1950) 99 CA2d 738, 739, 222 P2d 318, 319—right of perpetual renewal violates Civ.C. § 718; but see *Fisher v. Parsons* (1963) 213 CA2d 829, 842, 29 CR 210, 218—fact that lease *might* violate Civ.C. § 718 does not make term unlawful]

(c) [7:12] **Effect of excessive term:** Some of the statutes setting a maximum term are seemingly worded to make the lease invalid if it exceeds the maximum authorized term (see, e.g., Civ.C. § 717—no lease for agricultural or horticultural purposes exceeding 51 years "shall be valid"; Civ.C. § 718—no lease of town or city lot exceeding 99-year term "shall be valid"). Nonetheless these statutes are construed to void *only the excess term;* i.e., a lease exceeding the maximum authorized term is valid for the maximum authorized term. [See *Tufeld Corporation v. Beverly Hills Gateway, L.P.* (2022) 86 CA5th 12, 18, 29, 302 CR3d 203, 206, 214—amended commercial ground lease deemed void to extent its term exceeded 99 years in contravention of Civ.C. § 718's public policy, *discussed further at* ¶ 7:326; *Shaver v. Clanton* (1994) 26 CA4th 568, 576, 31 CR2d 595, 600, & fn. 9—town or city lot lease granting perpetual options to renew violates Civ.C. § 718 but is valid for 99-year term from its effective date; see also *Kendall v. Southward* (1957) 149 CA2d 827, 828-830, 308 P2d 915, 917-918—agricultural lease for life does not violate Civ.C. § 717 except to extent it may actually exceed statutory limit]

• [7:12.1] **Comment:** There is contrary authority holding that (at least with regard to the Civ.C. § 718 99-year term on town or city lot leases), a lease exceeding the maximum statutory term is void from its inception (*Epstein v. Zahloute* (1950) 99 CA2d 738, 739, 222 P2d 318, 319). However, that position has been criticized as a departure from a clear line of case law, including Cal. Supreme Court authority (*Harter v. City of San Jose* (1904) 141 C 659, 667, 75 P 344, 347—lease in violation of statutory term "would not be void except as to the excess of the period"). [See *Shaver v. Clanton* (1994) 26 CA4th 568, 576, 31 CR2d 595, 600, fn. 9]

(2) Restrictions on commencement date

(a) [7:13] **Rule against perpetuities:** Like ordinary leasehold estates, ground leases are, theoretically, subject to the rule against perpetuities (Prob.C. § 21205—nonvested property interest invalid unless (i) certain to vest or terminate no later than 21 years after death of an individual then alive, or (ii) it vests or terminates within 90 years after its creation). However, so long as *already vested*, a long-term lease is not affected by the rule. [*Fisher v. Parsons* (1963) 213 CA2d 829, 838-841, 29 CR 210, 215-217]

1) [7:14] **Compare—nonvested and contingent leaseholds:** On the other hand, leaseholds could be vulnerable to the rule against perpetuities where the tenant's rights are contingent and have not yet vested—e.g., if the commencement

date is uncertain and there are no deadlines after which the nonvested interest will terminate. [*First & C Corp. v. Wencke* (1967) 253 CA2d 719, 726, 61 CR 531, 536]

a) [7:14.1] **Commercial lease exemption:** Nonetheless, California law *exempts* all nondonative commercial transactions from the statutory rule against perpetuities. [See Prob.C. § 21225(a); *Shaver v. Clanton* (1994) 26 CA4th 568, 574, 31 CR2d 595, 599—commercial lease granting perpetual options to renew not violative of rule against perpetuities]

(*Comment:* Loose drafting of Prob.C. § 21200 et seq. has raised the question whether, by exempting these interests from the *statutory* rule against perpetuities, the Legislature meant for those interests to remain subject to the *common law* rule against perpetuities. *Shaver*, supra, did not consider the issue; and there is, as yet, no reported California decision on point.)

1/ [7:14.2] **Special rule of construction re renewal provisions:** Although enforceable, commercial lease provisions giving a tenant the right to perpetual renewals are disfavored. Indeed, leases allowing for unlimited extensions are enforceable only if they *clearly and unequivocally* establish the parties intended to give the tenant unlimited extensions. Otherwise, the leases are construed as providing for only one renewal. [See *Ginsberg v. Gamson* (2012) 205 CA4th 873, 889-893, 141 CR3d 62, 74-78—option to renew commercial lease for additional five-year periods did not unequivocally demonstrate parties' intent to create unlimited extension rights, rendering lease subject to only one renewal]

[7:14.3 - 7:14.4] ***Reserved.***

b) [7:14.5] **Reformation to cure perpetuities problems:** Even where the rule against perpetuities would otherwise apply to the transaction (primarily, donative family-oriented transfers), the court is empowered to *reform* the disposition to make it consistent with the rule and the parties' intent. [See Prob.C. § 21220; *Shaver v. Clanton* (1994) 26 CA4th 568, 575-576, 31 CR2d 595, 599 & fn. 8]

(b) [7:15] **Statutory maximum 30-year actual commencement date:** Even if consistent with the rule against perpetuities, a lease to commence at a specified future date or upon the happening of a future event *becomes invalid* if its term does not *actually commence in possession* within *30 years* after its execution. [Civ.C. § 715]

b. [7:16] **Construction of improvements:** Unlike many other leases, ground leases usually involve property that is initially either completely unimproved, minimally improved, or in need of rebuilding (hence, the term “ground” or “land” lease). Also, in contrast to most other landlord-tenant relationships, the ground lease *tenant* (rather than the landlord) constructs (and often initially owns) the improvements.

This feature of the tenancy relationship impacts a variety of other leasehold issues:

(1) [7:17] **Landlord approval rights:** The ground lease tenant will require that it be granted broad discretion regarding what it can build, with only minimal landlord rights of approval.

(2) [7:18] **Future alterations:** The ground lease tenant will also require wide latitude in making future alterations and modifications to the improvements, again subject to only minimal landlord rights of approval. (The longer the lease, the more likely the tenant will be making future alterations to modernize or adapt the property to a changing commercial environment.)

(3) [7:19] **Ownership of improvements:** Because the tenant is usually constructing and paying for the initial improvements or the renovation of existing ones, it often requires certain ownership rights in those structures during the lease term. Ultimately, however, the improvements become the landlord's property (certainly, at the end of the lease term unless the landlord requires their removal). [See *Auerbach v. Assessment Appeals Bd. No. 1 for County of Los Angeles* (2006) 39 C4th 153, 162-163, 45 CR3d 774, 779-780]

The tenant's ownership of the structures during the lease term may provide the tenant with certain tax benefits—such as the right to depreciate the construction costs. The parties' ownership designations in the lease, however, are *not binding on the taxing authorities*.

Aside from tax concerns, the issue of who owns the improvements often becomes important in the context of damage/destruction and condemnation; *see ¶ 7:222 ff.*

(4) [7:20] **Repair and maintenance obligations:** Because the tenant usually constructs (and, at least initially, owns) the improvements, the tenant typically has virtually all of the repair and maintenance obligations for the lease term.

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c. [7:21] **Financeability of leasehold:** Most ordinary leases do not contemplate that the tenant will finance its leasehold interest. However, because a ground lease tenant may need to borrow funds to pay for the construction of improvements (or may otherwise periodically desire to finance and refinance its interest in such a long-term leasehold), a ground lease should almost always be financeable and contain appropriate provisions granting rights to the tenant's lender (the "leasehold mortgagee"). *See ¶ 7:390 ff.*

d. [7:22] **Use:** Ground lease tenants must make certain that the lease allows for a flexible change of use. This is especially important because of the extensive duration of the rental term; i.e., ground lease tenants will rarely be able to foresee what potential uses might be desirable or necessary 30, 50 or 90 years hence.

Significantly, optimum change of use rights will be important for these reasons:

• [7:23] To accommodate the tenant's growth or change of plans during the course of the long-term lease.

• [7:24] To accommodate the needs of various *subtenants* who may be subleasing portions of the property from time to time.

• [7:25] To accommodate the needs of any third party to whom the tenant might *assign* its interest.

• [7:26] To satisfy a future *leasehold mortgagee*. The tenant's lender will require that the tenant have broad usage rights because, if it should become the owner of the leasehold interest through foreclosure, it will want the ability to select from as broad a pool of prospective new tenants as possible in assigning the lease. *See* ¶ *7:403, 7:406*.

➪ [7:27] ***PRACTICE POINTER:*** It thus behooves tenants to insist on a lease permitting open-ended use "for any lawful purpose" (or similar nonrestrictive language).

However, negotiating for such latitude can be difficult. The landlord (fee owner) may be looking for a particular usage as a source of income to satisfy the tenant's rent obligation. For example, a landlord who expects the property to be developed as a shopping center may require that use be restricted to retail purposes. Moreover, because the landlord will ultimately end up owning the improvements, it may be entering into the lease with an expectation that the property will always be used as (and the landlord will eventually inherit) a shopping center, retail office building, or medical building, etc. In these cases, the landlord may be unyielding on the issue of certain use (and change in use) restrictions. *See further discussion at ¶ 7:170 ff.*

e. [7:28] **Damage, destruction and partial condemnation:** In many leaseholds, landlord and/or tenant might desire that the lease terminate upon damage or destruction of the structures (or partial condemnation of the structures or land). But in the ground leasehold context, the landlord usually requires that the structures be rebuilt in the event of damage, destruction or partial condemnation. Moreover, the ground lease tenant will rarely want these events to trigger a termination of its long-term leasehold. Therefore, a ground lease typically will—and *should*—include extensive provisions governing the parties' rights and obligations upon damage, destruction or condemnation. *See discussion at ¶ 7:222 ff.*

[7:29] ***Reserved.***

f. [7:30] **Assignments and subletting:** Many ordinary leases restrict transferability of the tenant's interest, or condition the right of transfer on the landlord's prior consent. However, as with the subject of future use changes, the extensive duration of a ground lease makes flexible rights of assignment and subleasing important to ground lease tenants; also, potential leasehold mortgagees will require extremely liberal sublease/assignment rights (*¶ 7:406*). Thus, it is in the tenant's interest to negotiate for an *unrestricted* right to transfer its leasehold interest, keeping landlord approval rights to a minimum. *See detailed discussion at ¶ 7:60 ff.*

g. [7:31] **Maintenance of property:** Most ordinary leases put some responsibility for maintaining the property on the landlord (e.g., at a minimum, the landlord is often required to maintain the structural portions of the improvements). In contrast, the landlord characteristically has no maintenance obligations under a long-term ground lease; this is because, conceptually, the parties view the relationship as giving the tenant almost exclusive control of (and corresponding obligations for) the property during the term.

Indeed, the longer the lease term, the more likely courts are to construe lease language purporting to shift all repair and maintenance obligations to the tenant as *including* renovation and abatement responsibilities that normally accompany ownership interests and, under a short-term lease, would significantly benefit only the landlord's reversionary interest. [See *Brown v. Green* (1994) 8 C4th 812, 831-832, 35 CR2d 598, 610—relatively long-term (15-year) lease for substantial rent construed to shift *asbestos clean-up* responsibility to tenant; compare *Hadian v. Schwartz* (1994) 8 C4th 836, 847-848, 35

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CR2d 589, 596—relatively short-term (3 years with 5-year renewal option) low-rent lease construed *not* to shift seismic reconstruction obligation to tenant]

h. [7:32] **Allocation of repair, maintenance and operating costs:** The allocation of costs relating to the property is a matter of contract and is typically specified in great detail in a properly drafted ground lease. These costs include taxes, insurance, utilities, repair, maintenance and other operating expenses.

(1) [7:33] **"Gross lease" vs. "net lease":** The leasing industry typically utilizes the terms "gross" or "net" lease to describe expense allocations.

(a) [7:34] **"Gross lease"—allocated to landlord:** Generally, under a "*gross lease*," the tenant has no responsibility for costs relating to ownership of the property (taxes, insurance, repairs, maintenance, utilities, etc.).

(b) [7:35] **"Net lease"—allocated to tenant:** The term "net" or "triple net" means the tenant is responsible for most (or all) of the costs normally associated with ownership of the property. In economic terms, under a net lease, the landlord "foregoes the speculative advantages of ownership in return for the agreed net rental"; the tenant, in exchange, "gambles on the continued value of the location and the improvement[s] … and assumes all risks in connection therewith." [*Brown v. Green* (1994) 8 C4th 812, 826-828, 35 CR2d 598, 607-608 (internal quotes omitted); see also *Hadian v. Schwartz* (1994) 8 C4th 836, 845-846, 35 CR2d 589, 595—fact lessor retains obligations to pay major portion of property taxes and casualty insurance premiums tends to negate conclusion parties intended true "net" lease]

In practice, under a "net lease," the tenant may have certain minimal obligations regarding operating costs. Under a "*triple net* lease," *all* operating costs are the tenant's obligation. [*Tin Tin Corp. v. Pacific Rim Park, LLC* (2009) 170 CA4th 1220, 1226, 88 CR3d 816, 822, fn. 3 (citing text)]

(c) [7:36] **Variations:** There are many variations on the concepts set forth at ¶ 7:33 ff. For example, even though many commercial and retail leases are identified as "net" or "triple net," the landlord is responsible for certain costs and for maintaining various components of the leased property (such as structural portions). Conversely, under a so-called "gross lease," the tenant may be required to pay certain utility and/or other operating costs.

(d) [7:37] **Label not determinative:** Commercial leases often are labeled with the industry terminology "gross," "net," "triple net" or "modified net"; but the titles or labels themselves have *no legal significance* and are not decisive of the extent to which the parties intended to shift the expense burdens of various operating, repair and maintenance obligations from landlord to tenant. Rather, the allocation of cost responsibilities is dictated by the *substance* of the lease. [*Tin Tin Corp. v. Pacific Rim Park, LLC* (2009) 170 CA4th 1220, 1226, 88 CR3d 816, 822 (citing text)]

"What is persuasive is a consideration of the provisions of the lease agreement as a whole …" To conclude a *true* "net" (or "triple net") lease was created, it must be "reasonably clear *from the four corners of the agreement* itself that the parties intended to transfer from the lessor to the tenants the major burdens of ownership of real property over the life of the lease." [*Brown v. Green* (1994) 8 C4th 812, 828, 35 CR2d 598, 608 (emphasis in original); see *Hadian v. Schwartz* (1994) 8 C4th 836, 846, 35 CR2d 589, 595—despite title "net" lease, tenant did not agree to assume burden of complying with city seismic safety reconstruction order]

(2) [7:38] **Ground lease as "net lease":** Ground leases are almost invariably of the "triple net" type (i.e., tenant bears all maintenance and operating costs). There are several reasons:

• [7:39] The parties conceptually view a long-term ground lease much akin to the transfer of a fee interest; i.e., like the owner of a fee interest, the tenant is to have exclusive control of—and responsibility for—the improvements and operation of the property during the term.

• [7:40] Being the party who typically builds the improvements, the tenant prefers to have control over maintenance, repair and the like.

• [7:41] The landlord usually views the transaction as a long-term investment yielding a consistent cash flow, but without typical landlord responsibilities.

➪ [7:42] ***PRACTICE POINTER:*** Of course, even under a purported "triple net lease," not all expenses are necessarily passed on to ground lease tenants. For example, who bears the burden of property tax reassessments in the event the landlord sells the fee is usually intensely negotiated. The tenant obviously will take a hard position against any provision obligating it to pay increased taxes (which could be substantial) upon a sale of the fee … particularly since such tax consequences are triggered by an event solely within the landlord's (fee owner's) control. (*See ¶ 7:269*.)

[7:43 - 7:44] ***Reserved.***

3. [7:45] **Advantages of Ground Leasing:** From the tenant's perspective, the benefits and burdens attaching to a ground lease are conceptually quite similar to those that accompany the transfer of a fee interest. This raises the issue of why a “buyer” would prefer to create a leasehold relationship rather than a conventional purchase and sale of the fee interest. As discussed at ¶ 7:46 ff., there are distinct advantages to both the tenant and owner/landlord under a ground lease.

a. Fee owner's motivations

(1) [7:46] **Tax considerations:** From the owner's perspective, a ground lease may be tax motivated.

For example, for estate planning purposes or otherwise, the “seller” (landlord) may want to defer realization of the value of the land until a later date. A sale of the property could result in unwanted present tax consequences. By leasing the land, the owner will have taxable income, but the proceeds will be received in installments (of rent) over time. Moreover, by retaining its fee interest, the owner can ultimately realize the continued appreciation of the value of the property.

➪ [7:47] ***PRACTICE POINTER:*** To realize other tax benefits, a fee owner might sell the property and then lease it back through a ground lease.

This is called a sale-leaseback, whereby the former owner may obtain the tax benefits of being a tenant because rental payments and other payments are deductible for tax purposes. (For further discussion on tax treatment of sale-leaseback transactions, see *Frank Lyon Co. v. United States* (1978) 435 US 561, 572-584, 98 S.Ct. 1291, 1298-1304.)

(2) Other benefits

(a) [7:48] **Improvements and entitlements:** The fee owner also receives the benefit of the tenant's development of the property … because, as earlier noted, the tenant's improvements typically become the landlord's property upon termination of the lease (¶ *7:19*). This includes not only the tangible physical structures, but also the intangible benefit of the various entitlements and development permits the tenant will have obtained (which may include subdivision of the property, procurement and filing environmental impact reports, procurement of zoning variances, building permits and the like).

If nothing else, the owner benefits from the securing of certain vested rights that attach to such efforts by the tenant. For example, the owner may be able to avoid the possibility of “down zoning” (or other zoning changes) affecting the property while the land would otherwise remain vacant.

(b) [7:49] **Rent security:** Fee owners otherwise motivated to lease their property may find greater rent security in a ground lease tenant than a tenant under an ordinary lease. Typically, having invested substantial time and money in development of the property to allow for successful business operations, ground lease tenants may be more likely to keep current in their rent payments than tenants under an ordinary lease (who have no investment in the creation of improvements).

(c) [7:50] **Security from potential leasehold mortgagee:** The fee owner may also derive some comfort from knowing that, should the tenant finance its leasehold interest, the leasehold mortgagee might cure any default by the tenant rather than risk termination of the ground lease (which would wipe out the leasehold mortgagee's security for its loan).

b. Tenant's motivations

(1) [7:51] **Tax considerations:** The tenant might also be motivated by tax considerations. For example, rental payments, which include costs of operating the property (taxes, insurance, etc.) are deductible, whereas the buyer of a fee can deduct only the interest portion of the mortgage payments. Additionally, the tenant might be able to depreciate improvements constructed by it over the useful life of the improvements or the term of the lease, whichever is shorter. (This could mean faster depreciation for the tenant than if the property, with improvements, were purchased in fee.)

(2) Other considerations

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(a) [7:52] **Tailoring investment to use:** If the contemplated use of the property is to be limited in time or purpose, it may be unwise for the tenant to pay for the value of the underlying land. For example, a fast food restaurant or gas station operator may only want the property to operate its business and may not wish to tie up capital in a purchase of the land. Moreover, by building a structure which only has a useful life equal to the length of the ground lease term, the tenant does not leave any residual, excess value in the structure when the term ends.

(b) [7:53] **Use benefits equivalent to fee ownership:** When otherwise motivated to pursue a ground lease, tenants may effectively give up little in practical day-to-day benefits accompanying outright fee ownership. Ground lease tenants often have almost as much freedom to determine what they build, and how they use the property, as they would had they purchased the fee interest.

➪ [7:54] ***PRACTICE POINTER:*** Do not assume, however, that all—or even most—ground leases involve tenants who actually intend to operate their business from the property. Frequently, the ground lease tenant is a developer who has leased the land for the purpose of developing it and then subleasing the development to various commercial subtenants.

[7:55 - 7:59] ***Reserved.***

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Chapter 7. Ground Leaseholds

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(a) [7:125] Remedies not mutually exclusive

[7:60] For purposes of the balance of this Chapter, the term “selling tenant” refers to the tenant selling its existing leasehold interest in a ground lease. The term “purchasing tenant” refers to the tenant purchasing the selling tenant's ground leasehold interest. The term “landowner” means the landlord under the ground lease—i.e., the owner of the fee interest in the property.

1. [7:61] **Introduction:** The threshold legal issue confronting attorneys for the purchasing and selling tenants is to determine the selling tenant's *right to assign* its leasehold interest. Obviously, a contemplated sale will be subject to major obstacles if the ground lease prohibits or significantly restricts assignment.

The tenant's right to assign turns both on the terms of the ground lease and on statutory and case law regarding assignments of leaseholds generally. Further, because the law on assignments is inextricably bound with the law on subletting, the sections set forth at ¶ 7:62 ff. also address the parties' rights with respect to subletting.

2. [7:62] **Distinction Between "Assignment" and "Sublease":** Though the terms are often used interchangeably, "assignments" and "subleases" are distinct legal concepts and have distinct legal consequences.

a. [7:63] **Assignment:** A true "assignment" of a tenant's interest in a lease is the transfer of *all* of the tenant's right, title and interest in the leasehold. The tenant's assignee steps into direct privity of estate with the landowner, acquiring the benefits and becoming obliged by the burdens of all "covenants running with the land." If the assignee expressly assumes the master lease (*see* *¶ 7:334*), the assignee and landowner also stand in a privity of contract relationship. [*Vallely Investments, L.P. v. BancAmerica Comm'l Corp.* (2001) 88 CA4th 816, 822, 106 CR2d 689, 694]

Unlike a sublease (¶ 7:64), the selling tenant/assignor retains *no* reversionary interest in or right to reenter the leasehold, even if its assignee abandons the property; but the assignor remains in privity of contract with the landowner absent an express release. [See *Vallely Investments, L.P. v. BancAmerica Comm'l Corp.*, supra, 88 CA4th at 822-823, 106 CR2d at 694-695 (discussing distinctions between sublease and assignment); *Kendall v. Ernest Pestana, Inc.* (1985) 40 C3d 488, 492, 220 CR 818, 820, fn. 2]

b. [7:64] **Sublease:** In contrast, by a sublease, the tenant transfers *less* than the entire premises or *less* than the entire term of the lease to a third party. A sublease does *not change* the privity relationship between landowner and sublessor tenant; i.e., subtenant and landowner are neither in privity of contract nor privity of estate. The subtenant's rights are governed by the sublease with the master lease tenant (sublessor), which can be no greater than the rights granted by the master lease; and the landowner's rights remain governed by the master lease with the tenant (sublessor). [*Kendall v. Ernest Pestana, Inc.* (1985) 40 C3d 488, 492, 220 CR 818, 820, fn. 2; *Vallely Investments, L.P. v. BancAmerica Comm'l Corp.* (2001) 88 CA4th 816, 823, 106 CR2d 689, 695]

Thus, the tenant (not the subtenant) remains responsible for the payment of rent to the landowner (*Kendall v. Ernest Pestana, Inc.*, supra, 40 C3d at 502, 220 CR at 827); and, upon a default by the tenant, the landowner can usually terminate the sublease by terminating the ground lease.

➪ [7:64.1] ***PRACTICE POINTER:*** Under the definitions set forth at ¶ 7:62 ff., a sublease would be technically created if the ground lease tenant "subleased" the entire property for the entire balance of the term except for the last day. Similarly, a sublease would be technically created even though the "sublessor" leases to the subtenant all but a nominal portion of the property for the entire balance of the term. And, a sublease is created where the transferring tenant retains a right of reentry. Indeed, selling tenants may try to structure their deals in such a manner in an attempt to avoid the generally harsher restrictions on assignment (*see* *¶ 7:66 ff.*). [See generally, *Kendis v. Cohn* (1928) 90 CA 41, 58-60, 265 P 844, 851]

c. [7:65] **Importance of distinction:** To the extent a tenant is subject to transfer restrictions, most ordinary leases do not distinguish between leasehold transfers by assignment vs. sublease; i.e., an assignment will either be permitted or prohibited on the same basis as a sublease.

However, ground leases frequently subject the two types of transfers to different standards. The reasons are two-fold:

(1) [7:66] **Assignee steps into assignor's shoes; subtenant's creditworthiness less important to landlord:** Absent a novation (*¶ 7:326*), an assignment does not itself let the assignor tenant out of its contractual obligations under the lease (*see* *¶ 7:320*). Even so, privity of estate binds the new tenant/assignee to the lease obligations for so long as it remains in possession (*¶ 7:334 ff.*). Thus, for all practical purposes, an assignment substitutes one tenant for another; and, because the parties to a ground lease have a long-term relationship, the landlord is justifiably concerned about the quality—especially the creditworthiness—of any assignee.

On the other hand, a sublease disturbs neither the privity of contract *nor* privity of estate relationship between the original tenant and landowner; indeed, a sublease is subordinate to the covenants in the master lease. Since there is no substitution of the original tenant, the landowner is far less concerned about the quality of a subtenant.

(2) [7:67] **Tenant-developer's need for flexible sublease rights:** Because the ground lease tenant is frequently a developer who intends to enter into several subleases with subtenant/operators, it will not want to be hampered by severe subletting restrictions. For example, in the context of a retail ground lease, the developer must be able to create its own tenant mix and retail environment. The landowner will generally be receptive to broad subleasing rights since it is not looking to subtenants for the payment of rent.

➪ [7:68] ***PRACTICE POINTER:*** For the reasons set forth at ¶ 7:66 ff., it is not uncommon for ground leases to narrowly restrict assignment rights yet liberally permit subleases. In such event, to avoid creative attempts by tenants to avoid

assignment restrictions, a well-drafted ground lease should specify that a "subletting" of the entire property will constitute an assignment—notwithstanding the length of the sublease term.

If the ground lease is not properly drafted, the selling tenant might be able to completely change the operator of the property under the guise of a sublease, thereby defeating the landowner's goal of having the right to approve such a drastic change in tenants. (For example, the tenant could sublease the entire premises for a term ending just shortly before the end of the (master) ground lease term; or the tenant could sublease all but a small, insignificant portion of the property for the entire balance of the term, calling the transaction a "sublease.") [Cf. *Kendis v. Cohn* (1928) 90 CA 41, 56-59, 265 P 844, 850-851]

3. [7:69] **Validity and Construction of Contractual Restrictions on Assignment and Subletting:** The provisions of the ground lease will govern the selling tenant's right to assign and sublet. These provisions generally fall into the following categories:

• Unrestricted right to assign and sublease.

• Absolute prohibition on assignment and subletting.

• Express standards or conditions on the right to assign or sublease.

• Allowing assignment and subletting only with the landowner's prior consent, without stating standards for the giving or withholding of consent.

• Allowing assignment and subletting only with the landowner's prior consent, which consent may not unreasonably be withheld.

• Allowing assignment or subletting only upon the landowner's prior consent, but subject to specific standards on the giving or withholding of consent.

a. [7:70] **Governing law, generally:** The construction, validity and enforceability of assignment, sublease and other restrictions on the transfer of a nonresidential property leasehold interest are governed by Civ.C. § 1995.010 et seq. (The common law continues to apply to residential leasehold transfer restrictions; but § 1995.010 et seq. substantially tracks that law. See detailed discussion in Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 2B.)

Notwithstanding the traditional public policy abhorrence to restraints on alienation (Civ.C. § 711), these statutes essentially respect contractual restrictions on the transfer of a leasehold interest freely and voluntarily negotiated by parties of roughly equal bargaining strength. Subject to ordinary "adhesion"/"unconscionable" contract limitations (*¶ 7:73.5*), there are no statutory limits on the breadth of an enforceable leasehold transfer restriction. [See *Carma Developers (California), Inc. v. Marathon Develop. California, Inc.* (1992) 2 C4th 342, 367, 6 CR2d 467, 481—Civ.C. § 1995.020 et seq. preempts application of Civ.C. § 711 prohibition against "unreasonable" restraints on alienation; see also *Ilkhchooyi v. Best* (1995) 37 CA4th 395, 408-409, 45 CR2d 766, 774]

(1) [7:71] **Ambiguities resolved in favor of unrestricted transferability:** By the same token, in order to further public policy favoring free transferability of property and avoid the harsh consequences of a forfeiture of the lease, ambiguous leasehold transfer restrictions will be construed in favor of free transferability. [Civ.C. § 1995.220; *Karbelnig v. Brothwell* (1966) 244 CA2d 333, 341, 53 CR 335, 340]

(2) [7:72] **Narrow interpretation of controlling language:** So too, the public policy hostility toward restraints on alienation and forfeitures means courts will *narrowly construe* transfer restrictions in a lease. The language used in the restrictive clause is likely to be given a *literal* interpretation.

Thus, e.g., provisions barring or restricting an "assignment" have been held *inapplicable* to a *sublease* (*Stevinson v. Joy* (1912) 164 C 279, 286, 128 P 751, 754), a *mortgage* of the lease (*Chapman v. Great Western Gypsum Co.* (1932) 216 C 420, 426-427, 14 P2d 758, 760-761) and a *transfer of stock* by corporate tenants (*Ser-Bye Corp. v. C.P. & G. Markets, Inc.* (1947) 78 CA2d 915, 920-921, 179 P2d 342, 345 (superseded by statute on other grounds as stated in *In re Alberto* (2002) 102 CA4th 421, 430, 125 CR2d 526, 532, fn. 4).

(3) [7:73] **Compare—strict enforcement of clearly unambiguous transfer restrictions:** On the other hand, courts will not "read in" ambiguities where the lease language is plain and clear. If the contract was freely negotiated, and particularly

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where both sides had the benefit of independent counsel, a clear prohibition against "subleases and assignments"—as well as any other transfer restriction (subject to "unconscionability" limitations, ¶ 7:73.5 ff.)—will be enforced according to its terms … notwithstanding that it might work a forfeiture. [See *Carma Developers (California), Inc. v. Marathon Develop. California, Inc.* (1992) 2 C4th 342, 371, 6 CR2d 467, 483; *Boston Properties v. Pirelli Tire Corp.* (1982) 134 CA3d 985, 995, 185 CR 56, 62—"The courts are not required to resort to scholastic subtleties to save tenants from the consequences of their deliberate breach of their covenants"]

"Neither the law governing unreasonable restraints on alienation … nor the law governing the implied covenant of good faith and fair dealing … prevents the enforcement of a restriction on transfer in accordance with the express terms of the restriction." [See Civ.C. § 1995.210, Law Rev. Comm'n Comment; *Ilkhchooyi v. Best* (1995) 37 CA4th 395, 408, 45 CR2d 766, 774]

[7:73.1 - 7:73.4] ***Reserved.***

(4) [7:73.5] **"Unconscionable" contract limitations:** Despite Civ.C. § 1995.010 et seq.'s broad validation of any express transfer restriction in a commercial lease, that authority remains subject to "general principles limiting freedom of contract." Thus, "a party to a commercial lease who is trapped in a bad bargain" may still have a way out under the doctrines of "*adhesion and unconscionability*." [*Ilkhchooyi v. Best* (1995) 37 CA4th 395, 409, 45 CR2d 766, 774 (emphasis added); see Civ.C. §§ 1995.210, 1995.230, 1995.240, 1995.250, Law Rev. Comm'n Comments]

(a) [7:73.6] **Court power to deny enforcement of unconscionable provisions:** If a court finds, as a matter of law, a lease or any provision therein to have been *unconscionable at the time it was made*, it may refuse to enforce the lease or may enforce only part of the lease without the unconscionable provision, or may so limit application of any unconscionable provision as to avoid an unconscionable result. [Civ.C. § 1670.5; see also *AT&T Mobility LLC v. Concepcion* (2011) 563 US 333, 340, 131 S.Ct. 1740, 1745-1746 (recognizing courts may, under California law, refuse to enforce any contract "found to have been unconscionable at the time it was made," while simultaneously holding FAA preempts California's judicial rule regarding unconscionability of class arbitration waivers in consumer actions); *Ilkhchooyi v. Best* (1995) 37 CA4th 395, 409, 45 CR2d 766, 774—profit-shifting clause in commercial lease, giving landlord portion of sale price for tenant's business upon assignment of lease, held unconscionable and thus unenforceable (¶ 7:79.1); see also *Lennar Homes of Calif., Inc. v. Stephens* (2014) 232 CA4th 673, 688, 181 CR3d 638, 651 (unconscionable indemnity clause in residential buy-sell agreement held unenforceable; ¶ 7:73.10c)]

Some contracts, however, are so *permeated* with unconscionability, that they cannot be saved by severing "tainted" provisions, and the entire contract will be denied enforcement. [*Flores v. Transamerica HomeFirst, Inc.* (2001) 93 CA4th 846, 857, 113 CR2d 376, 385—arbitration clause in "reverse mortgage" loan agreement lacking "modicum of bilaterality" could not be saved by severing offending provisions]

(b) [7:73.7] **Establishing "unconscionability":** Because of the strong legislative policy favoring the enforceability of expressly agreed-upon transfer restrictions, a contracting party challenging those restrictions as "unconscionable" bears a "formidable burden." [*Ilkhchooyi v. Best* (1995) 37 CA4th 395, 409, 45 CR2d 766, 774; see also *Sanchez v. Valencia Holding Co., LLC* (2015) 61 C4th 899, 911, 190 CR3d 812, 821—because unconscionability is contract defense, party asserting it bears burden of proof]

"Unconscionability" generally is recognized as including an *absence of meaningful choice* on the part of one of the parties, together with contract terms that are *unreasonably favorable* to the other party. It has *procedural and substantive* elements, *both* of which must be present to invalidate a contractual provision as unconscionable. [*Sanchez v. Valencia Holding Co., LLC*, supra, 61 C4th at 910, 190 CR3d at 820; see also *Pardee Const. Co. v. Sup.Ct. (Rodriguez)* (2002) 100 CA4th 1081, 1088, 123 CR2d 288, 293]

1) [7:73.8] **Procedural element—oppression and surprise:** The procedural element of unconscionability includes (i) *oppression* arising from an inequality of bargaining power that results in no real negotiation and an absence of meaningful choice; and (ii) *surprise* involving the extent to which the supposedly agreed-upon terms are hidden in a "prolix printed form" drafted by the party seeking to enforce the disputed terms (i.e., essentially an adhesion contract). [*Ilkhchooyi v. Best* (1995) 37 CA4th 395, 409-410, 45 CR2d 766, 775]

a) Application

• [7:73.8a] Arbitration clauses in a loan agreement and deed of trust imposed on borrowers on a "take-it-or-leave-it" basis constituted adhesion contracts and thus were procedurally unconscionable. [*Flores v. Transamerica HomeFirst, Inc.* (2001) 93 CA4th 846, 853-854, 113 CR2d 376, 382]

• [7:73.8b] Arbitration clauses contained in 30-page booklets, printed in single-spaced 10-point type, buried in "voluminous" stacks of purchase and sale documents and presented to prospective buyers on a "take-it-or-leave-it" basis constituted adhesion contracts and thus were procedurally unconscionable. [*Bruni v. Didion* (2008) 160 CA4th 1272, 1293-1294, 73 CR3d 395, 413-414]

• [7:73.8c] Arbitration clauses that, on their face, applied to a limited category of actions and were included in approximately 800 pages of purchase and sale documents constituted adhesion contracts that were both oppressive and contained an element of surprise, rendering the arbitration provisions procedurally unconscionable. [*Thompson v. Toll Dublin, LLC* (2008) 165 CA4th 1360, 1372-1373, 81 CR3d 736, 746]

• [7:73.8d] Although the indemnity clause in a residential buy-sell agreement contained only a "low level" of procedural unconscionability (i.e., minimal evidence of inequality and surprise), it was enough to satisfy the requisite minimum and therefore justified consideration of the substantive element of unconscionability (¶ 7:73.10 ff.). [*Lennar Homes of Calif., Inc. v. Stephens* (2014) 232 CA4th 673, 688-690, 181 CR3d 638, 651-653]

b) [7:73.9] **Standard form contracts not per se procedurally unconscionable:** A seller's/landlord's standard form contract does not ipso facto prevent the buyer/tenant from negotiating for other terms. Thus, a form contract used by a party for many transactions is not necessarily a contract of adhesion and procedurally unconscionable. Rather, the particular circumstances under which the contract was executed must be considered. [*Crippen v. Central Valley RV Outlet, Inc.* (2004) 124 CA4th 1159, 1165-1167, 22 CR3d 189, 192-194]

2) [7:73.10] **Substantive element:** The substantive element of unconscionability includes *one-sided terms* lacking in justification that reallocate the risks of the bargain in an objectively unreasonable or unexpected manner. [*Ilkhchooyi v. Best* (1995) 37 CA4th 395, 410, 45 CR2d 766, 775]

• [7:73.10a] Arbitration provisions in a "reverse loan" agreement were deemed substantively unconscionable because they lacked a "modicum of bilaterality" in the arbitration remedy. [*Flores v. Transamerica HomeFirst, Inc.* (2001) 93 CA4th 846, 854, 113 CR2d 376, 382]

• [7:73.10b] Arbitration provisions contained in ancillary warranties (rather than in main residential purchase and sale agreements) were deemed substantively unconscionable. The provisions required purchasers to arbitrate, among other things, disputes concerning the sale of their homes and the arbitrability of the provisions themselves. This violated the purchasers' "reasonable expectations" because they reasonably would expect the arbitration provisions to apply only to disputes over the warranties. Moreover, the question of who should decide arbitrability is "well beyond a layperson's 'reasonable expectations.'" [See *Bruni v. Didion* (2008) 160 CA4th 1272, 1289-1295, 73 CR3d 395, 410-414—failure to pass "reasonable expectations" test generally treated as equivalent of "substantive unconscionability"]

• [7:73.10c] An indemnity clause in a residential buy-sell agreement that barred any possibility of meaningful recovery for claims falling within its scope, regardless of merit, was deemed *substantively unconscionable.* "[U]nder the bare language of the indemnity clause, there is not even the theoretical possibility a homeowner could be made whole for any damages arising from fraud committed by [Seller] with respect to disclosures. The clause is a paradigmatic example of a 'heads I win, tails you lose' proposition …" [*Lennar Homes of Calif., Inc. v. Stephens* (2014) 232 CA4th 673, 693, 181 CR3d 638, 655]

• [7:73.10d] *Compare:* Arbitration provisions in an automobile sales contract providing, among other things, that an award was final and binding unless the amount was $0 or in excess of $100,000, in which case it could be appealed to a three-arbitrator panel was not, "on its face," considered unreasonably one-sided and therefore substantively unconscionable. This was so even though the buyer was more likely to appeal $0 while the seller was more likely to appeal $100,000. "[N]othing in the record indicates that the latter provision is substantially more likely to be invoked than the former. We cannot say that the risks imposed on the parties are one-sided, much less unreasonably so." [See *Sanchez v. Valencia Holding Co., LLC* (2015) 61 C4th 899, 917, 924, 190 CR3d 812, 826, 832]

3) [7:73.11] **"Sliding scale" relationship between elements:** Although both procedural and substantive elements must be present to sustain a finding of unconscionability in the context of a commercial lease (¶ 7:73.7), there is a

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"sliding scale" relationship between the two concepts: The greater the degree of substantive unconscionability, the less the degree of procedural unconscionability that is required to annul the contract or clause. [See *Lennar Homes of Calif., Inc. v. Stephens* (2014) 232 CA4th 673, 687-690, 181 CR3d 638, 650-653 (residential buy-sell agreement)—indemnity clause containing only "low-level" of procedural unconscionability still met requisite minimum, thereby justifying "consideration of substantive portion of sliding scale" (¶ 7:73.8d)]

b. [7:74] **No provision concerning assignment or subletting; or provision allowing assignment and subletting without restriction:** Both of these situations are treated equally under the law. Unless the lease includes an express restriction on transfer, a tenant's rights under the lease include *unrestricted transfer* of the leasehold interest—i.e., at the tenant's sole discretion. [Civ.C. § 1995.210; see also *Kassan v. Stout* (1973) 9 C3d 39, 43, 106 CR 783, 785]

c. [7:75] **Absolute prohibition on assignment and subletting:** A lease may absolutely prohibit transfer of a tenant's leasehold interest—whether by way of assignment, subletting or otherwise. [Civ.C. § 1995.230]

Therefore, when a ground lease completely prohibits assignment or subletting, a "sale" of the tenant's interest is impossible for the duration of the term unless the landowner waives the restriction.

d. [7:76] **Assignment or sublease subject to express standards or conditions:** Since an absolute prohibition on assignment or sublease is valid (¶ 7:75), so too is any restriction that subjects the tenant's right to sublease or assign to express standards or conditions (typically, that the tenant obtain the landlord's prior consent, the giving or withholding of which may itself be subject to standards or conditions; *see ¶ 7:76.1 ff.*).

(1) [7:76.1] **"Reasonable" or "unreasonable" standards/conditions:** The lease may provide that transfer of the tenant's leasehold interest is subject to *any express* standard or condition, whether "reasonable" *or "unreasonable"* (subject, however, to "unconscionability" limitations, *¶ 7:73.5 ff.*). [See Civ.C. §§ 1995.210(a), 1995.240, and Law Revision Comm'n Comment thereto; *Carma Developers (California), Inc. v. Marathon Develop. California, Inc.* (1992) 2 C4th 342, 368, 6 CR2d 467, 481; but see also *Ilkhchooyi v. Best* (1995) 37 CA4th 395, 407, 45 CR2d 766, 773—profit-sharing condition on assignment, by which landlord would share in portion of proceeds from sale of tenant's business, held unconscionable and thus unenforceable (*¶ 7:79.1*)]

(a) [7:77] **Examples:** Some of the more common standards set forth in ground (and other) leases relate to:

- The quality of the assignee's business.
- The assignee's operating history and reputation.
- The assignee's financial strength (including a specified net worth).
- The assignee's intended use and the effect such use would have on the tenant mix.
- The assignee's contemplated alterations to improvements.

➪ [7:78] ***PRACTICE POINTER:*** Remember any leasehold mortgagee also will be keenly interested in assignability. Therefore, all ground lease assignment provisions should be viewed in the context of potential leasehold financing and lender requirements. (*See ¶ 7:406 ff.*)

(2) [7:79] **"Termination/recapture" conditions:** Civ.C. § 1995.240 expressly recognizes that the tenant's right to transfer may be made subject to a provision giving the landlord the right to "some or all of any consideration the tenant receives from a transferee in excess of the rent under the lease." [Civ.C. § 1995.240; *Carma Developers (California), Inc. v. Marathon Develop. California, Inc.* (1992) 2 C4th 342, 370, 6 CR2d 467, 482]

A provision giving the landlord the right to *terminate* the lease and enter into a new lease with the intended transferee (tenant's proposed assignee or sublessee), *reserving any profits* therefrom exclusively to the landlord, is within the contemplation of § 1995.240. Such "recapture/termination" conditions are enforceable transfer restrictions even though exercised solely for the landlord's financial gain. [*Carma Developers (California), Inc. v. Marathon Develop. California, Inc.*, supra, 2 C4th at 371, 6 CR2d at 483]

(Comment: Nonetheless, as a practical matter, such transfer conditions are less likely to be found in ground leases, where both parties contemplate a long-term uninterrupted tenancy.)

(a) [7:79.1] **Limitation on recapture conditions exceeding leasehold value:** Notwithstanding the "termination/recapture" conditions discussed at ¶ 7:79, statutory authority expressly recognizing the landlord's right to condition a

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transfer on being paid some or all of the "consideration" the tenant receives from the transferee in excess of the rent under the lease (Civ.C. § 1995.240) has been construed as limited to consideration *connected with the value of the lease*—i.e., a recapture of *appreciated rental value*. [*Ilkhchooyi v. Best* (1995) 37 CA4th 395, 407, 45 CR2d 766, 773]

A transfer restriction that goes further—essentially giving the landlord the right to share in consideration paid for the transferor tenant's *business* (i.e., proceeds from sale of business to proposed assignee)—may be deemed *unconscionable* (*¶ 7:73.5 ff.*) and thus *unenforceable* under ordinary contract principles. [*Ilkhchooyi v. Best*, supra, 37 CA4th at 410-411, 45 CR2d at 775-776—profit-sharing clause buried in "diminutive print" in lengthy form lease, purporting to give landlord right to 75% of consideration tenant received from sale of business to assignee (including share of payments for tenant's covenant not to compete with assignee), in addition to right to increase assignee's rent to market value, held to be "blatant overreaching"]

"Although the Legislature has insulated express transfer restrictions in commercial leases from attack as unreasonable restraints on alienation or as breaches of good faith, it did *not intend to allow commercial lessors to gouge their tenants* in the name of freedom of contract." [*Ilkhchooyi v. Best*, supra, 37 CA4th at 411, 45 CR2d at 775 (emphasis added)]

e. [7:80] **Assignment and subletting only with landlord consent:** A tenant's right to assign or sublet may be made subject to landowner consent. [Civ.C. § 1995.250] These "consent clause" restrictions themselves take various forms:

(1) [7:81] **No specified conditions—giving or withholding consent subject to implied "reasonableness" standard:** If a "consent clause" restriction contains *no express* standard for giving or withholding landowner consent to the contemplated leasehold transfer, the restriction is deemed to include an *implied standard* that the landowner's consent may *not "unreasonably" be withheld*. [Civ.C. § 1995.260 (applicable to transfer restrictions executed on or after 9/23/83; see Civ.C. § 1995.270(b)); *Kendall v. Ernest Pestana, Inc.* (1985) 40 C3d 488, 498, 220 CR 818, 824]

[7:82] *Reserved.*

(2) [7:83] **Express standard that consent may not be unreasonably withheld:** Perhaps the most common ground lease assignment provision is one which requires the landowner's prior consent, but expressly provides the consent cannot "unreasonably" be withheld.

(a) [7:84] **Fact question; burden of proof:** Whether the landowner "unreasonably" withheld consent in a given case is a *question of fact* on which the selling *tenant* has the burden of proof. [Civ.C. § 1995.260]

1) [7:84.1] **Not subject to anti-SLAPP statute:** Unreasonably refusing to consent to a lease assignment is not subject to anti-SLAPP protection. [*ValueRock TN Properties, LLC v. PK II Larwin Square SC LP* (2019) 36 CA5th 1037, 1048, 249 CR3d 179, 188]

(b) [7:85] **Statutory method of meeting burden of proof:** Section 1995.260 codifies one *nonexclusive* method of satisfying the burden of proof: Tenants may carry the burden of proving "unreasonable" withholding of consent by demonstrating that, in response to their *written request for a statement of reasons for withholding consent*, the landowner *failed*, within a "reasonable time," to state in writing a "reasonable objection" to the transfer. [Civ.C. § 1995.260]

(c) [7:86] **Otherwise, case-by-case approach—issue of *procedure* or *substance:*** Beyond the restrictions/conditions set forth at ¶ 7:80 ff., the statute offers no guidelines on the distinction between "reasonable" vs. "unreasonable" withholding of consent. Indeed the Legislature purposefully rejected any "absolute" approach; courts are supposed to apply an *objective standard as developed by case law* (¶ 7:87 ff.). [See Civ.C. § 1995.260, Law Rev. Comm'n Comment]

Whether a landowner unreasonably withheld consent in a particular case may be an issue of *procedure* or *substance*. Thus, tenants may carry their burden of proof by demonstrating *either:*

- The landowner acted unreasonably in its *procedure* for reviewing the proposed assignment or sublease—e.g., by delaying its response or failing to respond to the tenant's request for consent, or by requiring excessive investigation charges; *or*

- The landowner has no *justifiable substantive basis* for its objection to the assignment or sublease. [See Civ.C. § 1995.260, Law Rev. Comm'n Comment]

(d) [7:87] ***Kendall* "commercially reasonable" approach:** The Law Revision Commission indicates that, deferring to case law on the subject, the Legislature intended substantive "reasonableness" in this context to be judged under the

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Kendall "commercially reasonable" standard: i.e., landowners may reasonably withhold consent only if they have a "commercially reasonable objection" to the proposed transfer. [*Kendall v. Ernest Pestana, Inc.* (1985) 40 C3d 488, 496, 220 CR 818, 822; and see Civ.C. § 1995.260, Law Rev. Comm'n Comment]

[7:88] **Application:** Applying this approach, the following circumstances have been held "reasonable" grounds for withholding consent … on the theory they affect the landowner's interest in preserving the fee estate and in obtaining performance of the tenant's lease obligations (see generally, *Kendall v. Ernest Pestana, Inc.* (1985) 40 C3d 488, 501, 220 CR 818, 826; and *Cohen v. Ratinoff* (1983) 147 CA3d 321, 330, 195 CR 84, 89):

1) [7:89] **Proposed assignee's financial instability:** Landowners act reasonably in rejecting a proposed assignee whose ability to pay rent is suspect. [*Kendall v. Ernest Pestana, Inc.* (1985) 40 C3d 488, 501, 220 CR 818, 826; *Cohen v. Ratinoff* (1983) 147 CA3d 321, 330, 195 CR 84, 89]

2) [7:90] **Suitability of property for proposed use:** An objection to assignment is reasonable if the premises are not presently suitable for the proposed assignee's intended use. [*Kendall v. Ernest Pestana, Inc.*, supra; *Cohen v. Ratinoff*, supra]

3) [7:91] **Planned alterations:** Similarly, landowners act reasonably in withholding consent if the proposed assignee's contemplated use would require extensive alterations to the premises. [*Kendall v. Ernest Pestana, Inc.*, supra; *Cohen v. Ratinoff*, supra]

4) [7:92] **Illegal use:** Clearly, it is "commercially reasonable" for landowners to withhold approval of assignees proposing to use the property for an unlawful purpose. [*Kendall v. Ernest Pestana, Inc.*, supra; *Cohen v. Ratinoff*, supra]

5) [7:93] **Wholly different nature of occupancy:** Reasonableness may also turn on the nature of the proposed assignee's occupancy—e.g., office, clinic, factory, retail store, etc.: Landowners should not be required to accept an entirely *different type* of tenant. [*Kendall v. Ernest Pestana, Inc.*, supra; *Cohen v. Ratinoff*, supra—"undesired use" is basis for good faith reasonable objection]

6) [7:94] **Competitiveness of use:** Withholding consent to assignment of a shopping center lease is "commercially reasonable" when the proposed assignee's business would compete with another store in the center … even if the other store is owned by the landlord. [*Pay'N Pak Stores, Inc. v. Sup.Ct. (Miller)* (1989) 210 CA3d 1404, 1410-1411, 258 CR 816, 819-820—shopping center landlord "reasonably" refuses to approve sublease to potential competitor if such refusal reasonably necessary to protect landlord's ownership and operation of particular property]

7) [7:95] **Risk of receiving less rent (percentage rent leases):** It is "commercially reasonable" to refuse consent to a proposed assignment or sublease that would prevent the landowner from receiving *at least the same rental income* the tenant had been paying under the original lease. Here, the withholding of consent is validly based on the landowner's interest in preserving what was *originally bargained for;* it is *not* "commercially reasonable" to require the landowner to accept less. [*John Hogan Enterprises, Inc. v. Kellogg* (1986) 187 CA3d 589, 593, 231 CR 711, 713]

(However, the landowner cannot require the payment of an inordinate amount of money as a condition to granting its consent to an assignment. See *Schweiso v. Williams* (1984) 150 CA3d 883, 886, 198 CR 238, 240; see also *Ilkhchooyi v. Best* (1995) 37 CA4th 395, 407-411, 45 CR2d 766, 773-776, *discussed at ¶ 7:79 ff.*)

• [7:96] **Example:** Tenant operated a women's clothing store under a lease making rent payable according to a percentage of gross sales, with a $2,750 specified minimum. Her business generated sufficient gross sales to produce rental income consistently exceeding the minimum monthly rent (average $4,000/month). However, Tenant's proposed assignee, who intended to operate an antique store as a hobby, did not expect sufficient gross sales ever to generate more than the $2,750 minimum monthly rent.

"Unquestionably, Lessor would suffer substantial financial detriment upon the proposed assignment … To force Lessor to accept the minimum $2,750 … from an assignee who cannot generate more … is out of touch with commercial reality. Refusing consent to highway robbery cannot be deemed commercially unjustified." [*John Hogan Enterprises, Inc. v. Kellogg* (1986) 187 CA3d 589, 594, 231 CR 711, 713-714 (also suggesting it would have been "commercially reasonable" for Lessor to require a *new lease* with assignee or to require assignee or Tenant to make up the difference and pay the past average rent)]

(e) [7:97] **Withholding consent to exact higher rent?** *Kendall*, supra, holds that, *as a matter of law*, withholding consent *solely* for the purpose of exacting a *higher rent* than agreed to under the original lease is commercially *unreasonable*.

[*Kendall v. Ernest Pestana, Inc.* (1985) 40 C3d 488, 501, 220 CR 818, 826—assignee's proposed use was compatible with leased property (hangar space) and only obstacle was landlord's impermissible demand for higher rent]

The *Kendall* Court reasoned that the landlord's desire for a "better bargain" has nothing to do with the permissible purposes of the restraint on alienation (to protect landlord's interest in preserving premises and performance of lease covenants). A "consent clause" is intended to protect the landlord's *ownership and operation* of the property—*not* to further the landlord's general *economic* interests. [*Kendall v. Ernest Pestana, Inc.*, supra, 40 C3d at 501, 220 CR at 826]

1) [7:98] **Not necessarily under Civ.C. § 1995.260:** However, the *Kendall* "commercially unreasonable as a matter of law" conclusion did not survive Civ.C. § 1995.260. Again, the statute *rejects* an "absolute" approach to the question of commercial reasonableness, opting instead for a *case-by-case* analysis (*¶ 7:86*). [See Civ.C. § 1995.260, Law Rev. Comm'n Comment]

2) [7:99] **Compare—express provision for modification of rent upon transfer:** In any event, the *Kendall* result would be otherwise if the lease *expressly reserved* the landowner's right to change the rent (e.g., upward to current market value) upon the tenant's exercise of a right to assign or sublease. Subject to "unconscionability" limitations (*¶ 7:73.5 ff.*), a lease may make a tenant's transfer of interest subject to *any* express standard or condition (*¶ 7:76 ff.*). [*Carma Developers (California), Inc. v. Marathon Develop. California, Inc.* (1992) 2 C4th 342, 371, 6 CR2d 467, 483]

3) [7:100] **Compare—independent "recapture" clause:** Neither *Kendall* nor Civ.C. § 1995.260 (implied reasonableness consent clause condition, *¶ 7:81*) have any application to an *independent "recapture clause"* giving the landowner the right to terminate a lease upon an attempted assignment or sublease expressly for the purpose of realizing an appreciation in rental value. *See ¶ 7:79*.

4) [7:101] **Compare—express condition allocating "excess" transfer consideration to landowner:** Civ.C. § 1995.240 specifically permits landowners to subject a tenant's right to transfer to a *condition* entitling the landowner to "some or all of any consideration the tenant receives from a transferee in excess of the rent under the lease"—i.e., the lease may expressly obligate the tenant to remit to the landowner any specified portion of "appreciated rentals" or "bonus value" of the leasehold interest received as consideration for the assignment, sublease or other transfer. [See Civ.C. § 1995.240, and Law Rev. Comm'n Comment thereto; see also *Carma Developers (California), Inc. v. Marathon Develop. California, Inc.* (1992) 2 C4th 342, 371, 6 CR2d 467, 483; but see *Ilkhchooyi v. Best* (1995) 37 CA4th 395, 407, 45 CR2d 766, 773—§ 1995.240 recapture consideration does not include consideration unconnected with leasehold value (*¶ 7:79.1*)]

However, § 1995.240 is not intended to create any "presumption" that, *absent* such an express provision, a demand by the landowner for all or part of the transfer consideration as a condition for consenting to the transfer is either "reasonable" or "unreasonable." Whether such a demand would be "unreasonable" (under Civ.C. § 1995.250(a) (express reasonableness condition) or Civ.C. § 1995.260 (implied reasonableness condition)) "is a question governed by the case law on the subject." [See Civ.C. § 1995.240, Law Rev. Comm'n Comment]

(f) [7:102] **Compare—personal preferences:** Case law predating Civ.C. § 1995.010 et seq. holds it is *per se "unreasonable"* to withhold consent *solely* on the basis of personal taste, convenience, or sensibility … because these factors bear no relation to the landowner's interest in preserving ownership interests in the property or securing the benefit of the covenants in the original lease. [*Kendall v. Ernest Pestana, Inc.* (1985) 40 C3d 488, 501, 220 CR 818, 826]

But, as earlier noted, Civ.C. § 1995.260 rejects the *Kendall* "absolute" approach (*¶ 7:86*), leaving open the possibility the particular facts in a given case *might* warrant a contrary conclusion. [See Civ.C. § 1995.260, Law Rev. Comm'n Comment]

(3) [7:103] **Express standard that consent may be withheld for *any reason:*** Since (subject to "unconscionability" limitations, *¶ 7:73.5 ff.*) a restriction on transfer may be made subject to *any* standard or condition (Civ.C. §§ 1995.210(a), 1995.240, *¶ 7:76 ff.*), a lease may validly subject the tenant's right to assign or sublet to the landowner's prior consent *and* expressly provide such consent may be *withheld in the landowner's sole and absolute discretion*. Pursuant to such an express standard, the landowner need *not* have a justifiable basis for refusing its consent. [See Civ.C. § 1995.210, Law Rev. Comm'n Comment—"Neither the law governing unreasonable restraints on alienation … nor the law governing the implied covenant of good faith and fair dealing … prevents the enforcement of a restriction on transfer in accordance with the express terms of the restriction"]

[7:104 - 7:109] ***Reserved.***

4. Rights and Remedies Upon Breach of Contractual Transfer Restriction

a. General rules

(1) [7:110] **Remedies negotiable:** Remedies for the breach of an assignment/sublease restriction are subject to *express provisions in the lease* affecting the available remedies. Thus, the parties may *negotiate* the remedies to be applied in the event of breach of an assignment/sublease restriction and, in such event, the contract remedies control. [Civ.C. § 1995.300(a)]

(2) [7:111] **Waiver/estoppel defense:** Remedies for the violation of an assignment/sublease restriction are subject to "any applicable defense, whether legal or equitable"—including *waiver* and *estoppel*. [Civ.C. § 1995.300(b)]

However, the landlord's consent or waiver of restrictions as to a particular assignment or sublease does not waive lease restrictions as to *subsequent* assignments/subleases by a tenant, assignee or subtenant *unless* (a) the lease expressly provides the restriction is limited to the original tenant, or (b) the landlord expressly states in writing that the waiver applies to a subsequent assignment/sublease. [Civ.C. § 1995.340]

b. Landowner's recourse

(1) [7:112] **Contract damages and/or termination of lease:** An agreed-upon assignment/sublease restriction is a covenant, violation of which breaches the lease. Thus, if a tenant transfers its leasehold interest in violation of a transfer restriction, in addition to any other available remedies (e.g., injunctive or declaratory relief), the landowner may pursue ordinary contract remedies … including (but not limited to) *either or both:*

- A suit for *contract damages* caused by the wrongful assignment/sublease;

- *Termination of the lease*—i.e., the landlord may declare the lease *forfeited* by the breach and commence an unlawful detainer action. [Civ.C. § 1995.320; see also Civ.C. § 1946.2(b)(1)(G) (assigning or subletting property in violation of tenant's lease is grounds for "just cause" eviction) (1/1/2030 "sunset" date)]

(a) [7:112.1] **Limitation—COVID-19 rental debt and eviction moratorium:** As a result of the COVID-19 pandemic, California enacted the COVID-19 Tenant Relief Act (CCP § 1179.01 et seq. (10/1/25 "sunset" date)). The Act imposes a moratorium on residential evictions between March 1, 2020 and September 30, 2021 (i.e., the "covered time period"). [See CCP §§ 1179.02(a), 1179.03.5]

Cross-refer: For a more detailed discussion of the COVID-19 Tenant Relief Act, see Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Chs. 7 & 8.

1) [7:112.2] **Demanding payment of COVID-19 rental debt:** To demand payment of rent due between March 1, 2020, and September 30, 2021, residential landlords must serve tenants with statutorily-prescribed notice informing the tenants of their right to avoid eviction based on decreased income or increased expenses caused by COVID-19. [See CCP § 1179.02(c) (defining "COVID-19 rental debt") & § 1179.03(b), (c)]

2) [7:112.3] **Eviction protection based on COVID-19-related financial distress:** To avoid eviction, tenants must deliver a signed declaration of COVID-19-related financial distress to their landlord within 15 days of their landlord serving the required notice, excluding weekends and judicial holidays. In addition, tenants must pay at least 25 percent of the rent due during the "transition time period" between September 1, 2020, and September 30, 2021. However, tenants do not immediately have to pay any portion of the rent due during the "protected time period" between March 1, 2020, and August 30, 2020, to avoid eviction. Notwithstanding the foregoing, tenants will continue to owe the full amount of outstanding rent to their landlords. [See CCP § 1179.02(b), (d), (f), (i) (defining "COVID-19-related financial distress," "Declaration of COVID-19-related financial distress," "Protected time period" and "Transition time period") and CCP § 1179.03(g)]

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Compare: A court may not find a tenant guilty of unlawful detainer *before* October 1, 2021, unless it finds (i) the tenant was guilty of unlawful detainer before March 1, 2020, (ii) the tenant has failed to deliver a declaration of COVID-19-related financial distress as statutorily required (above), *or* (iii) the tenancy was terminated due to:

• an at-fault just cause (Civ.C. § 1946.2(b)(1) (1/1/2030 ("sunset" date));

• a no-fault just cause (Civ.C. § 1946.2(b)(2) (1/1/2030 "sunset" date)), *other than* an intent to demolish or substantially remodel the residential real property (Civ.C. § 1946.2(b)(2)(D) (1/1/2030 "sunset" date)), *unless* the demolition or remodeling is necessary to comply with Civ.C. § 1941.1, Health & Saf.C. §§ 17920.3 or 17920.10, or any other applicable laws governing the habitability of residential rental units; *or*

• the property owner entered into a sales contract with a buyer who intends to occupy the property and all Civ.C. § 1946.2(e)(8) (1/1/2030 "sunset" date) requirements have been satisfied. [CCP § 1179.03.5(a)]

(b) [7:113] **Remedies not mutually exclusive:** Section 1995.320 makes clear the landowner may pursue *both* a breach of contract (damages) action *and* a termination of the lease (unlawful detainer). This is a specific application of Civ.C. § 1951.2 (damages in connection with lease termination; see Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 7). [See Civ.C. § 1995.320, Law Rev. Comm'n Comment]

Alternatively, pursuant to § 1995.320, the landowner may waive the termination remedy and still recover contract damages for the wrongful assignment/sublease. (This is consistent with Civ.C. § 1951.4, pursuant to which the landowner may leave a breached lease in effect and recover damages for breach of covenant; see Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 7.) [See Civ.C. § 1995.320, Law Rev. Comm'n Comment]

(c) [7:114] **Waiver limitation:** An assignment, sublease or other transfer in violation of a transfer restriction is *not void;* it is simply *voidable* by the landowner, who must take affirmative action to declare a forfeiture of the lease (i.e., eviction action). [*People v. Klopstock* (1944) 24 C2d 897, 901, 151 P2d 641, 643]

If instead, the landowner accepts rent from an unauthorized assignee or subtenant, or otherwise expressly or by conduct manifests acquiescence in the breach, the transfer restriction is *unenforceable* as to the particular transfer —i.e., the landowner effectively *waives* the right to declare a forfeiture and/or pursue any other remedies for the breach. [*Karbelnig v. Brothwell* (1966) 244 CA2d 333, 341, 53 CR 335, 340; see also Civ.C. § 1995.320, Law Rev. Comm'n Comment]

(d) Application of remedies to unauthorized transferee

1) [7:115] **Joint and several damages liability:** An "assignee" who receives or makes a transfer in violation of a transfer restriction in a lease is *jointly and severally liable* with the tenant for contract damages under Civ.C. § 1995.320 (¶ 7:112 ff.). For this purpose, the provisions of Civ.C. § 1951.2 applicable to lessees (damages in connection with lease termination) apply to assignees as well. [Civ.C. § 1995.330(a)]

• [7:116] **Comment:** Civ.C. § 1995.330(a) uses the term "assignee" exclusively; it is unclear whether this was meant to exclude subtenants and other unauthorized transferees who are not "assignees" from joint and several contract damages liability to the landowner.

2) [7:117] **Termination of transfer without terminating lease:** Additionally, or alternatively, the landowner has the option of terminating the *transfer* (assignment or sublease) without terminating the lease. In such event, the unauthorized assignee or subtenant in possession is guilty of unlawful detainer and the landowner may obtain possession from the assignee or subtenant pursuant to CCP § 1159 et seq. (unlawful detainer procedures) without terminating the tenant's right to possession. [Civ.C. § 1995.330(b)]

(2) [7:118] **Declaratory relief:** Of course, a landowner can neither pursue a breach of contract remedy nor declare a forfeiture for an unauthorized assignment or sublease which is only *contemplated* (has not yet occurred). However, if the dispute concerns whether the contemplated transfer might violate a restriction in the lease, or whether the landlord is acting "reasonably" in withholding consent to the tenant's anticipated assignment/sublease under a "consent clause" provision subject to an express or implied "reasonableness" standard, the landowner may bring suit for *declaratory relief* … seeking a judicial determination of the issue. [CCP § 1060; see also Civ.C. § 1995.320, Law Rev. Comm'n Comment —other remedies available to landowner include declaratory relief]

(3) [7:119] **Injunctive relief:** Alternatively, a landowner facing a *proposed* assignment or sublease in violation of the master lease may seek a preliminary and permanent injunction preventing the anticipated assignment/sublease from proceeding. [CCP § 525; see Civ.C. § 1995.320, Law Rev. Comm'n Comment—other remedies available to landowner include injunctive relief]

A prohibitory injunction would bar the proposed assignee/sublessee from entering into possession and would be enforceable through contempt.

• [7:120] **Comment:** Except in extraordinary circumstances, an injunction is difficult to obtain because there must be a showing of "irreparable harm" and that the "legal remedy" would be inadequate (see CCP § 526). In addition, the remedy may be *expensive* … because an *undertaking* will ordinarily be required (CCP § 529). (See generally, Weil & Brown et al., *Cal. Prac. Guide: Civ. Pro. Before Trial* (TRG), Ch. 9 Part II.)

Accordingly, landowners faced with an *anticipated* prohibited assignment or sublease may be better off suing for declaratory relief (¶ 7:118); or deferring action until after the breach and then initiating appropriate eviction proceedings (¶ *7:112, 7:117*).

c. Tenant's recourse

(1) [7:121] **Declaratory relief:** A tenant contemplating an assignment or sublease under a "consent clause" lease subject to an express or implied "reasonableness" condition, and who is met with the landowner's objection, may bring an action for declaratory relief seeking a judicial determination that the landowner's withholding of consent is "unreasonable" and that the tenant is entitled to the landowner's approval.

(However, the *tenant* bears the burden of proving "unreasonable" withholding of consent. See Civ.C. § 1995.260; ¶ *7:84*.)

(2) [7:122] **Injunctive relief:** Alternatively, it may be possible to obtain a mandatory injunction ordering the landowner to approve the tenant's proposed assignment or sublease under a "consent clause" lease. [CCP § 525 et seq.]

• [7:123] **Comment:** As a practical matter, given the statutory prerequisites ("irreparable harm," and "inadequate legal remedy," CCP § 526), a mandatory injunction is unlikely to issue except in very extreme cases; declaratory relief and damages will ordinarily be more realistic remedies.

(3) [7:124] **Contract damages and/or termination of lease:** When a tenant's right to transfer is conditioned on landowner consent, the giving or withholding of which is subject to an express or implied "reasonableness" condition, the landowner *breaches* the lease by "unreasonably" withholding consent. In such event, in addition to any other remedies provided by law for breach of a lease, the tenant is entitled to pursue all available remedies for breach of contract—including (but not limited to) *either or both:*

• A suit for *contract damages* caused by the landlord's breach (see *Cohen v. Ratinoff* (1983) 147 CA3d 321, 195 CR 84);

• *Termination of the lease*—i.e., the tenant may give notice of termination and raise the landowner's breach in defense to a Civ.C. § 1951.2 or § 1951.4 damages action. [Civ.C. § 1995.310(a) & (b)]

(a) [7:125] **Remedies not mutually exclusive:** Just as the landowner may pursue both a damages remedy and an unlawful detainer, or one and not the other, when the tenant breaches an assignment/sublease restriction (¶ *7:112 ff.*), tenants aggrieved by an unreasonable withholding of consent in violation of the lease may both terminate the lease and seek contract damages or, instead, waive the termination remedy and still collect contract damages for the breach. [Civ.C. § 1995.310]

[7:126 - 7:129] ***Reserved.***

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[7:130] Almost all issues pertinent to the purchase and sale of a fee interest are also germane to the purchase and sale of a tenant's interest in a ground lease. Therefore, when representing the purchaser or seller of a tenant's interest in a ground lease, *Chapter 4* of this Practice Guide, regarding the purchase and sale of real property generally (including the purchase and sale agreement and the use and mechanics of an escrow), should be consulted.

In addition, however, the purchase of a leasehold interest also requires a thorough analysis and review of important leasing issues. Obviously, the starting point is a review of the ground lease itself.

1. [7:131] **Reviewing Ground Lease and Related Documents:** The importance of reviewing the selling tenant's pertinent files cannot be overemphasized. In particular, counsel's attention should focus on the ground lease (including any amendments and prior assignments), as well as correspondence between the landowner and selling tenant. (The review of *subleases* and related matters is discussed at *¶ 7:246 ff.*)

The following issues are of paramount importance:

a. Term

(1) [7:132] **General considerations:** The balance of the term (including any options to extend the lease term) should be lengthy enough to satisfy the purchasing tenant's needs. If the purchaser intends to finance its leasehold, the balance of the term must be sufficiently long to satisfy a lender as well (*see ¶ 7:399 ff.*).

(2) [7:133] **Options to extend term:** Ground leases often contain options to extend or renew the term. (Technically, an “extension” is a continuation of the term for a fixed period of time; whereas a “renewal” extends the lease term by an amount of time equal to the original term. While courts have distinguished an “extension” from a “renewal” (*Howell v. City of Hamburg Co.* (1913) 165 C 172, 177-178, 131 P 130, 132-133), the distinction usually has no practical importance.)

Commercial tenants generally have strong economic motives for renewing a lease—notably, e.g., recovering a reasonable return on investments in trade fixtures, avoiding moving expenses, and maintaining the goodwill attached to the location. Thus, including an option to renew or extend in the ground lease may be an important requirement for a commercial tenant. [See *Robert T. Miner, M.D., Inc. v. Tustin Avenue Investors, LLC* (2004) 116 CA4th 264, 273, 10 CR3d 178, 183]

As with the duration of the term, the extensions should be long enough to justify the purchasing tenant's economic investment in the leasehold and to satisfy any prospective leasehold mortgagee.

➪ [7:134] ***PRACTICE POINTER:*** When reviewing options to extend the term, remember that option provisions are generally *construed in favor of the tenant*. [*Mitchell v. Exhibition Foods, Inc.* (1986) 184 CA3d 1033, 1041-1043, 229 CR 535, 540-541]

(a) [7:135] **Assignable?** Also consider whether options to extend can be assigned to a purchasing tenant. Unless otherwise specifically provided in the lease, an option to extend is assignable to the leasehold transferee. [*Penilla v. Gerstenkorn* (1927) 86 CA 668, 261 P 488, 489]

However, a purchasing tenant will not be able to exercise an option to extend if the lease makes the option “personal” to the selling tenant. [Cf. Civ.C. § 1995.230, *¶ 7:75*—lease may absolutely prohibit transfer of a tenant's leasehold interest]

(b) [7:136] **Rent during option period:** Because the initial term of a ground lease is extensive, it is difficult for the parties to predict with certainty what a fair rent should be for an option period not set to commence for 20 years or more. More commonly, the lease incorporates a standard or formula for fixing the rent rather than a specified rent amount.

1) [7:137] **Agreement to agree unenforceable:** Courts will not write contracts for parties who have expressed no standards in their agreement for establishment of its terms. Therefore, an extension or renewal provision leaving the future rent to be fixed by agreement of the parties is *unenforceable unless* it contains an *ascertainable standard* for determining rent. [*ETCO Corp. v. Hauer* (1984) 161 CA3d 1154, 1161-1162, 208 CR 118, 123—commercial lease option unenforceable where rent left to parties' "mutual agreement"; *Ablett v. Clauson* (1954) 43 C2d 280, 285-286, 272 P2d 753, 756-757—option to renew for 5-year period "upon terms to be then agreed upon" too uncertain to be enforceable; see *Robert T. Miner, M.D., Inc. v. Tustin Avenue Investors, LLC* (2004) 116 CA4th 264, 274, 10 CR3d 178, 184 (discussing cases)]

2) [7:138] **Rental amount tied to specified formula or guideline:** On the other hand, failure to specify a sum certain in future rent is not fatal to an extension provision so long as the lease contains some formula or guideline by which the future rental amount can objectively be ascertained.

The methods for determining rent during the option term are virtually limitless. Common approaches include:

a) [7:139] **"Fair market value":** Rent due for the extension period may be tied to a percentage of the current "fair market value" of the leased premises. At least where the use being made of the property does not impact its fair market value, the rent is figured in accordance with the price the property will command in the market as of the renewal date—i.e., a rent based on the potential highest and best use of the property. [See, e.g., *Bullock's, Inc. v. Security-First Nat'l Bank of Los Angeles* (1958) 160 CA2d 277, 283, 325 P2d 185, 189—5% of "appraised value of the leased land"; *Eltinge & Graziadio Develop. Co. v. Childs* (1975) 49 CA3d 294, 298, 122 CR 369, 371—6% of "appraisal value"; *Humphries Investments, Inc. v. Walsh* (1988) 202 CA3d 766, 768, 248 CR 800, 801—7% of "current market value"]

b) [7:140] **"Fair market rental (or use) value":** On the other hand, where the rental amount for option periods is tied to the property's "fair market *rental* value" (or "fair market *use* value") and the tenant is only allowed to use the premises for a *limited purpose*, future rent must be based on the *particular use* for which the premises are leased—*not* the property's "highest and best use." [*Wu v. Interstate Consolidated Industries* (1991) 226 CA3d 1511, 1517, 277 CR 546, 550; see also *California Nat'l Bank v. Woodbridge Plaza, LLC* (2008) 164 CA4th 137, 143-146, 78 CR3d 561, 566-568—lease requiring tenant-bank's rent during option period to be calculated at "then prevailing rate," capped by amount paid by competitor bank (or its successor) leasing space in same shopping center, interpreted to mean comparable rent paid by nearby *financial institutions* for *bank space*, *not* rent paid by "just any other tenant" leasing for general office purposes competitor bank's former space]

"An interpretation that the rent during the option terms is to be based upon the highest and best use of the property despite the purposes for which lessor and lessee agreed it could be used, would be economically and commercially unreasonable and violate the intent of the parties (Civ.C. § 1643)." [*Wu v. Interstate Consolidated Industries*, supra, 226 CA3d at 1515, 277 CR at 548—movie theater lease setting rent during option periods at "fair market rental value" required rent to be determined on basis of use of premises as *movie theater*, rather than highest and best use for retail and specialty shops]

➪ [7:141] ***PRACTICE POINTER:*** Notwithstanding the limited use to which the premises are susceptible at the time the agreement is executed, a "highest and best use" approach may be utilized to measure future rent for option periods if the parties have expressly so agreed in the lease. *See further discussion at ¶ 7:165 ff.*

3) [7:142] **Arbitration/appraisal methods for determining rent:** It is also sufficient if the parties leave the exact amount of future rent open for later agreement but *also* provide that, if they fail to agree, they will submit the matter to *binding arbitration* (see *Ablett v. Clauson* (1954) 43 C2d 280, 285, 272 P2d 753, 756, and cases cited therein) or defer to the decision of *neutral appraisers* (see *Streicher v. Heimburge* (1928) 205 C 675, 676-677, 272 P 290, 291).

a) [7:143] **Three appraisers:** One popular method is to require the landowner and tenant each to select an appraiser who will attempt to reach an agreement. If those two appraisers cannot agree, they will jointly select another appraiser to independently determine the market rent.

Another method calls for the selection of three appraisers, each of whom renders an opinion on market rent. The two appraisals closest to each other are then averaged to arrive at the rent figure. [See also *Casden Park La Brea Retail, LLC v. Ross Dress for Less, Inc.* (2008) 162 CA4th 468, 471, 75 CR3d 763, 765—fair market rental value

determined by majority vote of arbitrators or, if two of them do not agree, by averaging two closest figures and then fixing rent at amount selected by party whose original proposed rent was closest to averaged figure]

b) [7:144] **"Baseball arbitration":** Under "baseball arbitration" (named after the method used to determine baseball players' salaries during arbitration), the tenant and landowner each select a rental figure and submit their respective figures to arbitration. The arbitrator must then decide which figure (tenant's or landowner's) is closer to the market value. The arbitrator cannot choose any other number or compromise the two figures. Theoretically, the risk of the arbitrator choosing the other party's rent figure should motivate each party to propose a conservative and reasonable rent figure.

(c) [7:145] **Right of first refusal to extend:** Like many other leases, ground leases sometimes grant the tenant a "right of first refusal" to extend the lease term. Such a provision essentially provides the tenant with the chance to match any offer from a third party at the end of the lease term. If the tenant matches the offer, the new lease will include all provisions of the third party offer (including any new options to extend). Conversely, if the tenant's election to renew differs in any material respect from the terms offered by the third party, the landlord generally can validly choose not to extend the tenant's term. [*Ellis v. Chevron, U.S.A., Inc.* (1988) 201 CA3d 132, 137, 246 CR 863, 865; *but see ¶ 7:148.1*]

1) [7:146] **Limitation—landowner bound by implied covenant of good faith and fair dealing:** If given unchecked discretion, landowners would be free to solicit unreasonably onerous third party offers, which they knew the existing tenant would be unable to match, for the sole purpose of inducing a rejection from the tenant and a termination of the tenancy. This would deprive the tenant of any *meaningful* opportunity to extend its lease and thus effectively render the right of first refusal to renew a benefit without any substance.

However, the *covenant of good faith and fair dealing*, implied in every contract (*¶ 4:275.5 ff.*), *limits* the landowner's discretionary power in soliciting and negotiating a third party deal. One of the components of this covenant in the context of commercial leases is a duty on the part of the landowner "to promote the *continued use and occupancy of the premises by an existing tenant*" … at least where doing so would not be economically detrimental to the landowner. While the landowner need not be an "altruistic agent" in protecting the existing tenant's interests, it must *keep those interests in mind;* and this is especially true if the landowner has reason to know of the tenant's desire to renew the tenancy. [*Mitchell v. Exhibition Foods, Inc.* (1986) 184 CA3d 1033, 1044, 229 CR 535, 542 (emphasis added)]

a) [7:147] **Application—unreasonable third party offer negotiated as pretext for eviction:** Thus, as a result of the implied covenant of good faith and fair dealing, the existing tenant is not obligated to match provisions in a third party offer that would "injure, frustrate or make impossible the tenant's continuing use of the property" where doing so holds *no economic advantage* for the landowner (e.g., tenant need not necessarily match an offer requiring a change of use or signage). [*Mitchell v. Exhibition Foods, Inc.* (1986) 184 CA3d 1033, 1045-1046, 229 CR 535, 543; and see *Ellis v. Chevron, U.S.A., Inc.* (1988) 201 CA3d 132, 142, 246 CR 863, 868—implied covenant does not *absolutely* require landlord to continue tenant's business after expiration of lease term, but *does* preclude landlord from selecting alternate use of property, not tied to any economic advantage, as pretext for ousting tenant upon expiration of term]

2) [7:148] **Equitable relief if third party offer solicited in "bad faith":** If a third party offer presents no economic advantage to the landowner (i.e., its enforcement would not preserve landowner's reasonable expectations), and is so unfair to the existing tenant that it can viewed only as a "bad faith" pretext for eviction, the tenant is not bound to match it on an "all or nothing basis." Invoking its equitable powers, the court can "piecemeal" the offer (excluding the "commercially unreasonable" components) so as to make it less burdensome for the tenant to match. [*Mitchell v. Exhibition Foods, Inc.* (1986) 184 CA3d 1033, 1045-1046, 229 CR 535, 543; but compare *Ellis v. Chevron, U.S.A., Inc.* (1988) 201 CA3d 132, 142, 246 CR 863, 868—court would not "red line" matching offer requirements where all terms of third party offer (including new use requirements) were clearly of economic advantage to landlord: landlord cannot be expected to continue expired lease to its economic disadvantage]

3) [7:148.1] **Exercise of right of first refusal by "mirror image" terms not required where "commercially unreasonable":** Without mentioning the implied covenant of good faith and fair dealing, one case concludes (in connection with a tenant's right of first refusal to purchase) that a tenant may properly exercise its right of first refusal

without a literal matching of terms offered by the third party where "mirror image" matching would be *commercially unreasonable* under the facts. [*Arden Group, Inc. v. Burk* (1996) 45 CA4th 1409, 1414-1415, 53 CR2d 492, 495]

"Because the party exercising a right of first refusal is stepping into a contract made by a third party, the court must *consider commercial realities* and allow modifications consistent with the intent of the parties whose contract created the right of first refusal." [*Arden Group, Inc. v. Burk*, supra, 45 CA4th at 1414-1415, 53 CR2d at 495 (emphasis added)—gasoline station tenant with right of first refusal to purchase held to have sufficiently "matched" third party offer even though tenant's terms eliminated gasoline tank removal condition (it would have been commercially unreasonable to hold tenant to that condition, and inconsistent with parties' intent in negotiating right of first refusal, since property had been operated as gas station for past 50 years)]

Cross-refer: This point is discussed in greater detail in connection with options to purchase and preemptive purchase rights; *see ¶ 8:212 ff.*

(d) [7:149] **Exercising options to extend—notice formalities:** Generally, to invoke an option to extend, the tenant must apprise the landowner in *unequivocal* terms of its *unqualified* intent to exercise the option "within the time, in the manner and on the terms stated in the lease." Since the option binds the landowner, while the tenant is free to accept or reject it, courts hold the tenant to *exact compliance* with option formalities specified in the lease—i.e., those terms are strictly construed *against the tenant*. [*Bekins Moving & Storage Co. v. Prudential Ins. Co. of America* (1985) 176 CA3d 245, 250, 221 CR 738, 740]

1) Application

a) [7:150] **Conduct not tantamount to "actual notice":** Thus, when the lease requires written notice to the landowner of an election to extend, notice cannot be inferred by the tenant's conduct. Even if the tenant has spent substantial sums on improvements before the option date (arguably indicative of an intent to renew), unless *actual notice* is given per the terms and in the manner specified in the lease, the landowner can refuse to renew when the lease expires. It makes no difference that the landowner knew the improvements were being made and failed to inquire about the tenant's intent. [*Bekins Moving & Storage Co. v. Prudential Ins. Co. of America* (1985) 176 CA3d 245, 251, 221 CR 738, 741; see also *Simons v. Young* (1979) 93 CA3d 170, 179, 155 CR 460, 465]

b) [7:151] **Compare—continued possession where actual notice not required:** The rule set forth at ¶ 7:149 ff. applies only where the lease expressly requires *actual notice* of intent to renew. If, on the other hand, actual notice is not a specified condition, the tenant's continued possession of the property upon termination of the original term, coupled with payment of appropriate rent, is itself evidence of intent to extend the term and thus to exercise the option. [*ADV Corp. v. Wikman* (1986) 178 CA3d 61, 65-66, 223 CR 262, 264-265]

c) [7:152] **Compare—mailed notice; landowner bears risk of transmittal loss:** When the lease requires *mailed* notice of the exercise of an option to extend, the tenant satisfies the burden by timely *deposit* of the notice with the U.S. Post Office in accordance with the lease provisions (typically, certified or registered mail, return receipt requested, postage prepaid). The *landowner* bears the risk the notice might get lost in transmission; thus, if a properly-mailed notice never reaches the landowner, the option nonetheless will be deemed properly exercised. [See *Jenkins v. Tuneup Masters* (1987) 190 CA3d 1, 8, 235 CR 214, 217-218]

➪ [7:153] ***PRACTICE POINTER:*** To avoid this result, landowners should insist on a lease provision calling for *actual delivery* of notice of the tenant's election to extend (i.e., by *personal delivery* of written notice to the landowner or landowner's agent).

2) [7:154] **Estoppel/waiver defense:** Conduct by the landowner upon which the tenant relies in failing to follow specified formalities for invoking an option to extend *may* excuse literal compliance. In effect, the landowner's conduct may be construed to *waive* the option conditions or *estop* it from asserting the option formalities. [*Leonhardi-Smith, Inc. v. Cameron* (1980) 108 CA3d 42, 47-48, 166 CR 135, 137-138]

a) [7:155] **Example—accepting rent after option period:** Landowners are likely to be held to a waiver or estoppel where they *accept rent* from tenants after the option period with knowledge the tenants, through their conduct, intend to renew.

For example, in *Leonhardi-Smith*, supra, the lease required written notice of intent to renew more than 90 days before expiration of the term. The tenants gave *oral* notice before the 90 days and followed up with written

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notice within the 90-day period. The landowner had accepted rent in the meantime and knew the tenants were making substantial improvements to the premises under the assumption the lease was extended. The lease was held properly renewed (landowner deemed to have *waived* the 90-day written notice condition). [*Leonhardi-Smith, Inc. v. Cameron* (1980) 108 CA3d 42, 48, 166 CR 135, 138]

[7:155.1 - 7:155.4] ***Reserved.***

(e) [7:155.5] **Effect of conflicting lease cancellation provision:** Where the lease contains both an option to extend the term and a provision allowing either party to *cancel* the lease upon occurrence of a specified contingency (such as destruction of the premises by fire or other disaster) within a certain period before expiration of the lease, the *cancellation provision prevails* over the tenant's option to renew. The tenant's exercise of the option cannot cut off the landlord's contractual right to cancel. [*11382 Beach Partnership v. Libaw* (1999) 70 CA4th 212, 216-218, 82 CR2d 533, 535-536]

(f) [7:156] **"Dual" option to extend provisions (tenant/sublessor-sublessee):** Where a tenant/sublessor with an option to extend gives an option to extend to its *sublessee*, the sublessor *impliedly promises* to exercise its option under the master lease so as not to injure the sublessee's rights (this is incident to the covenant of good faith and fair dealing implied in every contract, *¶ 4:275.5*). If the sublessor fails to exercise its option, thus preventing the sublessee from extending the term of its *sublease*, the sublessee has a damages remedy for injury caused by the breach. [See *Gilman v. Nemetz* (1962) 203 CA2d 81, 90, 21 CR 317, 323; *Northridge Hosp. Foundation v. Pic 'N' Save No. 9, Inc.* (1986) 187 CA3d 1088, 1094-1095, 232 CR 329, 332—sublessor could not abridge subtenant's right to renew by agreeing with landlord to forfeit master lease]

➪ [7:157] ***PRACTICE POINTER:*** Verification of the term, options to extend, and various other provisions of the lease can—and should—be confirmed through a landowner estoppel certificate. *See ¶ 7:292 ff.; Form 7:B*.

[7:158 - 7:159] ***Reserved.***

b. [7:160] **Rent and rent escalations:** Ground leases typically call for a "base" rent—i.e., a sum certain to be paid on a periodic (usually monthly) basis. Quite likely, the lease also includes provisions to increase (or adjust) the rent over time. There are a myriad of possible rent increase or rent adjustment formulas; but the following are the most common approaches:

(1) [7:161] **Consumer price index (CPI) increases:** A CPI approach increases rent periodically throughout the term by a percentage that parallels the increase in a particular consumer price index. (There can also be various minimums or maximums on the amount of the rent adjustment.) Although a variety of indexes can be used, the most common ones are the United States Department of Labor, Bureau of Labor Statistics, for either (a) the Consumer Price Index for All Urban Consumers; or (b) the Consumer Price Index for Urban Wage Earners and Clerical Workers.

However, even when one of these common indexes is selected, consideration should be given to the particular geographic location in which the property is located. (Each index is available for various regions throughout the country.) For example, it would be inappropriate to use a Northern California index when the subject property is located in Southern California.

(2) [7:162] **Percentage of sales:** Ground leases for retail premises frequently require the tenant to pay rent based on a percentage of sales generated from the property. (Although percentage rent is often said to be based upon the amount of "gross sales," there are usually a variety of exclusions from the definition of that term.)

There are a number of ways to calculate percentage rent. Some of the typical formulas are:

- A straight percentage of sales.
- A percentage of sales or the base (fixed) rent, whichever is greater. [See *College Block v. Atlantic Richfield Co.* (1988) 206 CA3d 1376, 1378, 254 CR 179, 181 & fn. 2—service station lease called for rent based on percentage of price paid for gasoline delivered, but in no event less than fixed minimum]
- A percentage of sales above a fixed, agreed-upon figure (e.g., 5% of gross sales which exceed one million dollars in any given year). If sales are below the agreed-upon figure, the rent is a fixed, base rent.

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• Base rent *plus* a percentage of sales. [See *Lippman v. Sears, Roebuck & Co.* (1955) 44 C2d 136, 139, 280 P2d 775, 777—lease called for $285/month base rent plus percentage of lessee's annual sales]

➪ [7:163] ***PRACTICE POINTERS:*** The assignment of a lease which has a percentage rent component presents some unique issues. For example:

• Under a "consent clause" lease (wherein tenant's right to assign is subject to landowner's prior consent), the proposed assignee's sales volume becomes crucial. If the proposed assignee cannot generate the same level of sales as the assignor tenant, the landowner acts "reasonably" in withholding consent to the assignment. [*John Hogan Enterprises, Inc. v. Kellogg* (1986) 187 CA3d 589, 593, 231 CR 711, 713; *see* ¶ *7:95 ff.*]

• A commonly-used provision designed to protect the landowner from an assignee's decreasing sales calls for any assignee to pay percentage rent (regardless of its actual sales) in an amount equal to the average percentage rent paid by the assignor over a 24-month period. If not carefully drafted, such a clause could *backfire* on the landowner. In one case, the court narrowly construed the provision, holding that, throughout the term, the assignee only had to pay the assignor's average monthly percentage rent (not a percentage of its actual sales) … even though the assignee's actual sales *exceeded* those of the assignor and would have yielded a higher percentage rent for the landowner. [*Waterbury v. T.G. & Y. Stores Co.* (9th Cir. 1987) 820 F2d 1479, 1481-1482]

(3) [7:164] **Percentage of total sublease rent:** Ground lease rent is sometimes calculated (in whole or in part) on the basis of total subtenant rents payable to the ground lease tenant. This arrangement is more typical where the tenant is a developer and the landowner and tenant contemplate the creation of subleases which will ultimately provide the business activity to support ground lease rent payments. In effect, the landowner shares in sublease rent increases, while the tenant/developer is under no independent burden to pay rent increases.

(4) [7:165] **Percentage of "fair market value":** A "fair market value" rent provision ties rent increases to appreciation in the fair market value of the property over the lease term.

(a) [7:166] **"Highest and best use" or current rental use valuation?** "Fair market value" rent increase provisions can be particularly problematic and impractical. Unless carefully drafted, such a clause is likely to generate dispute over the threshold issue of "fair market value."

Notably, does the term contemplate value based on the tenant's existing use or, instead, the "highest and best use" to which the property may be suited?

• [7:166.1] At least where the lease does *not* specify *current use (or "rental")*, market value in this context apparently must be determined by the property's "highest and best use" as if it were vacant and regardless of the fact the parties clearly contemplated the property would only be used for a particular purpose. [See, e.g., *Eltinge & Graziadio Develop. Co. v. Childs* (1975) 49 CA3d 294, 298, 122 CR 369, 371—parties contemplated use for shopping center] Therefore, if, for example, the highest and best use of the property is as an office building, the value will be established based on that use, not the actual use contemplated by the lease.

• [7:166.2] Another case qualifies the "highest and best use" approach when zoning and other governmental restraints are imposed on the property: While the appraiser may determine value based on the prospect that use can be changed, a particular use restricted by governmental regulations cannot be considered in assessing "highest and best use." [*Humphries Investments, Inc. v. Walsh* (1988) 202 CA3d 766, 773, 248 CR 800, 805] Nonetheless, that is little solace to a tenant when there are no governmental restraints to prevent an unanticipated "highest and best use" rent escalation.

• [7:166.3] At least in the context of rental rates for an *option period*, yet another case holds the "highest and best use" approach may *not* be used where the lease ties the rent determination to "fair market *rental* (or *use*) value" and also *limits* the tenant's use to a *specified* purpose. [See *Wu v. Interstate Consolidated Industries* (1991) 226 CA3d 1511, 1517, 277 CR 546, 550; ¶ *7:140*]

➪ [7:167] ***PRACTICE POINTER:*** Courts are unlikely to "rewrite" a lease to adopt a "highest and best use" approach where that is clearly *not* what the parties intended. Consequently, to avoid later dispute and wholly unanticipated rent adjustments under a lease calling for "fair market value" increases, it behooves the parties to *spell out in the lease* exactly

how "fair market value" will be determined. For example, if the tenant's current use, rather than the "highest and best use," is to be the yardstick, the lease should explicitly so state.

(5) [7:168] **Pass-through to subtenants:** Subleases sometimes include a provision allowing the ground lease tenant to pass along rent increases to the subtenants (usually pro rata among the subtenants). Therefore, a careful review of the various rent provisions in the subleases is important in assessing the net effect of rent increases under the ground lease. (*See ¶ 7:246 ff.; and see ¶ 4:410 ff.* regarding review of leases generally.)

(6) [7:169] **Certainty as to amount of rent escalations:** Certainty in the amount of (or method of determining) rent escalations should be a particular focal point for purchasing tenant's counsel. A prospective buyer will, of course, want to know what its future maximum rent exposure could be. In addition, any prospective leasehold mortgagee will require that rent increases be fixed, or at least tied to some objectively ascertainable standard (*see ¶ 7:401 ff.*).

c. [7:170] **Use provisions:** Though significant in any lease, use provisions and restrictions take on a heightened level of importance in a ground lease where, because of the extensive duration, a change in use is almost inevitable as years go by. Therefore, purchasing tenants will naturally be looking for broadly-worded use provisions, with optimum rights to initiate a change in use.

(1) [7:171] **Validity and enforceability of use restrictions, generally:** Generally, rental property may be used for any lawful purpose consistent with its "ordinary use," *unless* the lease confines use to a particular purpose. [*Davidson v. Goldstein* (1943) 58 CA2d Supp. 909, 136 P2d 665, 666; see also *Eltinge & Graziadio Develop. Co. v. Childs* (1975) 49 CA3d 294, 297, 122 CR 369, 370]

Most often, complex use restrictions are negotiated between parties to a commercial lease. As discussed at ¶ 7:172 ff., commercial lease use restrictions are governed by a statutory scheme (Civ.C. § 1997.010 et seq.) that is patterned after the Code sections regulating commercial rental property assignments and subleases (*¶ 7:69 ff.*).

These statutes apply to use restrictions in both a lease between landowner and tenant *and a sublease* between tenant and sublessee. They also apply to use restrictions contained in a modification or other agreement affecting a lease or sublease. Further, *assignees* are bound by these statutes to the same extent as are tenants and subtenants. [Civ.C. § 1997.020(a), (b) & (d)]

(a) [7:172] **Contemplated use "restrictions":** A "restriction on use" within the meaning of Civ.C. § 1997.010 et seq. is a lease provision restricting tenant use of commercial rental property by either:

- Limiting use to a specified purpose;
- Mandating use for a specified purpose;
- Prohibiting use for a specified purpose;
- Limiting or prohibiting a change in use;
- "Or otherwise" (i.e., any other provision regulating usage of the premises). [Civ.C. § 1997.020(c)]

(b) [7:173] **No implied use restrictions:** Unless the lease includes an express restriction on use, tenants have the right under the lease to engage in *any "reasonable" use* of the rented premises. [Civ.C. § 1997.210(b)]

(c) [7:174] **Express use restrictions valid and enforceable:** Subject to the limitations noted at ¶ 7:175 ff., a commercial property lease may include any restriction on the tenant's use of the property (whether "reasonable" or "unreasonable"). [Civ.C. § 1997.210(a); *and see ¶ 7:172* re breadth of use restrictions]

1) Limitations

a) [7:175] **Unlawful restrictions:** Civ.C. § 1997.010 et seq. does *not* authorize a use restriction "that is otherwise prohibited by law" (e.g., a restriction on use that would effectively work an *unlawful discrimination*). [Civ.C. § 1997.030]

b) [7:176] **Ambiguous provisions:** Any ambiguity in a use restriction "shall be construed in favor of *unrestricted use*." [Civ.C. § 1997.220 (emphasis added)]

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2) [7:177] **Impact on Civ.C. § 1951.4 remedies:** A use restriction does not affect the landowner's right to invoke the Civ.C. § 1951.4 remedy to continue an unexpired lease (recover rent as it becomes due) after the tenant's breach and abandonment of the premises. [Civ.C. § 1997.040(b)]

The use restriction is applied under § 1951.4 to limit the abandoning tenant's right to sublet or assign *except* to the extent the tenant proves enforcement of the restriction would be "unreasonable" under all the circumstances (including, but not limited to, circumstances involving both the leased property and any building or complex in which it is located). [Civ.C. § 1997.040(b); and see comprehensive treatment of Civ.C. § 1951.4 remedy in Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 7]

3) [7:178] **Impact on Civ.C. § 1951.2 remedy:** A landowner's right under Civ.C. § 1951.2 to terminate a lease upon tenant breach and recover (in addition to other authorized damages) posttermination accruing rental losses is subject to a duty to mitigate damages by making reasonable efforts to relet the premises for the balance of the now-terminated tenant's unexpired term. [See Civ.C. § 1951.2; and detailed treatment in Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 7]

For this purpose, the reasonably avoidable amount of rental loss is computed by taking into account any reasonable use of the leased property. However, if the lease contains a use restriction enforceable under Civ.C. § 1997.010 et seq., the computation must take into account the *restricted use* except to the extent the tenant proves enforcement of the restriction would be "unreasonable" under all the circumstances (including, but not limited to, circumstances involving the leased property and any building or complex in which it is located). [Civ.C. § 1997.040(a)]

(2) [7:179] **Changes in use:** Civ.C. § 1997.010 et seq. also governs *change in use* lease provisions.

Commercial property leases may either *limit* or *prohibit* a tenant's change in use (Civ.C. § 1997.020(c)) as follows:

(a) [7:180] **Absolute bar:** A use restriction may *absolutely prohibit* the tenant's (or subtenant's or assignee's) change in use. [Civ.C. § 1997.230]

• [7:181] **Comment:** Such a prohibition is common in large-scale commercial development leases (such as shopping centers) … where the landowner typically wants to maintain a particular "tenant mix," or ensure the maintenance of a particular business to preserve the value of a "percentage rent" lease, or ensure adherence to "exclusive use" or noncompetition rights of other tenants.

(b) [7:182] **Conditional change in use, generally:** A restriction on tenant use may provide that a change in use is subject to *any express standard or condition*. [Civ.C. § 1997.240]

1) [7:183] **Whether "reasonable" or "unreasonable":** The "reasonableness" of an express standard or condition on change in use has no impact on enforceability. The parties are free to agree to *any* conditional change in use—whether reasonable *or unreasonable;* courts will enforce the restriction according to its terms so as to give effect to the parties' expectations in negotiating the lease. [Civ.C. § 1997.240—"*any* express standard or condition"]

• [7:184] **Comment:** Civ.C. § 1997.240 parallels Civ.C. § 1995.240 regarding assignment/sublease restrictions. As with express standards or conditions on transferability of a leasehold interest (¶ *7:76*), *no* "reasonableness" limitation will be implied in connection with a standard or condition on a change in use.

(c) [7:185] **"Consent clause" change in use:** The tenant's right to change its use of the leased property may be made subject to the landowner's *prior consent*. [Civ.C. §§ 1997.240 (subject to "any" express standard or condition), 1997.250]

1) [7:186] **Express standard or conditions on consent:** The lease may provide for *express* standards or conditions for the giving or withholding of landowner consent, including (but not limited to):

• That the landowner's consent may not "unreasonably" be withheld;

• That the landowner's consent may be withheld subject to express standards or conditions. [Civ.C. § 1997.250(a) & (b)]

2) [7:187] **Implied "reasonableness" consent clause condition where no express standards:** When a "consent clause" use restriction provides *no express* standard for giving or withholding landowner consent, it must be construed to include an *implied* standard that landowner consent to the change in use will *not "unreasonably" be withheld*. [Civ.C. § 1997.260 (applicable to use restrictions executed on or after 1/1/92; see Civ.C. § 1997.270(a) & (b))]

[7:188 - 7:189] ***Reserved.***

3) [7:190] **Determining whether withholding of consent "reasonable":** On the question whether the landowner acted "reasonably" in withholding consent to a change in use, the statutes adopt the same approach utilized in connection with assignments and subleases requiring landowner consent (*¶ 7:83 ff.*).

a) [7:190.1] **Case-by-case fact question:** Reasonable vs. unreasonable withholding of consent raises a question of fact, to be decided on a case-by-case basis. [Civ.C. § 1997.260 (applicable only to post-1991 use restrictions, per Civ.C. § 1997.270)]

Though there is yet no known case law applying § 1997.260, presumably courts will defer to the *Kendall* "commercially reasonable" approach governing the issue in connection with assignments and subleases—i.e., the landowner properly withholds consent if it has a commercially reasonable justification. [See *Kendall v. Ernest Pestana, Inc.* (1985) 40 C3d 488, 500, 220 CR 818, 826; *and ¶ 7:87 ff.*] Thus, e.g., if the ground lease calls for percentage rent based on tenant sales, the landowner's refusal to consent to a change in use generally will be considered "reasonable." [See *John Hogan Enterprises, Inc. v. Kellogg* (1986) 187 CA3d 589, 593, 231 CR 713; *and ¶ 7:95 ff.*]

b) [7:191] **Tenant's burden of proof:** The *tenant* bears the burden of proof on the issue of "unreasonable" withholding of consent. [Civ.C. § 1997.260 (applicable only to post-1991 use restrictions, per Civ.C. § 1997.270)]

1/ [7:192] **Statutory method of meeting burden:** A tenant claiming unreasonable withholding of consent may meet the burden of proof by showing that, in response to the tenant's written request for a statement of reasons for withholding consent, the landowner failed, within a "reasonable time," to state in writing a reasonable objection to the change in use. [Civ.C. § 1997.260 (applicable only to post-1991 use restrictions, per Civ.C. § 1997.270)]

(Note this provision simply *facilitates* meeting the tenant's burden of proof; it is *not* the sole method of carrying the burden on the unreasonable withholding of consent issue.)

(3) [7:193] **Continuous operations/use issues:** Counsel for the purchasing tenant should carefully scrutinize the ground lease for "continuous operations" or "continuous use" provisions. Landowners typically negotiate such provisions to optimize profitability and ensure maximum rents under a percentage rent lease. (For example, Landowner owns a shopping center and has ground leased a parcel to a major supermarket as "anchor tenant." A continuously-operated supermarket will attract patrons to the shopping center, thereby attracting other tenants, increasing business in the center, and benefiting the landowner's overall profitability.)

However, landowner and tenant are likely to have competing concerns on this issue. Most tenants do not want to be locked into a "continuous operations" covenant (indeed, they are usually reluctant to agree to operate for any specified minimum number of hours or days in a given period), because the obligation to maintain operations over an extended period of time could be economically disastrous. If a tenant's business is doing poorly, it may be less expensive simply to cease operations, close the building and continue paying rent, than to incur the cost of keeping the business running. (After closing down, the tenant would obviously seek to find a buyer for its leasehold interest.)

(a) [7:194] **Tenant's implied covenant to continue business operations (percentage rent leases):** If rent is based in whole or in part on a percentage of the tenant's sales or other revenue, purchasing tenants should also be cautioned that they may be obligated under an *implied covenant of continued business operations* throughout the term of the lease. "To make a commercial lease mutually profitable when the rent is a minimum plus a percentage, or is based totally on a percentage, a covenant to operate in good faith will be implied … *if the minimum rent is not substantial*." [*College Block v. Atlantic Richfield Co.* (1988) 206 CA3d 1376, 1380, 254 CR 179, 182 (emphasis added); see *Lippman v. Sears, Roebuck & Co.* (1955) 44 C2d 136, 141, 280 P2d 775, 781—covenant of continued operations implied in retail store lease because minimum base rent not "substantial or adequate"]

Whether the minimum base rent yields a "substantial" (or "adequate") amount for this purpose is a question of fact, determined on a case-by-case basis under the circumstances as they existed at the time the lease was entered into. Essentially, the court must decide if the specified base rent provides the landowner with what was *reasonably expected* when the lease was executed. [*College Block v. Atlantic Richfield Co.*, supra, 206 CA3d at 1383, 254 CR at 184]

d. [7:195] **Options and rights of first refusal to purchase:** Ground leases sometimes grant the tenant an option to purchase or right of first refusal to purchase the fee interest in the property. Clearly, the existence of such provisions can enhance the value of the leasehold.

(1) Legal effect; distinctions

(a) [7:196] **Option to purchase:** An "option to purchase" gives the tenant an *absolute right* to buy the leased premises for the duration of the option and on specified terms. But the option is not itself a binding contract of sale. It is the landowner's (optionor's) *irrevocable offer to sell* to the tenant (optionee), giving the tenant the *power* to create a binding contract of sale upon performance of a specified condition precedent (i.e., manifesting acceptance of the offer to sell). Upon acceptance of the offer to sell, the option "ripens" into a bilateral contract of sale and purchase; but, until then, the optionor/landowner and optionee/tenant stand solely in a landlord-tenant relationship. [*Palo Alto Town & Country Village, Inc. v. BBTC Co.* (1974) 11 C3d 494, 502, 113 CR 705, 709; see *Arden Group, Inc. v. Burk* (1996) 45 CA4th 1409, 1414, 53 CR2d 492, 495; *Marriage of Joaquin* (1987) 193 CA3d 1529, 1532-1533, 239 CR 175, 176-177]

(b) [7:197] **Right of first refusal:** On the other hand, a "right of first refusal to purchase" simply gives the tenant the *first opportunity*, or *privilege*, to buy over another third party. The right of first refusal generally provides that the tenant may purchase the property on the same terms and conditions as any bona fide third party offer received by the landowner which the landowner intends to accept. The landowner retains the sole right to determine whether to sell the property; hence, a right of first refusal cannot ripen into a right of purchase unless the landowner elects to sell. [See generally, *McCulloch v. M & C Beauty Colleges, Inc.* (1987) 194 CA3d 1338, 240 CR 189; and *Arden Group, Inc. v. Burk* (1996) 45 CA4th 1409, 1414, 53 CR2d 492, 495 (distinguishing options to purchase)]

(2) [7:198] **Assignable?** From a purchasing tenant's perspective, it is vital to ascertain whether any option or right of first refusal to purchase is *assignable*—i.e., whether it is "personal" to the selling tenant and thus not transferable.

If the lease is silent on this issue, the option or right of first refusal apparently *will be assignable.* [*Penilla v. Gertsenkorn* (1927) 88 CA 668, 261 P 488, 489; see *Maron v. Howard* (1968) 258 CA2d 473, 484, 66 CR 70, 77—absent express restrictions, assignment of lease "also includes an assignment of the right to purchase"] However, the better practice is to obtain the landowner's confirmation of assignability in its estoppel certificate (and/or in the landowner's written consent to the assignment). (*See* *Form 7:B*.)

It may also be prudent to require a representation from the selling tenant (assignor) to the effect that an assignment of the option and/or right of first refusal is included within the transfer of interest in the ground lease.

(3) [7:199] **Recordation:** Purchasing tenants should verify that any assignable option to purchase is properly *recorded* in the office of the county recorder where the property is located. Proper recordation imparts *constructive notice* "to the world," thus ensuring the value of the option will not be jeopardized by intervening bona fide purchasers (see Civ.C. § 1214).

(a) [7:200] **Possession alone not necessarily constructive notice of option to purchase:** A tenant's *possession* of leased premises imparts constructive notice of the tenant's option to purchase *contained in an unrecorded lease* … so that subsequent purchasers (or encumbrancers) charged with such notice take subject to the tenant's right to complete the purchase. [*Gates Rubber Co. v. Ulman* (1989) 214 CA3d 356, 368, 262 CR 630, 638; see, e.g., *Claremont Terrace Homeowners' Ass'n v. United States* (1983) 146 CA3d 398, 408-409, 194 CR 216, 222-223]

However, the result is otherwise if the option is contained in a *separate* document *not referenced* in a *recorded lease:* Where a tenant is in possession pursuant to and *consistent with* a *recorded lease* which does not refer to an additional unrecorded option to purchase, and there are no circumstances indicating the tenant has additional rights, third parties have *no duty* to inquire about any other rights the tenant may possess; and, therefore, a subsequent purchaser (not otherwise on notice) *takes free and clear* of the tenant's *unrecorded* option to purchase. [*Gates Rubber Co. v. Ulman*, supra, 214 CA3d at 365-366, 262 CR at 636, 636—tenant only recorded short-form lease, which did not mention separately-negotiated option to purchase]

Cross-refer: For a detailed treatment of options to purchase and rights of first refusal, *see Ch. 8*.

e. [7:201] **Scope of leased property and rights conveyed:** It is essential to ascertain precisely what *real property* is the subject of the leasehold. Additionally, counsel should determine what other property and rights are to be conveyed along with the leasehold. Whereas the conveyance of a fee interest transfers all the benefits and burdens of the real property (*see*

Ch. 4), a leasehold conveyance transfers something less; and certain rights, appurtenances, property and remedies may not be deemed to be conveyed unless expressly stated in the conveyancing instrument.

Generally, the following issues should be considered:

• [7:201.1] **Personal/intangible property:** What personal and/or intangible property should be included in the transfer of the ground leasehold? (For example, a bill of sale may be necessary.)

• [7:201.2] **Easements and other appurtenances:** Make certain that all appurtenances to the property—including easements, rights of way, etc.—were previously granted to the selling tenant and are specifically being transferred to the purchasing tenant.

• [7:201.3] **Assignment:** To ensure a transfer of the leasehold's full bundle of rights which puts the purchasing tenant in privity of estate with the landowner, the transaction should be structured as a true “assignment”; and the assignment documents should make clear the selling tenant is retaining no interest or rights in and to the leasehold; i.e., the conveyancing language should assign “all right, title and interest” of the assignor in the lease. *See Forms 7:C & 7:D*.

➪ [7:202] ***PRACTICE POINTER:*** When representing a purchasing tenant, always remember there are two other parties with whom you must be concerned: the landowner *and* the selling tenant. Both own certain rights that can be (and may need to be) conveyed; and, thus, the purchaser may have to look to both for the conveyance of various rights.

(1) [7:203] **Reciprocal easement agreements:** Because ground leases usually involve larger parcels of property and longer terms than other kinds of leases, reciprocal easement agreements are more likely to be germane in a ground lease situation than in an ordinary lease. A “reciprocal easement agreement” is a contractual arrangement created by property owners who own parcels that are adjacent (or within close proximity) to each other. Its general objective is essentially to combine two (or more) adjacent properties into one for the purpose of specified daily operations.

Reciprocal easement agreements are often used in connection with adjacent shopping centers, where the respective owners and tenants can benefit from combining the properties to create a larger retail environment while at the same time sharing costs (e.g., parking, traffic flow, security, etc.).

A reciprocal easement agreement can be broad or narrow in scope. For example, it may simply provide that adjacent owners, their respective tenants, guests and invitees, have reciprocal rights to use parking space on the property owned by the other; or, it could be broader in scope by also requiring joint construction and operation of substantial improvements, such as parking structures, loading areas, etc. Many reciprocal easements even provide that real estate taxes applicable to the combined properties are to be shared by all owners on a pro rata basis.

➪ [7:204] ***PRACTICE POINTERS:*** Typically, reciprocal easement agreements will be reflected in a preliminary title report. However, in reviewing the documents, bear in mind that reciprocal easement agreements are not necessarily titled as such; e.g., they may be identified as “joint ownership agreements,” “development agreements,” or “covenants, conditions and restrictions.”

Purchasing tenants should also consider that, where a reciprocal easement does not exist, it may have to be created to optimize productive and profitable use of the leasehold interest.

(2) [7:205] **Development permits:** Even if the improvements have been completed, major alterations or new improvements may have to be constructed in the future to suit the purchasing tenant's needs. Therefore, the purchasing tenant must have the right to acquire appropriate development permits. Because the tenant does not own the fee, this often requires a special grant or right under the ground lease. A tenant can, without the landowner's consent or involvement, seek variances or other government approvals if the lease provides for such. [*Shell Oil Co. v. City & County of San Francisco* (1983) 139 CA3d 917, 921, 189 CR 276, 278]

f. Security deposits

(1) [7:206] **Transfer to purchaser:** The purchasing tenant is typically assigned the benefit of the seller's security deposit, and the assignment documents should thus reflect a transfer of the deposit (*see ¶ 7:360 ff.*). (The selling tenant, of course, will receive a credit for such amount upon closing the leasehold sale.)

The precise amount of the deposit that remains should be confirmed in the landowner's estoppel certificate. (*See Form 7:B*.)

(2) [7:207] **Increase:** The purchasing tenant should also determine whether an increase in the security deposit will be required. Ground leases frequently call for a security deposit increase upon the happening of any number of events. For example:

(a) [7:208] **New construction:** An increase in the security deposit is often given in lieu of any construction performance or payment bond. Such an increase provides the landowner with additional monies to complete construction in the event the tenant defaults on its obligation to complete construction.

(b) [7:209] **Rent raise:** If the goal of a security deposit is to guarantee rent payment upon the tenant's default, an increase in the security deposit equal to incremental rent raises may be required.

(c) [7:210] **"Subordinating fee" to secure tenant's leasehold financing:** The tenant may request the landowner to secure the tenant's leasehold mortgage by pledging the fee interest in the property to the leasehold mortgagee. If that should occur, the landowner usually will reserve the right to require a substantial increase in the security deposit. The purpose is to give the landowner a source with which to cure any subsequent breach by the tenant under its loan and thus protect the fee from foreclosure. (*See ¶ 7:392 ff.*)

g. [7:211] **Construction of improvements:** Regardless of whether the selling tenant has completed construction of improvements, the purchasing tenant should always contemplate that additional improvements (or a major remodeling or rehabilitation) could become necessary or desirable in the future because of the long-term duration of the ground lease.

Naturally, the purchasing tenant will prefer that the ground lease grant the broadest possible latitude with respect to construction and alteration of improvements. Additionally, these important issues must be considered:

(1) [7:212] **Ownership of improvements:** Who *owns* the improvements will impact a host of other issues, such as rights to insurance proceeds upon damage or destruction (¶ 7:226 ff.), rights to condemnation awards (¶ 7:228 ff.), and tax benefits (¶ 7:51). Ownership of the improvements may be held by the tenant during the entire ground lease term (or any portion of it) (*see ¶ 7:19*).

(2) [7:213] **Seller's compliance with ground lease construction requirements:** If construction of the improvements has yet to be completed, the purchasing tenant should review the ground lease to ascertain the selling tenant's obligations on that issue. Provisions regarding construction obligations are unenforceable unless *definite and certain*. [See *Sanders Const. Co., Inc. v. San Joaquin First Fed'l Sav. & Loan Ass'n* (1982) 136 CA3d 387, 394-395, 186 CR 218, 222]

(a) [7:214] **Permit issues:** Other "due diligence" regarding construction should be a part of the purchasing tenant's review as well. For example, if the selling tenant has already obtained permits for the anticipated construction, the purchaser must verify that those permits can be assigned (*¶ 7:205*) and, if so, whether the permits remain valid even though construction has not yet commenced or been completed. Most permits have expiration dates and thus could lapse after the closing of the leasehold purchase. [See *Baird v. Wendt Enterprises, Inc.* (1967) 248 CA2d 52, 54-55, 56 CR 118, 119]

➪ [7:215] ***PRACTICE POINTER:*** The landowner should certify in its estoppel certificate whether the selling tenant has completed its construction obligations under the ground lease. *See ¶ 7:292 ff.; and Form 7:B*.

(3) [7:216] **Assignability before completion of construction:** Preliminarily, a determination must be made whether the lease prohibits assignment before the completion of required improvements. Such a provision is not uncommon, since many landowners are reluctant to have a stranger (whose identity, reliability and fiscal integrity the landlord would not have known when the ground lease was created) thrust upon them before the improvements are even built.

(4) [7:217] **Existing contracts:** The selling tenant may have entered into contracts with architects, contractors, engineers and others regarding the development of improvements. The purchasing tenant should determine to what extent it desires to acquire the selling tenant's rights, and assume the selling tenant's obligations, under those contracts.

Consider, e.g., who will own the plans, specifications and drawings for the improvements in the event a contract with the architect is not assumed. Additionally, there may be various construction warranties from contractors and suppliers of materials that should be assigned to the purchasing tenant.

(5) [7:218] **Mechanic's liens:** Every purchasing tenant should be concerned about mechanic's liens. This issue is particularly important if the improvements have not been completed because there are more likely to be mechanic's lien claimants prior to completion.

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If hired by the selling tenant, contractors can file a mechanic's lien against the selling tenant's leasehold interest. It follows that purchasing tenants should both (a) review the preliminary title report for the existence of mechanic's liens, and (b) obtain appropriate mechanic's lien coverage under a leasehold policy of title insurance (*cf.* ¶ *3:42, 3:258 ff.*).

(6) [7:219] **Obligation to remove:** The tenant may have the contractual obligation to remove improvements at the end of the lease term. Such removal may simply involve the demolition of structures; but it could also be far more cumbersome, costly and fraught with potential liability—e.g., digging up underground storage tanks at the end of the lease term (*see Ch. 5* regarding environmental liability considerations in the sale of real property).

h. [7:220] **Insurance provisions:** Either the purchasing tenant, or its insurance broker or attorney, should scrutinize provisions relating to insurance. Typically, the ground lease requires the tenant to carry casualty, liability and workers' compensation insurance (among other policies) for, and relating to, the entire property. The lease may also require the tenant to carry flood, earthquake and/or some form of rental income coverage (the latter to guarantee the landowner an uninterrupted flow of rental income throughout the term). Moreover, ground leases often permit the landowner to require the tenant to increase insurance limits at various times during the rental term.

➪ [7:221] ***PRACTICE POINTER:*** Two important points should be remembered regarding insurance:

• First, the *cost* of certain kinds of policies (such as earthquake coverage) could be so extraordinarily high as to make the ground lease economically unwise.

• Second, because of the cost and risks at stake, it is best to defer to appropriate *insurance brokers* (who have the requisite expertise in the matter) to advise your clients regarding insurance; and the purchasing tenant should be counseled accordingly.

i. [7:222] **Damage and destruction:** There is no “generic” damage and destruction provision suitable to every ground lease. However, because the landowner is desirous of an uninterrupted flow of rental income while at the same time having minimal involvement in the property, most damage and destruction provisions share certain typical characteristics: They usually require the tenant to repair any damage to (or destruction of) the improvements; and rarely give either party the right to terminate the lease upon damage or destruction. (Indeed, any present or future leasehold mortgagee will almost always require that the lease continue in effect notwithstanding damage or destruction.)

Typically, a ground lease, by its terms, will terminate because of damage or destruction to improvements only when substantial or total damage or destruction occurs close to the end of the term. Under such circumstances, the tenant certainly does not want to incur the cost of rebuilding. Likewise, the landowner probably does not want improvements resurrected near the end of the term, preferring instead to recoup the insurance proceeds. In these limited instances, the tenant is usually relieved of any obligation to rebuild, the insurance proceeds are paid over to the landowner (thereby providing a fund for the landowner to rebuild whatever it desires), and the lease terminates.

(1) [7:222.1] **Cancellation provision preempts option to extend/renew:** *See* ¶ *7:155.5*.

(2) [7:223] **Rent abatement upon damage or destruction:** Leases generally grant the tenant some form of rent abatement after damage or destruction, to account for the fact the tenant cannot use the premises until repair or restoration. However, *ground leases* rarely provide for such rent abatement; there are several reasons:

• [7:223.1] A ground lease tenant functionally has most all of the rights and obligations of a *fee* owner; and the landowner has correspondingly few obligations with respect to the property and improvements. Thus, the landowner is depending on an uninterrupted flow of “net” rental income from the property.

• [7:223.2] The *tenant* typically builds and insures the improvements; logically, therefore, the tenant should have the obligation to rebuild them without the landowner incurring any loss.

➪ [7:224] ***PRACTICE POINTER:*** For these reasons, the purchasing tenant should consider buying *business interruption insurance;* or, if it is an owner/operator, rental income insurance; or some other form of insurance that would compensate the tenant for its loss of income while improvements are being rebuilt.

(a) [7:225] **Compare—sublease rent abatement:** The purchasing tenant should also scrutinize *subleases* on the question of rent abatement rights. Whereas the ground lease tenant may not be entitled to any rent adjustment upon damage or destruction, *subtenants* may have rent abatement rights under their subleases. If damage or destruction occurs, the ground lease tenant would then find itself in the difficult position of having to pay its ground lease rent, while its

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supply of sublease rent is cut off. In such situations, it is particularly important to secure appropriate insurance covering loss of sublease rental income.

(3) [7:226] **Disposition of insurance proceeds:** A well-drafted ground lease usually contains fairly extensive provisions about the disbursement of insurance proceeds upon damage or destruction (*see Form 7:A*). Indeed, both landowner and tenant are typically named as beneficiaries under the policy (as to their respective interests). (The leasehold mortgagee will also have to be a named insured; *see ¶ 7:413*.)

Sometimes an independent third party (such as the leasehold mortgagee) is designated to hold the insurance proceeds and/or control disbursement of the proceeds as and when reconstruction of the improvements progresses. Both landowner and tenant have an interest in seeing that neither has exclusive control of the funds. The landowner, in particular, is concerned that the proceeds be used to fund restoration of the improvements.

(a) [7:226.1] **Result if no contractual provision:** Absent a lease provision governing these issues, the parties' rights regarding insurance proceeds upon damage or destruction will depend upon who is the named insured under the policy. [See, e.g., *Jones v. Aetna Cas. & Sur. Co.* (1994) 26 CA4th 1717, 1722-1725, 33 CR2d 291, 294-296—where lease obligated lessor, at tenant expense, to maintain rental income insurance for damage/destruction of tenant's restaurant on leased premises, and stated proceeds would be payable to lessor with equitable abatement of tenant's rent, tenant was neither coinsured nor third party beneficiary with standing to sue insurer for wrongful withholding of benefits]

(b) [7:227] **Upon termination of lease:** If the ground lease permits termination of the lease upon damage or destruction (*¶ 7:222*), landowner and tenant will have competing interests in the insurance proceeds. Although ground leases vary markedly on these issues, the landowner is usually entitled to the proceeds if termination of the lease occurs close to the end of the term (because that is when ownership of the improvements would vest in the landowner anyway).

j. [7:228] **Condemnation:** On the issue of condemnation, counsel for the purchaser should review the lease for provisions regarding rent abatement, termination and allocation of a condemnation award in the event of a public taking of all or a portion of the ground leasehold estate (whether by eminent domain or inverse condemnation; *see ¶ 7:236.5*).

The parties' rights in and to a condemnation award are governed by the Eminent Domain Law (CCP § 1230.010 et seq.) *unless* they have otherwise agreed (CCP § 1265.160). [*City of Vista v. Fielder* (1996) 13 C4th 612, 617-618, 54 CR2d 861, 865-866—"[Eminent domain] rules may indeed be displaced by a provision of a lease to the contrary"; *United States v. 1.377 Acres of Land* (9th Cir. 2003) 352 F3d 1259, 1269 (applying Calif. law); *see also ¶ 7:233.6*]

(1) [7:229] **Termination of lease by complete taking:** Where all of the property subject to a lease is taken by eminent domain, the *lease terminates* as a matter of law; and the tenant is thereby released from liability for subsequently accruing rent. [CCP § 1265.110; *City of Vista v. Fielder* (1996) 13 C4th 612, 617, 54 CR2d 861, 865]

Termination of the lease does not, however, impair the tenant's right to *compensation* for the taking unless the lease otherwise provides. [CCP § 1265.150; see *City of Vista v. Fielder*, supra, 13 C4th at 617-618, 54 CR2d at 865-866; *and discussion at ¶ 7:233.1 ff.*]

(a) [7:230] **Compare—partial taking:** Where only part of the leased property is taken for public use, the lease ordinarily terminates only as to the condemned portion, and the lease remains in force as to the balance; but the rent obligation is adjusted accordingly (*see ¶ 7:232 ff.*). [CCP § 1265.120; *Carlstrom v. Lyon Van & Storage Co.* (1957) 152 CA2d 625, 632, 313 P2d 645, 649]

However, either party to the lease may petition the court to terminate the entire lease. A termination order may issue if the court determines an "essential" part of the property was taken or that the remainder not taken is "no longer suitable for the purpose of the lease." [CCP § 1265.130]

(b) [7:231] **Effective date of termination:** Condemnation effectively terminates a lease, in whole or in part (¶ 7:229 ff.), at the *earlier* of the following times:

• As of the time title to the property is taken by the person who will put it to public use; *or*

• The time an order for possession entitles the transferee to take possession. [CCP § 1265.140]

(2) [7:232] **Rent abatement upon partial condemnation:** A public taking of a portion of the improvements and/or leased land could make it impossible to rebuild the improvements or even operate any business or development as originally contemplated by the parties. Recognizing that partial condemnation leaves less of the land available for lease, the tenant's

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rent obligation is adjusted to account for the portion taken. [CCP § 1265.120—"rent reserved in the lease that is allocable to the part taken is extinguished"]

(Compare: The result is otherwise where the ground leasehold estate is diminished by damage or destruction. As indicated, there ordinarily is *no* rent abatement in such cases; *see ¶ 7:223*.)

(a) [7:233] **Extent of abatement:** Ground leases usually provide for a rent abatement upon a partial condemnation (see CCP § 1265.160—parties can provide for their rights and obligations upon condemnation) but the abatement methodology can be very complex. The rent adjustment is not necessarily equal to the percentage of land condemned.

For example, a 10% condemnation will not necessarily result in a 10% reduction in rent. If the 10% taken disproportionately affects the value of the property, a substantially greater reduction in rent would be justified. (Indeed, if a relatively minor condemnation affects a critical portion of the property, a *termination* of the lease might be justified; *¶ 7:230*.)

(3) [7:233.1] **Tenant's right to compensation:** *Unless* the lease otherwise allocates or waives the tenant's interest in the condemnation proceeds, the tenant is entitled to compensation for the value of its leasehold interest taken and any of its property taken, including goodwill. [CCP §§ 1265.150, 1263.310, 1263.510; *City of Vista v. Fielder* (1996) 13 C4th 612, 617-618, 54 CR2d 861, 865-866; see also *Galardi Group Franchise & Leasing, LLC v. City of El Cajon* (2011) 196 CA4th 280, 286-288, 125 CR3d 394, 398-400—contractual lease provision waiving tenant's interest in condemnation award did not preclude tenant from subsequently assigning his interest in goodwill condemnation rights to landlord (lease provision interpreted to benefit landlord, *not* condemning agency); *United States v. 1.377 Acres of Land* (9th Cir. 2003) 352 F3d 1259, 1266—tenant operating business on condemned property entitled to recover goodwill regardless whether contractual lease provision confers such right]

(a) [7:233.2] **Lease termination clause not a waiver of rights in condemnation award:** A lease provision declaring that the lease terminates if all of the property is acquired for public use is *not itself* an agreement waiving the tenant's right to compensation. Indeed, such a provision is of no significant legal consequence because the same result (termination of the lease) obtains by operation of law pursuant to CCP § 1265.110 (*¶ 7:229*). [*City of Vista v. Fielder* (1996) 13 C4th 612, 618, 54 CR2d 861, 866; see *Konig v. City of Hawaiian Gardens Redevelop. Agency* (2002) 101 CA4th 1317, 1328-1329, 125 CR2d 1, 9-10 & fn. 5]

(b) [7:233.3] **Contractual allocation of tenant's compensable interest to landlord:** The parties may contractually agree to allocate the tenants share of the condemnation award to the landlord. [*City of South San Francisco v. Mayer* (1998) 67 CA4th 1350, 1354, 79 CR2d 704, 707; see also *Galardi Group Franchise & Leasing, LLC v. City of El Cajon* (2011) 196 CA4th 280, 287, 125 CR3d 394, 399—not only may tenant and landlord apportion condemnation award "any way they see fit," but tenant may assign tenant's condemnation rights; *City of Beverly Hills v. Albright* (1960) 184 CA2d 562, 564, 7 CR 706, 707—lease assigned to lessor lessee's right to damages for property taken by condemnation]

1) [7:233.4] **Compare—leasehold held by condemning agency:** A condemning agency that itself holds a leasehold interest in the subject property is not required to condemn its *own* leasehold interest. Thus, a public agency tenant can exercise its power of eminent domain to take the landlord's interest in the leasehold property without "taking" its own leasehold interest. In such cases, the landlord has no rights in a leasehold condemnation award *notwithstanding the tenant's contractual allocation of the award* to the landlord. [*City of South San Francisco v. Mayer* (1998) 67 CA4th 1350, 1356, 1361, 79 CR2d 704, 708, 711—City (as condemning authority *and* lessee) not required to condemn leasehold valued at $5.5 million even though it agreed to allocate its award to landlord]

➪ [7:233.5] ***PRACTICE POINTER:*** The scenario described at ¶ 7:233.4 raises a legitimate concern that a public agency contemplating condemnation of property encumbered by a lease containing a landlord-favorable condemnation clause could evade paying the value of the leasehold interest to the landlord by simply purchasing the leasehold interest from the tenant for a nominal amount. [*City of South San Francisco v. Mayer* (1998) 67 CA4th 1350, 1359, 79 CR2d 704, 710]

To avoid the possibility that a tenant might assign its leasehold interest to a potential condemning agency (thereby preempting a landlord-favorable condemnation clause), landlords should consider placing *restrictions on a tenant's right to assign or sublet its leasehold* (*¶ 7:69 ff.*). [See *City of South San Francisco v. Mayer*, supra, 67 CA4th at 1359, 79 CR2d at 710]

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[7:233.6 - 7:233.9] ***Reserved.***

(c) [7:233.10] **Contractual allocation to tenant directly from landlord:** Pursuant to the so-called “undivided fee rule,” after the governmental authority provides just compensation for condemned property, the holders of possessory interests in the property apportion the award among themselves by either judicial intervention *or* contract. [*United States v. 1.377 Acres of Land* (9th Cir. 2003) 352 F3d 1259, 1269 (applying Calif. law)—“Once the government provides just compensation for the condemned property, its role is at an end”]

Accordingly, landlord and tenant may provide in their lease that in the event of a condemnation award paid to the landlord only, the tenant has the right to recover its proportionate amount of the award *directly* from the *landlord*. [*United States v. 1.377 Acres of Land*, supra, 352 F3d at 1270-1271]

[7:233.11 - 7:233.14] ***Reserved.***

(d) [7:233.15] **Contractual allocation to mortgagee:** The leasehold mortgagee may also have some contractual interest in a condemnation award; *see* *¶ 7:414*.

(4) [7:234] **Compensable interests:** The landlord ordinarily receives the greater share of the compensation award—the present worth of the future rental payments, plus the present value of the reversionary interest. [See *County of Los Angeles v. American Sav. & Loan Ass'n* (1972) 26 CA3d 7, 9, 102 CR 439, 441]

The tenant's share is based on its business interests (e.g., goodwill) and its leasehold interest—i.e., the value of the tenant's possessory rights for the lease term, less what the tenant is paying for those rights (“bonus value”) and for the value of the removable fixtures and improvements. [*City of Vista v. Fielder* (1996) 13 C4th 612, 617, 54 CR2d 861, 865, fn. 1; *New Haven Unified School Dist. v. Taco Bell Corp.* (1994) 24 CA4th 1473, 1478-1479, 30 CR2d 469, 471-472; *United States v. 1.377 Acres of Land* (9th Cir. 2003) 352 F3d 1259, 1266-1268]

➪ [7:234.1] ***PRACTICE POINTER:*** Technically, each affected party can independently pursue its claims against the condemning authority. However, to conserve resources, time and expense, it may be beneficial to include a provision in the ground lease indicating who, as between landowner and tenant, has the right to litigate or compromise any dispute between the condemning authority and owners of the interests taken.

(a) [7:235] **Loss of goodwill:** Compensable “goodwill” includes the “benefits that accrue to a business as a result of its location, reputation for dependability, skill or quality, and any other circumstances resulting in probable retention of old or acquisition of new patronage.” [CCP § 1263.510(b); see also *Galardi Group Franchise & Leasing, LLC v. City of El Cajon* (2011) 196 CA4th 280, 282, 125 CR3d 394, 395—only owners of businesses conducted on condemned property may claim compensation for lost goodwill; *City & County of San Francisco v. Coyne* (2008) 168 CA4th 1515, 1522, 86 CR3d 255, 259-260—statute's purpose is to provide monetary compensation for type of loss that typically occurs when small business is forced to move and give up benefits of former location; *Chhour v. Community Redevelop. Agency of Buena Park* (1996) 46 CA4th 273, 284-285, 53 CR2d 585, 591—despite lease's general assignment of tenant's interest in condemnation award to landlord, tenant retained right to seek compensation for loss of business goodwill and damage to business inventory]

1) [7:235.1] **Compare—federal law:** Under *federal* law, tenants are *not* entitled to compensation for loss of goodwill in eminent domain actions. [*United States v. General Motors Corp.* (1945) 323 US 373, 383, 65 S.Ct. 357, 362; *United States v. 1.377 Acres of Land* (9th Cir. 2003) 352 F3d 1259, 1266]

2) [7:235.2] **Ongoing business required:** There cannot be compensation for loss of goodwill in the absence of an *ongoing* business conducted on the condemned property. [CCP § 1263.510(b); see *City & County of San Francisco v. Coyne* (2008) 168 CA4th 1515, 1523-1525, 86 CR3d 255, 261-262—tenant not entitled to recovery for loss of goodwill in planned residential and retail development where no ongoing related business was located on undeveloped parcel taken]

3) [7:235.3] **Amount lost; right to jury determination:** A business owner has the right to a jury determination on the amount of goodwill lost. However, the right attaches only if the owner first meets the CCP § 1263.510(a) “qualifying conditions” (i.e., proves goodwill loss was caused by a taking (*causation*), cannot reasonably be prevented by relocating or taking other steps a reasonably prudent person would take to preserve goodwill (*unavoidability*), and will not be duplicated by government relocation payments or other compensation (*no double recovery*)). [See

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People ex rel. Dept. of Transp. v. Presidio Performing Arts Foundation (2016) 5 CA5th 190, 200-201, 209 CR3d 461, 469; *People ex rel. Dept. of Transp. v. Dry Canyon Enterprises, LLC* (2012) 211 CA4th 486, 491, 149 CR3d 601, 604-605 (same)]

In addition, the business owner *must* establish as a "threshold matter" that the business *had goodwill* to lose. [See *People ex rel. Dept. of Transp. v. Presidio Performing Arts Foundation,* supra, 5 CA5th at 200-204, 209 CR3d at 469-472 (finding precise amount of lost goodwill is issue for jury to decide)—although nonprofit foundation not making profit even before taking, substantial evidence showed it suffered loss of goodwill where, among other things, it ended up with less desirable location, increased lease payments, diminished reputation, operational disruptions, declining patronage and shortfall in expected cash flow that could not be attributed to tangible assets or any factors other than decline in goodwill; *People ex rel. Dept. of Transp. v. Dry Canyon Enterprises, LLC,* supra, 211 CA4th at 491-493, 149 CR3d at 605-606 (raising but not deciding issue of business owner's precise burden of proof)—struggling winery that failed to present *any* competent evidence of preexisting goodwill not entitled to jury determination as to amount lost since it had none as "a matter of law"]

(b) [7:236] **Improvements:** Improvements to the property (fixtures, etc.) are properly taken into account in determining compensation *only* to the extent they *remain on the premises* after the condemnor takes possession. [See CCP § 1263.230; *New Haven Unified School Dist. v. Taco Bell Corp.* (1994) 24 CA4th 1473, 1483-1484, 30 CR2d 469, 474]

1) [7:236.1] **Tenant's right of recovery:** Traditionally, the tenant was entitled to compensation for improvements only if the tenant had the right to remove the improvements prior to or upon expiration of the term. [*Los Angeles County v. Kling* (1972) 22 CA3d 916, 921, 99 CR 642, 645]

However, that is not the touchstone for a right to compensation under current law, which recognizes that condemnation "may inevitably frustrate the tenant's expectations as to the economic value of the improvements constructed on the land." [See CCP § 1263.205 et seq. (compensation for improvements); *Lanning v. City of Monterey* (1986) 181 CA3d 352, 359, 226 CR 258, 262; *Chhour v. Community Redevelop. Agency of Buena Park* (1996) 46 CA4th 273, 282-283, 53 CR2d 585, 589-590—distinguishing compensable "improvements" from noncompensable "personal property" (which presumably "will, or should be, removed by its owner when the realty is acquired" and thus is not "taken" by condemnation)]

2) [7:236.2] **Landlord's right of recovery:** If the condemnation occurs close to the end of the term, the landowner undoubtedly will want all (or most) of the award relating to the improvements (because the improvements usually become the landowner's property at the end of the term).

For that reason, agreed-upon allocations commonly apportion an escalating percentage of the award to the landlord as years go by.

3) [7:236.3] **Compare—partial condemnation:** In the case of a partial condemnation, where the improvements are to be rebuilt on the remaining property, the award is often paid to an independent third party who disburses the proceeds to fund the cost of reconstruction. But if the proceeds (or a portion thereof) will not be used for rebuilding improvements, both landowner and tenant will have justifiable competing interests in the award:

• The landowner will want compensation for the taking of its fee interest; and may also expect remuneration for a taking of any present or inchoate interest it has in the affected improvements.

• On the other hand, the tenant will be seeking a portion of the award because it has typically built the improvements and the leasehold interest presumably has some value (CCP § 1265.150).

(c) [7:236.4] **Relocation costs:** In addition to compensation for the loss of real property, the condemnor may be required to pay reasonable expenses incurred by the ousted tenant in moving the tenant's business and personal property (plus compensation for loss of personal property that could not be relocated). [Gov.C. §§ 7260, 7262; see *County of San Diego v. Cabrillo Lanes, Inc.* (1992) 10 CA4th 576, 583, 12 CR2d 613, 616; *Barthelemy v. Orange County Flood Control Dist.* (1998) 65 CA4th 558, 568, 76 CR2d 575, 581—relocation expenses also recoverable under CCP § 1263.510; *Konig v. City of Hawaiian Gardens Redevelop. Agency* (2002) 101 CA4th 1317, 1326-1329, 125 CR2d 1, 7-10—displaced subtenant entitled to relocation benefits]

(d) [7:236.5] **Application to inverse condemnation:** The same rules apply to suits in inverse condemnation (where governmental action constitutes the "substantial equivalent" of condemnation even though government does not actually

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exercise its power of eminent domain). [See *Langer v. Redevelopment Agency of City of Santa Cruz* (1999) 71 CA4th 998, 1003, 84 CR2d 19, 22; *Barthelemy v. Orange County Flood Control Dist.* (1998) 65 CA4th 558, 568, 76 CR2d 575, 581; and *San Diego Metropolitan Transit Develop. Bd. v. Handlery Hotel, Inc.* (1999) 73 CA4th 517, 533, 535, 86 CR2d 473, 485, 487, fns. 16 & 19]

1) [7:237] **Compare—breach of lease agreement cases:** Inverse condemnation principles, including those related to compensable interests (¶ 7:236.5), have *no* application in suits for breach of contract or lease against governmental entities. This is so because the parties' rights, duties and liabilities "spring from the lease" itself. Indeed, "[t]here is no reason to impose extra-contractual liability for breach, simply because the breaching party is a governmental entity." [See *County of Ventura v. Channel Islands Marina, Inc.* (2008) 159 CA4th 615, 625, 71 CR3d 762, 768-769—county lessor's wrongful refusal to allow marina lessee to remove improvements following lease's expiration did not amount to inverse condemnation (tenant's rights re improvement removal arose from lease alone)]

k. [7:238] **Default notice provisions:** The default notice provisions under a ground lease (i.e., notice to "cure" or "perform" in event of nonpayment of rent or other default under the lease) should allow the tenant a longer period to cure than under a standard commercial lease (cf. CCP § 1161). A very short notice/cure period (often seen in standard commercial leases) is not appropriate in ground lease situations, given the tenant's substantial rights and investment in the leasehold estate. Moreover, the leasehold mortgagee will require an even longer notice period, as well as the specific right to step in and cure the tenant's default (*see* ¶ *7:415*).

l. [7:239] **Late charges:** Leases typically assess tenants "late charges" for monetary defaults (e.g., late payment of rent). A late charge provision may call for (1) a flat fee (or, perhaps, a specified percentage of the overdue amount), and/or (2) an ongoing interest charge on the overdue amount. In any event, purchasing tenants should scrutinize the ground lease on this issue.

(1) [7:240] **No usury problem:** Late fees charged as interest on overdue accounts do not risk violating the state usury law, which limits interest payable "for any loan or forbearance of any money" (Cal.Const. Art. XV, § 1).

Reason: The rental of property is akin to the "transfer of property in a thing for a price in money"; as such, a late charge assessed on overdue rent (or other monetary obligations under the lease) does not involve payment for a "loan" (the delivery of a sum of money under a contract to return an equivalent amount at some future time) or a "forbearance of money" (the giving of further time for payment of a debt or an agreement not to enforce a claim at its due date). [See *Southwest Concrete Products v. Gosh Const. Corp.* (1990) 51 C3d 701, 704, 274 CR 404, 406]

Cross-refer: Usury issues are discussed in greater detail in connection with financing at ¶ *6:280 ff.*

m. [7:241] **Real estate broker commissions:** Counsel should determine whether the ground lease requires the tenant to pay any real estate broker commissions (either for the initial term, or any extended term). Tenants rarely have the obligation to pay broker commissions; but if the lease provides otherwise, the purchasing tenant's assumption of the ground lease obligations (¶ *7:334 ff.*) will include liability for the commissions.

[7:242 - 7:244] ***Reserved.***

2. [7:245] **Prior Assignments:** It is possible (indeed, likely, if several years have passed since commencement of the lease term) that the selling tenant's leasehold interest has previously been transferred. Therefore, it may be advisable to review the prior assignment documents. (However, this step may not be necessary if a landowner's estoppel certificate is obtained and leasehold title insurance is acquired by the purchasing tenant—both of which are *always* recommended.)

The purchasing tenant's principal concern here is that the chain of title regarding various transfers of the tenant's interests over time is in order; and that the landowner and tenant are in agreement as to the state of ownership of the tenant's interest under the ground lease.

3. [7:246] **Review of Subleases:** A purchase of the ground leasehold will be subject to all existing subleases. Therefore, all subleases should be analyzed from both a business and legal perspective (*see also* ¶ *4:410 ff.*).

a. [7:247] **Subleases and rent roll:** Just as the buyer of a fee interest in rental property should obtain and review a "rent roll" disclosing leases, security deposits, current rentals, etc., the purchasing tenant should obtain and review all subleases and a sublease rent roll (*see* ¶ *4:410 ff.*).

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b. [7:248] **Tenant estoppel certificates:** To the extent possible, an estoppel certificate should be obtained from each of the subtenants (*see ¶ 4:418 ff.; and Form 4:J*).

c. [7:249] **Sublease terms:** Subleases should be reviewed with the same scrutiny given the ground lease.

(1) [7:250] **Rental rates:** In particular, sublease rents should be compared with the rent to be paid under the ground lease. The motivation, of course, is to determine whether rental income from subtenants will be sufficient to at least cover the ground lease rent.

(2) [7:251] **Pass-throughs:** Another important point is whether the purchasing tenant will be able to pass through to the subtenants the costs of operating and maintaining the property (including taxes and insurance). (In other words, are the subleases essentially “triple net” leases (*¶ 7:35*), so that the purchasing tenant's rent and operating costs will be offset by the sublease rent?)

In some projects (usually office buildings), it is commonplace to find subleases which allow the sublessor (ground lease tenant) to pass through only the increases in operating costs (over a particular base year or over a particular amount). Subleases may also provide that any increase in the ground lease rent is to be passed through to subtenants on a pro rata basis.

(3) [7:252] **Restrictive covenants:** Any *recorded* sublease could create a *restrictive covenant* on future use of the land. These restrictions will be enforceable against the successor purchasing tenant. [Cf. *Hudson Oil Co., Inc. v. Shortstop* (1980) 111 CA3d 488, 493, 168 CR 801, 803]

Examples

(a) [7:253] **Tenant exclusives:** Such restrictions might include exclusive rights to operate a particular kind of business (e.g., exclusive rights given to subtenants in a retail center typically restrict the sublessor (ground lease tenant) from leasing space to a competing retailer). These “exclusive use” provisions are generally enforceable. [*Keating v. Preston* (1940) 42 CA2d 110, 122-124, 108 P2d 479, 486; *Martikian v. Hong* (1985) 164 CA3d 1130, 1133-1134, 211 CR 66, 68-69; see also *Edmond's of Fresno v. MacDonald Group, Ltd.* (1985) 171 CA3d 598, 607-608, 217 CR 375, 381—exclusive use rights in shopping center extended to newly acquired property later made part of center]

(b) [7:254] **“Anchor-satellite” tenant leases:** Restrictive covenants may provide subtenants with a basis for termination of their leases or a substantial damages action for breach of covenant. For instance, it has become popular for shopping center tenants to negotiate rights to terminate if (i) the center is not fully (or substantially) leased by a certain date; or (ii) a particular large (so-called “anchor”) tenant is not obtained or maintained.

“Anchor-satellite” leases are common in shopping centers where landowners have secured smaller tenants (the “satellites”) upon an express covenant to lease to a major tenant or tenants (the “anchors”) who are likely to attract business patrons for the satellites.

1) [7:255] **Implied covenant to *maintain anchor:*** *Such covenants could be a trap for the unwary*. For example, in one case, the tenant signed a 20-year lease to operate a restaurant and the landlord expressly agreed to secure three major “anchors” (a supermarket, a department store and a drug store) for a minimum 20-year period before commencement of the tenant's term. The landlord secured the anchors as agreed; but two of the anchors vacated the next year and no replacements were obtained. When the tenant's business dropped off, it sued for breach of lease and lost business profits.

Although the lease expressly required that the landlord simply *procure* 20-year leases with the anchors prior to commencement of the tenant's term, the court held the tenant should be allowed to amend its complaint to allege the existence of an *implied covenant* that the landlord not only obtain but also *exercise good faith to “maintain”* the three anchors for the specified 20-year period. [*Cordonier v. Central Shopping Plaza Associates* (1978) 82 CA3d 991, 1001, 147 CR 558, 563]

➪ [7:256] ***PRACTICE POINTER:*** *Cordonier*, supra, points out the importance of analyzing the “hidden” implications of restrictive covenants; the purchasing tenant might be assuming difficult obligations under subleases.

Again, however, subtenant *estoppel certificates* confirming that the selling tenant is not in default under the respective subleases will alleviate some of the risks posed by restrictive covenants. (*See ¶ 7:292 ff.*)

(4) [7:257] **Claims against subtenants:** The selling tenant might have lawsuits pending against prior or existing subtenants for breach of the sublease. This issue should be investigated; and the purchase and sale documents should properly allocate

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who is entitled to pursue the claims and keep any damages recovery. [See *Blumenfeld v. R.H. Macy & Co., Inc.* (1979) 92 CA3d 38, 41, 154 CR 652, 653—claim against subtenant deemed assigned where sale documents did not specify whether selling tenant transferred or retained claim]

(The same concerns re allocation of leasehold rights and liabilities are presented in connection with the purchase and sale of a fee containing rental property; *see ¶ 4:413*.)

(5) [7:258] **Assignment of subleases:** The purchase and sale documents should include a specific assignment of subleases and should separately identify each of the leases. (*See generally, Forms 7:C & 7:D*.)

(6) [7:259] **Representations/warranties; subtenant estoppel certificates:** A selling tenant should provide the purchasing tenant with appropriate representations and warranties concerning the subleases (*see ¶ 4:441*); and also provide subtenant estoppel certificates similar to those given by tenants to the purchaser of a fee interest (*see ¶ 4:418 ff.*).

4. [7:260] **Leasehold Financing:** There may be a loan (or loans) encumbering the leasehold interest at the time of the sale. (This encumbrance would have been created by the selling tenant or any of its predecessors in interest.) The purchase documents should make clear whether the seller will be paying off the loan before the closing or, instead, whether the purchaser will be assuming or taking subject to the loan; in the latter case, counsel should advise the purchaser of the risks and benefits of such financing (*see ¶ 4:295 ff.; and detailed discussion at ¶ 6:310 ff.*).

In either case, counsel should review all recorded loan documents (deeds of trust, assignments of rents, etc.), as well as all available unrecorded documents pertinent to the financing (promissory notes, loan agreements, personal property security agreements, etc.).

a. [7:261] **Due-on-sale provisions:** In particular, scrutinize the loan documents to determine whether the leasehold mortgagee has the right to "call" the loan (demand payment in full) upon sale of the leasehold interest. If such a provision exists, consent to the transfer should be obtained from the mortgagee; otherwise, the purchasing tenant will bear the risk the loan might be called. [*Miller v. Cote* (1982) 127 CA3d 888, 895, 179 CR 753, 757; *see also ¶ 6:388 ff.* for detailed discussion of due-on-sale provisions]

b. [7:262] **Restrictions on junior, subordinate financing:** Also consider whether the purchasing tenant intends to obtain junior or subordinate leasehold financing (i.e., another loan secured by the leasehold which would create a second, junior deed of trust encumbering the purchaser's interest in the lease). If so, review the existing (first position) loan documents for a provision that might prohibit junior financing. If such a prohibition exists, consent to the junior financing should be obtained from the lender holding the senior (first position) deed of trust on the leasehold interest. Otherwise, a purchasing tenant who proceeds with junior financing risks the loan being called. (*See ¶ 6:397* for further discussion of restrictions on junior financing ("due-on-encumbrance" provisions).)

c. [7:263] **Personal property financing:** If substantial personal property is involved in the leasehold transfer, a review of the California Secretary of State's records (UCC search) may be necessary to determine whether any of such property has been encumbered by the selling tenant. (*See ¶ 4:36*.)

5. [7:264] **Title Insurance:** It is *essential* that the purchasing tenant acquire a leasehold policy of title insurance insuring the existence and priority of the leasehold. (Title insurance is discussed in *Ch. 3*.)

6. [7:265] **Taxes, Assessments and Bonds:** The ground lease tenant is typically responsible for all real property taxes, bonds and assessments relating to the property. To determine the purchaser's future liability, a preliminary review should thus include inquiry into all applicable taxes, bonds and assessments.

a. [7:266] **Proposition 13 reappraisal:** The sale of a leasehold with at least 35 years remaining in the term (including options to extend) constitutes a "change in ownership" triggering property tax reassessment (and, hence, potentially increased taxes). [Rev. & Tax.C. § 61(c)]

In effect, the Legislature has declared such long-term leases substantially equivalent to the value of an ownership (fee) interest, the transfer of which falls under the Proposition 13 umbrella. [*E. Gottschalk & Co., Inc. v. County of Merced* (1987) 196 CA3d 1378, 1384, 242 CR 526, 529—§ 61 not violative of Cal.Const. Art XIIIA, § 2 (Prop. 13); see also *Phelps v. Orange County Assessment Appeals Bd. No. 1* (2010) 187 CA4th 653, 658-661, 114 CR3d 463, 467-469—transfer of trust-held ground lease and improvements built thereon following income beneficiary's death constituted change in ownership

sufficient to trigger property tax reassessment (lease provision requiring surrender of improvements when lease concluded showed that trust held fee interest)]

Cross-refer: Property taxation and assessment (Prop. 13) are discussed in detail at *¶ 13:65 ff.*

b. [7:267] **Documentary transfer tax:** Likewise, the sale of a leasehold triggers a local documentary transfer tax (Rev. & Tax.C. § 11911) if the remaining term is for 35 years or more (including renewal options). [See *Thrifty Corp. v. County of Los Angeles* (1989) 210 CA3d 881, 885-886, 258 CR 585, 587-588—sale of leasehold is "realty sold" for purposes of § 11911 tax if it would trigger reassessment under Rev. & Tax.C. § 61(c)]

(1) [7:267.1] **Compare—extension of existing lease:** The *extension* of an existing lease will trigger a documentary transfer tax only if the *prospective lease term*—i.e., the balance of the existing term plus the extended term (including renewal options)—is at least 35 years. [*McDonald's Corp. v. Board of Supervisors of Mendocino County* (1998) 63 CA4th 612, 617, 74 CR2d 101, 104-105—documentary transfer tax not triggered by 15-year extension of 36-year lease with only 13 years remaining]

(2) [7:267.2] **Sale of property subject to lease:** The sale or transfer of property subject to a lease with a remaining term of *35 years or more* does not result in a "change in ownership." Therefore, the lease is not subject to a documentary transfer tax for "realty sold." The "change in ownership" occurs when the lease is created. [*731 Market Street Owner, LLC v. City & County of San Francisco* (2020) 50 CA5th 937, 946-948, 264 CR3d 490, 496-497—where property subject to 45-year lease is sold 4 years after lease is created, city and county cannot impose new transfer tax based on value of rental payments due under lease; see Rev. & Tax.C. § 62(g); *and* ¶ 4:306a]

The sale or transfer of property subject to a lease with a remaining term of *less than 35 years*, however, does constitute a "change in ownership" and, therefore, rental payments due under the lease would be subject to a documentary transfer tax. [Rev. & Tax.C. § 61(c)(1)(D); *731 Market Street Owner, LLC v. City & County of San Francisco*, supra, 50 CA5th at 946-948, 264 CR3d at 496-497; see also *Equinix LLC v. County of Los Angeles* (2024) 101 CA5th 1108, 1117, 320 CR3d 803, 809—sale of property subject to lease with remaining term of 26 years amounted to "change in ownership," permitting reassessment at property's current market value, *discussed at* ¶ 13:70]

c. [7:268] **Other local taxes:** There may also be other local tax obligations triggered by leasing transactions.

For example, certain municipal codes impose a tax based on the amount of the rent. Usually, such local taxes are assessed on the *landowner's* receipt of rental income. However, the ground lease might shift that obligation to the tenant.

d. [7:269] **Tenant liability for increased taxes upon sale of fee interest (reassessment pass-through):** Purchasing tenants should also beware of potential adverse economic consequences that may result from a provision passing through the *landowner's* real property tax liability to the tenant.

Ground leases frequently require the tenant to pay all real property taxes on the land—including increases caused by a reassessment when the landowner sells its fee interest. This could be particularly risky for tenants: First of all, the tenant cannot plan for the potential tax liability because it has no control over when the fee sale (and, thus, the reassessment) will occur. Moreover, the tenant receives no corresponding benefit from the sale of the property.

7. Obtaining Landowner's Consent to Sale

a. [7:270] **Risk of lease termination:** Do *not* proceed with a ground lease assignment before scrutinizing the lease to determine whether landowner consent is required. If the ground lease contains a transfer restriction permitting assignment only with landowner consent (*¶ 7:80*), the failure to request such consent may itself be ground for *termination* of the lease. [*Thrifty Oil Co. v. Batarse* (1985) 174 CA3d 770, 776, 220 CR 285, 289; see also *Boston Properties v. Pirelli Tire Corp.* (1982) 134 CA3d 985, 992-993, 185 CR 56, 60-61 (same re sublease); *and ¶ 7:112*]

➪ [7:271] ***PRACTICE POINTER:*** When the ground lease contains a "consent clause" transfer restriction, the purchase and sale documents should clearly provide the transaction is contingent upon obtaining the landowner's consent to the assignment.

It also behooves the purchasing tenant to include a provision in the purchase documents *obligating the selling tenant to seek the landowner's consent* and to proceed in "good faith" to obtain such consent, including taking all steps "reasonably necessary" in that regard. (Although such obligations may be somewhat vague, they close a loophole that might otherwise

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give the seller a way out of the deal—i.e., by deliberately taking no action to obtain consent in order to intentionally avoid satisfaction of a condition to the closing.)

Finally, out of an abundance of caution, consider including a provision in the sale documents allowing the purchasing tenant to deal directly with the landowner to obtain the requisite consent.

b. [7:272] **Rescission remedy:** If the selling tenant fails to procure the requisite landowner consent to the assignment, the purchasing tenant may rescind the purchase and sale agreement on the ground of fraud. [*Bush v. Vernon* (1955) 135 CA2d 33, 36-37, 286 P2d 903, 905; *Civille v. Bullis* (1962) 209 CA2d 134, 138, 25 CR 578, 581; *and see ¶ 11:460 ff.* for detailed discussion of rescission]

8. [7:273] **Nondisturbance and Attornment Agreements:** Tenants (and subtenants) are rightfully concerned that extinguishment of the greater estate under which they hold their interest will terminate their leasehold interest. For example, if the landowner were to lose its fee interest by foreclosure of a lien that is senior to the ground lease, the foreclosing lender will typically wipe out the ground lease, thereby extinguishing the tenant's interest (*see* ¶ *6:534, 6:542*). Subtenants are similarly concerned that their subleases would be extinguished upon a termination of the (master) ground lease, such as by a rejection of the primary lease in the sublessor's bankruptcy (11 USC § 365(d)(4)).

To preserve tenant and subtenant leasehold interests, each can enter into a so-called “nondisturbance and attornment agreement” (sometimes called a “subordination, nondisturbance and attornment agreement” or “SNDA”) with the holder of the greater estate. Thus, a ground lease tenant would so agree with the holder of the deed of trust encumbering the fee interest (the fee mortgagee); and subtenants would so agree with the landowner (and, in some cases, the fee mortgagee as well).

a. [7:274] **Features of agreement:** A nondisturbance and attornment agreement has two principal components:

(1) [7:275] **“Nondisturbance”:** The holder of the senior interest (landowner/prime lessor or fee mortgagee) agrees that, notwithstanding a default under or termination of the prime lease, or a foreclosure upon the senior estate, the junior estate (leasehold) will be recognized by the holder of the senior estate (prime lessor or fee mortgagee) and the tenant's (or subtenant's) right of possession will remain undisturbed. [See *Chumash Hill Properties, Inc. v. Peram* (1995) 39 CA4th 1226, 1233, 46 CR2d 366, 369]

(a) [7:275a] **Mortgagee/tenant agreements:** In other words, pursuant to a nondisturbance agreement between a fee mortgagee and ground lease tenant, the fee mortgagee agrees that, upon foreclosure of its lien (deed of trust), it will nevertheless recognize the ground leasehold and tenant rights under the leasehold for so long as the tenant continues to comply with the terms of the lease and is not in default. [*Miscione v. Barton Develop. Co.* (1997) 52 CA4th 1320, 1327, 61 CR2d 280, 285]

(b) [7:275b] **Landlord/mortgagee agreements:** A tenant may also be able to negotiate a provision in its lease requiring that the *landlord* obtain from its lender a nondisturbance agreement. This can often be accomplished by conditioning an attornment provision (*¶ 7:275.1*) on receipt of the nondisturbance agreement. [See *Principal Mut. Life Ins. Co. v. Vars, Pave, McCord & Freedman* (1998) 65 CA4th 1469, 1478, 77 CR2d 479, 483 (abrogation on other grounds recognized by *City of Oakland v. Oakland Raiders* (2022) 83 CA5th 458, 474, 299 CR3d 463, 475)]

(c) [7:275c] **Landlord/subtenant agreements:** *See ¶ 7:280*.

(2) [7:275.1] **“Attornment”:** Under an attornment provision, the tenant agrees with the original landlord that, upon foreclosure, it will recognize (“attorn to”) the landlord's successor in interest as the new landlord. [*Vallely Investments, L.P. v. BancAmerica Comm'l Corp.* (2001) 88 CA4th 816, 824, 106 CR2d 689, 696, fn. 3; *Miscione v. Barton Develop. Co.* (1997) 52 CA4th 1320, 1326, 61 CR2d 280, 284]

When a lease obligates a tenant to attorn to a new landlord in the event of foreclosure by a senior encumbrancer, the terms of the attornment provision govern how that is to occur and its effect on the existing lease. [*Principal Mut. Life Ins. Co. v. Vars, Pave, McCord & Freedman* (1998) 65 CA4th 1469, 1478, 77 CR2d 479, 483 (abrogation on other grounds recognized by *City of Oakland v. Oakland Raiders* (2022) 83 CA5th 468, 299 CR3d 463)]

(a) [7:275.2] **Foreclosure purchaser as third party beneficiary of attornment clause:** One common form of attornment clause requires the tenant to agree to enter into a new lease on the same terms with any successor landlord or, at the successor's option, to have the existing lease remain effective as a *new lease* between the tenant and successor. [*Principal Mut. Life Ins. Co. v. Vars, Pave, McCord & Freedman* (1998) 65 CA4th 1469, 1485-1486, 77 CR2d 479,

488-489 (abrogation on other grounds recognized by *City of Oakland v. Oakland Raiders* (2022) 83 CA5th 468, 299 CR3d 463)]

In this case, the tenant's existing lease is extinguished by the foreclosure, but the successor, as a *third party beneficiary* of the attornment clause, has the right to require the tenant to enter into a landlord-tenant relationship with the successor. [*Principal Mut. Life Ins. Co. v. Vars, Pave, McCord & Freedman*, supra, 65 CA4th at 1485-1486, 77 CR2d at 488-489 (abrogation on other grounds recognized by *City of Oakland v. Oakland Raiders* (2022) 83 CA5th 468, 299 CR3d 463); see *Vallely Investments, L.P. v. BancAmerica Comm'l Corp.* (2001) 88 CA4th 816, 824, 106 CR2d 689, 696—contract obligations survive foreclosure when they do not impair foreclosing mortgagee's rights]

(b) [7:275.3] **Attornment clause preventing extinguishment:** Another form attornment clause requires the tenant to “attorn to” the purchaser at a foreclosure sale (i.e., accept the purchaser as the tenant's landlord) if the purchaser acquires and *accepts the premises subject to the lease*. [*Miscione v. Barton Develop. Co.* (1997) 52 CA4th 1320, 1331-1332, 61 CR2d 280, 287-288]

In this situation, the parties have simply contracted that, if the purchaser accepts the existing lease, *the lease will not be extinguished* by the foreclosure. [*Principal Mut. Life Ins. Co. v. Vars, Pave, McCord & Freedman* (1998) 65 CA4th 1469, 1485, 77 CR2d 479, 488, fn. 8 (abrogation on other grounds recognized by *City of Oakland v. Oakland Raiders* (2022) 83 CA5th 468, 299 CR3d 463)]

(c) [7:275.4] **Subtenant's attornment:** *See ¶ 7:280*.

FORM: Nondisturbance and Attornment Agreement, *see Form 7:E*.

b. [7:276] **Nondisturbance and attornment agreements between lender and ground lease tenant/subtenants:** This kind of nondisturbance and attornment agreement can be classified in two ways, depending on what security is given for the loan:

(1) [7:277] **Loan encumbering ground lease only:** This is an agreement given to all subtenants providing that if the lender (leasehold mortgagee) forecloses on the leasehold interest: (a) the leasehold mortgagee (or any purchaser by or through the leasehold mortgagee) will recognize the sublease; (b) the sublease will remain in full force and effect; and (c) the subtenant will continue to enjoy all of its rights under the sublease. The subtenant's attornment requires it to perform all obligations under its sublease for the benefit of the leasehold mortgagee (or subsequent purchaser).

Without these agreements, the subleases could be terminated, adversely affecting both the subtenants and the leasehold mortgagee. Thus, this arrangement benefits both the leasehold mortgagee and the subtenant:

• The obvious advantage to subtenants is that their leases are preserved even though the ground lease has terminated.

• The advantage to the leasehold mortgagee is that, by preserving the sublease(s), it has preserved a rental income stream. (Clearly, the leasehold mortgagee would not have entered into a nondisturbance and attornment agreement unless it felt the sublease was economically favorable.)

(2) [7:278] **Loan encumbering fee interest:** This kind of nondisturbance and attornment agreement is a little more expansive. It protects the ground lease tenant from losing its rights in the event of foreclosure of a deed of trust encumbering the fee interest in the property. The agreement preserves the ground lease, thereby providing the party who takes title to the fee upon a foreclosure sale with the benefit of a continuation of the ground lease. (Occasionally, the agreement might include protection of the subleases as well; but this is not technically necessary since preservation of the ground lease necessarily preserves the sublease estates under it.)

➪ [7:279] ***PRACTICE POINTER:*** When the fee is encumbered by a deed of trust, it is extremely important to make certain the selling tenant has procured a nondisturbance and attornment agreement from the *fee* mortgagee. The purchasing tenant should not proceed with the ground lease acquisition *until such agreement is obtained*. Otherwise, the purchaser runs the risk of a *termination of the ground lease* by foreclosure upon the fee interest should the landowner default on its mortgage obligation.

c. [7:280] **Nondisturbance and attornment agreement between landowner and subtenants:** Under this kind of nondisturbance and attornment agreement, the landowner agrees that, if the ground lease terminates by reason of the ground lease tenant's default: (1) the landowner will recognize the subleases; (2) the subleases will remain in full force and effect; and (3) the subtenants will continue to enjoy all rights granted under their respective subleases. Correspondingly, the subtenants agree that in the event the ground lease terminates they will continue to perform their sublease obligations directly for the

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landowner's benefit. (In effect, this arrangement converts subleases into direct leases with the landowner.) [See *Chumash Hill Properties, Inc. v. Peram* (1995) 39 CA4th 1226, 1232-1233, 46 CR2d 366, 369-370]

Without such agreement, termination of the ground lease would, of course, terminate all junior subleases. [*Fifth & Broadway Partnership v. Kimny, Inc.* (1980) 102 CA3d 195, 201, 162 CR 271, 275]

d. [7:281] **Other provisions in nondisturbance and attornment agreements:** Because most nondisturbance and attornment agreements are drafted by, and principally for the benefit of, lenders, the purchasing tenant should be cognizant of several additional provisions that are typically included:

(1) [7:282] **Offsets/defenses:** The lender generally will not be subject to offsets or defenses the ground lease tenant might have against the landowner. For example, the tenant may be precluded from withholding rent from the lender if the landowner has defaulted under the lease (*see also* *¶ 7:286*).

(2) [7:283] **Rent prepayments:** The lender is generally unwilling to be bound by any tenant prepayment of rent (for more than a limited period of time).

(3) [7:284] **Security deposits:** The lender may also be unwilling to take responsibility for the return of security deposits (since the lender has not received the deposits).

(4) [7:285] **Improvements:** Nor will the lender want responsibility for the completion of improvements or the payment of tenant improvement allowances for which the landowner would have been liable.

(5) [7:286] **Landowner defaults:** Further, the lender may be unwilling to assume any obligation to cure landowner defaults that occurred before the foreclosure was consummated, or may give itself an extended period of time to cure any such default.

(6) [7:286.1] **Lease termination or amendment:** The lender may prohibit the tenant from terminating or amending the lease without the lender's consent.

(7) [7:286.2] **Environmental covenants:** The lender may require that the tenant not hold the lender responsible under any environmental covenants binding the landowner.

9. [7:287] **Subordination Agreements:** Ground leases sometimes contain a provision permitting the landowner to further encumber its fee interest, while requiring the tenant to *subordinate the ground lease* to any future loan against the fee. A subordination "involves a change or reversal of the relative priority of two interests in the same property created as a matter of lien law." [*Protective Equity Trust #83, Ltd. v. Bybee* (1991) 2 CA4th 139, 148, 2 CR2d 864, 868, fn. 3; *Miscione v. Barton Develop. Co.* (1997) 52 CA4th 1320, 1327, 61 CR2d 280, 285; see also *Aviel v. Ng* (2008) 161 CA4th 809, 813, 74 CR3d 200, 203—clause subordinating lease to "mortgages" applied with equal force to trust deeds]

Cross-refer: Subordination agreements in real property purchase and sale transactions are also discussed at *¶ 6:450 ff.*

a. [7:288] **Certainty of terms required:** Priority rights conferred by a subordination agreement "extend to and are limited strictly by the express terms and conditions of the agreement." [*Miller v. Citizens Sav. & Loan Ass'n* (1967) 248 CA2d 655, 663, 56 CR 844, 851] Thus, an agreement to subordinate in the future is not effective unless the terms are spelled out in detail. [See *Handy v. Gordon* (1967) 55 CR 769, 770-771, 422 P2d 329, 330-331; *Roskamp Manley Associates, Inc. v. Davin Develop. & Inv. Corp.* (1986) 184 CA3d 513, 520-521, 229 CR 186, 190]

b. [7:289] **Nondisturbance and attornment agreement advisable:** When the ground lease requires future subordination, the purchasing tenant should make certain there is a corresponding requirement that any new fee mortgagee agree (as a condition to and concurrently with the subordination) to enter into a *nondisturbance and attornment agreement* with the ground lease tenant. In this manner, although the ground lease will become subordinate to the new fee mortgage, the ground lease tenant's interest will nevertheless be protected (*¶ 7:278 ff.*).

10. [7:290] **Conveyancing Instrument:** The appropriate instrument for conveyance of a ground leasehold interest is an "assignment of lease." Occasionally, however, a grant deed (describing the real property as a leasehold interest) is used.

• ***FORMS:*** Alternate Forms of Assignment of Lease, *see Forms 7:C & 7:D*.

a. [7:291] **Writing requirement (statute of frauds):** The statute of frauds applies to lease assignments, just as it does to the conveyance of a fee interest (*¶ 4:263 ff.*). Specifically, an agreement to lease real property for more than one year *or to sell an interest in real property* is invalid *unless* "*in writing* and *subscribed by the party to be charged* or by the party's agent …" [Civ.C. §§ 1624(a)(3), 1091; *Bed, Bath & Beyond of La Jolla, Inc. v. La Jolla Village Square Venture Partners* (1997) 52

CA4th 867, 877, 60 CR2d 830, 836; see *Maron v. Howard* (1968) 258 CA2d 473, 485, 66 CR 70, 77—assignment of lease subject to statute of frauds must itself be by instrument in writing; but see also *Signal Hill Aviation Co. v. Stroppe* (1979) 96 CA3d 627, 637-638, 158 CR 178, 183-184—oral promise to assign enforceable under principal of promissory estoppel, notwithstanding statute of frauds]

11. [7:292] **Estoppel Certificates:** An "estoppel certificate" is a signed certification of various matters with respect to a lease (*see ¶ 4:418*). It reveals the present intent and understanding of the parties to a commercial lease agreement, thereby preventing any unwelcome post-transaction surprises. [*Robert T. Miner, M.D., Inc. v. Tustin Avenue Investors, LLC* (2004) 116 CA4th 264, 273, 10 CR3d 178, 183-184 (citing text); *Plaza Freeway Ltd. Partnership v. First Mountain Bank* (2000) 81 CA4th 616, 626, 96 CR2d 865, 871-872]

➪ [7:292.1] ***PRACTICE POINTER:*** Estoppel certificates are almost always used in commercial real estate transactions. They inform lenders and buyers of the tenant's understanding of the lease agreement; lenders and buyers rely upon the certificates in finalizing loans and purchases. [*Plaza Freeway Ltd. Partnership v. First Mountain Bank* (2000) 81 CA4th 616, 628-629, 96 CR2d 865, 874]

In the purchase and sale of a ground lease, obtaining estoppel certificates *from both landowner and subtenants* is vitally important to purchasing tenants … because the disclosures made will invariably impact desirability of the leasehold and assist the purchaser in evaluating whether subtenants nearing the end of their tenancy terms should be evicted or kept.

FORMS

• Tenant Estoppel Certificate, *see Form 4:J*. (Tenant and subtenant estoppel certificates are basically the same.)

• Landowner (Ground Lessor) Estoppel Certificate (With Consent to Assignment), *see Form 7:B*.

a. [7:292.2] **Binding effect:** An estoppel certificate is a "written instrument" triggering the Ev.C. § 622 *conclusive presumption* that the facts recited are "true as between the parties thereto, or their successors in interest" (Ev.C. § 622 (emphasis added)). [*Plaza Freeway Ltd. Partnership v. First Mountain Bank* (2000) 81 CA4th 616, 621, 626, 96 CR2d 865, 868, 871—although "written instrument" within meaning of § 622 usually refers to a contract, it also applies to estoppel certificates]

Thus, an estoppel certificate *binds* the signatories (and their successors in interest) to the statements made and *estops* them from claiming to the contrary at a later time. [*Plaza Freeway Ltd. Partnership v. First Mountain Bank*, supra, 81 CA4th at 626, 629, 96 CR2d at 872, 874 (quoting text)]

(1) [7:292.3] **Conclusive statement of lease terms:** An estoppel certificate may conclusively set forth the key terms of a lease agreement where the terms are ambiguous or wholly absent from the lease. [*Plaza Freeway Ltd. Partnership v. First Mountain Bank* (2000) 81 CA4th 616, 628, 96 CR2d 865, 873—tenant's estoppel certificate conclusively provided lease termination date where date was uncertain from terms of lease agreement]

(2) [7:292.4] **Binding even if recitations erroneous:** Moreover, the facts contained in an estoppel certificate are conclusively presumed to be true, and thus binding on the signatories, *even if the certificate erroneously recites the lease terms*. [*Plaza Freeway Ltd. Partnership v. First Mountain Bank* (2000) 81 CA4th 616, 628, 96 CR2d 865, 873 & fns. 10 & 11]

(3) [7:292.5] **Effect of contradictory language:** When an estoppel certificate refers to the lease as being "in full force and effect," the "contract" between the landowner and tenant consists of the lease *and* the estoppel certificate. Therefore, if the estoppel certificate contains language that contradicts a provision of the lease, *both* documents are considered together and general rules of contract interpretation apply: i.e., when the ambiguities cannot otherwise be resolved under the statutory rules of construction, the "contract" is interpreted *against the party that drafted the documents* (Civ.C. § 1654). [*Robert T. Miner, M.D., Inc. v. Tustin Avenue Investors, LLC* (2004) 116 CA4th 264, 271-272, 10 CR3d 178, 182-183—where lease clearly stated option right but estoppel certificate did not, trial court erred in ruling estoppel certificate presumptively established tenant had no option right]

➪ [7:292.6] ***PRACTICE POINTER FOR BUYER'S COUNSEL:*** It is recommended that counsel for the purchasing tenant (i) compare each sublease with the corresponding estoppel certificate to ensure the two are consistent and the certificate does not contain any ambiguities; and (ii) clarify and resolve any perceived inconsistencies and ambiguities before closing the transaction. In this way, should it later become necessary for the purchasing tenant to use an estoppel certificate as

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evidence against a subtenant (e.g., in an eviction proceeding), there will be less room for dispute as to what the subtenant intended to represent in the certificate.

b. [7:293] **Matters covered:** These are some of the most significant issues covered by an estoppel certificate (whether executed by landowner or subtenant) in connection with a ground leasehold purchase and sale:

• Date of lease;

• Parties to the lease;

• Amendments to the lease;

• Lease commencement and termination dates;

• Whether the tenant has rights of first refusal or options to purchase the property;

• Whether the tenant is in default under the lease;

• Confirmation that all improvements have been built in accordance with the terms of the ground lease (or sublease, as appropriate);

• Amount of the security deposit;

• Amount of rent.

➪ [7:294] ***PRACTICE POINTER:*** The *landowner's* estoppel certificate should also include a statement that all subleases were executed in conformity with the terms of the ground lease and have been approved by the landowner (where ground lease conditions tenant's right to sublet on obtaining landowner's prior consent).

c. [7:295] **Alternative to estoppel certificates:** Some leases are silent on the issue of landowner/subtenant estoppel certificates. If the ground lease and subleases do not require delivery of estoppel certificates (or they cannot be procured), the purchase and sale agreement should provide some mechanism to fill the gap.

One approach is to require the selling tenant to make various representations and warranties as to the status of the ground lease and subleases. However, unlike estoppel certificates, this alternative will *not bind* the landowner and subtenants; it simply gives the purchasing tenant the right to sue the seller for breach in the event the seller misstated the facts. (*See ¶ 4:420.1*.)

➪ [7:296] ***PRACTICE POINTER:*** Requesting an estoppel certificate from the landowner presents an opportune time to obtain clarifications, confirmations or consents under the ground lease.

For example, if any provisions in the ground lease are ambiguous, the landowner's estoppel certificate can be used to effectively amend the lease by providing appropriate clarifications (*see ¶ 7:292.3*). An estoppel certificate can also function as the landowner's written consent to a transfer of the selling tenant's interest (where the ground lease conditions the tenant's right to assign on obtaining the landowner's prior consent; *see Form 7:B*).

12. [7:297] **Seller's Representations and Warranties:** The purchasing tenant should obtain representations and warranties from the selling tenant concerning a wide range of issues. Most of these are the same representations and warranties sellers should give in connection with the transfer of a fee (*see ¶ 4:431 ff.*). However, a few representations are uniquely important to purchasers of a ground leasehold interest:

a. [7:298] **No breaches:** The seller is not presently in breach of the ground lease or any sublease; and no event has occurred which, with the passage of time or the giving of notice, would constitute such a breach.

b. [7:299] **Options/rights of first refusal:** The selling tenant has no options or rights of first refusal to lease or purchase which are not being conveyed to the purchasing tenant.

c. [7:300] **Modifications/“side agreements”:** There are no undisclosed agreements (whether written or oral) between the selling tenant and landowner or any subtenants which would modify the terms of the written ground lease or subleases.

d. [7:301] **Improvements:** All improvements have been constructed in a workmanlike manner and do not contain any material latent or patent defects.

e. [7:302] **Claims:** The selling tenant holds no claim against any subtenants, nor any claim against any other party that relates to the property, which is not being assigned to the purchasing tenant.

f. [7:303] **Environmental hazards:** The property is free of hazardous materials. (*See Ch. 5*.)

➪ [7:304] ***PRACTICE POINTER:*** As with the purchase and sale of a fee interest, counsel should anticipate intense negotiations over representations and warranties accompanying a ground leasehold sale. The seller, of course, typically prefers to transfer its interest on an "as is" basis, without any representations or warranties. (The impact of an "as is" sale in real property purchase and sale transactions generally is discussed at *¶ 4:351 ff.*)

13. [7:305] **Purchase and Sale Agreement and Use of an Escrow:** The final consideration is the form of the purchase and sale agreement and the use of an escrow for the sale of a ground leasehold.

a. [7:306] **Agreement:** The basic form of purchase and sale agreement for the transfer of a fee interest can easily be modified for use in transferring a ground leasehold. While the conveyancing instrument will differ (i.e., an *assignment* rather than a deed, ¶ *4:59, 7:290*), the issues pertaining to the purchase and sale are almost identical. *See detailed discussion at ¶ 4:260 ff.* (Selecting the Form of Written Agreement) *and 4:280 ff.* (Drafting the Purchase and Sale Agreement—Terms and Conditions).

• ***FORM:*** Sample Purchase and Sale Agreement, *see Form 4:H*.

b. [7:307] **Escrow:** The same considerations that make an escrow the preferred mechanism to effectuate closing and a completed transfer and in the purchase and sale of a fee apply as well to ground leasehold transactions. *See detailed discussion at ¶ 4:560 ff.*

[7:308 - 7:309] ***Reserved.***

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Chapter 7. Ground Leaseholds

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[7:310] The selling tenant should be concerned with most all of the issues that are of importance to the seller of a fee (*see Ch. 4*). In addition, however, the following matters are of particular concern to tenants assigning (selling) a leasehold interest:

• Obtaining the *landowner's consent* to the assignment (where the ground lease subjects transferability of the leasehold to the landowner's prior consent; *see ¶ 7:80 ff.*);

• Verifying that the assignment will not breach or jeopardize agreements with third parties; and

• Attempting to *limit its continuing liability* under the ground lease (and perhaps other contracts) after the assignment.

1. [7:311] **Landowner's Consent to Assignment:** If the ground lease requires the landowner's consent to the assignment, a sale of the ground leasehold would breach the lease *unless* such consent is requested (and obtained). The consequences of an assignment in breach of the lease can be drastic:

a. [7:312] **Failure to seek landowner consent justifies withholding consent:** The tenant's *failure to request* landowner consent in derogation of the lease itself breaches the lease and amounts to a *per se* justification for withholding consent, whether or not consent could properly have been withheld under the facts had the request been made. [Cf. *Thrifty Oil Co. v. Batarse* (1985) 174 CA3d 770, 776, 220 CR 285, 289; *see* ¶ *7:270*]

b. [7:313] **Purchaser's rescission remedy:** Moreover, when the requisite consent is not obtained, the tenant who agreed to purchase the leasehold is entitled to *rescind* the assignment. [*Bush v. Vernon* (1955) 135 CA2d 33, 36-37, 286 P2d 903, 905; *Civille v. Bullis* (1962) 209 CA2d 134, 138, 25 CR 578, 581; ¶ *7:272*]

c. [7:314] **Damages and/or lease termination:** And, having breached the lease, the selling tenant is subject to *contract damages* and/or *termination* of the ground lease (at landowner's election)*; see* ¶ *7:112 ff., 7:270*.

(For an example of the draconian consequences that may befall a selling tenant who fails to comply with assignment restrictions, see *Artesia Med. Develop. Co. v. Regency Associates, Ltd.* (1989) 214 CA3d 957, 960-961, 266 CR 657, 658—selling tenant not only lost benefits of attempted leasehold sale, but lost its lease as well.)

➪ [7:315] ***PRACTICE POINTER:*** Some selling tenants, in an effort to avoid a prohibition on “assignment” (which might not apply to a “sublease”), attempt to characterize an assignment of the ground lease as a “sublease.” (*See* ¶ *7:62 ff.* regarding distinctions between “assignment” and “sublease.”) However, this practice can be dangerous because it might ultimately be construed as a mere subterfuge and artifice for an assignment, in violation of landowner consent provisions.

2. [7:316] **Other Agreements to Which Selling Tenant is a Party:** The selling tenant should make certain that an assignment of the ground lease will not violate other agreements (apart from the ground lease) to which it is a party.

a. [7:317] **Options:** For example, the selling tenant may have granted a prior option to purchase the leasehold interest (perhaps to a subtenant). Unless the preexisting option agreement has terminated, or the optionee thereunder elects not to exercise its option, an assignment to a third person would breach the option agreement and subject the selling tenant to substantial damages liability.

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b. [7:318] **Mortgagee's consent:** The seller's right to assign might also be subject to a *leasehold mortgagee's* prior consent. (In any event, the selling tenant should be concerned about a default in the leasehold mortgage after an assignment of its interest because it may still have continuing liability on the promissory note. *See* *¶ 6:310 ff.*)

[7:319] ***Reserved.***

3. Continuing Liability Under Ground Lease

a. [7:320] **General rules—privity of contract notwithstanding assignment:** As a general rule, unless the ground lease provides otherwise (or the landowner otherwise agrees to a release, *¶ 7:326*), the selling tenant, as a party to the ground lease, *remains liable* under the lease despite its assignment of interest. [*De Hart v. Allen* (1945) 26 C2d 829, 832, 161 P2d 453, 455]

In other words, the selling tenant and landowner *remain in privity of contract*. The seller/assignor's contract liability continues for the duration of the lease term even though the purchaser/assignee *expressly assumes the lease obligations* and *notwithstanding the landowner's consent to the assignment*. [*De Hart v. Allen*, supra; *Meredith v. Dardarian* (1978) 83 CA3d 248, 252, 147 CR 761, 763; see *Tsemetzin v. Coast Fed. Sav. & Loan Ass'n* (1997) 57 CA4th 1334, 1345-1347, 67 CR2d 726, 732-733—where lease and assignment of lease specifically provided original tenant was not released from its lease obligations, original tenant remained liable notwithstanding that new tenant who expressly assumed lease was ultimately exonerated by reason of its insolvency; compare *Standard Fireproof Bldg. Co. v. Carpenter* (1947) 79 CA2d 330, 331, 180 P2d 53, 54—lease relieved assignor of postassignment obligations]

➪ [7:321] ***PRACTICE POINTER:*** Consequently, the selling tenant must make certain the purchaser has the ability (and the reliability) to perform its obligations under the ground lease for the *entire balance of the term*. This is especially important where a substantial term remains under a lengthy ground lease.

For example, if a ground lease is assigned in year five of a 99-year lease, the assignor tenant remains liable for another 94 years after it has relinquished all interest in the leasehold. Although the landowner might be willing to release the assignor of future liability (either when the assignment is executed or at some later time), that is a matter for negotiation; the landowner has no obligation to do so.

(1) [7:322] **Selling tenant more than a "guarantor":** It is often said that the effect of an assignment is to make the selling tenant a guarantor (or surety) for the purchaser/assignee's performance. [*Kendall v. Ernest Pestana, Inc.* (1985) 40 C3d 488, 502, 220 CR 818, 827] This may be true as between seller/assignor and purchaser/assignee. However, as between seller/assignor *and landowner*, the selling tenant is *more* than a mere guarantor or surety: The selling tenant remains a *primary obligor* under the ground lease *without the benefit of surety defenses.* [*De Hart v. Allen* (1945) 26 C2d 829, 832, 161 P2d 453, 455; *Meredith v. Dardarian* (1978) 83 CA3d 248, 252, 147 CR 761, 764]

Indeed, whereas a surety is exonerated by a material alteration of the principal obligation without the surety's consent (Civ.C. § 2819, *¶ 6:586*), a selling tenant/assignor effectively gives its purchaser/assignee the right to make modifications to the lease that will be *binding* on the assignor. [See *Meredith v. Dardarian*, supra, 83 CA3d at 252, 147 CR at 764; *De Hart v. Allen*, supra, 26 C2d at 832, 161 P2d at 455; compare *Bennett v. Leatherby* (1992) 3 CA4th 449, 453, 4 CR2d 340, 343—lease guarantors exonerated from guarantor liability when lessor settles with sublessees and executes all-encompassing release, thereby impairing guarantors' subrogation rights against sublessees]

➪ [7:323] ***PRACTICE POINTER:*** For this reason, unless the selling tenant will be released from its lease obligations upon the assignment (¶ 7:326 ff.), an agreement requiring the seller's *prior written consent* to any postassignment modification of the ground lease is crucial. *See* *¶ 7:336*.

(2) [7:324] **Continuing liability for option rent:** Also, if the lease contains an option to extend the term, the selling tenant remains liable for accruing rent during the option period (as well as all other lease obligations during the option term) in the event the purchaser/assignee exercises the option. [*Realty & Rebuilding Co. v. Rea* (1920) 45 CA 673, 188 P 621, 622-623]

(a) [7:325] **Compare—holdover rent:** However, once the lease term (including renewal options) expires, the selling tenant's contractual obligations cease. The seller is not liable for rent during any period in which the purchasing tenant (or any successor) wrongfully *holds over* in violation of the lease. [*Meredith v. Dardarian* (1978) 83 CA3d 248, 253-255, 147 CR 761, 764-766]

b. [7:326] **Exception—release from postassignment liability:** The selling tenant's contractual obligations terminate after an assignment where either (1) the ground lease expressly so provides, or (2) the landowner separately agrees to release the seller/assignor from future liability (this may occur at the time of the assignment or at some point in the future).

In effect, under such circumstances, transfer of the leasehold interest is a *novation*—i.e., the creation of an entirely new lease that *extinguishes* and *supersedes* the original lease, leaving the landowner to look only to the new tenant (ground leasehold purchaser) for performance. [Civ.C. §§ 1530, 1531; see *Wells Fargo Bank v. Bank of America NT & SA* (1995) 32 CA4th 424, 431-432, 435, 38 CR2d 521, 525, 527-528; *Fanucchi & Limi Farms v. United Agri Products* (9th Cir. 2005) 414 F3d 1075, 1081 (applying Calif. law); and *Tufeld Corporation v. Beverly Hills Gateway, L.P.* (2022) 86 CA5th 12, 29-30, 302 CR3d 203, 215-216 (concluding 2003 assignment constituted "novation" that reset Civ.C. § 718's 99-year time limit (¶ 7:12)]

(1) [7:326.1] **Three-party assent:** Because it extinguishes the original lease and substitutes a new lease, a novation requires the assent of the landowner, the original (transferor) tenant and the new tenant. However, all the parties need not manifest their assent simultaneously or in the same document. [*Wells Fargo Bank v. Bank of America NT & SA* (1995) 32 CA4th 424, 435, 38 CR2d 521, 525]

Thus, if the ground lease provides that the tenant will be relieved of liability from the date of any assignment, an assignment by the tenant and assumption by the assignee will complete the novation. The landlord's contemporaneous consent is not required. [See *Wells Fargo Bank v. Bank of America NT & SA*, supra, 32 CA4th at 432, 38 CR2d at 525]

(2) [7:327] **Limitation—"sham" assignments:** A release-upon-assignment provision in the ground lease will not be enforceable where the assignment was effected as a mere subterfuge or "sham" to enable the selling tenant to escape its leasehold obligations. In other words, the exoneration provision will effectively release the tenant assignor *only* if the assignment is to a *bona fide* third party. [*O'Donnell v. Weintraub* (1968) 260 CA2d 352, 357-358, 67 CR 274, 278—assignment to "alter ego" corporation was mere sham undertaken to allow tenant to escape personal liability while retaining economic benefits of lease through control of "dummy" assignee]

➪ [7:328] ***PRACTICE POINTER:*** As a matter of prudence, it makes sense for the selling tenant to have the landowner *reaffirm* (in writing) any lease provision exonerating the selling tenant from liability upon assignment at the time the landowner grants its written consent to the assignment. Having approved the assignment and reaffirmed the exoneration provision, the landowner will be hard pressed to avoid the release by claiming a "sham" assignment.

(3) [7:329] **Exoneration of seller's guarantors:** An agreement to release the *seller* from its principal obligations will not itself terminate any *third party guaranties* given for the seller's leasehold liabilities (although the guarantors will be exonerated as a matter of law if the principal obligations are altered in any material respect without the guarantors' consent; see Civ.C. § 2819, *¶ 7:322*). Thus, unless the lease expressly provides that third party *guaranties* (e.g., by the seller's principal or affiliate) are extinguished upon a bona fide assignment, the selling tenant will want to negotiate for a separate agreement to exonerate the guaranty obligations.

(4) [7:330] **Exoneration of other contract liabilities:** Likewise the selling tenant's liability under third party contracts *independent of the lease* (e.g., construction contracts, management agreements, reciprocal easement agreements and various other agreements concerning operation of the property) will not be affected by the *landowner's* agreement to release the seller from its *lease* obligations. Thus, the seller should also negotiate for the purchaser's assumption of these independent obligations (*¶ 7:334 ff.*) and a concurrent postassignment exoneration from the third parties (i.e., additional third party contract novations).

c. [7:331] **Indemnification from purchasing tenant:** Regardless of whether the selling tenant might be exonerated from its lease obligations upon an assignment, it behooves the seller to obtain a blanket indemnification from the purchasing tenant for all matters arising out of the ground lease or affecting the property, and/or relating to any of the subleases. The indemnification should be effective from and after the closing of the sale.

Though the scope of any indemnification is negotiable, the parties should specifically delineate its application to postassignment claims. This issue is important because postassignment claims might be predicated on acts or events that occurred *before* the leasehold transfer (in which event, the purchaser would not want to be held to an indemnification obligation).

Cross-refer: Indemnification issues facing seller and buyer in a ground lease transaction are the same as those that arise in connection with the purchase and sale of a fee interest. For a more detailed discussion, *see ¶ 4:461 ff.*

➪ [7:332] ***PRACTICE POINTER:*** In addition to an indemnity, the selling tenant should consider obtaining *guaranties*, whereby the principals of the purchasing tenant (or perhaps other creditworthy parties) agree to become secondarily liable for the purchaser's performance under the ground lease. Also pursue the possibility of *securing* indemnification and guaranty obligations with property of the purchasing tenant or guarantors.

The purchasing tenant is often a one-asset entity—e.g., a corporation or limited partnership established for the sole purpose of owning the tenant's ground lease interest. In such situations, adequate guaranties from solvent individuals or entities who can stand behind the purchaser's performance are a particularly important safeguard for the seller.

d. [7:333] **No right of reentry to protect seller:** Absent a release, an assignment does not disturb the selling tenant's and landowner's privity of contract relationship (*¶ 7:320*); however, an assignment *does* extinguish the parties' *privity of estate* relationship. Consequently, the tenant/assignor has *no right of reentry* following an assignment of its leasehold interest. [*Kendall v. Ernest Pestana, Inc.* (1985) 40 C3d 488, 492, 220 CR 818, 820, fn. 2; see *Vallely Investments, L.P. v. BancAmerica Comm'l Corp.* (2001) 88 CA4th 816, 822, 106 CR2d 689, 694; *and ¶ 7:63*]

This is true even if the assignee abandons the property. Thus, upon an assignment, the selling tenant might not have the ability to cure the purchasing tenant's breach of the lease. [*Flynn v. Mikelian* (1962) 208 CA2d 305, 311-312, 25 CR 138, 142]

e. [7:334] **Purchaser's assumption of lease obligations—privity of estate vs. privity of contract:** As between purchaser/assignee and landowner, an assignment puts them in a *privity of estate* relationship for so long as the assignee retains possession. But the assignee is *not contractually* bound under the ground lease (*no privity of contract* relationship) *unless* it expressly *agrees in writing to assume* all of the selling tenant's lease obligations (*see Forms 7:C and 7:D*). [*Kelly v. Tri-Cities Broadcasting, Inc.* (1983) 147 CA3d 666, 676, 195 CR 303, 308; *Vallely Investments, L.P. v. BancAmerica Comm'l Corp.* (2001) 88 CA4th 816, 822, 106 CR2d 689, 694; see also *Ellingson v. Walsh, O'Connor & Barneson* (1940) 15 C2d 673, 676, 104 P2d 507, 509; see also *BRE DDR BR Whittwood CA LLC v. Farmers & Merchants Bank of Long Beach* (2017) 14 CA5th 992, 1000-1004, 222 CR3d 435, 440-444 (purchase of leasehold estate through foreclosure did not constitute express agreement to assume lease obligations)—commercial tenant's lender who purchased leasehold estate through foreclosure following tenant's default had no duty to continue paying rent to landlord after surrendering premises]

(1) [7:335] **Consequences of purchaser's privity of estate:** Being in privity of estate, the assignee takes all of the benefits *and burdens* of the tenant assignor's leasehold interest; and, for so long as it continues in possession, the assignee remains liable to the landowner under all tenant covenants "running with the land"—including the obligation to pay rent. [*Realty & Rebuilding Co. v. Rea* (1920) 184 C 565, 569, 194 P 1024, 1026; see *Kelly v. Tri-Cities Broadcasting, Inc.* (1983) 147 CA3d 666, 678-679, 195 CR 303, 310; see also *Vallely Investments, L.P. v. BancAmerica Comm'l Corp.* (2001) 88 CA4th 816, 822, 106 CR2d 689, 694; *and ¶ 4:63 ff.* for general discussion of "covenants running with the land"]

(2) [7:336] **Consequences of purchaser's lack of contractual privity—seller's risk:** Since most of the lease covenants "run with the land," the purchaser's/assignee's privity of estate may theoretically suffice to protect the seller/assignor (as well as the landowner). However, relying exclusively on the assignee's privity of estate to bind it to the lease obligations is a *real risk* for the seller … because, absent an express assumption (putting it in privity of contract), the assignee is bound to pay rent and perform the other lease obligations *only for so long as it remains in possession of the property*. Immediately upon cessation of its possession, the assignee's privity of estate terminates and it is no longer obligated under the lease. [See *BRE DDR BR Whittwood CA LLC v. Farmers & Merchants Bank of Long Beach* (2017) 14 CA5th 992, 1000-1004, 222 CR3d 435, 440-444 (¶ 7:334)]

In addition, where the "facts and circumstances" of the lease transaction dictate, the seller may continue to be bound by *implied* covenants (arising from the lease as a whole or from its express covenants) that could expose it to liability even after the transfer of its leasehold interest to the purchaser. [See *Del Taco, Inc. v. University Real Estate Partnership V* (2003) 111 CA4th 16, 27-28, 3 CR3d 311, 319-320—undisputed facts of lease transaction did *not* support inference of seller/assignor's implied promise to provide lifetime maintenance and repair of sewer line]

Consequently, it is extremely important to the selling tenant that the purchaser agree to an express assumption. Otherwise, the seller risks the possibility that the purchaser might *abandon* the property at some future time, leaving the seller as the *only* obligor under the ground lease. [See *Realty & Rebuilding Co. v. Rea* (1920) 184 C 565, 569, 194 P 1024, 1026; *Kelly v. Tri-Cities Broadcasting, Inc.* (1983) 147 CA3d 666, 678-679, 195 CR 303, 310]

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➪ [7:337] ***PRACTICE POINTER:*** The selling tenant should be similarly motivated to obtain the purchaser's agreement to assume all independent obligations affecting the property under agreements with *third parties* (construction contracts, management agreements, reciprocal easement agreements, etc.); *see ¶ 7:330*. And likewise as to the seller's *sublease* obligations; *see ¶ 7:358*.

f. [7:338] **Protection from increased liability by postassignment ground lease modifications:** If the selling tenant will remain liable under the ground lease following the assignment (and especially in the absence of the purchaser's assumption, ¶ 7:334), an agreement prohibiting the purchaser from modifying or amending the lease (including any extension of the term) without the seller's/assignor's prior written consent is crucial. Absent such a provision, the seller risks unanticipated and unpredictable increased liability under the ground lease.

(Recall that a seller/*assignor* is not a mere "guarantor" or "surety" for the purchaser's/assignee's liability and thus not protected by the rule that material alterations of the principal obligation without the guarantor's consent extinguish the guaranty; *see ¶ 7:322*.)

g. [7:339] **Seller's right to notice of default:** Remaining in postassignment *contractual privity* with the landowner (absent a novation or other express release from the landowner, ¶ 7:326 ff.), the selling tenant/assignor risks a *termination* of the lease and *damages liability* for breach of the lease should the purchaser/assignee default on the lease obligations; this could happen without prior notice of default to the seller/assignor and without a right to "cure" and recover possession. [*Flynn v. Mikelian* (1962) 208 CA2d 305, 311-312, 25 CR 138, 142] Depending on the language of the default provisions in the ground lease, such damages may include future rent. [*Desert Plaza Partnership v. Waddell* (1986) 180 CA3d 805, 812-813, 225 CR 775, 780; see also *Danner v. Jarrett* (1983) 144 CA3d 164, 166-167, 192 CR 535, 536-537]

Accordingly, a selling tenant who is unable to obtain the landowner's agreement to exonerate it from postassignment liability under the ground lease should negotiate for a provision requiring the landowner to give the seller *both* (1) *notice* of the purchasing tenant's default and (2) an *opportunity to cure* before the landowner may take action that could prejudice the leasehold interest. (Such a provision could be set forth in the document that evidences the landowner's consent to the assignment.)

h. [7:340] **Additional seller protections:** If the selling tenant will not be relieved of postassignment liability under the ground lease, consider these additional steps that may help protect it from future liability:

(1) [7:341] **Sublessees pay rent directly to seller:** The purchasing tenant's agreement that, in the event the purchaser defaults under the ground lease, all subtenant rents then due (and thereafter coming due) will be paid directly to the seller will provide the seller with a fund from which to discharge the ground lease rent obligations.

(2) [7:342] **Seller's right to insurance proceeds:** Another safeguard is the purchaser's agreement to assign insurance proceeds to the seller in the event the property is damaged by an insured peril and the purchaser refuses to make the necessary repairs.

(3) [7:343] **Seller's right to reenter and take possession:** The selling tenant may want to negotiate with the *landowner* for a right to reenter and retake possession of the property following a default and termination of the purchaser's interest.

Retaining a right of reentry technically converts the assignment into a sublease. [*Kendall v. Ernest Pestana, Inc.* (1985) 40 C3d 488, 492, 220 CR 818, 820, fn. 2; *Barkhaus v. Producers' Fruit Co.* (1923) 192 C 200, 205-206, 219 P 435, 437-438; *Flynn v. Mikelian* (1962) 208 CA2d 305, 310, 25 CR 138, 141; *see ¶ 7:63*] Nevertheless, it will give the selling tenant some protection as to the leasehold itself … whereas, without a right of reentry, the seller's only remedy would be a claim for damages against the purchasing tenant.

i. Structuring sale as sublease instead of assignment

(1) [7:344] **Advantages to seller:** Structuring a sale of the tenant's interest as a "sublease" rather than an "assignment" may offer advantages to the selling tenant (*but see ¶ 7:68* regarding construction of sublease as assignment):

(a) [7:345] **Preserving income over time:** A sublease may make sense if one of the seller's goals is to receive a stream of income over time (instead of one lump-sum payment for a transfer of its leasehold interest). Although the same goal could be achieved through an assignment that requires the purchasing tenant's payment of an installment note secured by the leasehold interest, the grant of such a security interest may be prohibited by the terms of the ground lease or any existing (or future) leasehold financing.

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(b) [7:346] **Curing defaults:** Ordinarily, following a true assignment, the selling tenant has no right of reentry to cure the purchaser's defaults (*¶ 7:63*). But a sublease effectively keeps the seller informed of the purchaser's failure to perform its obligations; as sublessor, the seller can readily step in to cure any nonfeasance that would be a default under the ground lease. [*Barkhaus v. Producers' Fruit Co.* (1923) 192 C 200, 219 P 435, 438]

(2) [7:347] **Purchasing tenant's competing concerns:** On the other hand, the purchasing tenant has competing concerns which may render it disinclined to treat the transaction as a "sublease":

(a) [7:348] **Privity:** As a sublessee, the purchaser is neither in privity of estate nor privity of contract with the landowner; thus, the ground lease covenants do not run to the purchaser's benefit. (The purchaser's rights and remedies lie solely against the seller/sublessor under the sublease.) [See generally, *Hartman Ranch Co. v. Associated Oil Co.* (1937) 10 C2d 232, 242, 73 P2d 1163, 1168]

(b) [7:349] **Termination:** The purchaser's/subtenant's rights can be no greater than those of the seller/sublessor. Thus, the purchaser's leasehold interest would be terminated upon a termination of the ground lease. (To avoid this result, the purchasing tenant would have to negotiate for notice and opportunity to cure, or a nondisturbance agreement, or both; *¶ 7:280*.) [*Fifth & Broadway Partnership v. Kimny, Inc.* (1980) 102 CA3d 195, 201, 162 CR 271, 275; see also *Buck v. Morrossis* (1952) 114 CA2d 461, 466, 250 P2d 270, 274]

(c) [7:350] **Financing:** A sublease is likely to be more difficult to finance than a ground lease.

(d) [7:351] **Renewal options:** Not being in privity with the landowner, the purchasing tenant would not be entitled to exercise any options to *extend* the lease term granted by the ground lease (they would be exercisable only by the seller/sublessor). The purchaser would thus need to separately contract with the landowner for option rights. [*Ablett v. Clauson* (1954) 43 C2d 280, 283, 272 P2d 753, 754]

(e) [7:352] **Purchase options:** Likewise, a sublease will not automatically transfer any option to *purchase* the fee interest; the purchaser will acquire the seller's option to purchase only if it is specifically assigned.

[7:353 - 7:354] *Reserved.*

4. [7:355] **Estoppel Certificates:** Though critical for the purchasing tenant (*¶ 7:292 ff.*), "estoppel certificates" can also be beneficial to the selling tenant. Through an estoppel certificate, the seller can confirm it is not in breach at the time of the ground lease assignment (or, if it allegedly is in breach, the seller will know the extent of the claimed breach).

a. [7:356] **From subtenants:** Subtenant estoppel certificates can be used to verify that the seller is not presently in default under the subleases. Through appropriate language, the certificates can also effectively exonerate the selling tenant upon the transfer of its interest under the sublease (assuming the seller is not automatically exonerated under the sublease). (See more detailed discussion of tenant estoppel certificates at *¶ 4:418 ff.; see also Form 4:J*.)

b. [7:357] **From landowner:** The landowner's estoppel certificate can be used to verify that the selling tenant is in compliance with the terms of the ground lease; it is also an appropriate vehicle to obtain the landowner's clarification of incidental issues important to the purchase and sale transaction—e.g., that the tenant has performed its construction obligations in accordance with the terms of the ground lease; that all subleases are in conformity with the landowner's requirements (and if consent to the subleases was required, that the landowner's consent has been given).

• ***FORM:*** Landowner (Ground Lessor) Estoppel Certificate (With Consent to Assignment), *see Form 7:B*.

5. [7:358] **Assumption and Indemnifications Regarding Subleases:** Absent its express assumption of the seller's *sublease* obligations, the purchaser might attempt to avoid any contractual obligations to the subtenants on the theory there is no privity of contract between them. [*Kelly v. Tri-Cities Broadcasting, Inc.* (1983) 147 CA3d 666, 676, 195 CR 303, 308; *Ellingson v. Walsh, O'Connor & Barneson* (1940) 15 C2d 673, 676, 104 P2d 507, 509; *Treff v. Gulko* (1932) 214 C 591, 594, 600, 7 P2d 697, 699, 701] Consequently, for both the seller's and subtenants' protection, the leasehold assignment (or separate agreement) should specifically provide that the purchasing tenant assumes all obligations of the selling tenant under each and all of the subleases. (*See Forms 7:C & 7:D*.)

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6. [7:359] **Purchaser's Representations and Warranties:** Those representations and warranties which are important to the seller of a fee interest (*see ¶ 4:431 ff.*) are also important to sellers of a ground leasehold interest. In particular, however, because the selling tenant may have residual liability under the ground lease in the event the purchasing tenant subsequently defaults, the selling tenant should be acutely interested in the purchaser's representations and warranties regarding the purchaser's (a) *financial condition*; and (b) *prior operating/business history*.

7. [7:360] **Handling Security Deposit:** Counsel for the selling tenant should be aware of certain issues relating to security deposits.

a. [7:361] **Seller's deposit to landowner:** In all likelihood, the selling tenant will have paid a security deposit to the landowner. That deposit is usually transferred to the benefit of the purchasing tenant. Thus, it is essential that the seller obtain a credit from the purchasing tenant for the full amount of the deposit.

b. [7:362] **Subtenant deposits to selling tenant:** Appropriate provisions regarding the handling of *subtenant* security deposits should also be included in the purchase and sale documents. (The purchasing tenant will obviously want an assignment of, and credit for, the deposits.)

Like the owner of a fee interest in nonresidential rental property (*¶ 4:421*), the selling tenant will remain personally liable for its subtenants' security deposits *unless* it *either:*

- *Transfers to its buyer* that portion of the deposits remaining after lawful deductions *and* thereafter *notifies the subtenants*, by personal delivery or certified mail, of the transfer, of any claims made against the security deposit, and of the transferee's name and address; *or*

- *Returns to the subtenants* that portion of the security deposits remaining after lawful deductions. [See Civ.C. § 1950.7(d); see also Civ.C. § 1950.7(c) re "lawful deductions" from deposit]

8. [7:363] **Payment of Purchase Price:** Broadly, issues relating to payment of the consideration for a ground lease assignment are identical to those arising in connection with the purchase and sale of a fee interest (*see ¶ 4:288 ff.*). However, on this subject, a few points are peculiar to ground lease transactions:

a. [7:364] **Sharing consideration with landowner:** Seller's counsel should review the ground lease for any provision giving the landowner the right to share in a portion of the consideration paid to the selling tenant. (Although such a provision is more likely to be found in leases other than ground leases, there is no reason why it could not appear in a ground lease.)

b. [7:365] **Leasehold interest as security for purchase obligation:** Sellers willing to take some or all of the purchase price over time will naturally want *security* for the unpaid balance—typically, in the form of a *deed of trust* encumbering the purchaser's interest in the ground lease. This arrangement is feasible only if the ground lease permits encumbrancing of the leasehold interest. Seller's counsel should thus review the lease before committing to such an arrangement.

Also, in negotiations for such an installment transaction, bear in mind the purchaser may be seeking the seller's agreement to *subordinate* its deed of trust to any additional leasehold financing the purchaser may desire in the future.

[7:366 - 7:369] ***Reserved.***

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Chapter 7. Ground Leaseholds

E. Representing the Landowner

1. [7:370] Threshold Issue—Right to Consent to Assignment
2. [7:375] Status of Construction
3. [7:376] Due Diligence Regarding Purchasing Tenant
4. [7:378] Assignee's Assumption of Lease Obligations
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7. [7:384] Seller's Estoppel Certificate
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9. [7:386] Consent Fee

1. [7:370] **Threshold Issue—Right to Consent to Assignment:** Upon a proposed ground lease assignment, the landowner's primary concern is with the new tenant's (assignee's) qualifications—notably, its creditworthiness, stability and reliability. However, a tenant's leasehold interest is freely transferable *unless* the lease contains an *unambiguous restriction* on transfer (Civ.C. §§ 1995.210(b), 1995.220; *see* ¶ *7:71, 7:74*). Consequently, where the ground lease contains *no* restrictions on transferability of the tenant's interest, the landowner has *no* right to approve or disapprove a proposed assignment (regardless of the intended assignee's qualifications) and, hence, no right to be involved in the leasehold purchase and sale transaction.

It follows that the threshold task for landowner's counsel is to review the ground lease for language restricting the tenant's right to assign (or sublease):

• [7:371] A lease provision that *absolutely prohibits* any transfer of the tenant's interest is valid and enforceable according to its terms. [Civ.C. § 1995.230; ¶ *7:73, 7:75*] Hence, unless the landowner is willing to negotiate an appropriate modification, the assignment cannot proceed.

(Of course, if the ground lease purchase and sale is consummated despite an absolute prohibition on transferability, the landowner has the right to pursue appropriate damages and/or termination remedies. *See ¶ 7:112 ff.*)

• [7:372] The lease might prohibit "assignment," but be silent on the right to "sublease." Here, counsel must determine whether the selling tenant's proposed "sublease" is, for all practical purposes, really a prohibited assignment (*see* ¶ *7:64, 7:68*).

• [7:373] If the lease contains a landowner *consent* condition to transferability, it must next be determined under what circumstances consent may properly be withheld: This issue turns on the language of the lease; if the lease contains no express standards for the giving or withholding of consent, a "reasonableness" standard will be implied. [See Civ.C. §§ 1195.260 & 1995.270; *and detailed discussion at ¶ 7:80 ff.*]

➪ [7:374] ***PRACTICE POINTERS FOR LANDOWNERS:*** If (as landowner) you *decline approval* of a tenant's proposed assignment pursuant to a "consent clause" condition that is subject to a "reasonableness" standard, promptly respond in writing to the tenant's request for a statement of reasons for withholding consent. Failure to do so within a reasonable time (or to provide a "reasonable objection" to the transfer) effectively proves an *unreasonable* withholding of consent. [See Civ.C. § 1995.260; *and ¶ 7:85*]

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In any event, under a "consent clause" lease (or any lease restricting the tenant's right to transfer), landowners should not sit on their rights: *Immediately* object to an unauthorized assignment or risk *waiving* the right to do so. [*Sexton v. Nelson* (1964) 228 CA2d 248, 258, 39 CR 407, 413]

2. [7:375] **Status of Construction:** The status of construction will ordinarily have a significant impact on the landowner's decision to grant or withhold consent to the transfer. The landowner is more likely to have a reasonable basis for withholding consent when the tenant's construction of improvements has not been completed. In such event, the landowner may be concerned that the purchasing tenant will not have the ability (financial or otherwise) to complete the required construction.

Short of rejecting the purchaser outright, the landowner might consider requiring a performance bond from a surety, insuring that the construction will be completed in accordance with the terms of the ground lease.

3. [7:376] **Due Diligence Regarding Purchasing Tenant:** A "due diligence" review of the purchasing tenant's financial condition and operating history should be conducted in much the same way the original tenant's qualifications were reviewed. Of particular importance are the purchasing tenant's:

• Business—i.e., the nature and quality of its business.

• Operating history and reputation.

• Financial strength.

• Intended use.

• Contemplated alterations to the property.

• Ability to generate sufficient sales so as not to jeopardize rent payable under a *percentage rent lease:* i.e., if the ground lease calls for percentage rent (a specified percentage of the tenant's sales, perhaps coupled with a minimum base rent), the landowner must make certain the purchasing tenant's business operations on the property will generate sales at least equal to that of the selling tenant; otherwise, the landowner risks a decrease in rental income. (Here, the risk of receiving less rent would provide a "commercially reasonable" basis for rejecting the proposed purchaser; *see* *¶ 7:95 ff.*)

➪ [7:377] ***PRACTICE POINTER:*** In lieu of exercising the right to withhold consent to a proposed purchaser/assignee who does not satisfy a due diligence review, the landowner may want to consider obtaining a guaranty from a financially sound third party (e.g., the purchasing tenant's principal) as a condition to its agreement to approve the assignment.

4. [7:378] **Assignee's Assumption of Lease Obligations:** To optimize its recourse against the purchasing tenant, the landowner should make certain the purchaser agrees to *assume all* of the selling tenant's obligations under the ground lease. Otherwise, landowner and purchaser/assignee will not be in privity of contract; the purchaser will be bound by the ground lease obligations (through privity of estate) only for so long as it remains in possession of the premises … effectively leaving the purchaser free to terminate its occupancy at will without further obligations to the landowner. [*Kelly v. Tri-Cities Broadcasting, Inc.* (1983) 147 CA3d 666, 676, 195 CR 303, 308-309]

Moreover, absent the purchaser's express assumption of all of the selling tenant's ground lease obligations, the purchaser may be able to avoid obligations under the ground lease in the event it subsequently mortgages the leasehold and a foreclosure of the mortgaged leasehold occurs. [See *Vallely Investments, L.P. v. BancAmerica Comm'l Corp.* (2001) 88 CA4th 816, 824, 106 CR2d 689, 696—landlord that required ground lease assignee to *expressly assume* all obligations thereunder successfully enforced rent payment provision against assignee even though assignee's mortgaged leasehold interest was extinguished by foreclosure; *and more detailed discussion at* *¶ 7:334 ff.*]

5. [7:379] **Release of Selling Tenant's Ground Lease Rights and Obligations:** For all practical purposes, a true "substitution" of tenants under the ground lease—i.e., a *novation* (*¶ 7:326 ff.*)—facilitates and simplifies dealings between landowner and tenant for the balance of the term; i.e., the landowner may prefer to deal with one party, rather than two (or more).

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Thus, if the purchasing tenant will be assuming the ground lease obligations (¶ 7:378), and the landowner feels confident about the purchaser's qualifications, reliability and integrity, the landowner may be willing to release (exonerate) the selling tenant from both its ground lease obligations and its rights in the rental property—including the right to reenter or cure any postassignment default under the lease. Such release may be made a condition to the landowner's granting consent to the assignment. (*See ¶ 7:326 ff.*)

➪ [7:380] ***PRACTICE POINTER:*** While such a novation might simplify future dealings, it has at least one major drawback: When the selling tenant is completely substituted out of the picture, the landowner's sole recourse will be against the purchaser/assignee. Should the purchaser be unable to cure a future default, the landowner will be left only with a termination/damages remedy against the purchaser … and, perhaps, with the unwelcome prospect of having to find a new tenant. Therefore, the landowner may deem it more prudent to both keep the selling tenant liable under the ground lease and give the selling tenant the right to reenter and cure any default by the purchaser. (*See* ¶ *7:339, 7:343*.)

6. [7:381] **Confirmations:** As a matter of prudence from the landowner's perspective, certain matters that could be affected by the landowner's consent to the assignment should be confirmed in writing by the selling and buying tenants:

a. [7:382] **Nonwaiver of future assignment restrictions:** Under current law, ground lease restrictions on the right to assign or sublet the leasehold interest are not extinguished by the landowner's consent to a prior transfer or waiver of a standard or condition for a prior transfer … *unless* (1) the lease expressly provides the transfer restriction is limited to the original tenant, or (2) the landowner expressly states in writing that its consent or waiver on one occasion applies to subsequent transfers as well. [Civ.C. § 1995.340; *see ¶ 7:111*]

Even so, to avoid misunderstandings, the selling and purchasing tenants should confirm in writing that the landowner's approval of the present assignment will not amount to a waiver of its right under the ground lease to approve or disapprove future proposed assignments of the ground lease.

b. [7:383] **Seller's continuing liability:** Unless the landowner has agreed to exonerate the seller from its postassignment contract liability, the documentation reflecting landowner consent to the assignment should also confirm that, notwithstanding the assignment, the selling tenant remains liable under the terms and conditions of the ground lease (*see ¶ 7:320 ff.*).

7. [7:384] **Seller's Estoppel Certificate:** The landowner should attempt to obtain an estoppel certificate from the selling tenant, confirming the status and various terms and conditions of the ground lease—including, the seller's confirmation that the landowner is not presently in default under the ground lease. (*See generally, ¶ 4:418 ff.; and Form 4:J*.)

8. [7:385] **"Clean-Up" Matters (Ground Lease Clarifications and Modifications):** Either because the ground lease was not properly drafted at its inception, or because of changed circumstances, various modifications to the lease may be desirable. Negotiations over landowner consent to the assignment may be an ideal opportunity for the landowner to require appropriate clarifications and amendments to the ground lease to clean up lingering problems, disputes and/or inconsistencies. (*See ¶ 7:296*.)

9. [7:386] **Consent Fee:** Ground leases sometimes require that a fee be paid to the landowner to cover its expenses (including legal fees) incurred in investigating a proposed purchaser/assignee under a "consent clause" provision. Landowner's counsel should, of course, review the lease for such a provision; depending upon the lease terms, it may be necessary to advise the parties at the inception of the transaction of the nature of the contemplated investigation and the fee amount likely to be due.

[7:387 - 7:389] ***Reserved.***

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Cal. Prac. Guide Real Prop. Trans. Ch. 7-F

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 7. Ground Leaseholds

F. Leasehold Provisions to Assure Financeability

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1. [7:390] **Overview:** Extremely long-term ground leases can be almost as valuable as a fee interest, and in many instances just as mortgageable. Indeed, financeability of the leasehold interest is likely to be of great importance to prospective tenant purchasers:

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• The tenant often needs leasehold financing to obtain funds to build improvements.

• Also, quite apart from the question of financing for improvements, the leasehold is an asset which the tenant may wish to pledge at a future date to secure a loan for an independent purpose (unrelated to the property).
Therefore, before consummating the assignment, it is crucial for buyer's counsel to review the ground lease for financing provisions. If the lease is silent on the subject, or if the financing provisions are too restrictive or otherwise insufficient, appropriate amendments to the ground lease should be negotiated.
The sections set forth at ¶ 7:392 ff. provide a checklist of leasehold financing issues prospective tenants should consider before buying an interest in a ground lease.

• ***FORM:*** See Sample Ground Lease, Article 14, *Form 7:A*.
➪ [7:391] ***PRACTICE POINTER—PROSPECTIVE LENDER'S INVOLVEMENT*:** The leasehold financing provisions must reflect the prospective lender's (contemplated leasehold mortgagee's) requirements. Consequently, to the extent feasible, the purchaser's prospective lender should be involved at the *outset* of negotiations.

2. [7:392] **Subordinating the Fee (“Fee Joinder”):** Subordinating the fee (sometimes called “fee joinder”) refers to a leasehold financing arrangement in which the landowner allows its fee interest in the property to serve as security for performance of the loan made to the ground lease tenant.
a. [7:393] **Landowner's motivation:** Since the landowner is not the beneficiary of the financing proceeds, such subordination agreements generally are the *exception* (not the norm). Nonetheless, a “fee joinder” provision is sometimes found in ground leases because:

• It is simply part of the deal struck with the tenant as an inducement to enter into the ground lease; and/or

• The landowner may recognize that fee subordination is the only way the tenant can secure financing for the construction of improvements.
b. [7:394] **Consequences:** When subordinated to a leasehold mortgage, the fee interest could be wiped out by a foreclosure of the deed of trust. However, if the leasehold financing proceeds will be used solely for purposes of constructing improvements, the landowner might not be giving up much by the subordination agreement; this is because, if the tenant defaults and the landowner has to step in and pay off the loan, the landowner will still have received the benefit of the loan proceeds—i.e., the completed improvements.
➪ [7:395] ***PRACTICE POINTER FOR LANDOWNER COUNSEL:*** If a fee subordination is required, counsel for the landowner should insist that it be conditioned upon all loan proceeds being used *exclusively* to construct required tenant improvements. This will ensure that the landowner ultimately receives the benefit of completed improvements. Otherwise, should the tenant borrow money for some other purpose, the landowner obtains no benefit in consideration of its “fee joinder” agreement.

3. [7:396] **Threshold Inquiry—Ground Lease Provision Allowing Leasehold Mortgage:** The initial task for buyer's counsel is to determine whether the ground lease addresses the subject of financing the leasehold interest and, if so, whether the lease permits such financing. On these issues, note the following points in particular:
a. [7:397] **Transfer restrictions:** A provision permitting leasehold financing is inextricably bound to, and governed by, provisions regarding *transferability* (assignment) of the leasehold … since a pledge of the leasehold is, in effect, a transfer (hypothecation) to the leasehold mortgagee. However, the ground lease should also clearly and specifically contemplate a leasehold mortgage.
b. [7:398] **Restrictions on eligible lenders:** Some ground leases only allow financing by an “institutional lender” (such as a bank, insurance company, savings and loan association or pension fund). Such a restriction would be unacceptable to a purchasing tenant who contemplates (1) private party financing or (2) taking back a deed of trust encumbering the leasehold when it transfers its interest in the ground lease to a subsequent assignee tenant.

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4. [7:399] **Lease Term:** At a minimum, the term of the lease must be as long as the term of the loan; but most lenders require that the lease term be even longer. Depending on the particular lender, options to extend the term may or may not be included in calculating sufficiency of the length of the term.

➪ [7:400] ***PRACTICE POINTER:*** Occasionally, commencement of the term might not occur until the happening of certain events (or satisfaction of certain conditions). In such cases, it is unlikely a lender will fund any loan until all conditions precedent have been satisfied.

5. [7:401] **Ascertainable Rent:** Any prospective lender will require that the amount of rent (including increases) be clearly ascertainable or certain. Otherwise, it will be difficult for a lender to determine (a) the fair market value of the leasehold (in order to evaluate the desirability of taking the leasehold as security for the loan), and (b) the financial burden the lease payments place on its borrower.

The problem here could be particularly acute with regard to periodic increases during the lease term or rent to be paid during option terms. Rent formula clauses may be a stumbling block to financeability unless keyed to readily ascertainable standards (*see* ¶ *7:136 ff.*, *7:160 ff.*).

➪ [7:402] ***PRACTICE POINTER:*** Lender objections might be ameliorated by a provision setting forth a *maximum ceiling* on rent increases, thus enabling the lender to determine the "outside" obligation it would have to take over in the event it has to foreclose on the leasehold.

6. Use and Competing Use Provisions

a. [7:403] **Lender's desire for liberal use clauses:** Use restrictions in the lease may hamper financeability. The lender will be looking for optimum flexibility with regard to use because, in the event of foreclosure, it will want to assign the leasehold interest as quickly as possible (without regard to an eligible assignee's intended use). Hence, use restrictions in the ground lease may have to be renegotiated before a purchaser contemplating future financing can proceed with the transaction. (On the construction and enforceability of use restrictions, *see ¶ 7:170 ff.*)

b. [7:404] **"Radius" restrictions:** The lender will also be concerned about leasehold provisions restricting the tenant's right to engage in a certain kind of business within a specified radius of the property. These so-called "radius" provisions are generally designed to facilitate another tenant's "exclusive use" rights or to protect the landowner from business competition by a tenant.

Leasehold mortgagees generally object to such restrictions because, in the event of foreclosure, they want to be able to market the property to a broad base of prospective tenants. (For example, if the lease precludes the tenant from opening two fast-food restaurants within a five-mile radius, the lender will not be able to assign the lease to many of the most successful fast-food chains who frequently have two locations within any five-mile urban radius.) Again, the purchaser may have to renegotiate the objectionable restrictions before proceeding with the transaction.

7. [7:405] **Alteration of Improvements:** The lender will want the tenant to have the right to alter or modify the improvements with minimal (or no) restrictions. Its concern is the same as with liberal use rights—i.e., to ensure optimum choice of assignees in the event of a foreclosure (*see ¶ 7:403*).

8. [7:406] **Assignment and Sublease Rights:** Restrictions on transferability of the leasehold interest will undoubtedly hamper financeability of the leasehold. A lender will be looking for the broadest rights to assign and sublease so as to be assured of optimum transferability of the leasehold in the event of foreclosure. (Subtenants, however, will want a nondisturbance and attornment agreement; *see ¶ 7:277*.)

➪ [7:407] ***PRACTICE POINTER:*** If the landowner is unwilling to relieve the purchasing tenant of transfer restrictions in the ground lease, consider negotiating for an exception that will exempt the *lender* from the restrictions (or at least attempt to modify the restrictions to the lender's satisfaction).

9. [7:408] **Provisions Affecting Subtenant Rents:** A lender will want to be assured of a certain and steady stream of subtenant rental income. Thus, the subleases should not contain any provision allowing subtenants to reduce rent or offset their rent against monies due from the sublessor (ground lease tenant).

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The lender will also require that the subleases contain provisions (a) precluding any modification, cancellation or early termination of the lease without the lender's prior written consent; and (b) precluding prepayment of rent (so as not to reduce future rent flows).

10. [7:409] **Options:** To the extent the ground lease grants options to extend or renew the term, lease additional space, or purchase the fee interest, a lender will require a provision expressly making such rights exercisable by the lender. Hence, language in the lease making such options "personal" to the ground lease tenant may have to be renegotiated.

11. [7:410] **Cancellation, Surrender or Modification:** The lender will want to be assured that the lease will not be modified in any manner that might adversely affect its security for the loan. Consequently, the ground lease should contain a provision barring cancellation, surrender or modification of the lease without the lender's prior written consent.

12. [7:411] **Ground Lessor Estoppel Certificate:** The lender will want to be able to verify at any given time whether the tenant is in compliance with its obligations under the ground lease. Thus, the lease should include a provision requiring the landowner to furnish an estoppel certificate from time to time during the rental term. (*See ¶ 7:292 ff.* on ground lessor estoppel certificates; *and Form 7:B*.)

13. Insurance

a. [7:412] **Policy provisions:** The lender typically will require that all insurance policies with regard to the premises and improvements thereon provide that (1) policy proceeds be paid to the lender to the extent of its interest (i.e., to the extent of the loan balance); and (2) the policies are cancellable only upon prior written notice to the lender.

b. [7:413] **Proceeds:** The lender will be looking for strict controls with respect to the disbursement of insurance proceeds —in particular, that (1) the proceeds be used to *rebuild* damaged improvements and, if not, (2) the proceeds be used to pay down the loan. (Typically, insurance proceeds are paid to a third party trustee, such as the lender (or a party controlled by the lender), who then disburses them to fund the repairs/rebuilding.) *See ¶ 7:226*.

Additionally, the lender will not want to have any obligation to rebuild improvements in the event the insurance proceeds are insufficient.

14. [7:414] **Condemnation:** The lender's concerns regarding condemnation generally parallel those of the ground lease tenant (*see ¶ 7:228 ff.*).

In particular, however, the lender will want the same control over disposition of any condemnation award as it has over disposition of insurance proceeds (¶ 7:412 ff.)—i.e., that the award be used to fund the rebuilding of improvements and, if not, to pay down the loan. [But see *Milstein v. Security Pac. Nat'l Bank* (1972) 27 CA3d 482, 486, 103 CR 16, 18—lender prohibited from enforcing provision allowing condemnation proceeds to pay down loan unless security impaired]

15. Default Provisions

a. [7:415] **Right to cure tenant's default:** To protect itself against forfeiture of the leasehold interest, with the consequence that its collateral may become worthless, a lender must obtain a *contractual right* to receive *notice* of the tenant's defaults and an *opportunity to cure* the defaults. The lender can either reach a separate agreement with the landowner permitting it to cure any defaults; or may obtain an amendment of the tenant's lease so providing (*¶ 7:421*). Alternatively, the lender may obtain an option for a new lease in the event the tenant's lease is terminated by default. [See *Glendale Fed'l Bank v. Hadden* (1999) 73 CA4th 1150, 1153-1154, 87 CR2d 102, 104-105—nonpayment of rent unlawful detainer against tenants terminated lender's lien interest in the leasehold where lender had no contractual right to receive notice of tenant defaults and to cure those defaults]

The lender-protective contract should also specifically provide that any default can be cured by the lender *in lieu of* the tenant and that the lender has the right to *enter upon the property* for that purpose.

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b. [7:415.1] **Reasonable time to cure:** In addition, the lender should insist upon a lengthier cure period than granted to the ground lease tenant. And, because it is often not feasible for the lender to obtain physical access to the property to cure nonmonetary defaults, its contractual rights should include protection from termination of the ground lease so long as it is diligently pursuing the requisite cure.

• [7:415.2] For example, assume the tenant is in default for failing to make required repairs to the improvements. Because the lender cannot get access to repair the property and cure the breach, it will want the right to have such additional time as may be necessary to complete its foreclosure, obtain possession and thereafter cure the default.

16. [7:416] **Notices:** Lenders require that *all* notices to the tenant (not limited to notices of default; e.g., notice of rent increases, of operating cost pass-throughs, etc.) also be given to the lender.

17. [7:417] **Consequences of Tenant Bankruptcy:** The lender will require certain provisions to protect its interests in the event of the tenant mortgagor's bankruptcy:

a. [7:418] **Nontermination:** The ground lease should contain a provision that the lease will not be terminated by the tenant's bankruptcy. (Even so, as a matter of bankruptcy law, rental payments will have to be kept current during the bankruptcy proceedings; see 11 USC § 365(d)(3)—bankruptcy trustee's duty to timely perform tenant's postpetition lease obligations as they come due (but court may extend time for performance if debtor experienced "material financial hardship" due directly or indirectly to COVID-19 pandemic).)

b. [7:419] **"New lease" provision in event of rejection and surrender in bankruptcy:** A nontermination provision in the lease (¶ 7:418) cannot supersede bankruptcy law, pursuant to which the lease may be rejected (requiring a surrender of the leasehold) by the trustee in bankruptcy (see 11 USC § 365(a)) *or* may be *"deemed rejected" by operation of law* (see 11 USC § 365(d)(4)—tenant debtor's unexpired nonresidential property lease deemed rejected and property must be surrendered if not assumed or rejected by trustee by earlier of 210 days after petition filed or entry of order confirming a plan, subject to court extension of time for cause).

There is a split of authority, however, whether rejection of the lease in bankruptcy also terminates a lender's security interest in the leasehold. [See *Matter of Austin Develop. Co.* (5th Cir. 1994) 19 F3d 1077, 1083-1084—bank's security interest in ground lease *not extinguished* by "deemed rejection" in bankruptcy; *McLaughlin v. Walnut Properties, Inc.* (2004) 119 CA4th 293, 300-301, 14 CR3d 369, 375-376 (collecting cases); contra, *In re LCO Enterprises* (9th Cir. 1993) 12 F3d 938, 941; and *In re Giles Assocs., Ltd.* (BC WD TX 1988) 92 BR 695, 696 (declined to follow by *Matter of Austin Development Co.* (5th Cir. 1994) 19 F3d 1077, 1081-1083)—rejection in bankruptcy terminates lease as to all parties, including tenant debtor's *mortgagees*] Lenders, therefore, will also want to reserve the right to enter into a new lease with the landowner upon a bankruptcy termination of the existing lease during the otherwise unexpired term.

Cross-refer: For a comprehensive treatment of the impact of tenant bankruptcy during an unexpired lease term, see Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 10.

18. [7:420] **No Merger:** A "no merger" provision ensures that, should the fee and leasehold interests be acquired by the same party, the interests will not merge so as to destroy the leasehold (or the leasehold mortgage). In other words, the lender wants to be assured that if the ground lease tenant purchases the property, its leasehold mortgage will stay intact.

(Some lenders include provisions in their leasehold mortgages expanding the security for the loan to cover the fee interest if the ground lease tenant purchases fee title to the property.)

19. [7:421] **Amendments:** Because there may be several leasehold financings during a long-term ground lease, it is difficult to anticipate every protection the various leasehold mortgagees may require. To ensure optimum financeability, a provision should be included obligating the landowner to make certain modifications to the ground lease that will reasonably accommodate any leasehold mortgagee so long as the amendments do not materially change the landowner's rights or remedies or jeopardize the economics of the transaction.

20. [7:422] **Arbitration:** The lender will want the right to participate in any arbitration of disputes called for (or permitted) by the ground lease.

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California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 7. Ground Leaseholds

Forms

[Form 7:A] Ground Lease

GROUND LEASE

This **LEASE,** dated as of this _____ day of ___________, ___, by and between ___________, a ___________ ("Landlord") and ___________, a ___________ ("Tenant"), is made with reference to the following facts:

A. Landlord is the owner of certain real property, situated in the County of ___________, State of California, more particularly described on attached Exhibit "A" (the "Premises"), including the building presently located thereon (which building is to be demolished as provided below), but excepting all buildings, structures and improvements hereafter located on the Premises (the "Improvements"), the ownership of which will be acquired and will be retained by Tenant, subject to the provisions of this Lease. (The Improvements and the Premises are sometimes referred to as the "Property.") It is the intention of Landlord and Tenant that the separation of title to the Premises and the Improvements is not to change the character of the Improvements as real property and that the same shall be and remain real property; and

B. Tenant desires to lease the Premises from Landlord, and Landlord desires to lease the Premises to Tenant upon the terms and conditions set forth below.

NOW, THEREFORE, for and in consideration of the rent, covenants and agreements contained in this Lease, Landlord hereby leases the Premises to Tenant and Tenant hereby leases the Premises from Landlord, and Landlord and Tenant hereby covenant and agree as follows:

CERTAIN DEFINITIONS

For all purposes of this Lease, unless the context otherwise requires, the following words and phrases shall have the following meanings:

(a) "Improvements" shall mean any structures or improvements now or hereafter erected or situated on the Premises, including without limitation, the foundations and footings thereof, title and ownership of which shall be in Tenant, any and all fixtures, equipment and machinery of every kind and nature whatsoever now or hereafter affixed or attached thereto, or now or hereafter used or procured for use in connection with the operation, use or occupancy thereof, and the appurtenances thereto, but excluding from the foregoing all fixtures and articles of personal property, title of which, pursuant to any lease of space in the Improvements shall be vested in the tenant under such lease;

(b) "Premises" shall mean the real property particularly described on Exhibit "A";

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(c) "Termination of this Lease" shall mean the expiration of the term of this Lease or any sooner termination of the term of this Lease pursuant to any of the provisions of this Lease;

(d) "Leasehold Mortgage" shall mean any mortgage or deed of trust constituting a lien upon this Lease and the leasehold estate hereby created and Tenant's title to the Improvements;

(e) "Institution" shall mean a savings bank, a savings or building and loan association, a commercial bank or trust company (whether acting individually or in any fiduciary capacity), an insurance company, an educational institution or a state, municipal or similar public employees' welfare, pension or retirement fund or system, a charitable or other eleemosynary institution, a real estate investment trust or any other person or entity with assets (capital and surplus) in excess of Fifty Million Dollars ($50,000,000), whose principal businesses include interim or permanent financing secured by real estate;

(f) "Institutional Leasehold Mortgage" and "Institutional Leasehold Mortgagee" shall mean respectively, a Leasehold Mortgage held by an Institution and the holder of an Institutional Leasehold Mortgage;

(g) "Fee Mortgage" shall mean any mortgage or deed of trust constituting a lien upon the Premises subject to the encumbrance of this Lease and to any new lease made pursuant to Section 14.04 below and to the rights of Tenant hereunder and thereunder;

(h) "Event of Default" shall have the meaning set forth in Article 15;

(i) "Unavoidable Delays" shall mean the delays due to strikes, lockouts, acts of God, inability to obtain labor or materials, governmental restrictions, enemy action, civil commotion, fire, unavoidable casualties or similar causes beyond the control of Tenant;

(j) "Mortgage" shall include an indenture of mortgage and deed of trust and Institutional Leasehold Mortgagee shall include a bank or trust company acting as trustee under such indenture of mortgage or deed of trust; and

(k) "Initial Improvements" shall mean the first Improvements to be constructed by Tenant on the Premises and shall include a first-class [office, industrial, etc.] building of not less than ___ stories containing not less than ___________ (_____) net rentable square feet, together with parking facilities (subterranean or otherwise) for not less than the number of cars required by local governmental authorities having jurisdiction thereof, and such other facilities, improvements and appurtenances necessary or desirable in connection with such a development.

ARTICLE 1
TERM

The term of this Lease shall commence ___________, (the "Commencement Date") and unless sooner terminated under any subsequent provision of this Lease, shall expire and terminate at 12:00 midnight, ___________.

ARTICLE 2
RENT

Section 2.01. Tenant shall pay to Landlord as basic annual rent, without deduction, set-off, prior notice or demand, the sum of ___________ Thousand and no/100 Dollars ($________) per annum, which sum is subject to possible upward adjustment as provided in Section 2.02 below, in advance in equal monthly installments on the first day of each calendar month, commencing on the Commencement Date and continuing during the Lease term. Basic rent for the first month or portion of it shall be paid on the Commencement Date. Basic rent for any partial month shall be prorated on the basis of 1/360th of the basic annual rent, per day. All rent shall be paid to Landlord at the address to which notices to Landlord are given, or to such other person or such other place as directed from time to time by written notice to Tenant from Landlord.

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Section 2.02. The basic annual rent provided for in Section 2.01 above shall be subject to adjustment at the commencement of the third year of the lease term and every third year thereafter (the “adjustment date”) as follows:

(a) The base for computing the adjustment is the Consumer Price Index for [select appropriate CPI Index] published by the United States Department of Labor, Bureau of Labor Statistics (the “Index”), which is published for the month nearest the Commencement Date (the “Beginning Index”). If the Index published nearest the adjustment date (the “Extension Index”) has increased over the Beginning Index, the basic annual rent until the next rent adjustment shall be set by multiplying the basic annual rent set forth in Section 2.02 above by a fraction, the numerator of which is the Extension Index and the denominator of which is the Beginning Index. In no case shall the basic annual rent be less than the basic annual rent set forth in Section 2.01 above. Upon adjustment of the basic annual rent as set forth in this Lease, the parties shall immediately execute an amendment to the Lease stating the new basic annual rent.

(b) If the Index is changed so that the base year differs from that used as of the month immediately preceding the month in which the Commencement Date occurs, the Index shall be converted in accordance with the conversion factor published by the United States Department of Labor, Bureau of Labor Statistics. If the Index is discontinued or revised during the Lease term, such other government index or computation with which it is replaced shall be used in order to obtain substantially the same result as would be obtained if the Index had not been discontinued or revised.

Section 2.03. It is the purpose and intent of Landlord and Tenant that the rent payable under this Article 2 shall be absolutely net to Landlord and this Lease shall yield, absolutely net to Landlord, the rent specified and provided in this Article 2, and that Tenant shall pay all costs, charges and expenses of every kind and nature whatsoever against the Property which may arise or become due during the term and which, except for the execution and delivery of this Lease, would or could have been payable by Landlord. However, nothing in this Lease shall require, or be construed to require, Tenant to pay any interest or principal payments or other payments on or required under any mortgage or trust deed on the fee of the Premises.

ARTICLE 3
PAYMENT OF TAXES, ASSESSMENTS, ETC.

Section 3.01. Tenant covenants and agrees to pay, before any fine, penalty, interest or cost may be added thereto for the non-payment thereof, all property taxes, assessments, water and sewer rates and charges, and other governmental charges, general and special, ordinary and extraordinary, unforeseen as well as foreseen, of any kind and nature whatsoever (all of which taxes, assessments, water and sewer rates or charges, and other governmental charges are hereinafter referred to as “imposition”), which are assessed, levied, imposed or become a lien upon the Premises and/or the Improvements and the sidewalks or streets in front of or adjoining the Premises and the Improvements, or become payable, during the term of this Lease; provided, however, that if, by law, any such imposition may at the option of the taxpayer be paid in installments (whether or not interest shall accrue on the unpaid balance of such imposition), Tenant may exercise the option to pay the same (and any accrued interest on the unpaid balance of such imposition) in installments and shall pay only such installments as may become due during the term of this Lease as the same respectively become due and before any fine, penalty, interest or cost may be added thereto, for the non-payment of any such installment and interest; and provided, further, that any imposition relating to a fiscal period of the taxing authority, a part of which period is included within the term of this Lease and a part of which is included in a period of time after the termination of this Lease, other than a termination of this Lease pursuant to Article 15 below, shall (whether or not such imposition shall be assessed, levied, imposed or become a lien upon the Premises and/or the Improvements, or shall become payable, during the term of this Lease) be adjusted between Landlord and Tenant as of the expiration of the term of this Lease, so that Landlord shall pay that portion of such imposition which relates to that part of the fiscal period after the termination of this Lease, and Tenant shall pay that portion of which relates to the period prior to the termination of the Lease.

Section 3.02. Nothing contained in this Lease shall require Tenant to pay any franchise, corporate, estate, inheritance, succession, capital levy, stamp tax or transfer tax of Landlord, or any income, excess profits or revenue tax or any other tax, assessment,

charge or levy upon the basic rent payable by Tenant under this Lease, nor shall any tax, assessment, charge or levy of the character hereinabove in this Section described be deemed to be included within the term "imposition" as defined in Section 3.01 above.

Section 3.03. Tenant covenants, upon request of Landlord, to furnish to Landlord for inspection by it within sixty (60) days after the date when any imposition is payable, official receipts of the appropriate taxing authority, or other evidence satisfactory to Landlord, evidencing the payment of such imposition.

Section 3.04. Tenant shall have the right to contest the amount or validity, or to seek a refund, in whole or in part, of any imposition by appropriate proceedings, and notwithstanding the provisions of Section 3.01 above, this shall not be deemed or construed in any way as relieving, modifying or extending Tenant's covenants to pay any such imposition at the time and in the manner as provided in this Article 3 unless Tenant shall have deposited with Landlord or a bank or trust company designated by Landlord, as security for the payment of such imposition, money or a corporate surety bond or other security acceptable to Landlord in the amount so contested and unpaid together with the estimated amount of all interest and penalties in connection therewith and all charges that may or might be assessed against or become a charge on the Premises and/or Improvements or any part thereof in said proceedings, whereupon Tenant may postpone or defer payment of such imposition. Upon the termination of such proceedings, Tenant shall pay the amount of such imposition or part thereof as finally determined in such proceedings, the payment of which may have been deferred during the prosecution of such proceedings, together with any costs, fees, interest, penalties or other liabilities in connection therewith, and upon such payment Landlord shall return, or cause such bank or trust company to return, the amount above referred to without interest. If, at any time during the continuance of such proceedings, Landlord shall deem the amount deposited with it insufficient, Tenant shall, upon demand, deposit with Landlord or such bank or trust company such additional sum as Landlord may reasonably request, and upon failure of Tenant to do so, the amount theretofore deposited may be applied by Landlord or such bank or trust company to the payment, removal and discharge of such imposition and the interest and penalties in connection therewith any costs, fees or other liability accruing in any such proceedings, and the balance, if any, shall be returned to Tenant. Notwithstanding the foregoing provisions of this Section, if an Institutional Leasehold Mortgagee shall be the tenant under this Lease, such Institutional Leasehold Mortgagee shall not be required to make the deposit required under this Section. Landlord agrees not to unreasonably withhold its consent to joining in any such proceedings or permitting the same to be brought in its name. Landlord shall not ultimately be subjected to any liability for the payment of any costs or expenses in connection with any such proceeding, and Tenant covenants to indemnify, save and hold harmless Landlord from any such costs or expenses. Tenant shall be entitled promptly to any refund of any such imposition and penalties or interest thereon, which have been paid by Tenant, or which have been paid by Landlord and for which Landlord has been fully reimbursed.

Section 3.05. The certificate, advice or bill of the appropriate official designated by law to make or issue the same or to receive payment of any imposition, of non-payment thereof, shall be prima facie evidence that such imposition is due and unpaid at the time of the making or issuance of such certificate, advice or bill.

ARTICLE 4
INSURANCE

Section 4.01. At all times Tenant shall keep the Improvements insured for the mutual benefit of Landlord and Tenant against

(a) loss or damage by fire, and such other risks as may be included in the standard form of extended coverage insurance from time to time available, in an amount not less than one hundred percent (100%) of the then full insurable value of the Improvements; and

(b) claims for personal injury or property damage, under a policy of general public liability insurance, with such limits to be not less than ____________ Dollars ($_________) for any one (1) person and ____________ Dollars ($_________) for any one (1) occurrence in respect of bodily injury or death, and ____________ Dollars ($_________) for property damage.

The term "full insurable value" shall mean the actual replacement cost of the Improvements (excluding foundation and excavation costs) and said "full insurable value" shall be determined by an architect, appraiser, appraisal company or one of the insurers, reasonably acceptable to Landlord, selected by Tenant, which determination shall be made no less frequently than once every three (3) years.

Section 4.02. All insurance provided for under this Lease shall be effected under valid enforceable policies issued by insurers of recognized responsibility and licensed to do business in the State of California. The original policies shall be delivered to the holder of the first Leasehold Mortgage and certificates of such insurance shall be delivered to Landlord and to the holder of the Fee Mortgage, if any. If there is no Leasehold Mortgage, the original policies shall be delivered to the holder of the Fee Mortgage, or if there is none, to Landlord. At least ten (10) days prior to the expiration date of any policy, the original renewal policy for such insurance shall be delivered by Tenant to the holder of the expiring original policy, and certificates thereof shall be delivered as aforesaid, together with satisfactory evidence of payment of the premium on such policy. All such policies shall contain a non-cancellation clause except upon thirty (30) days prior written notice to each named insured and loss payee.

Section 4.03. All policies of insurance required under this Lease shall name Landlord and Tenant as the insureds as their respective interests may appear. Subject to the provisions and limitations hereinafter set forth in this Section 4.03 and Sections 4.04 and 4.05 below, all policies of the character referred to in Section 4.01 above shall also provide, if required by either Landlord or Tenant, for any loss thereunder to be payable to the holder of any Fee Mortgage and the holder of any Leasehold Mortgage, as the respective interests of such holders may appear, pursuant to a standard mortgagee clause or endorsement. The loss, if any, under the policies referred to in Section 4.01 above, shall be adjusted with the insurance companies by Tenant, except that in case of any particular casualty resulting in damage or destruction exceeding ____________ Dollars ($_________) in the aggregate, no adjustment shall be made with the insurance companies without the prior approval of Landlord, unless an Institutional Leasehold Mortgagee shall have approved the amount of the adjustment, in which event Landlord's prior approval shall not be required.

Section 4.04. The loss, if any, under all policies of the character referred to in Section 4.01 above shall be payable (a) in the case of any particular casualty resulting in a loss payment not exceeding ____________ Dollars ($_________) to Tenant, or (b) in case of any particular casualty resulting in a loss payment in excess of ____________ Dollars ($_________) to the Institutional Leasehold Mortgagee holding the first Leasehold Mortgage, or if there is none, to a bank or trust company, as insurance trustee, to be designated by Tenant in a notice given to the insurance companies and to Landlord promptly following the occurrence of the casualty, which bank or trust company shall have its principal office in ____________, California, and have a capital and surplus account according to its last published statement in excess of Fifty Million Dollars ($50,000,000). All policies of the character referred to in Section 4.01 above shall expressly provide that loss thereunder shall be adjusted and paid as provided in Section 4.03 and this Section 4.04.

Section 4.05. Any loss paid under any insurance policy to Tenant shall be held by Tenant in trust for application to the cost of restoring, repairing, replacing or rebuilding the Improvements. Any loss so paid to the Institutional Leasehold Mortgagee or the insurance trustee shall be disbursed by it in accordance with the provisions of Article 11 below.

Section 4.06. Nothing in this Article shall prevent Tenant form taking out insurance of the kind and in the amount provided for under Section 4.01 above under a blanket insurance policy or policies which can cover other properties owned or operated by Tenant, as well as the Premises and the Improvements; provided, however, that any such policy of blanket insurance of the

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kind provided for by Section 4.01 above (i) shall specify therein (or Tenant shall furnish Landlord and the holder of any Fee Mortgage and Leasehold Mortgage with a written statement from the insurers under such policies specifying) the amount of the total insurance allocated to the Improvements, which amount shall be not less than the amount required to be carried pursuant to Section 4.01 above, and (ii) shall not contain any clause which would result in the insured thereunder being required to carry insurance with respect to the property covered thereby in an amount not less than any specific percentage of the full insurable value of such property in order to prevent the insured therein named from becoming a co-insurer of any loss with the insurer under such policy. Tenant covenants to furnish to Landlord and to the holder of any Fee Mortgage and any Leasehold Mortgage, within thirty (30) days after the filing thereof with any insurance rate-making body, copies of the schedule or make-up of all property affected by any such policy of blanket insurance.

ARTICLE 5
LANDLORD'S RIGHT TO PERFORM TENANT'S COVENANTS ADDITIONAL RENT

Tenant covenants and agrees that if it shall at any time fail, within the time limit in Section 15.01(b), below, after any notice of any default has been given thereunder, (except in the case of maintaining the insurance policies provided in Article 4 above for which such time limitation shall not apply for purposes of this Article 5), to pay any imposition in accordance with the provisions of Article 3, or to take out, pay for, maintain or deliver any of the insurance policies provided for in Article 4, or fail to cause any lien of the character referred to in Article 12 to be discharged as provided therein, or shall fail to perform any other act on its part to be performed, then Landlord may (but shall not be obligated to) and without further notice or demand upon Tenant and without waiving or releasing Tenant from any obligations of Tenant contained in this Lease contained, (a) pay any imposition payable by Tenant pursuant to the provisions of Article 3, or (b) take out, pay for and maintain any of its insurance policies provided for in Article 4, or (c) discharge any lien of the character referred to in Article 12 as provided therein, or (d) perform any other act on Tenant's part to be performed as provided in this Lease; provided, however, that so long as a Leasehold Mortgage shall be outstanding, (i) Landlord shall not take any action of the character specified in the foregoing clauses (a), (b), (c), or (d) (except in the case of an emergency) until after the expiration of the time limited in Section 14.04 after the notice specified therein has been given to the Leasehold Mortgagee, and (ii) with respect to any action of the character specified in the foregoing clause (d), Landlord shall not take any such action (except in the case of an emergency) if the holder of the Leasehold Mortgage, prior to the expiration of the time limited in Section 14.04 below, shall have given the notice provided for in clause (d) of Section 14.04. All sums so paid by Landlord and all necessary incidental costs and expenses paid or incurred by Landlord in connection with the performance of any such act by Landlord, together with interest thereon at the rate of ten percent (10%) per annum from the date of making of such expenditure by Landlord, shall be payable to Landlord on demand or, at the option of Landlord, may be added to any basic rent then due or thereafter becoming due under this Lease, and Tenant covenants to pay any such sum or sums payable by Tenant for impositions pursuant to Article 3, insurance premiums pursuant to Article 4 and all other charges and expenses of whatsoever nature which Tenant assumes or agrees to pay pursuant to this Lease, shall be deemed additional rent under this Lease and payable as provided in this Lease, and Landlord shall have (in addition to any other right or remedy of Landlord) the same rights and remedies in the event of the non-payment of any such sums by Tenant as in the case of default by Tenant in the payment of basic rent.

ARTICLE 6
COVENANTS TO MAINTAIN THE
PREMISES AND THE IMPROVEMENTS

Tenant, at its sole expense, shall keep the Improvements, the Premises and the adjoining sidewalks and curbs clean and in good condition free of accumulations of dirt and rubbish, and shall make all repairs (including structural repairs) and replacements necessary to maintain the Premises and the Improvements in a condition appropriate for buildings of similar construction, use or class in ____________, California; provided, that in any event Tenant shall make all repairs necessary to avoid any structural damage or injury to the Improvements. Landlord shall not be required to furnish any services or facilities or to make any repairs

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or alterations to the Premises or the Improvements and Tenant hereby assumes the full and sole responsibility for the condition, operation, repair, replacement, maintenance and management of the Premises and the Improvements.

ARTICLE 7
COMPLIANCE WITH ORDERS, ORDINANCES, ETC.

Section 7.01. Tenant covenants throughout the term of this Lease, at Tenant's sole cost and expense, promptly to comply with all laws and ordinances and the orders, rules, regulations and requirements of all federal, state and municipal governments and appropriate departments, commissions, boards and officers thereof, and the orders, rules, and regulations of the California Board of Fire Underwriters, or any other body hereafter constituted exercising similar functions, which may be applicable to the Premises and the Improvements. Tenant shall likewise observe and comply with the requirements of all policies of public liability, fire, and all other policies of insurance at any time in force with respect to the Improvements.

Section 7.02. Tenant shall have the right to contest by appropriate legal proceedings, in the name of Tenant or Landlord or both, without costs or expense to Landlord, the validity or application of any law, ordinance, order, rule, regulation or requirement of the nature referred to in Section 7.01 above, and if by the terms of any such law, ordinance, order, rule, regulation or requirement, compliance therewith pending the prosecution of any such proceeding may legally be held in abeyance without the incurrence of a lien, charge or liability of any kind against the Premises or the Improvements or Tenant's leasehold interest therein and without subjecting Tenant or Landlord to any criminal liability of whatsoever nature for failure so to comply therewith, Tenant may postpone compliance therewith until the final determination of any proceedings, provided that all such proceedings shall be prosecuted with all due diligence and dispatch, and if any lien, charge or civil liability is incurred by reason of non-compliance, Tenant may nevertheless make such contest and delay compliance as provided above, provided that Tenant furnishes to Landlord security, reasonably satisfactory to Landlord, against any loss or injury by reason of such non-compliance or delay therein and prosecutes the contest aforesaid with due diligence. Notwithstanding the foregoing provisions of this Section, if an Institutional Leasehold Mortgagee shall be the tenant under this Lease, such Institutional Leasehold Mortgagee shall not be required to furnish the security required under this Section. Landlord agrees to execute and deliver any papers which may be necessary or proper to permit Tenant to contest the validity or application of any such law, ordinance, order, rule, regulation or requirement.

ARTICLE 8
DAMAGE TO OR DESTRUCTION OF THE IMPROVEMENTS

Section 8.01. Tenant covenants that in case of damage to or destruction of the Improvements by fire or any other cause, similar or dissimilar, insured or uninsured, it will promptly, at its sole cost and expense, but subject to reimbursement to the extent provided in Article 11 below, restore, repair, replace or rebuild the Improvements as nearly as possible to the condition, quality and class it was in immediately prior to such damage or destruction, or with such changes or alterations as Tenant shall elect to make in conformity with Article 10 below. Such restoration, repairs, replacement or rebuilding shall be commenced promptly and prosecuted with reasonable diligence.

Section 8.02. If insurance proceeds, if any, recovered in respect of any insured damage or destruction, less any cost of recovery, shall be insufficient to pay the entire cost of such restoration, repairs, replacement or rebuilding, Tenant covenants to pay the deficiency.

Section 8.03. Tenant's obligation to make payment of the basic rent and all other charges on the part of Tenant to be paid and to perform all other covenants and agreements on the part of Tenant to be performed shall not be affected by any such damage to or destruction of the Improvements and Tenant hereby waives the provisions of Sections 1932(2) and 1933(4) of the California

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Civil Code and of any other statute or law now or hereafter in effect contrary to such obligations of the Tenant as set forth in this Lease, or which relieves Tenant from such obligation.

ARTICLE 9
CONDEMNATION

Section 9.01. If, at any time during the term of this Lease, there shall be a total taking or a constructive total taking of the fee title to the Premises and Improvements in condemnation proceedings or by any right of eminent domain, this Lease shall terminate on the date of such taking and the basic rent and other charges payable by Tenant under this Lease shall be apportioned and paid to the date of such taking. For the purposes of this Article, the term “a constructive total taking” shall mean a taking of such scope that the untaken portion of the Premises and Improvements is insufficient to permit the restoration of the existing Improvements so as to constitute a complete, economical project. In the event of a dispute between Landlord and Tenant as to whether or not there has been “a constructive total taking” within the meaning above set forth, such dispute shall be determined by arbitration in the manner provided in Article 21 below, except that Tenant may elect, at Tenant's sole option and notwithstanding the foregoing, that the same does not constitute “a constructive total taking”, in which event the provisions of this Article 9 subsequent to Section 9.02 hereof shall apply.

Section 9.02. In the event of any such total taking or constructive total taking and the termination of this Lease, the award or awards for such taking, less the costs of the determination and collection of the amount of the award or awards (“Condemnation Proceeds”), shall be distributed as follows:

(a) Landlord shall first be entitled to receive and retain as its own property, and Tenant hereby assigns to Landlord, such portion of the Condemnation Proceeds as shall equal the fair market value of the Premises as encumbered by this Lease including any untaken portion of the Premises, exclusive of the Improvements; however, to the extent Condemnation Proceeds on account of such total taking are available therefor, in no event shall Landlord receive less than:

(i) the sum of ___________ Dollars ($________) if such total taking or constructive total taking occurs prior to the last day of the tenth (10th) year of the Lease term;

(ii) the sum of ___________ Dollars ($________) if such total taking or constructive total taking occurs on or subsequent to the last day of the tenth (10th) year of the Lease term but prior to the last day of the twentieth (20th) year of the Lease term;

(iii) the sum of ___________ Dollars ($________) if such total taking or constructive total taking occurs on or subsequent to the last day of the twentieth (20th) year of the Lease term but prior to the last day of the Lease term.

(b) Tenant shall then be entitled to receive, and Landlord hereby assigns to Tenant, the balance of the Condemnation Proceeds, if any.

Section 9.03. In the event of a taking which is less than a total taking or constructive total taking (a “partial taking”), this Lease shall not terminate or be affected in any way, except as provided in Section 9.04, below, and Landlord shall first be entitled to receive and retain as its own property, that portion of the Condemnation Proceeds applicable to the Premises as encumbered by this Lease, equal to the fair market value of the portion of the Premises as encumbered by this Lease so taken exclusive of the Improvements (“Landlord's Proceeds”). Tenant shall then be entitled to receive the balance of the Condemnation proceeds (“Tenant's Proceeds”) and the same shall be payable, and Landlord hereby so assigns the same, if ___________ Dollars ($________) or less, in trust to Tenant for application by Tenant to the cost of restoring, repairing, replacing or rebuilding the Improvements, but if in excess of ___________ Dollars ($________), then to the Institutional Leasehold Mortgagee holding the first Leasehold Mortgage, or if there is none, to a bank or trust company designated by Tenant which shall have the same qualification as the insurance trustee referred to in the case of the payment of proceeds of insurance pursuant to Section 4.04

above. The portion of the Condemnation Proceeds so paid to the Institutional Leasehold Mortgagee holding the first Leasehold Mortgage or to such bank or trust company shall be disbursed by it in accordance with the provisions of Article 11 below.

Section 9.04. In the event of a partial taking, Tenant, at its sole cost and expense, but subject to reimbursement as provided in Article 11 below, and whether or not Tenant's Proceeds shall be sufficient for the purpose, shall proceed with due diligence to restore, repair, replace or rebuild the remaining part of the Improvements to substantially its former condition or with such changes or alterations as Tenant may elect to make in conformity with Article 10 below so as to constitute a complete, rentable project.

Section 9.05. In the event of a partial taking, this Lease shall terminate as to the portion of the Premises so taken and the basic rent payable for the balance of the term of this Lease shall be reduced by a sum equivalent to the portion of the Premises taken, such reduction to be effective as of the date of Landlord's receipt of such Condemnation Proceeds. Until the amount of the reduction of the basic rent shall have been determined, Tenant shall continue to pay to Landlord the basic rent provided for in Article 2 above.

Section 9.06. If, at any time during the Lease term, the whole or any part of the Premises, or of Tenant's leasehold estate under this Lease, or of the Improvements shall be taken in condemnation proceedings or by any right of eminent domain for temporary use or occupancy (a “temporary taking”) the foregoing provisions of this Article shall not apply and Tenant shall continue to pay, in the manner at the times specified in this Lease, the full amounts of the basic rent and all additional rent and other charges payable by Tenant under this Lease, and, except only to the extent that Tenant may be prevented from so doing pursuant to the terms of the order of the condemning authority, Tenant shall perform and observe all of the other terms, covenants, conditions and obligations of this Lease upon the part of Tenant to be performed and observed, as though such taking had not occurred. In the event of any such temporary taking, Tenant shall be entitled to receive the entire amount of the Condemnation Proceeds made for such taking, whether paid by way of damages, rent or otherwise unless such period of temporary use or occupancy shall extend beyond the termination of this Lease, in which case the Condemnation Proceeds shall be apportioned between Landlord and Tenant as of the date of termination of this Lease. Tenant covenants that, upon the expiration of any such period of temporary use or occupancy during the Lease term, it will, at its sole cost and expense, restore the Improvements, as nearly as may be reasonably possible, to the condition in which the same was immediately prior to such taking, wear and tear during such temporary use or occupancy excepted. To the extent that Landlord receives any portion of the Condemnation Proceeds as compensation for the cost of restoration or repair of the Improvements, Landlord shall, upon restoration of the Improvements by Tenant as provided above, pay such sum to Tenant. Any portion of the Condemnation Proceeds received by Tenant as compensation for the cost of restoration of the Improvements shall, if such period of temporary use or occupancy shall extend beyond the term of this Lease, be paid to Landlord on the date of termination of this Lease.

Section 9.07. If the order or decree in any condemnation or similar proceeding shall fail separately to state the amount to be awarded to Landlord and the amount to be awarded to Tenant under the provisions of Section 9.02 or 9.03, above, or the amount of the compensation for the restoration of the Improvements under Section 9.05, above, and if Landlord and Tenant cannot agree thereon within sixty (60) days after the final award or awards shall have been fixed and determined, any such dispute shall be determined by arbitration in the manner provided in Article 21 below.

Section 9.08. If Tenant shall assign to any Leasehold Mortgagee any Condemnation Proceeds to which it shall be entitled under the provisions of Section 9.02(b), above, Landlord shall recognize such assignment and shall consent to the payment of the Condemnation Proceeds to such assignee as its interest may appear.

Section 9.09. Tenant and the holder of any Leasehold Mortgage shall have the right to participate in any condemnation proceeding for the purpose of protecting their rights under this Lease, and in this connection, specifically and without limitation to introduce evidence independently of Landlord to establish the value of or damage to the Improvements.

ARTICLE 10
CONSTRUCTION OF INITIAL IMPROVEMENTS;
CHANGES AND ALTERATIONS BY TENANT

Section 10.01. Tenant shall have the right, at any time and from time to time during the Lease term, to construct the Initial Improvements, to make such changes and alterations, structural or otherwise, to the Initial Improvements and/or other Improvements as Tenant shall deem necessary or desirable, including, without limiting the foregoing, the right to increase or reduce the height of any of the Improvements, or to demolish any of the Improvements or any part thereof. Such changes, alterations, demolition, new construction or construction of the Initial Improvements (collectively referred to as “Changes or Alterations” or “Changes and Alterations”) shall be made in all cases subject to the following conditions which Tenant covenants to observe and perform:

(a) No Change or Alteration shall be undertaken until Tenant shall have procured and paid for, so far as the same may be required, from time to time, all municipal and other governmental permits and authorizations of the various municipal departments and governmental subdivisions having jurisdiction and Landlord agrees, at no cost to Landlord, to join in the application for such permits or authorizations whenever such action is necessary;

(b) Any structural Change or Alteration shall be conducted under the supervision of an architect or engineer licensed as such in the State of California (who may be an employee of Tenant) selected by Tenant and plans therefore shall be submitted to Landlord, in order to give Landlord an opportunity to determine that such Changes or Alterations will comply with the provisions of this Article;

(c) All Changes and Alterations shall be of such a character that, when completed, the value and utility of the Improvements shall be not less than the value and utility of the Improvements immediately before any such Change or Alteration; except that in the case of a Change or Alteration involving demolition or the construction of any of the Improvements having a value in excess of ____________ Dollars ($_________), Tenant shall, prior to the commencement of demolition or construction submit to Landlord preliminary drawings and outline specifications to be approved by Landlord which approval shall not be unreasonably withheld and which shall have reference only to establishing that such new Improvements will be of a value not substantially less than the value of the Improvements to be demolished and that such new Improvements, when completed, will constitute all or a part of a completed rentable project capable of producing a fair and reasonable net annual income, after payment of all operating expenses. For purposes of this Section 10.01(c), “operating expenses” shall include all expenses of operation of the Improvements, the basic rent, additional rent and other charges reserved under this Lease and the cost of performance of all covenants and agreements of Tenant provided to be performed by Tenant under this Lease, and shall be deemed to exclude depreciation, income taxes and franchise taxes of Tenant. In the event of a dispute with respect to the foregoing, the same shall be determined by arbitration in the manner provided in Article 21 below, and in the event Landlord fails to approve or disapprove such demolition or construction as provided in this Section 10.01(c) within thirty (30) days after receipt of such drawings and specifications, the same shall be deemed approved for purposes of this Section 10.01(c);

(d) All work done in connection with any Change or Alteration shall be done in a good and workmanlike manner and in compliance with all applicable laws, ordinances, orders and requirements of all federal, state and municipal governments and their appropriate departments, commissions, boards and officers. The cost of any such Change or Alteration shall be paid in cash or its equivalent, so that the Premises and the Improvements shall at all times be free of liens for labor and materials supplied or claimed to have been supplied. The work of any Change or Alteration shall be prosecuted with reasonable dispatch, Unavoidable Delays excepted. Worker's compensation insurance covering all persons employed in connection with the work and with respect to whom death or bodily injury claims could be asserted against Landlord, Tenant or the Premises or the Improvements, and

general liability and property damage insurance (which may be effected by indorsement, if obtainable, on the insurance required to be carried pursuant to Section 4.01 above) for the mutual benefit of Tenant and Landlord with limits of not less than those required to be carried pursuant to Section 4.01, above, shall be maintained by Tenant at Tenant's sole cost and expense at all times when any work is in process in connection with any Change or Alteration.

(e) If the estimated cost of any Changes or Alterations shall be in excess of ____________ Dollars ($_________), Tenant shall, prior to the commencement of any such Change or Alteration, at Tenant's sole cost and expense, furnish to Landlord a surety company performance and completion bond in form and substance acceptable to Landlord, issued by a surety company acceptable to Landlord, naming Landlord and any first lien Institutional Leasehold Mortgagee as the obligees thereunder, guaranteeing:

(i) the completion of construction of such Changes or Alterations in accordance with the approved plans and specifications within a reasonable time, subject to Unavoidable Delays, free and clear of all mechanic's liens or liens of a similar nature; or,

(ii) at the election of Landlord and the holders of any first lien Leasehold Mortgage, (A) to demolish and remove any Improvements not substantially completed, where the construction activities of which, except for Unavoidable Delays, has terminated for a continuous period of ninety (90) days, and (B) to place the Improvements and the Premises in substantially the same condition as they existed prior to the commencement of such demolition or construction, provided that Landlord, at its option, may elect within ninety (90) days from the expiration of such termination period to accept the Improvements in the condition that they then exist, thereby waiving any rights of demolition and restoration as provided in this Section 10.01(e).

Subsequent to completion of the Initial Improvements, no Changes or Alterations involving an expenditure in excess of ____________ Dollars ($_________) shall commence until Tenant shall have given Landlord twenty (20) days prior written notice of such work in order that Landlord may post and/or file notices of non-responsibility or notices of a similar nature.

Section 10.02. Tenant covenants that in performing any work or repairs to, or restoration, replacement or rebuilding of, any of the Improvements required to be performed by Tenant pursuant to the provisions of Article 6, Article 7, Article 8, or Article 9, it will observe and perform, insofar as the nature of such repairs, restoration, replacement or rebuilding make such observation and performance appropriate, the conditions relating to Changes and Alterations set forth in Section 10.01, above.

Section 10.03. **[Describe any unique requirements regarding reconstruction.]**

Section 10.04. Tenant covenants and agrees to construct the Initial Improvements, as approved by Landlord in accordance with the provisions of Section 10.01(c), above, and in accordance with all of the provisions of this Lease, with the demolition of existing Improvements and construction of the Initial Improvements to be commenced no later than _____ months following the date of this Lease, and to complete the same (as evidenced by a duly executed and recorded notice of completion for all such Improvements) subject to Unavoidable Delays, not later than _____ months following the date of this Lease, or such later date as diligent prosecution and pursuance of such construction, subject to Unavoidable Delays, would permit such completion. In the event demolition of the existing Improvements and construction of the Initial Improvements stops or is terminated for a continuous period of more than ninety (90) days after the commencement of such work, except for Unavoidable Delays, the same shall, at the option of Landlord, constitute an Event of Default as provided in Article 15, below.

ARTICLE 11
DISBURSEMENT OF DEPOSITED MONEYS

Section 11.01. All sums of the character referred to in Section 4.04 or 9.03, above, (collectively referred to as “Deposited Sums”) paid to or deposited with a bank or trust company or paid to the Institutional Leasehold Mortgagee holding the first Leasehold Mortgage (the “Depositary”), shall be disbursed in the manner provided in this Article 11.

Section 11.02. From time to time as any Change or Alteration progresses, or as the restoration, repair, replacement or rebuilding of any Improvement or any portion thereof damaged or destroyed by fire or any other cause, or not taken in a proceeding of the character described in Section 9.03 progresses (collectively referred to as the "Work"), disbursement of any Deposited Sums shall be made upon receipt by the Depositary of the following:

(a) A certificate signed by an architect or engineer licensed as such in the State of California (who may be an employee of Tenant) selected by Tenant who shall be reasonably satisfactory to Landlord and also signed by Tenant, dated not more than thirty (30) days prior to the application for such disbursement, setting forth in substance the following:

(i) That the sum then requested to be disbursed either has been paid by Tenant and/or is justly due to contractors, subcontractors, materialmen, engineers, architects or other persons (whose names and addresses shall be stated) who have rendered and furnished certain labor and materials for the Work and giving a brief description of such services and materials and the principal subdivisions or categories of such Work, and the several amounts so paid or due to each of such persons in respect of such Work, and stating the progress of the Work up to the date of such certificate;

(ii) That the sum then requested to be disbursed, plus all sums previously disbursed, does not exceed the cost of the Work insofar as actually accomplished up to the date of such certificate, and that the balance of the Deposited Sums will be sufficient to pay in full for the completion of the Work, or Landlord shall have received other assurances reasonably satisfactory to it of payment in full for completion of such Work;

(iii) That except for the amounts, if any, stated in such certificate pursuant to Subsection 11.02(a)(i), above, to be due for services or materials, there is no outstanding indebtedness known to the person signing the certificate, after due inquiry, which is then due and payable for work, labor, services and materials in connection with the Work, which, if unpaid, might become the basis of a vendor's, mechanic's, laborer's or materialmen's statutory or similar lien upon Tenant's leasehold estate or Tenant's interest in the Improvements or Landlord's interest in the Premises or future interest in the Improvements or any part thereof.

(b) A certificate signed by an officer or other duly authorized representative of Tenant dated not more than thirty (30) days prior to the application for such disbursement, setting forth in substance that, to the best knowledge of the signer, after due inquiry:

(i) All materials and all property described in the certificate furnished pursuant to Subsection 11.02(a)(i), above, are free and clear of all mortgages, liens, charges or encumbrances, except (A) encumbrances, if any, securing indebtedness due to persons (whose names and addresses and the several amounts due then shall be stated) specified in such certificate, which encumbrances will be discharged upon payment of such indebtedness, (B) the leasehold estate created by this Lease, (C) any Mortgage on Tenant's interest under this Lease or the Improvements, (D) encumbrances created by Landlord, (E) impositions not due and delinquent, and (F) encumbrances to which this Lease is subject; and

(ii) That no Event of Default has occurred which has not been remedied.

Upon compliance with the foregoing provisions of this Section 11.02, the Depositary shall, out of the Deposited Sums, disburse to the persons named in the certificate pursuant to the foregoing Subsection 11.02(a)(i) the respective amounts stated in the certificate to be due to them and/or shall disburse to Tenant the amount stated in the certificate to have been paid by Tenant.

Section 11.03. At any time after the completion in full of the Work, the whole balance of the Deposited Sums not theretofore disbursed pursuant to the provisions of Section 11.02, above, shall be disbursed to Tenant upon receipt by the Depositary of:

(a) a certificate signed by an officer of Tenant, dated not more than thirty (30) days prior to the application for such disbursement, setting forth in substance the following: (i) that the Work has been completed in full; (ii) that all amounts which Tenant is or may be entitled to have disbursed under the foregoing provisions of this Section 11.02 on account of services rendered or materials

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furnished in connection with the Work have been disbursed under such provisions; (iii) that all amounts for whose payment Tenant is or may become liable in respect of the Work have been paid in full; and (iv) that no Event of Default has occurred which has not been remedied, and

(b) an official search or a certificate of a title company reasonably satisfactory to Landlord showing that there has not been filed with respect to Tenant's leasehold estate or Tenant's interest in the Improvements or Landlord's interest in the Premises or any part thereof, any vendor's, mechanic's, laborer's, or materialmen's statutory or similar lien which has not been discharged of record, or if the same has not been discharged, Tenant has given Landlord security therefor in an amount equal to one and one-half (1-1/2) times the amount of the lien or claim of lien.

Section 11.04. If an Event of Default shall have occurred and be continuing prior to the disbursement of the Deposited Sums or any part thereof, Landlord may notify the Depositary and thereupon the Depositary shall have no further right or obligation to disburse any of the Deposited Sums to Tenant as provided in this Article 11, but shall disburse the same to or for the account of the Leasehold Mortgagee who shall have given the notice as provided in Section 14.04(d) below, or, in the event of the termination of this Lease, who shall have obtained a new lease pursuant to Section 14.04(f) below, or, if any such Leasehold Mortgagee shall not have elected within the period specified in Section 14.04 to obtain a new lease, to Landlord upon Landlord's direction to do so.

Section 11.05. Landlord and Tenant agree that the Depositary shall have the right to deduct from the Deposited Sums prior to any disbursement pursuant to Sections 11.02 or 11.03, above, its reasonable charges for acting as Depositary under this Lease. An executed copy of this Lease shall be deposited by Tenant with the Depositary and shall constitute authority to the Depositary to act as such in accordance with the provisions of this Article 11 without further direction from Landlord or Tenant.

ARTICLE 12
MECHANIC'S LIENS

Tenant shall not suffer or permit any mechanic's, vendor's, laborer's, or materialman's statutory or similar liens (collectively “mechanic's liens”) to be filed against the Premises or the Improvements, nor against Tenant's leasehold interest in the Premises, by reason of work, labor, services or materials supplied or claimed to have been supplied to Tenant or anyone holding any interest in the Premises and/or the Improvements or any part thereof through or under Tenant. If any such mechanic's lien shall be filed, Tenant shall, within thirty (30) days after notice of the filing thereof, cause the same to be discharged of record by payment, deposit, bond, order of a court of competent jurisdiction or otherwise; provided, however, that Tenant shall have the right to contest, with due diligence, the validity or amount of any such lien or claimed lien, if Tenant shall give to Landlord security in an amount equal to one and one-half (1-1/2) times the amount of such lien or claimed lien. Subject to the foregoing provisions, if Tenant shall fail to cause such lien to be discharged within such 30-day period, then, in addition to any other right or remedy of Landlord, Landlord may, but shall not be obligated to, discharge the same either by paying the amount claimed to be due or by procuring the discharge of such lien by deposit or by bonding proceedings. Nothing in this Lease contained shall be deemed or construed in any way as constituting the consent or request of Landlord, express or implied by inference or otherwise, to any contractor, subcontractor, laborer or materialman for the performance of any labor or the furnishing of any materials for any specific improvements, alteration to or repair of the Premises or the Improvements or any part thereof, nor as giving Tenant a right, power or authority to contract for or permit the rendering of any services or the furnishing of any materials that would give rise to the filing of any mechanic's liens against the Premises.

ARTICLE 13
LAWFUL USE; SURRENDER OF IMPROVEMENTS AND THE PREMISES; INSPECTION OF IMPROVEMENTS AND THE PREMISES

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Section 13.01. Tenant shall not use or allow the Improvements or any part thereof, or the Premises, to be used or occupied for any unlawful purpose or for any dangerous or noxious trade or business. This restriction shall not apply during any period of governmental occupancy.

Section 13.02. Upon termination of this Lease, Tenant shall surrender to Landlord the Premises and the Improvements, in good order and repair, reasonable wear and tear excepted and also except as Tenant may have been prevented from maintaining the Improvements in good order and repair by occupation of the Improvements by any sovereign who shall have taken the temporary use of the Improvements and shall then be in possession of the Improvements. Upon such termination, Tenant shall also deliver to Landlord all leases, lease files, plans, records, registers and all other papers and documents which may be necessary or appropriate for the proper operation and management of the Premises and the Improvements.

Section 13.03. Tenant agrees to permit Landlord and the authorized representatives of Landlord and of the holder of any Fee Mortgage to enter the Premises or the Improvements at all reasonable times during usual business hours for the purpose of inspecting the same or exhibiting the same to prospective purchasers of the Premises.

ARTICLE 14
ASSIGNMENT, SUBLETTING AND MORTGAGING

Section 14.01. Prior to the lien-free completion of construction of the Initial Improvements, this Lease and the interest of Tenant under this Lease may not be assigned without the prior written consent of Landlord in each instance. Subsequent to completion of such construction, and without the prior consent of Landlord, this Lease and the interest of Tenant under this Lease may be assigned on one or more occasions to any person, firm or corporation, provided that (a) no such assignment shall be effective for any purpose unless and until (i) the assignor's interest in the Improvements shall be transferred to the assignee of this Lease and (ii) there shall be delivered to Landlord (A) a duplicate original of the instrument or instruments of transfer of this Lease and of the assignor's interest in the Improvements in recordable form, containing the name and address of the transferee and (B) an instrument of assumption by the transferee of all of Tenant's obligations under this Lease; and (b) no such assignment and assumption shall operate or be deemed to operate as a release of the within-named Tenant and/or the duties, obligations and liabilities of Tenant (and/or any guarantor or guarantors of the duties, obligations and liabilities of the within-named Tenant) under this Lease.

Section 14.02. Without the prior consent of Landlord, Tenant shall have the right at any time during the term of this Lease to sublet the Premises or the Improvements or any portion thereof, provided that the term of any such sublease (including any options to extend the same as therein provided) shall not have a term extending beyond the then remaining term of this Lease.

Section 14.03. Landlord hereby agrees for the benefit of any tenant under any sublease made by Tenant covering a portion of the Improvements and, or the Premises made by Tenant, or by a tenant under a total sublease for occupancy by the tenant thereunder (such tenants being hereinafter in this Section called a "space tenant"), that, if (a) an Institutional Leasehold Mortgagee shall have agreed in writing not to join the space tenant as a party defendant in any foreclosure action or proceeding which may be instituted or taken by the Institutional Leasehold Mortgagee, nor to evict the space tenant from the portion of the Improvements demised to it, nor to affect any of the space tenant's rights under its sublease by reason of any default under such Institutional Leasehold Mortgage, or (b) Tenant shall deliver to Landlord a certificate of an independent real estate appraiser who is a member of the American Institute of Appraisers, or such other similar organization reasonably satisfactory to Landlord, stating in substance that the rent payable by the space tenant under its sublease, after taking into account any credits, offsets or deductions to which the space tenant may be entitled thereunder, constitutes the then fair rental value of the space demised thereunder at the time of execution of such sublease, then upon the termination of this Lease pursuant to any of the provisions of Article 15 below, Landlord will recognize the space tenant under such sublease as the direct tenant of Landlord; provided, however, that at the

time of the termination of this Lease (w) not more than _____ (___) months' rent shall be prepaid under such sublease, (x) no default exists under the space tenant's sublease which at such time would then permit the landlord thereunder to terminate the same or to exercise any dispossess remedy provided for therein or under law, and (y) the space tenant shall deliver to Landlord an instrument confirming the agreement of such space tenant to attorn to Landlord and to recognize Landlord as the space tenant's landlord under its sublease.

Section 14.04. Without the prior consent of Landlord, Tenant shall have the right to mortgage this Lease and the leasehold estate hereby created and Tenant's interest in the Improvements; provided, however, that no such mortgage shall be valid for any purpose unless it shall constitute both a lien on the leasehold estate created by this Lease and on Tenant's interest in the Improvements. The execution and delivery of any Leasehold Mortgage shall not be deemed to constitute an assignment or transfer of this Lease nor shall the holder of any Leasehold Mortgage, as such, be deemed an assignee or transferee of this Lease so as to require such holder to assume the performance of any of the terms, covenants or conditions on the part of Tenant to be performed under this Lease. Landlord and Tenant agree that so long as any Leasehold Mortgage is a lien on the Improvements and the leasehold estate created by this Lease as follows:

(a) If Tenant or any Leasehold Mortgagee shall have delivered to Landlord prior written notice of the address of any Leasehold Mortgagee, Landlord will mail to such Leasehold Mortgagee a copy of any notice or other communication from Landlord to Tenant under this Lease at the time of giving such notice or communication to Tenant, and will give to such Leasehold Mortgagee notice of any rejection of the Lease by the trustee in bankruptcy of the Tenant or by Tenant as debtor in possession, and no termination of this lease or termination of Tenant's right of possession of the Premises or reletting of the Premises by Landlord predicated on the giving of any notice shall be effective unless Landlord gives to such Leasehold Mortgagee written notice or a copy of its notice to Tenant of such default or termination, as the case may be.

(b) In the event of any default by Tenant under the provisions of this Lease, any Leasehold Mortgagee will have the same periods as are given Tenant for remedying such default or causing it to be remedied, plus, in each case, an additional period of thirty (30) days after the expiration of the initial period or after Landlord has served a notice or a copy of a notice of such default upon the Leasehold Mortgagee, whichever is later.

(c) In the event that Tenant shall default under any of the provisions of this Lease, any Leasehold Mortgagee, without prejudice to its rights against Tenant, shall have the right to cure such default within the applicable grace periods provided for in the preceding Subsection 14.04(b), above, whether the same consists of the failure to pay rent or the failure to perform any other matter or thing which Tenant is hereby required to do or perform, and Landlord shall accept such performance on the part of such Leasehold Mortgagee as though the same had been done or performed by Tenant. For such purpose, Landlord and Tenant hereby authorize such Leasehold Mortgagee to enter upon the Premises and to exercise any of its rights and powers under this Lease and subject to the provisions of this Lease.

(d) In the event of any default by Tenant, and if prior to the expiration of the applicable grace period specified in Subsection 14.04(b), above, a Leasehold Mortgagee shall give Landlord written notice that it intends to undertake the curing of such default, or to cause the same to be cured, or to exercise its rights to acquire the leasehold interest of Tenant by foreclosure or otherwise, and shall immediately commence and then proceed with all due diligence to do so, whether by performance on behalf of Tenant of its obligations under this Lease, or by entry on the Premises and/or the Improvements by foreclosure or otherwise, then Landlord will not terminate or take any action to effect a termination of the Lease or re-renter, take possession of or relet the Premises or the Improvements or similarly enforce performance of this Lease in a mode provided by law so long as such Leasehold Mortgagee is with all due diligence and in good faith engaged in the curing of such default, or effecting such foreclosure; provided, however, that the Leasehold Mortgagee shall not be required to continue such possession or continue such foreclosure proceedings if such default shall be cured.

(e) In the event that Tenant's interest under this Lease shall be terminated by a sale, assignment or transfer pursuant to the exercise of any remedy of a Leasehold Mortgagee, or pursuant to judicial proceedings, and if (i) no rent or other charges shall then be

due and payable by Tenant under this Lease, or (ii) the Leasehold Mortgagee shall have arranged to the reasonable satisfaction of Landlord for the payment of all rent and other charges (less a credit for any income received by Landlord during such period) due and payable by Tenant under this Lease as of the date of such termination, together with the rent and other charges which but for such termination would have become so due and payable from the date of such termination through the sixtieth (60th) day thereafter, and upon payment of all expenses, including attorneys' fees, incident thereto, Landlord will execute and deliver to such Leasehold Mortgagee or its nominee a new lease of the Premises. Such new lease shall be for a term equal to the remainder of the term of this Lease before giving effect to such termination and shall contain the same covenants, agreements, terms, provisions and limitations as this Lease, and shall be subject only to the encumbrances and other matters recited in this Lease and acts done or suffered by Tenant. Upon the execution and delivery of such new lease, the new tenant, in its own name or in the name of Landlord, may take all appropriate steps as shall be necessary to remove Tenant from the Premises and the Improvements, but Landlord shall not be subject to any liability for the payments of fees, including reasonable attorneys' fees, costs or expenses in connection with such removal; and such new tenant shall pay all such fees, including attorneys' fees costs and expenses or, on demand make reimbursements therefor to Landlord.

(f) In the event a default under a Leasehold Mortgage shall have occurred, such Leasehold Mortgagee may exercise with respect to the premises and the Improvements any right, power or remedy under the Leasehold Mortgage which is not in conflict with the provisions of this Lease.

(g) This Lease may be assigned, without the consent of Landlord, to or by any Leasehold Mortgagee or its nominee, or pursuant to foreclosure or similar proceedings, or the sale, assignment or other transfer of this Lease in lieu thereof, or the exercise of any other right, power or remedy of the Leasehold Mortgagee, and any Leasehold Mortgagee shall be liable to perform the obligations imposed on Tenant in this Lease only for and during the period it is in possession or ownership of the leasehold estate created by this Lease.

(h) There shall be no merger of this Lease or any interest in this Lease nor of the leasehold estate created by this Lease with the fee estate in the Premises, by reason of the fact that this Lease or such interest in this Lease or such leasehold estate may be directly or indirectly held by or for the account of any person who shall hold the fee estate in the Premises, or any interest in such fee estate, nor shall there be such a merger by reason of the fact that all or any part of the leasehold estate created by this Lease may be conveyed or mortgaged in a Leasehold Mortgage to a Leasehold Mortgagee who shall hold the fee estate in the Premises or any interest of the Landlord under this Lease.

(i) No surrender (except a surrender upon the expiration of the term of this Lease or upon termination by Landlord pursuant and subject to the provisions of this Lease) by Tenant to Landlord of this Lease, or of the Premises, or any part thereof, or of any interest therein, and no termination of this Lease by Tenant shall be valid or effective, and neither this Lease nor any of the terms of this Lease may be amended, modified, changed or cancelled and no consents of Tenant under this Lease shall be valid or effective without the prior written consent of any Leasehold Mortgagee who shall have previously given Landlord written notice of the existence of its Leasehold Mortgage.

(j) Landlord consents to a provision in Leasehold Mortgages or otherwise for an assignment of rents from subleases of the Property to the holder of any such Leasehold Mortgage, effective upon any default under such Leasehold Mortgage.

(k) If at any time there shall be more than one Leasehold Mortgage constituting a lien on this Lease and the leasehold estate created by this Lease and Tenant's interest in the Improvements, and the holder of the Leasehold Mortgage prior in lien to any other Leasehold Mortgage shall fail or refuse to exercise the rights set forth in this Article 14, each holder of a Leasehold Mortgage in the order of the priority of their respective liens shall have the right to exercise such rights and provided further, however, that with respect to the right of the holder of a Leasehold Mortgage under Section 14.04(e), above, to request a new lease, such right may, notwithstanding the limitation of time set forth in Section 14.04(e), be exercised by the holder of any junior Leasehold Mortgage, in the event the holder of prior Leasehold Mortgage shall not have exercised such right, more than sixty (60) days but not more than seventy-five (75) days after the giving of notice by Landlord of termination of this Lease as provided in said Section.

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(l) **[The Tenant will often request that a provision be added which states that the Landlord will enter into a Lease amendments "reasonably requested" by a prospective Leasehold Mortgagee, "as long as the request to changes do not change the rent to be received by the Landlord and do not materially or adversely affect the Landlord's rights or interests in the Premises."]**

ARTICLE 15
DEFAULT; BANKRUPTCY

Section 15.01. Tenant agrees that in the event all or substantially all of Tenant's assets are placed in the hands of a receiver or trustee, and such receivership or trusteeship continues for a period of thirty (30) days, or should Tenant make an assignment for the benefit of creditors or be finally adjudicated a bankrupt, or should Tenant institute any proceeding under the Federal Bankruptcy Code as the same now exists or under any amendment thereof which may hereafter be enacted, or under any other act relating to the subject of bankruptcy, or to be discharged of its debts, or to effect a plan of liquidation, composition or reorganization, or should any involuntary proceeding be filed against Tenant under any such bankruptcy laws and such proceeding is not dismissed within ninety (90) days thereafter, then this Lease or any interest of Tenant in and to the Property shall not become an asset in any of such proceedings and, in any such events and in addition to any and all rights or remedies of Landlord under this Lease or as otherwise provided by law, it shall be lawful for Landlord to declare the Lease term ended and to reenter the Property and take possession thereof and remove all persons therefrom, and Tenant shall have no further claim thereon or hereunder. The provisions of this Section 15.01 shall also apply to any guarantor of this Lease.

Section 15.02. (i) Should Tenant at any time be in default with respect to any rental payments or other charges payable by Tenant under this Lease, and should such default continue for a period of ten (10) days after written notice from Landlord to Tenant; or (ii) should Tenant default in the timely payment of rent or other charges payable by Tenant under this Lease so as to necessitate the issuance by Landlord of written notice of default, on two or more occasions within any consecutive six (6) month period (whether or not any such default is subsequently cured by Tenant within ten (10) days after any such notice; or (iii) should Tenant be in default in the prompt and full performance of any other of its promises, covenants or agreements contained in this Lease and should such default or breach of performance continue for more than a reasonable time (not to exceed thirty (30) days except as otherwise expressly provided in Section 15.08, below) after written notice thereof from Landlord to Tenant specifying the particulars of such default or breach of performance; or (iv) should Tenant abandon the premises; then Landlord may treat the occurrence of any one or more of the foregoing events as a breach of this Lease (an "Event of Default"), and in addition to any or all other rights or remedies of Landlord under this Lease or as otherwise permitted by law, it shall be, at the option of Landlord, without further notice or demand of any kind to Tenant or any other person, except as otherwise expressly provided in Article 14, above:

(a) The right of Landlord to declare the Lease term ended and to reenter the Property and take possession thereof and remove all persons therefrom, and Tenant shall have no further claim thereon or thereunder; or

(b) The right of Landlord without declaring this Lease ended to reenter the Property and occupy the whole or any part thereof for and on account of Tenant and to collect the rent and any other charges that may thereafter become payable.

(c) The right of Landlord, even though it may have reentered the Property, to thereafter elect to terminate this Lease and all of the rights of Tenant in or to the Property.

Section 15.03. Should Landlord have reentered the Property under the provisions of Subsection 15.02(b), above, Landlord shall not be deemed to have terminated this Lease, or the liability of Tenant to pay rent thereafter to accrue, or its liability for damages under any of the provisions of this Lease, by any such reenter or by any action in unlawful detainer, or otherwise, to obtain possession of the Property, unless Landlord shall have notified Tenant in writing that it has so elected to terminate this Lease. Tenant further covenants that the service by Landlord of any notice pursuant to the unlawful detainer statutes of the State of California and the surrender of possession pursuant to such notice shall not (unless Landlord elects to the contrary at the time of

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or at any time subsequent to the serving of such notices and such election is evidenced by a written notice to Tenant) be deemed to be a termination of this Lease. In the event of any entry or taking possession of the Property as provided above, Landlord shall have the right, but not the obligation, to remove from the Property all or any part of the personal property located therein and may place the same in storage at a public warehouse at the expense and risk of the owner or owners thereof.

Section 15.04. Should Landlord elect to terminate this Lease under the provisions of Subsections 15.02(a) or (c), above, Landlord may recover from Tenant as damages:

(a) the worth at the time of award of any unpaid rent which had been earned at the time of such termination; plus

(b) the worth at the time of award of the amount by which the unpaid rent which would have been earned after termination until the time of award exceeds the amount of such rental loss Tenant proves could have been reasonably avoided; plus

(c) the worth at the time of award of the amount by which the unpaid rent for the balance of the term after the time of award exceeds the amount of such rental loss that Tenant proves could be reasonably avoided; plus

(d) any other amount necessary to compensate Landlord for all the detriment proximately caused by Tenant's failure to perform its obligations under this Lease or which in the ordinary course of things would be likely to result therefrom, including, but not limited to, any costs or expenses incurred by Landlord in maintaining or preserving the Property after such default, preparing the Improvements for reletting to a new tenant, any repairs or alterations to the Improvements for such reletting, leasing commissions, or any other costs necessary or appropriate to relet the Property;

(e) at Landlord's election, such other amounts in addition to or in lieu of the foregoing as may be permitted from time to time by the laws of the State of California.

Section 15.05. As used in Subsections 15.04(a) and (b) above, the “worth at the time of award” is computed by allowing interest at the rate of ten percent (10%) per annum. As used in Subsection 15.04(c), above, the “worth at the time of award” is computed by discounting such amount at the discount rate of the San Francisco Federal Reserve Bank, at the time of award, plus one percent (1%).

Section 15.06. For all purposes of this Lease, “rent” shall be deemed to be the basic annual rent and all other sums required to be paid by Tenant pursuant to the terms of this Lease.

Section 15.07. In the event of default, all of Tenant's fixtures, furniture, equipment, improvements, additions, alterations, and other personal property shall remain on the Premises and in that event, and continuing during the length of such default, Landlord shall have the right to take the exclusive possession of same and to use same, rent or charge free, until all defaults are cured or, at its option, at any time during the Lease term, to require Tenant to forthwith remove same.

Section 15.08. Notwithstanding any other provisions of this Article 15, Landlord agrees that if the default complained of, other than for the payment of monies, is of such a nature that the same cannot be rectified or cured within the thirty (30) day period requiring such rectification or curing as specified in the written notice relating thereto, then such default shall be deemed to be rectified or cured if Tenant within such period of thirty (30) days shall have commenced the rectification and curing thereof and shall continue thereafter with all due diligence to cause such rectification and curing and does so diligently complete the same.

Section 15.09. Upon the expiration of the term of this Lease pursuant to any of the provisions of this Article, it shall be lawful for Landlord, without formal demand or notice of any kind, to re-enter the Premises and the Improvements by summary dispossess

proceedings or any other action or proceeding authorized by law, or by force or otherwise and to remove Tenant therefrom without being liable for any damages therefor.

Section 15.10. Landlord shall not be deemed to be in default in the performance of any obligation required to be performed by it under this Lease until it has failed to perform such obligation within thirty (30) days after written notice by Tenant to Landlord specifying the nature of Landlord's default; provided, however, that if the nature of Landlord's obligation is such that more than thirty (30) days are required for its performance, then Landlord shall not be deemed to be in default if it shall commence such performance within such thirty (30) day period and thereafter diligently prosecute the same to completion.

ARTICLE 16
INDEMNIFICATION OF LANDLORD

Tenant agrees to indemnify and save harmless Landlord against and from any and all claims by or on behalf of any person arising from the conduct or management of or from any work or thing whatsoever done in and on the Premises and/or Improvements and will further indemnify and save Landlord harmless against and from any and all claims arising during the term of this Lease from any condition of the Improvements or any street, curb, or sidewalk adjoining the Premises and/or Improvements, or passageways or space therein or appurtenant thereto, or arising from any breach or default on the part of Tenant in the performance of any covenant or agreement on the part of Tenant to be performed pursuant to this Lease, or arising from any act or negligence of Tenant or any subtenant or occupant of the Improvements or any part thereof, or of its or their agents, contractors, servants, employees or licensees, or arising from any accident, injury or damage whatsoever caused to any person or property occurring during the term of this Lease in or about the Premises and/or Improvements, or upon or under the sidewalks and the land adjacent thereto, and from and against all judgments, costs, expenses and liabilities incurred in or about any such claim or action or proceeding brought therein; and in case any action or proceeding is brought against Landlord by reason of any such claims, Tenant upon notice from Landlord covenants to resist or defend such action or proceeding by counsel reasonably satisfactory to Landlord.

ARTICLE 17
LIMITATION OF LANDLORD'S LIABILITY

The term “Landlord” as used in this Lease so far as covenants or obligations on the part of Landlord are concerned shall be limited to mean and include only the owner or owners at the time in question of the fee of the Premises and in the event of any transfer or transfers of the title to such fee Landlord herein named (and in case of any subsequent transfers or conveyances the then grantor) shall be automatically freed and relieved from and after the date of such transfer or conveyance from all obligations on the part of Landlord contained in this Lease to be performed thereafter, provided that any prepaid rent or trust funds in the hands of such Landlord or the then grantor at the time of such transfer, shall be transferred to the grantee or transferee, who shall expressly assume, subject to the limitations of this Article, all of the terms, covenants and conditions in this Lease contained on the part of Landlord thereafter to be performed, it being intended by this Article that the covenants and obligations contained in this Lease on the part of Landlord shall, subject to the provisions of this Article 17, be binding on Landlord, its successors and assigns, only during and in respect of their respective successive periods of ownership.

ARTICLE 18
INVALIDITY OF PARTICULAR PROVISIONS

If any term or provision of this Lease or the application thereof to any person or circumstance, shall to any extent be invalid or unenforceable, the remainder of this Lease, or the application of such term or provision to persons or circumstances other than those as to which it is invalid or unenforceable, shall not be affected thereby, and each term and provision of this Lease shall be valid and be enforced to the fullest extent permitted by law.

ARTICLE 19
CERTIFICATES OF LANDLORD AND TENANT

Section 19.01. Tenant agrees at any time and from time to time upon not less than twenty (20) days prior notice by Landlord to execute, acknowledge and deliver to Landlord a statement in writing certifying that this Lease is unmodified and in full force and effect (or if there have been modifications that the Lease is in full force and effect as modified and stating the modifications), and the dates to which the basic rent has been paid, and stating whether or not to the best knowledge of the signer of such statement Tenant is then in default or may be in default with notice or the passage of time, or both, in keeping, observing or performing any term, covenant, agreement, provision, condition or limitation contained in this Lease, and, if in default, specifying each such default, it being intended that any such statement delivered pursuant to this Section may be relied upon by Landlord or any prospective purchaser of the fee or any Fee Mortgage thereof or any assignee of any Fee Mortgage but reliance on such statement may not extend to any default as to which the signer shall have had no actual knowledge.

Section 19.02. Landlord agrees at any time and from time to time upon not less than twenty (20) days prior notice by Tenant or any Leasehold Mortgagee to execute, acknowledge and deliver to Tenant a statement in writing certifying that this lease is unmodified and in full force and effect (or if there shall have been modifications that the Lease is in full force and effect as modified and stating the modifications) and the dates to which the basic rent has been paid, and stating whether or not to the best knowledge of the signer of such statement Tenant is then in default or may be with notice or the passage of time, or both, in keeping, observing or performing any term, covenant, agreement, provision, condition or limitation contained in this Lease and, if Tenant shall be in default, specifying each such default of which the signer may have knowledge, it being intended that such statement delivered pursuant to this Section may be relied upon by any prospective transferee of Tenant's interest in this Lease and the Improvements or any Leasehold Mortgagee or any assignee of any Leasehold Mortgage, but reliance on such certificate may not extend to any default as to which the signer shall have had no actual knowledge.

ARTICLE 20
NOTICES

All written notices or demands of any kind which either party may be required or may desire to serve on the other in connection with this Lease must be served (as an alternative to personal service) by registered or certified mail, shall be deposited in the United States mail with postage thereon fully prepaid and addressed to the party to be served as follows:

If the party so to be served is Landlord, address Landlord at:

	....
	....
with a copy thereof to	....
	....
	....

If the party so to be served is Tenant, address Tenant at:

	....
	....
with a copy thereof to	....
	....
	....

Service of any such notice or demand so made by mail shall be deemed completed on the day of actual delivery as shown by the addressee's registry or certification receipt or at the expiration of the second day after the date of mailing, whichever is earlier in time. If requested in writing by the holder of any Leasehold Mortgage (which request shall be made in the manner provided above as between the parties hereto and shall specify an address to which notices or demands shall be given or made) any such notice or demand shall also be given or made in the manner specified in this Article and contemporaneously to such holder. Either party, and the holder of any Leasehold Mortgage who shall have made the request referred to above, may designate by notice in writing given in the manner specified above a new or other address to which such notice or demand shall thereafter be so given or made. No Event of Default predicated on the giving of any notice to Tenant shall be complete unless like notice shall have been given contemporaneously therewith to each holder of a Leasehold Mortgage who shall have made a request for notices and demands as provided above.

ARTICLE 21
ARBITRATION

Section 21.01. If at any time, or from time to time during the Lease term, any dispute shall occur between Landlord and Tenant or any assignee of Tenant pursuant to any provision of this Lease with respect to a matter which this Lease provides shall be settled by arbitration, such dispute shall be settled by arbitration in accordance with the Rules then obtaining of the American Arbitration Association and the law of the State of California, and judgment upon the award rendered in such arbitration may be entered in any court having jurisdiction thereof; provided, however, that in any arbitration proceeding conducted pursuant to this Section, at least one arbitrator shall be an attorney at law, admitted to practice in the State of California.

Section 21.02. In the event Tenant shall fail to proceed diligently with any matter which is the subject of arbitration under this Lease, Landlord agrees that the holder of any Leasehold Mortgage shall have the right in the place and stead of Tenant to arbitrate such dispute as provided in this Article and any award made in such arbitration proceeding shall be binding upon Tenant with the same force and effect as if Tenant had proceeded with such arbitration. The arbitrator or arbitrators may not change any of the terms of this Lease or deprive any party to this Lease of any right of remedy expressly or impliedly reserved under this Lease.

ARTICLE 22
CUMULATIVE REMEDIES—NO WAIVER—NO ORAL CHANGE

Section 22.01. The specified remedies to which Landlord may resort under the terms of this Lease are cumulative and are not intended to be exclusive of any other remedies or means of redress to which Landlord may be lawfully entitled in case of any breach or threatened breach by Tenant of any provision of this Lease. The failure of Landlord to insist in any one or more cases upon the strict performance of any of the covenants of this Lease or to exercise any option contained in this Lease shall not be construed as a waiver or a relinquishment for the future of such covenant or option. A receipt by Landlord of rent with knowledge of the breach of any covenant of this Lease shall not be deemed a waiver of such breach, and no waiver by Landlord of any provision of this Lease shall be deemed to have been made unless expressly in writing and signed by Landlord. In addition to the other remedies provided in this Lease, Landlord shall be entitled to the restraint by injunction of the violation, or attempted or threatened violation, of any of the covenants, conditions or provisions of this Lease.

Section 22.02. This Lease cannot be changed orally, but only by an agreement in writing signed and acknowledged by Landlord and Tenant.

ARTICLE 23

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QUIET ENJOYMENT

Landlord covenants and agrees that Tenant, upon paying the rent provided for in this Lease and upon observing and keeping all of the covenants, agreements and provisions of this Lease on its part to be observed and kept, shall lawfully and quietly hold, occupy and enjoy the Premises during the term of this Lease, without hindrance by or from anyone claiming by, through or under Landlord.

ARTICLE 24
REAL ESTATE BROKERS

Tenant hereby represents and warrants that it has dealt with no real estate broker, agent or party who may be entitled to a commission or fee on account of this Lease. Tenant hereby indemnifies and agrees to hold Landlord harmless from and against any loss, cost, liability and expense, including reasonable attorneys' fees, which may be incurred in the event the foregoing representation and warranty proves incorrect.

ARTICLE 25
REPRESENTATIONS

Landlord hereby disclaims any warranty, guaranty or representation of the nature and condition of the Premises, including (but not by way of limitation) the soil and geology and suitability thereof for any and all activities and uses which Tenant may elect to conduct thereon at any time during the Lease term, the manner of construction and the conditions and state of repair or lack of repair of all improvements located thereon, and the nature and extent of the rights of others with respect to the Premises, whether by way of easement, right of way, lease, possession, lien, encumbrance, license, reservation, condition or otherwise.

ARTICLE 26
MISCELLANEOUS

Section 26.01. All rent and other sums which may from time to time become due and payable by Tenant to Landlord under any of the provisions of this Lease shall bear interest from and after the due date thereof at the rate of ten percent (10%) per annum.

Section 26.02. In all cases the language in all parts of this Lease shall be construed simply, according to its fair meaning and not strictly for or against Landlord or Tenant.

Section 26.03. The word titles underlying the article designations contained in this Lease are inserted solely for convenience and under no circumstances are they or any of them to be treated or construed as any part of this instrument.

Section 26.04. Subject to the other provisions of this Lease, this Lease shall be binding upon and inure to the benefit of Landlord and Tenant and their respective successors and assigns, and wherever a reference in this Lease is made to either Landlord or Tenant, such reference shall be deemed to include, wherever applicable, also a reference to the successors and assigns of such party, as if in every case so expressed.

Section 26.05. At the request of either Landlord or Tenant, a Memorandum of Lease (in the form attached hereto as Exhibit “B”) shall be executed by Landlord and Tenant and recorded in the Office of the County Recorder of ____________ County, California. In no event shall this Lease be recorded.

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Section 26.06. This Lease shall be governed by and construed in accordance with the laws of the State of California.

Section 26.07. This Lease, together with any written modifications or amendments hereafter entered into shall constitute the entire agreement between the parties relative to the subject matter of this Lease, and shall supersede any prior agreement or understanding, if any, whether written or oral, which Tenant may have had with Landlord relating to the subject matter of this Lease.

Section 26.08. This instrument may be executed in two or more counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

Section 26.09. In the event of any litigation or arbitration between Landlord and Tenant with respect to the subject matter of this Lease, the unsuccessful party to such litigation or arbitration shall pay to the prevailing party all costs and expenses, including reasonably attorneys' fees, incurred therein by the successful party, all of which shall be included in and as a part of the judgment rendered in such litigation or arbitration.

ARTICLE 27

[To the extent the parties negotiate rights and liabilities with respect to environmental matters, they should be set forth in the Lease. See Chapter 5, generally.]

IN WITNESS WHEREOF, Landlord and Tenant have executed this Lease as of the day and year first above written.

LANDLORD:	**TENANT:**
....	....
By:	By: ....
Title:	Title: ....
By:	By: ....
Title:	Title: ....

Exhibit “A”
[DESCRIPTION OF PREMISES]

EXHIBIT “B”
MEMORANDUM OF GROUND LEASE

RECORDING REQUESTED BY AND WHEN RECORDED, MAIL TO

____
____
____

....

MEMORANDUM OF GROUND LEASE

THIS MEMORANDUM OF GROUND LEASE (this “Memorandum”) is made and entered into this ___ day of ___________, ___, by and between ___________, whose present address is ___________, California _____ (“Landlord”) and ___________, whose present address is ___________, California _____ (“Tenant”), with reference to the following facts:

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A. Landlord is the owner of that certain real property located in the City of ___________, County of ___________, State of California, commonly known as ___________ and more particularly described in Exhibit "A" attached hereto (the "Property").

B. Landlord desires to lease the Property to Tenant, and Tenant desires to lease the Property from Landlord, all subject to the terms and provisions of this Memorandum.

NOW, THEREFORE, the parties hereto hereby agree as follows:

Lease of the Property. Landlord hereby leases the Property to Tenant, and Tenant hereby leases the Property from Landlord for a term of _____ (___) years commencing on ___________ and terminating on ___________, _____, all subject to and on terms and conditions more fully set forth in that certain Ground Lease executed by and between Landlord and Tenant and dated _____, _____ (the "Lease"). The said Ground Lease is incorporated herein by this reference. Should any party require any information concerning the said Ground Lease, they should contact the Landlord and Tenant at the above-referenced addresses.

IN WITNESS WHEREOF, the parties hereto have executed this Memorandum on the day and year first above written.

TENANT	**LANDLORD**
[Add Notary Acknowledgement]	[Add Notary Acknowledgement]

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End of Document

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Chapter 7. Ground Leaseholds

Forms

[Form 7:B] Landowner (Ground Lessor) Estoppel Certificate (With Consent to Assignment)

The undersigned, ___________ ("Lessor") hereby certifies as of the date of this Estoppel Certificate as follows:

1. Lessor is the landlord under a certain Lease (the "Lease") described on Exhibit "A" leasing certain premises and more fully described on Exhibit "A" (the "Premises"), wherein ___________ is the lessee ("Lessee").

2. The document or documents described on Exhibit "A" correctly identify the document or documents comprising the Lease. The Lease described contains all of the terms and provisions of the Lease, except to the extent that the Lease refers to documents or instruments not a part thereof. The Lease is unmodified, except for those certain amendments dated ___________ (attached as part of Exhibit "A"). The Lease is in full force and effect and expresses the entire agreement between the Lessor and Lessee pertaining to the leasehold estate created by (and property covered by) the Lease.

3. Lessee presently occupies the Premises and is paying rent and all other charges to be paid under the Lease on a current basis. Except to the extent noted as "Exceptions" below, Lessor knows of no setoffs, claims, liens or defenses against Lessee or to the enforcement of the Lease.

4. The commencement date of the Lease was ___________. The termination date of the Lease, excluding options to renew, if any, is _____. There are ___________ options to extend the term for a period of _____ years each. [Indicate whether the Lessee holds a right of first refusal to lease additional space; or right to purchase of property; or option to purchase the property; or option to extend the Lease term. Also, indicate that all such options are assignable.]

5. The monthly rental under the Lease is $________ payable in advance on the first day of each month. Said rent has been paid through _____, and there has been no prepayment of rental for any period beyond said date.

6. To the best of Lessor's knowledge, all of the obligations of the Lessee for the construction of improvements to the property have been complied with as of the date hereof.

7. To the best of Lessor's knowledge, all of the subleases between Lessee and the subtenants set forth on Exhibit "B" are in compliance with the terms of the Lease and Lessor has consented thereto.

8. A security deposit in the amount of $________ is now held by Lessor.

9. Except and as to the extent noted as "Exceptions" below, to the best knowledge of Lessor, Lessee is not in default in the performance of the Lease and no event has occurred which, with the giving of notice or the passage of time (or both), would constitute a breach or default by Lessee under the Lease.

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10. Lessor makes this Estoppel Certificate and Consent with the understanding that ___________ is contemplating acquiring the interest of Lessee in the Lease. Lessor acknowledges that ___________ is materially relying on this Estoppel Certificate in connection with said transaction.

Exceptions (if any):

____

CONSENT

Lessor hereby consents to the assignment of the Lessee's interest of the Lease to ___________, reserving all rights of Lessor:

(a) In and to any security held by Lessor pursuant to the Lease; and

(b) Against assignor and all predecessors in interest of assignor; and

(c) Relating to the provisions of the Lease regarding assignment or subletting as such provision may apply to any future assignment or subletting.

Whenever by the terms of the Lease any notice shall or may be given, such notice shall be given in accordance with the terms of the Lease and shall be given to the Assignee at ___________, ___________, California.

GROUND LESSOR

Dated: ....

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Chapter 7. Ground Leaseholds

Forms

[Form 7:C] Alternate Form of Assignment of Lease

RECORDING REQUESTED BY AND
WHEN RECORDED, MAIL TO:

____
____
____

....

ASSIGNMENT OF LEASE

THIS ASSIGNMENT OF LEASE ("Assignment") is made this _____ day of ___________, ___, by and between ___________, (hereinafter referred to as "Assignor"), ___________ and ___________, (hereinafter referred to as "Assignee").

WITNESSETH:

WHEREAS, Assignor is the holder of the lessee's interest under that certain Ground Lease (the "Lease") dated ___________, ___, and all other documents pertaining thereto between ___________ ("Landlord") and Assignor covering the land located at ___________, City of ___________, County of ___________, California and more particularly described in Exhibit "A" attached hereto and incorporated herein by this reference; and

WHEREAS, Assignor desires to transfer, assign and set over to Assignee and Assignee desires to acquire all of Assignor's right, title and interest in, to and under the Lease.

NOW THEREFORE, for valuable consideration, receipt of which is hereby acknowledged, the parties hereby mutually consent as follows:

1. Assignor hereby sells, transfers and assigns to Assignee all of Assignor's right, title and interest in and to the Lease including, without limitation, the security deposit, if any, held by Landlord.

2. Assignee hereby accepts the foregoing assignment and transfer and specifically assumes and agrees to pay, perform and observe each and every covenant, agreement and condition to be paid, performed or observed by the lessee pursuant to the Lease.

IN WITNESS WHEREOF, the parties hereto have duly executed this Assignment as of the day and year first hereinabove written. This instrument may be executed in any number of counterpart copies, each of which counterpart copy shall be deemed an original for all purposes.

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ASSIGNOR

....

ASSIGNEE

....

[Add Notary Acknowledgement]

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Chapter 7. Ground Leaseholds

Forms

[Form 7:D] Alternate Form of Assignment of Lease

RECORDING REQUESTED BY AND
WHEN RECORDED, MAIL TO:

____
____
____

AGREEMENT
ASSIGNMENT, ASSUMPTION AND CONSENT

THIS AGREEMENT is entered into as of this ___ day of _____, ___, by and between ___________ referred to as "Tenant" in this Agreement; ___________ referred to as "Tenant's Assignee" in this Agreement; and ___________ referred to as "Landlord" in this Agreement.

ASSIGNMENT OF LEASE

1.0 Tenant hereby assigns, sells, and conveys and otherwise transfers to Tenant's Assignee all of Tenant's right, title and interest as tenant or lessee in and to that certain Lease (including but not limited to any security deposit, prepaid rent and all options and rights contained therein, and all subleases of the Premises) which is dated ___________, ___ for the premises commonly known as ___________ and more particularly described therein. Said Lease has subsequently been amended by those certain amendments dated ___________. Said lease and all amendments thereto are referred to as the "Lease" and the premises therein demised is referred to as the "Premises" in this Agreement. A copy of the Lease (including all amendments thereto, if any) is attached as Exhibit "A" to this Agreement and Tenant warrants such copy to be a true and correct copy of the entire agreement between Landlord and Tenant with respect to the Premises. This assignment of Tenant's right, title and interest in the Lease to Tenant's Assignee shall be effective on ___________, ___ (the "Effective Date"), provided that Landlord consents thereto as evidenced by its execution of this Agreement in the space set forth below. Notwithstanding this assignment of Tenant's right, title and interest in the Lease to Tenant's Assignee and the corresponding acceptance thereof and assumption hereby by Tenant's Assignee of all of Tenant's obligations, terms, covenants, conditions and agreement under the Lease, Tenant shall continue to remain liable for the performance of all of such obligations, terms, covenants conditions and agreements and hereby agrees and guarantees to perform the same upon written notice of the default in the performance thereof by Tenant's Assignee. Service of such notice shall be deemed given forty-eight (48) hours after the same has been deposited in the U.S. Mail, with first class postage prepaid, addressed to Tenant at the address stated below or, if personally served, upon delivery thereof to Tenant.

ASSUMPTION OF LEASE

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2.0 Tenant's Assignee hereby accepts all of Tenant's right, title and interest in and to the Lease and assumes and agrees to perform all of Tenant's corresponding obligations, terms, covenants, conditions and agreements under the Lease on, from and after the Effective Date. Tenant's Assignee acknowledges that Tenant's Assignee has inspected the Premises and knows the present condition thereof and accepts the Premises in the condition disclosed by such inspection. Further, Tenant's Assignee acknowledges that Landlord has made no representation concerning the condition of the Premises, expressed or implied, and Tenant's Assignee does not accept the Premises in reliance upon any such representation or any nondisclosure on the part of Landlord or Landlord's agents or employees.

CONSENT

3.0 Landlord hereby consents to the foregoing assignment of Tenant's right, title and interest in the Lease to Tenant's Assignee and the corresponding acceptance thereof and assumption of Tenant's obligations, terms, covenants, conditions and agreements made under the Lease by Tenant's Assignee subject to all of the terms, covenants, conditions and agreements set forth in this Agreement, and provided that Tenant shall not default in the performance of its obligations, terms, covenants, conditions and agreements under the Lease at any time prior to the Effective Date. Landlord shall in no event be required to charge or credit or make any other adjustment, as between Tenant and Tenant's Assignee, on account of any other sums paid either before or after the Effective Date under the Lease by Tenant or Tenant's Assignee. Landlord's consent to the assignment of Tenant's right, title and interest in and to the Lease set forth herein shall not be construed as a waiver of Landlord's right to reasonably refuse consent to any future proposed assignment nor as a waiver of any other rights which Landlord is provided under the Lease upon the occurrence of any proposed or purported future assignments or subletting of the Premises.

TENANT:	**TENANT'S ASSIGNEE:**
....	....
LANDLORD:	
....	

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Cal. Prac. Guide Real Prop. Trans. Form 7:E

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Chapter 7. Ground Leaseholds

Forms

[Form 7:E] Nondisturbance and Attornment Agreement

Recording Requested By
And When Recorded Mail To:

____
____
____
____

NONDISTURBANCE AND ATTORNMENT AGREEMENT

This **NONDISTURBANCE AND ATTORNMENT AGREEMENT** (this "Agreement") is made and entered into as of the _____ day of ___________, ___, by and among ______________________ ("Landlord"), whose address is ___________, California _____, ___________ ("Tenant"), whose address is ___________, California _____ and _____ ("Lender"), whose address is ___________, California _____.

RECITALS

WHEREAS, Tenant is the tenant under that certain Lease dated on or about ___________, ___ ("the Lease") by and between Landlord and Tenant, pertaining to and covering that certain real property which is legally described on Exhibit "A" attached hereto and the buildings and improvements located thereon (the "Property"); and

WHEREAS, Lender is the holder of a note in the original principal amount of ___________ DOLLARS ($________) executed by Landlord, as maker (the "Loan"), secured by that certain Deed of Trust, Assignment of Rents and Security Agreement of dated ___________ in favor of Lender encumbering the Property (the "Deed of Trust"); and

WHEREAS, Tenant desires that, subject to the conditions and limitations stated below, Lender consent to the Lease and recognize Tenant's rights under the Lease in the event that Lender (or any Successor Landlord, as defined below) succeeds to the interest of Landlord under the Lease, and in consideration therefor, Tenant is willing to agree to attorn to Lender (or any Successor Landlord) in the event that Lender (or any Successor Landlord) succeeds to the interest of Landlord under the Lease, and to acknowledge and agree that Tenant's leasehold interest is subordinate in all respects to Lender's interest under the Deed of Trust.

NOW, THEREFORE, for valuable consideration, receipt whereof is hereby acknowledged, and for and in consideration of their respective covenants herein made, the parties agree as follows:

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1. The Lease, all extensions, modifications, replacements and renewals thereof, and all the provisions thereof, and all of Tenant's rights and interests thereunder, shall be, are hereby made, and shall remain completely subject and subordinate to the Deed of Trust and the rights of Lender thereunder, including any renewals, modifications, replacements, consolidations or extensions of the Deed of Trust. The provisions of this Section 1 shall be effective notwithstanding any provisions to the contrary in the Lease. Without limiting the foregoing, Landlord and Tenant agree to comply with provisions of the Deed of Trust related to disbursement of insurance proceeds.

2. Landlord agrees that the rentals payable under the Lease shall, at Lender's demand, be paid directly by Tenant to Lender upon the occurrence of a default by Landlord under the Deed of Trust. Accordingly, after notice is given by Lender to Tenant that the rentals under the Lease shall be paid to Lender, Tenant shall pay to Lender (or otherwise in accordance with the directions of Lender) all rentals and other monies due and to become due to Landlord under the Lease. Tenant shall have no responsibility to ascertain whether such demand by Lender is authorized, and any such payment to Lender shall discharge the obligations of Tenant to make such payment to Landlord. Lender shall not be liable for any claims, damages or set-offs arising out of the Lease or Landlord's interest in the Property.

3. Notwithstanding the fact that the Lease is subordinate to the Deed of Trust as stated above, in the event that Lender or any other party (collectively a “Successor Landlord”) succeeds to the rights of Landlord under the Lease, whether through foreclosure, the acceptance of a deed in lieu of foreclosure or any possession, surrender, assignment, judicial action or any other action taken by Lender, then Tenant agrees that it shall attorn to, be liable to and recognize Successor Landlord as the lessor under the Lease for the balance of the term of the Lease upon and subject to all the terms and conditions of this Agreement and of the Lease, with the same force and effect as if the Successor Landlord was the original lessor under the Lease, and Tenant waives provisions of any statute or rule of law giving it the right to elect to terminate the Lease. Such attornment shall be self-operative without the execution of any further documents; however, at the Successor Landlord's request, Tenant agrees to execute any instruments to confirm the foregoing provisions, including a new lease directly with the Successor Landlord.

4. So long as Tenant shall pay, when due, the rent, impositions and other amounts owing under the Lease and otherwise perform such other tenant obligations as set forth in the Lease, Tenant shall not be joined as an adverse party defendant in any action or proceeding which may be instituted or commenced by Lender to foreclose or enforce the Deed of Trust (unless Lender is legally required to so join Tenant to protect Lender's ability to foreclose against Landlord), Tenant shall not be evicted from the Property, nor shall any of Tenant's rights under the Lease, including but not limited to the right to use and possession, be affected in any way by reason of being subordinate to the Deed of Trust, and Tenant's leasehold estate under the Lease shall not be terminated or disturbed during the term of the Lease by reason of any default under the Deed of Trust. Notwithstanding the foregoing, Successor Landlord shall not be:

(a) liable for any action or omission, representation or warranty of any prior lessor, including Landlord;

(b) subject to any offsets or defenses which Tenant may have against any prior lessor, including Landlord;

(c) bound by any payment of rent or any other amounts which Tenant may have paid to any prior lessor, including Landlord;

(d) liable for any security deposit or any other such payments;

(e) liable for paying (or giving Tenant a credit) for any construction allowance or any other allowance;

(f) bound by any modifications or amendment of the Lease made without Lender's prior written consent;

(g) bound by any notice of termination given by any lessor, including Landlord, to Tenant without Lender's prior written consent; and

(h) personally liable under the Lease (provided that Lender's liability shall be limited to its ownership interest as Successor Landlord in the premises demised by the Lease (the “Premises”)).

(i) liable for representations, warranties or indemnities given by Landlord to Tenant whether under the Lease or implied or expressly provided by law.

5. Notwithstanding anything stated in the Lease or this Agreement to the contrary, Tenant agrees that, if Successor Landlord, including Lender, should succeed to the interest of Landlord under the Lease, then the Lease shall be modified to provide that the entirety of any condemnation award, settlement or compromise, whether for a total or partial condemnation and whether such award shall be made as compensation for diminution in value of the leasehold, or for the taking of the fee, or severance damages, or any other claims, shall belong to and be the property of Successor Landlord; and Tenant shall be entitled only to recover such compensation as may be separately awarded to Tenant for the taking of Tenant's trade fixtures and for relocation expenses.

6. Notwithstanding anything stated in the Lease, Tenant agrees not to subordinate the Lease to any other lien or encumbrance without Lender's prior written consent. Additionally, before any assignment or sublease under the Lease shall become effective, such assignee or sublessee must be approved by Lender in writing.

7. Tenant agrees to give written notice to Lender of any default by Landlord (or other lessor) under the terms of the Lease and Lender shall have the right (but not the obligation) to cure any default of Landlord (or other lessor). Tenant shall not take action with respect to such default under the Lease, including without limitation, any action in order to terminate, rescind or void the Lease, or to withhold any rental thereunder, for a period of twenty (20) calendar days after receipt of such written notice by Lender with respect to any such default capable of being cured by the payment of money and for a period of thirty (30) calendar days after receipt of such written notice by Lender with respect to any other such default (provided, that in the case of any default which cannot be cured by the payment of money and cannot with due diligence be cured within such thirty (30) calendar day period because of the nature of such default or because Lender requires time to obtain possession of the Premises in order to cure the default, if Lender shall proceed promptly to attempt to obtain possession of the Premises, where possession is required, and to cure the same thereafter, and shall prosecute the curing of such default with diligence and continuity, then the time within which such default may be cured shall be extended for such period as may be necessary to complete the curing of the same with diligence and continuity).

8. Tenant declares, agrees and acknowledges that Lender, in making disbursements pursuant to any agreement relating to the Deed of Trust, is under no obligation or duty to, nor has Lender represented that it will, see to the application of such proceeds by the person or persons to whom Lender disburses such proceeds, and any application or use of such proceeds for purposes other than those provided for in the Deed of Trust shall not defeat the subordination acknowledged and agreed to herein in whole or in part.

9. This Agreement shall inure to the benefit of, and shall be binding upon, Tenant and Lender and each of their respective heirs, personal representatives, successors and assigns. In the event that any one or more of the provisions contained in this Agreement shall for any reason be held to be invalid, illegal or unenforceable in any respect, such invalidity, illegality or unenforceability shall not affect any of the provisions of this Agreement, but this Agreement shall be construed as if such invalid, illegal or unenforceable provision was not contained herein. This Agreement may not be modified orally or in any manner other than by a written agreement signed by the parties hereto or their respective successors or assigns. This Agreement shall be governed by and construed according to the internal laws of the State of California without resort to choice of law principles.

10. Nothing contained in this Agreement shall be deemed to amend, modify or otherwise limit the provisions of the Deed of Trust, which shall remain in full force and effect. The parties hereto agree that (i) any inconsistency between this Agreement and the Lease shall be governed by this Agreement; (ii) any inconsistency between the Deed of Trust and this Agreement shall be governed by the Deed of Trust; and (iii) any inconsistency between the Deed of Trust and the Lease shall be governed by the Deed of Trust.

11. This Agreement may be executed in counterparts, all of which when taken together shall constitute one and the same instrument.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be duly executed in manner and form sufficient to bind them, as of the day and year first above written.

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LANDLORD:

....

TENANT:

....

....

By: ....

Name: ....

Title: ....

LENDER:

....

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Cal. Prac. Guide Real Prop. Trans. Ch. 8-A

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 8. Options to Purchase and Preemptive Purchase Rights

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[8:1] Prospective buyers are sometimes interested in acquiring a piece of property but, for various reasons, not yet willing or able to commit to a binding obligation to purchase. For example, the prospective buyer might not be entirely convinced the property is suitable for the buyer's purposes, or might not have sufficient funds to purchase the property; or the prospective buyer's interest in purchasing the property might hinge on the ability to acquire an adjoining parcel as well.

Under such circumstances, acquiring the *right* to purchase the property without any corresponding obligation to purchase can be extremely valuable. An *option to purchase* or some form of *preemptive purchase right* may be a viable alternative. This Chapter discusses those alternatives to an outright purchase.

1. Nature of Options and Preemptive Rights—In General

a. [8:2] **Options to purchase:** An "option to purchase" is a unilateral contract under which a property owner, for consideration, agrees to sell its property to another (optionee) if, within a specified time period, the optionee elects to exercise the right to purchase. [*Steiner v. Thexton* (2010) 48 C4th 411, 418, 106 CR3d 252, 258; *Erich v. Granoff* (1980) 109 CA3d 920, 927-928, 167 CR 538, 542; see also *Cyr v. McGovran* (2012) 206 CA4th 645, 648, 142 CR3d 34, 36—option to purchase, *if exercised,* gives optionee proverbial "bundle of rights" equated with ownership]

Fundamentally, an option to purchase is not a sale of the property but, rather, a sale of the *right to purchase*. It consists of the owner's *irrevocable offer* to sell on specified terms *for the term of the option* in return for a separate consideration paid by the optionee. The optionee has *no binding obligation to purchase;* but if the option is timely exercised, it is effectively converted into a binding bilateral purchase and sale agreement. [*Wachovia Bank v. Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 1049-1050, 52 CR3d 168, 175-176] *See detailed discussion at ¶ 8:40 ff.*

(1) [8:3] **Tantamount to purchase and sale agreement liquidating seller's damages:** In practical effect, options to purchase are virtually identical to a binding purchase and sale agreement with a *liquidated damages clause* for the seller's benefit:

Under an option to purchase, the optionee pays consideration for the right to purchase the property but has no obligation to purchase. Under a purchase and sale agreement in which the buyer's only liability is a specified amount of liquidated damages, the buyer essentially has the right, but not the obligation, to refuse to close so long as the buyer pays the seller the stipulated liquidated sum (*see ¶ 4:310 ff.*). Thus, in both transactions, the buyer pays a fixed amount for the *right* to buy the property but, in effect, *without any corresponding obligation* to purchase.

Nonetheless, the consideration given for a true option contract does not constitute liquidated damages in *legal* effect and is not subject to restrictions on enforceable liquidated damages provisions. [*Allen v. Smith* (2002) 94 CA4th 1270, 1279, 114 CR2d 898, 904] *See further discussion at ¶ 8:156 ff.*

b. [8:4] **Preemptive purchase rights—"rights of first refusal" and "rights of first offer":** There are two predominant types of "preemptive purchase rights"—a "*right of first refusal*" and a "*right of first offer*" (*discussed in detail at ¶ 8:200 ff.*). [*Bill Signs Trucking, LLC v. Signs Family Ltd. Partnership* (2007) 157 CA4th 1515, 1523, 69 CR3d 589, 595 (citing text)]

(1) [8:5] **Right of first refusal:** A "right of first refusal" grants the prospective buyer the right of *first opportunity* to *"match" any third party purchase offer* the owner is willing to accept. Upon receiving a satisfactory third party offer, the owner is obligated to notify the party holding the right of first refusal and to allow them the right, for an agreed-upon time, to purchase the property on the same terms and conditions offered by the third party. *See* ¶ *8:206, 8:212 ff.*

(2) [8:6] **Right of first offer:** A "right of first offer" also gives the prospective buyer a *preemptive* right to purchase: The owner is required to *first offer to sell* the property *to the holder of the right of first offer* before offering the property for sale to anyone else. The owner is permitted to sell the property to a third party on terms identical to, or better than, those proposed to the holder of the right of first offer only if the holder does not elect to purchase the property on the owner's proposed terms. *See ¶ 8:208*.

c. Similar application in leasing transactions

(1) [8:7] **Options to lease and preemptive lease rights:** Options *to lease* and preemptive *lease* rights are (with the exception of the *interest* to be conveyed) almost identical to options to purchase and preemptive purchase rights. Therefore, although many of the cases cited in this chapter relate to options and preemptive rights with respect to a leasehold interest, they are equally applicable to options and preemptive rights with respect to a fee interest.

(2) [8:7.1] **Compare—right to purchase after lease expires (holdover tenancy):** Options to purchase and preemptive purchase rights (¶ 8:4 ff.) can be included in lease agreements. After the lease expires, the tenant might remain in possession and a "holdover" tenancy would be created. [See *Smyth v. Berman* (2019) 31 CA5th 183, 192, 242 CR3d 336, 344]

Unless the parties specifically agree in writing (*see* ¶ 8:41, 8:75 ff.), however, options to purchase and preemptive purchase rights do not continue after a lease expires. Indeed, options to purchase and preemptive purchase rights are not "essential" lease terms and, therefore, do not automatically carry forward into a holdover tenancy. [*Spaulding v. Yovino-Young* (1947) 30 C2d 138, 143-144, 180 P2d 691, 694—option to purchase not "essential" term and did not continue after lease expired and holdover tenancy began; *Smyth v. Berman*, supra, 31 CA5th at 192-193, 242 CR3d at 344 (concluding *Spaulding's* logic applies "with equal force" to preemptive right of first refusal)—right of first refusal to purchase not "essential" term and did not presumptively carry forward into holdover tenancy]

Cross-refer: For a detailed discussion on "holdover" tenancies, see Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Chs. 2, 7.

2. Advantages to Buyer

a. [8:8] **Buyer not bound:** From a buyer's perspective, the principal advantage of options to purchase and preemptive purchase rights is that the buyer is *not legally obligated to consummate a purchase and sale*, and has *complete discretion* to decide whether to exercise the option and proceed with the purchase of the property. Thus, questions of good faith and satisfaction of conditions do not arise. [See *Allen v. Smith* (2002) 94 CA4th 1270, 1280, 114 CR2d 898, 905]

Unless and until the option is exercised, the prospective buyer's only commitment is the consideration paid for the option or preemptive right; and that commitment may be relatively negligible in practical effect because the seller is often willing to apply the consideration to the ultimate purchase price.

b. [8:9] **Fixing purchase price:** Under options to purchase, the prospective buyer is able to fix the purchase price for the duration of the option (although sometimes the seller will require an increase in the purchase price over the term of the option). [See *County of San Diego v. Miller* (1975) 13 C3d 684, 692, 119 CR 491, 495—option "freezes" maximum sale price at optioned price]

In an appreciating real estate market, this feature will work toward a prospective buyer's advantage. On the other hand, in a *depreciating market*, a fixed purchase price is likely to offer no real advantage from the buyer's perspective (who, instead, is more apt simply to decline to exercise the option when it calls for an above-market price; *see ¶ 8:21 ff.* re seller's disadvantages).

c. [8:10] **Additional time to investigate property:** An option to purchase gives prospective buyers time to investigate the property at a more leisurely pace than is typically permitted under a purchase and sale agreement. This is particularly important when the buyer is considering developing or otherwise changing the use of the subject property and needs time to apply for (and perhaps obtain) various governmental permits; or the buyer needs time to conduct various investigations and feasibility studies (e.g., traffic surveys, geological and excavation studies, and the procurement of environmental impact reports). [See *County of San Diego v. Miller* (1975) 13 C3d 684, 692, 119 CR 491, 496]

d. [8:11] **Ability to assemble parcels:** Developers, in particular, find options advantageous because they often want to combine adjoining or nearby parcels but do not want to commit to the purchase of one parcel until they have acquired the right to buy all of the properties in which they have an interest. Acquiring options to purchase can be a relatively inexpensive method of tying up adjoining or nearby properties pending confirmation of the right and/or ability to purchase the entire package.

e. [8:12] **Flexibility:** The duration of an option to purchase can be structured flexibly so that the optionee need only pay for that period of the option term which it uses. For example, the agreement may call for a fixed sum for the initial term of the option, but allow the optionee the right to *extend* the term on a periodic basis by paying the optionor (prospective seller) additional consideration for each extension.

Alternatively, the agreement may provide for an allocation of a fixed option fee based on the time at which the optionee exercises the option. (For example, if optionee pays $50,000 for a six-month option, but exercises the option half-way through the term, $25,000 would be applied toward the purchase price.)

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3. Pros and Cons for Seller

a. [8:13] **Seller advantages:** Sellers naturally are interested in procuring a *committed*, rather than simply a "potential," buyer. Consequently, it is somewhat unusual for sellers to propose an option or preemptive right agreement. Nevertheless, options or preemptive rights can offer considerable advantages to sellers:

(1) [8:14] **Fee to seller:** The seller is given consideration for the grant of the option or preemptive right, separate and apart from the purchase price. (Sometimes, however, the consideration might simply be the prospective buyer's agreement to enter into a related transaction, such as a lease; *see ¶ 8:18*.)

(2) [8:14.1] **Avoiding liquidated damages restrictions:** Although similar in practical effect to a liquidated damages provision in a purchase and sale contract, the consideration paid for an option does not constitute liquidated damages and is not subject to restrictions on valid liquidated damages. Payment of a freely-negotiated option price avoids any possibility that the seller's retention of a prospective buyer's purchase deposit might be unenforceable liquidated damages (*see ¶ 4:315 ff.*). For that reason, many sellers prefer to structure a purchase and sale agreement as an option. [*Allen v. Smith* (2002) 94 CA4th 1270, 1279, 114 CR2d 898, 904]

(3) [8:15] **Seller sacrifices little:** Under an option agreement wherein the seller negotiates a favorable purchase price for the duration of the option term, the seller does not really give up much other than its ability to market the property (and thus liquidate its equity) during the term.

Under a preemptive right agreement, the seller gives up even less … because the seller is still free to market its property whenever it chooses and upon whatever price and terms it desires. (The seller simply has to give the holder of the preemptive right the paramount right of purchase by matching a third party offer procured during the term; *see ¶ 8:206 ff.*)

(4) [8:16] **Alternative where no present sale likely:** If the owner cannot presently sell the property on desirable terms, the grant of an option or preemptive right for present consideration is often better than no present sale at all.

(5) [8:17] **Satisfaction of contingencies and expedited closing:** Usually (but not necessarily), under an *option to purchase*, the buyer's contingencies will have been satisfied by the time the buyer elects to exercise its option. The transaction then often becomes one in which the buyer has no right to withdraw from the purchase contract and the time period for closing should be relatively short.

(On the other hand, under a *preemptive purchase right*, the sale terms necessarily cannot be identified at the outset; consequently, buyer contingencies are less likely to have been satisfied and the seller obtains no benefit in this regard.)

(6) [8:18] **Effecting related transactions:** Sometimes, the owner must grant options to purchase and preemptive purchase rights in order to induce a prospective buyer to enter into a related transaction (usually a *lease*). Frequently, a prospective tenant is unwilling to enter into a lease unless it is also granted an option to purchase and/or preemptive purchase rights.

These rights are also often granted to *partners* of a partnership which owns real property, giving the partners (or some of them) the right to purchase the partnership real property. Similarly, options and preemptive rights may frequently arise in real property *coownership agreements* (*see ¶ 12:40*).

b. [8:19] **Disadvantages to seller:** Notwithstanding the potential advantages (¶ 8:13 ff.), from the seller's perspective, the grant of options and preemptive purchase rights is a "two-edged sword." Again, having decided to sell, owners naturally want buyers who are legally bound to close the transaction—not mere "prospects" who have the right, but not the obligation, to buy. In particular, sellers should weigh the following disadvantages:

(1) [8:20] **Inability to market property:** Once an option or preemptive purchase right is granted, it is exceedingly difficult to market the subject property to other prospective buyers. Third parties (prospective buyers as well as brokers) are unlikely to be interested in property subject to an *option to purchase* because they will have to wait until the option term expires before learning whether the owner will be able to sell the property free and clear of the option.

Similarly, third party buyers and brokers are reluctant to pursue property subject to a *preemptive purchase right* because their offer might be second in line behind the preemptive right grantee.

Again, holders of options and preemptive rights are *not legally bound to consummate* a purchase and sale. Hence, for the term of the option or preemptive right the owner's property is effectively *off the market* with no guarantee that a sale can or will be concluded.

(2) Risks from fluctuating market values

(a) [8:21] **Loss of appreciation in value:** As indicated, *options* typically grant the optionee the right to purchase on specified terms at a specified (*fixed*) price. Consequently, unless the owner (optionor) has reserved the right to increase the purchase price during the term to reflect escalating market values, the owner (optionor) risks not obtaining the benefit of *appreciation*. (And if the option builds in a right to increase the purchase price, the optionee may be less likely to *exercise* the option; *see ¶ 8:22*.)

(b) [8:22] **Certainty of sale diminished by depreciating market:** On the other hand, if the property *decreases* in value, the optionee is unlikely to exercise an option calling for a higher fixed price. Thus, in a depreciating market, the owner will have lost its prospective sale to the optionee and also have missed a "window opportunity" to sell to someone else when the market was stronger.

(3) [8:23] **Clearing cloud on title upon expiration of option/preemptive right:** The rights of an optionee or grantee of a preemptive right are perfected as against subsequent lienholders and encumbrancers by *recording* a document evidencing the option or preemptive right (*see ¶ 8:123 ff.*). The recordation, of course, creates a cloud on the owner's title (see *County of San Diego v. Miller* (1975) 13 C3d 684, 688, 119 CR 491, 493) and thus may interfere with the property's marketability upon expiration of the option or preemptive right—i.e., there is always the possibility that a recalcitrant optionee or holder of a preemptive right will refuse to deliver (or delay delivery of) a quitclaim deed or other recordable written release even though the option or preemptive right has terminated unexercised.

Though the grantee may have no lawful basis for refusing to deliver the necessary release, the owner's title will nonetheless remain clouded, leaving the owner at the grantee's mercy with *no immediate* recourse other than to file a lawsuit (all the while impeding marketability).

➪ [8:24] ***PRACTICE POINTER:*** As will be discussed, steps can be taken to help avoid this problem (*see ¶ 8:141 ff.*). In addition, by statute, unexercised *options* automatically expire "of record" within a specified period of time (see Civ.C. §§ 884.010 & 884.020, *discussed at ¶ 8:144 ff.*).

4. [8:25] **General Drafting Considerations:** In the context of consummating a purchase and sale, options to purchase and preemptive purchase rights can be viewed as two-step (if not two separate) transactions: The first step is the grantee's *exercise* of its right (in effect, the grantee's *acceptance* of the owner's *offer to sell*); the second step is the actual *consummation* of the purchase and sale … which involves all of the terms of the sale (including everything from the parties' respective representations and warranties to the closing mechanics; *see comprehensive discussion in Ch. 4*).

Therefore, when negotiating, structuring, drafting and/or reviewing options to purchase or preemptive purchase rights, counsel must keep in mind that those rights constitute only the *initial* step in the targeted purchase and sale transaction. *All of the terms and conditions* of the sale must be documented to the greatest extent possible. In particular, consider the following points:

a. [8:26] **Memorialize all purchase and sale terms in option agreement:** A properly-drafted *option* to purchase should, upon exercise, be practically *self-executing* in the sense that no further negotiation (and very little documentation) should be required to consummate the purchase and sale. Thus, an option agreement that reflects only the purchase price and other economic terms of the sale (leaving to a later date the negotiation of a definitive purchase and sale agreement) may be insufficient.

(1) [8:27] **Compare—preemptive purchase rights:** By contrast, *preemptive purchase rights*, by their nature, do not lend themselves to full negotiation of all purchase and sale terms … since most (if not all) of the sale terms are subject to those set by a *third party offer* that is not in existence when the preemptive right is granted.

b. [8:28] **Perfection by recordation:** A grantee's rights under an option or preemptive right of purchase could be cut off by liens that are senior in the chain of title. Therefore, grantees should perfect their option or preemptive rights by promptly *recording* the document granting those rights (or a memorandum of such document). *See discussion at ¶ 8:123 ff.*

c. [8:29] **Title insurance:** Options and preemptive rights are *insurable interests;* hence, the grantee should consider obtaining *title insurance* insuring the priority of its interest.

Of course, hand-in-hand with obtaining title insurance is a *review of existing senior liens* and encumbrances which might impact the value of the option or preemptive right. For example:

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- If the owner has already granted an option or preemptive purchase right that is *senior* to the option or preemptive right now being granted, the new option or preemptive right could be valueless should the senior purchase right be exercised.

- If the property is encumbered by a senior monetary lien which exceeds the purchase price under an option to purchase, the option may be worthless as a practical matter because, even if exercised, there will not be sufficient sale proceeds for the seller to pay off the senior lien.

[8:30 - 8:39] ***Reserved.***

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California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 8. Options to Purchase and Preemptive Purchase Rights

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1. [8:40] **Definition:** An "option to purchase" real property is a unilateral contract under which a property owner (optionor), for consideration, grants a prospective buyer (optionee) the irrevocable right to purchase the owner's property (or an interest therein) within a specified period of time and upon specified terms. [See *Steiner v. Thexton* (2010) 48 C4th 411, 418, 106 CR3d 252, 258; *Wachovia Bank v. Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 1049, 52 CR3d 168, 175; see also *Corrie v. Soloway* (2013) 216 CA4th 436, 444, 156 CR3d 709, 715—option binds owner/optionor in advance to make contract if optionee accepts upon terms and within time designated in option]

a. [8:41] **Contract law applies:** Because it is a contract giving the optionee the right (but not the obligation) to purchase an interest in real property, an option is subject to general rules of *contract law*, the *statute of frauds* (Civ.C. § 1624(a)(3), ¶ *8:75*) and other principles germane to real property purchase agreements. [See generally, *Robert T. Miner, M.D., Inc. v. Tustin Avenue Investors, LLC* (2004) 116 CA4th 264, 270, 10 CR3d 178, 181—"In determining whether [optionee] has any option rights, … we apply contract principles"; *Arden Group, Inc. v. Burk* (1996) 45 CA4th 1409, 1414, 53 CR2d 492, 495—contract rules of offer and acceptance apply in deciding whether option has been validly exercised (¶ *8:85.1*); *Torlai v. Lee* (1969) 270 CA2d 854, 858, 76 CR 239, 241—"irrevocable option based on consideration is a contract as defined by … [Civ.C. §§ 1549 & 1550]"]

b. [8:42] **Not a sale of real property:** An option to purchase real property is *not itself* a sale of property; rather, it is a sale of a *right to purchase.* [*Wachovia Bank v. Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 1049, 52 CR3d 168, 175; *San Jose Parking, Inc. v. Sup.Ct. (City of San Jose Redevelop. Agency)* (2003) 110 CA4th 1321, 1326, 2 CR3d 505, 509; see also *Cyr v. McGovran* (2012) 206 CA4th 645, 650, 142 CR3d 34, 38—option to purchase constitutes mere offer to sell, vesting no estate in optioned property]

Thus, the option conveys no interest in land, but only a personal right in the optionee to buy at the optionee's election. [*Warner Bros. Pictures v. Brodel* (1948) 31 C2d 766, 772, 192 P2d 949, 952; *Palo Alto Town & Country Village, Inc. v. BBTC Co.* (1974) 11 C3d 494, 503, 113 CR 705, 710; *Wachovia Bank v. Lifetime Indus., Inc.*, supra, 145 CA4th at 1050, 52 CR3d at 176]

c. [8:43] **Dual nature:** In legal effect, an option is of a dual nature, contemplating two separate contracts or transactions. [*Palo Alto Town & Country Village, Inc. v. BBTC Co.* (1974) 11 C3d 494, 502-503, 113 CR 705, 709-710; see also *Glovis America, Inc. v. County of Ventura* (2018) 28 CA5th 62, 68, 238 CR3d 895, 900 (applying same analysis to option to extend *lease* term)]

(1) [8:44] **Grant of option—unilateral contract to convey:** The first contract is the grant of the option itself for a separate consideration. It is the optionor's *binding promise* to sell (on specified terms) subject to the condition precedent of acceptance by the optionee (within the time and in the manner specified by the option). The option contract sets forth the terms and conditions under which the optionee can create a bilateral purchase and sale agreement (¶ 8:45); but since an option binds only the optionor, it is a *unilateral contract.* [*Palo Alto Town & Country Village, Inc. v. BBTC Co.* (1974) 11 C3d 494, 503, 113 CR 705, 710; *Allen v. Smith* (2002) 94 CA4th 1270, 1279, 114 CR2d 898, 904; see also *Glovis America, Inc. v. County of Ventura* (2018) 28 CA5th 62, 68, 238 CR3d 895, 900 (applying same analysis to option to extend *lease* term)]

(2) [8:45] **Bilateral purchase and sale agreement upon proper exercise of option:** The second contract is the mutually enforceable *bilateral* purchase and sale agreement into which the option "ripens" upon its timely and proper exercise by the optionee. In effect, by properly exercising the option, the optionee "accepts" the optionor's offer to sell (on specified terms), thus transforming what was a unilateral contract into a contract of sale binding on both parties. [*Palo Alto Town & Country Village, Inc. v. BBTC Co.* (1974) 11 C3d 494, 503-504, 113 CR 705, 710; see also *Steiner v. Thexton* (2010) 48 C4th 411, 418, 106 CR3d 252, 258—if offer is accepted upon terms and in time specified, bilateral contract that arises may become basis for specific performance suit should either party thereafter refuse to perform]

➪ [8:46] ***PRACTICE POINTER:*** As indicated earlier, an effective option agreement should set forth in detail *both* the "option" portion of the contract (consideration for the option, terms and conditions for exercise of the option, how option exercised, etc.) *and* the terms and conditions of the contemplated *purchase and sale* (giving due consideration to all issues important to a well-drafted purchase and sale agreement; *see Ch. 4*). Leaving to later negotiations and drafting that portion of the agreement relating to the terms and conditions of the purchase and sale defeats the "self-executing" feature of an option to purchase (*see ¶ 8:25 ff.*).

d. [8:46.1] **Compliance with Subdivision Map Act (SMA):** An option to purchase a *portion* of real property must comply with the SMA (Gov.C. § 66410 et seq.), which expressly conditions the purchase of divided land on the approval and recordation of a final map. Nonetheless, parties may enter into option contracts without first filing subdivision maps so long as their contracts are expressly conditioned on SMA compliance *before the close of escrow*. [See Gov.C. § 66499.30(a), (b) & (e); *Corrie v. Soloway* (2013) 216 CA4th 436, 439-440, 156 CR3d 709, 712—option agreement conditioning property's sale on SMA compliance deemed valid replacement for previous unlawful agreement]

e. [8:46.2] **Compare—right to purchase in expired lease (holdover tenancy):** *See discussion at* ¶ 8:7.1.

2. Optionee's Rights

a. [8:47] **Right of purchase pursuant to irrevocable offer to sell:** Technically, an option to purchase is simply the property owner's *irrevocable offer* to sell to the optionee during the term of the option. In other words, during the option term, the optionee has an enforceable contract right to accept or reject the optionor's present offer to sell on specified terms by timely exercise of the option. [*Warner Bros. Pictures v. Brodel* (1948) 31 C2d 766, 772, 192 P2d 949, 952; *County of San Diego v. Miller* (1975) 13 C3d 684, 688, 119 CR 491, 493; *Arden Group, Inc. v. Burk* (1996) 45 CA4th 1409, 1414, 53 CR2d 492, 495]

(1) [8:48] **Compare—not an "exclusive right" to purchase:** Some cases refer to an option as granting the optionee the "exclusive right" to purchase. [*County of San Diego v. Miller* (1975) 13 C3d 684, 688, 119 CR 491, 493; *Wachovia Bank v. Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 1049, 52 CR3d 168, 175; *Allen v. Smith* (2002) 94 CA4th 1270, 1279, 114 CR2d 898, 904] This is not technically correct inasmuch as a seller can grant any number of options, and no one option truly gives the optionee the "exclusive" right to purchase. (However, the option that is the first to be *perfected* by proper recordation has priority over all options junior thereto; *see ¶ 8:124*.)

Additionally, owners can sell their property to whomever they desire without necessarily breaching an option agreement … although any buyer with actual or constructive knowledge of the option will take subject thereto. [Civ.C. § 1213; *see ¶ 8:124*]

[8:48.1 - 8:48.4] ***Reserved.***

b. [8:48.5] **Option not terminable without optionee's consent:** Because it is an *irrevocable* offer to sell (on specified terms for a specified duration), an option may not be terminated during the option period without the optionee's consent. [*Allen v. Smith* (2002) 94 CA4th 1270, 1279, 114 CR2d 898, 904]

c. [8:49] **Optionee not bound to purchase:** The optionee has *no contractual obligation to purchase* unless and until the optionee *accepts* the optionor's irrevocable offer to sell (i.e., timely *exercises* the option on terms specified in the option). Thus, from the optionee's perspective, the option is not a binding contract, but simply an irrevocable offer (¶ 8:47 ff.) that the optionee can *convert* into a binding bilateral contract by accepting the offer. [*Palo Alto Town & Country Village, Inc. v. BBTC Co.* (1974) 11 C3d 494, 503, 113 CR 705, 710; see *City of Turlock v. Paul M. Zagaris, Inc.* (1989) 209 CA3d 189, 194, 256 CR 902, 904—option is a "*unilateral contract* under which the optionee, for consideration, receives the right and the power to *create a contract of purchase* during the life of the option" (emphasis added)]

On the other hand, upon granting an option, the landowner thereby becomes contractually bound to sell *subject to* the optionee's proper exercise of the option. In this respect then, an option creates only a *unilateral* obligation on the part of the seller. [*Palo Alto Town & Country Village, Inc. v. BBTC Co.*, supra, 11 C3d at 502, 113 CR at 709]

This feature distinguishes an option from a purchase and sale agreement, which constitutes a true "bilateral" contract binding both parties (even though their performance may be subject to certain conditions precedent). [See *Menzel v. Primm* (1907) 6 CA 204, 209, 91 P 754, 756; *Palo Alto Town & Country Village, Inc. v. BBTC Co.*, supra, 11 C3d at 502-503, 113 CR at 709-710]

(1) [8:50] **Distinguish—option as enforceable contract:** Though it creates only a one-sided obligation, an option is nonetheless a *binding unilateral contract*, since it is a promise (irrevocable offer by seller) supported by separate consideration (*see ¶ 8:55 ff.*). [See *Palo Alto Town & Country Village, Inc. v. BBTC Co.* (1974) 11 C3d 494, 502, 113 CR 705, 709]

d. [8:51] **Exercise of option within optionee's discretion:** Again, an option does *not bind* the optionee to purchase. The optionee may exercise the option (i.e., accept the optionor's "offer") or let the option lapse unexercised (i.e., *not* accept the optionor's "offer") *in its discretion* and without legal consequences. [See *Steiner v. Thexton* (2010) 48 C4th 411, 419, 106 CR3d 252, 259—buyer's "absolute and sole" right to withdraw means agreement is an option; *Beran v. Harris* (1949) 91 CA2d 562, 564, 205 P2d 107, 108—option terms "may or may not be complied with at the election of the optionee"]

e. Optionee's interest

(1) [8:52] **Compensable property right:** An optionee's rights are akin to those of a buyer under a purchase and sale agreement. Like a purchase agreement, an option does not itself effect a sale of property or create in the optionee any "estate" in land. [*County of San Diego v. Miller* (1975) 13 C3d 684, 691, 119 CR 491, 495; *Cyr v. McGovran* (2012) 206 CA4th 645, 650, 142 CR3d 34, 38; *see ¶ 8:42*]

However, at least for due process purposes upon condemnation of the subject property for public use, the owner of an unexercised (but as yet unexpired) option to purchase possesses a valuable property right that is compensable to the extent the condemnation award exceeds the optioned purchase price. [*County of San Diego v. Miller*, supra, 13 C3d at 693, 119 CR at 496—based on optionee's expectation of realizing any value in excess of optioned price and increased importance of options in the marketplace, considerations of "fairness" and "public policy" require that optionee be compensated; *San Jose Parking, Inc. v. Sup.Ct. (City of San Jose Redevelop. Agency)* (2003) 110 CA4th 1321, 1326-1327, 2 CR3d 505, 509]

(2) [8:53] **Compare—no inherent right to use or occupy optioned property:** Because optionees basically acquire no more than an irrevocable right to accept the optionor's offer to sell during the option term—*not* any interest or estate in the land—they have no greater rights to use, occupy or possess the subject real property than would a prospective buyer under a purchase and sale agreement. Accordingly, prior to the conveyance of title, the optionee (as prospective buyer) has a right to use, occupy and/or possess the property only to the extent *specifically granted* in the option agreement.

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➪ [8:54] ***PRACTICE POINTER:*** Often, a prospective buyer's primary motivation in acquiring an option to purchase is to tie up the property (effectively take it off the market) while the prospective buyer investigates possibilities for future development. These investigations frequently entail taking soil samples and conducting other geological tests (as well as processing various applications for development) which require *access* to the property.

In such cases, it is imperative that the option agreement *specifically confer* the necessary rights of access and entry, as well as perhaps require the optionor to cooperate with the optionee in pursuit of development permits. (*See ¶ 8:174 ff.; and Form 8:A*.)

3. [8:55] **Consideration for Option:** An option to purchase is an enforceable contract only if supported by *legally sufficient consideration*. [See generally, Civ.C. § 1550, subd. 4—"sufficient cause or consideration" is essential to existence of contract; *Steiner v. Thexton* (2010) 48 C4th 411, 420, 106 CR3d 252, 260; *Torlai v. Lee* (1969) 270 CA2d 854, 858-859, 76 CR 239, 241-242—option without consideration is not a contract in traditional sense or a contract under Civ.C. § 1550]

a. [8:56] **"Sufficient" consideration:** "Sufficient" consideration need not necessarily be "substantial" or even "adequate"; nor need it be in cash. The consideration need simply be "valuable." [*Kowal v. Day* (1971) 20 CA3d 720, 727-728, 98 CR 118, 122; *Wheat v. Morse* (1961) 197 CA2d 203, 206, 17 CR 226, 228; *Stough v. Hanson* (1941) 46 CA2d 504, 116 P2d 77, 78]

(1) [8:57] **Application:** Broadly, the optionee gives legally "sufficient" consideration by performing an act, incurring a detriment or rendering a return promise that is *bargained for in exchange* for the optionor's irrevocable offer to sell. [*Steiner v. Thexton* (2010) 48 C4th 411, 420-421, 106 CR3d 252, 260; *Prather v. Vasquez* (1958) 162 CA2d 198, 204-205, 327 P2d 963, 967-968]

Good consideration is statutorily defined as "[a]ny benefit conferred, or agreed to be conferred, upon the promisor, by any other person, to which the promisor is not lawfully entitled, or any prejudice suffered, or agreed to be suffered, by such person, other than such as he is at the time of consent lawfully bound to suffer, as an inducement to the promisor …" [Civ.C. § 1605; see also *Steiner v. Thexton*, supra—benefit or prejudice must induce promisor's promise]

(a) [8:58] **Examples—sufficient consideration:** Virtually any consideration, however small, is "sufficient" to support an option contract. [*Kowal v. Day* (1971) 20 CA3d 720, 727, 98 CR 118, 122]

For example:

• [8:59] An option given for 25 cents is supported by "sufficient" consideration. [*Marsh v. Lott* (1908) 8 CA 384, 389-390, 97 P 163, 165; see also *Wheat v. Morse* (1961) 197 CA2d 203, 206, 17 CR 226, 228—$1 consideration suffices; *Stough v. Hanson* (1941) 46 CA2d 504, 116 P2d 77, 78 (same)]

• [8:60] The optionee's transfer of valuable property *for the optionor's use* during the option period "satisfies the consideration requirement for the option contract" … even though the optionee has the right to return of the property if the option is not exercised. [*Kowal v. Day* (1971) 20 CA3d 720, 728, 98 CR 118, 122]

"In the event that the optionee does not exercise the option and he regains the thing deposited, the optionor has received the benefit of the use of the thing, and the optionee has suffered the detriment of not having the use of the thing deposited. The consideration requirement is thereby satisfied." [*Kowal v. Day*, supra, 20 CA3d at 728, 98 CR at 122—optionee's transfer of possession of automobile for optionor's use and benefit sufficient consideration though optionee had right to return of auto upon disaffirmance of purchase transaction; *but see ¶ 8:66 ff.*]

• [8:61] Likewise, if *bargained for* in exchange for the optionor's promise, the optionee's *activities* in taking steps toward consummation of an eventual purchase (e.g., consulting with lending institutions regarding financing of proposed development, commencing surveys of the property, etc.) may be sufficient consideration. [Cf. *Kelley v. Rouse* (1961) 188 CA2d 92, 96-98, 10 CR 235, 238-239 (not sufficient consideration under the facts because *not bargained for* between the parties)]

• [8:62] And an optionee's part performance of a *bargained-for* promise to seek a parcel split created sufficient consideration to render an option to purchase a 10-acre parcel irrevocable even though the optionee was entitled to revoke the transaction at *any time and for any reason*. [See *Steiner v. Thexton* (2010) 48 C4th 411, 421-422, 106 CR3d 252, 261]

"It is true that [the optionee's] promise to undertake the burden and expense of seeking a parcel split may have been illusory at the time the agreement was entered into, given the language of the escape clause. However, there can be no dispute that [the optionee] subsequently undertook substantial steps toward obtaining the parcel split

and incurred significant expenses doing so. . [T]he only possible conclusion is that [the optionee] both conferred a bargained-for benefit on [the optionor] and suffered bargained-for prejudice unaffected by his power to cancel, making up for the initially illusory nature of his promise." [*Steiner v. Thexton*, supra, 48 C4th at 422, 106 CR3d at 261]

[8:63 - 8:64] ***Reserved.***

(b) [8:65] **Compare—insufficient consideration:** On the other hand, legally-"sufficient" consideration was found lacking in the following cases:

• [8:66] A purported option agreement that gives the optionee the right to a *full refund of a cash deposit* in the event the optionee decides not to exercise the option is *not based on any consideration* and thus is not an enforceable option contract. [See *Torlai v. Lee* (1969) 270 CA2d 854, 859, 76 CR 239, 242—no consideration where optionee's $2,000 deposit was contingent on his approval of subject building and leases and fully refundable if optionee did not approve; *Allen v. Smith* (2002) 94 CA4th 1270, 1280, 114 CR2d 898, 905—option not supported by independent consideration where optionee entitled to return of deposit if inspection contingencies not satisfied]

—. [8:67] *Comment:* The cases at ¶ 8:66 may seem at odds with the result in *Kowal v. Day*, supra (where optionee's giving optionor use of its auto during the option period was sufficient consideration *even though optionee had the right to a return of the auto upon electing not to exercise the option*).

The distinction probably rests in the fact that the optionor in *Kowal* had the benefit of the use of the optionee's property until the optionee elected not to exercise the option; in the other cases, by contrast, because the optionees' cash consideration was *fully refundable*, the optionor *obtained no benefit at all*. [See also *Seymour v. Shaeffer* (1947) 82 CA2d 823, 825, 187 P2d 95, 97 (disapproved on other grounds by *Ellis v. Mihelis* (1963) 60 C2d 206, 216, 32 CR 415, 421 & distinguished in *Kowal*)—prospective buyer's transfer of refundable deposit by check to escrow holder *insufficient* consideration because check *could not be cashed by optionor*]

• [8:68] A purported option agreement fails as an enforceable contract when the optionee's alleged consideration was *neither bargained for nor given in exchange* for the optionor's continuing offer to sell. Thus, e.g., a prospective buyer's effort in endeavoring to obtain approval for rezoning and subdivision is not consideration for an option agreement when the seller never agreed to accept it as such. [*Prather v. Vasquez* (1958) 162 CA2d 198, 205, 327 P2d 963, 967-968]

Similarly, a prospective buyer's acts of canceling another lease, contracting to lease a portion of a building to another, ordering blueprints for remodeling, purchasing business stationery for a new address, etc., are "not the type of detrimental reliance that satisfies the consideration requirement *because they were not bargained for* …" [*Kowal v. Day* (1971) 20 CA3d 720, 726, 98 CR 118, 121 (emphasis added)]

[8:69] ***Reserved.***

b. [8:70] **Presumption of sufficient consideration:** By statute, "a written instrument is presumptive evidence of a consideration." [Civ.C. § 1614; see *Hersh v. Garau* (1933) 218 C 460, 467, 23 P2d 1022, 1025—presumption applies to written options]

But the mere written recital of a consideration is not conclusive; the statutory presumption is *rebuttable*, although the burden of showing a lack of sufficient consideration lies with the party seeking to avoid the option contract (Civ.C. § 1615; *Hersh v. Garau*, supra, 218 C at 467, 23 P2d at 1025). [See *Prather v. Vasquez* (1958) 162 CA2d 198, 204, 327 P2d 963, 967—"The true consideration or lack of consideration for a contract may always be shown"]

c. [8:71] **Effect of lack of consideration:** Absent consideration, a purported option agreement is no more than a continuing offer to sell that, like any other offer, is *revocable* by the offeror-owner at any time (prior to communication of an effective acceptance). [See *Steiner v. Thexton* (2010) 48 C4th 411, 420, 106 CR3d 252, 260; *Torlai v. Lee* (1969) 270 CA2d 854, 858-859, 76 CR 239, 241-242—"option without consideration is not binding on either party until actually exercised and is *not a contract* ..." (emphasis added)]

[8:72 - 8:74] ***Reserved.***

4. [8:75] **Compliance With Statute of Frauds:** Like a purchase and sale agreement, an option to purchase real property falls within the *statute of frauds* and therefore must be *in writing*, signed by the "party to be charged" (Civ.C. § 1624(a)(3)—agreement "for the sale of real property, or of an interest therein"). [*Pacific Southwest Develop. Corp. v. Western Pac. R.R. Co.* (1956) 47 C2d 62, 66, 301 P2d 825, 828; see *Woods v. Bradford* (1967) 254 CA2d 501, 505, 62 CR 391, 393; see also *Chevron U.S.A. Inc. v. Schirmer* (9th Cir. 1993) 11 F3d 1473, 1477 (decided under Ariz. statute of frauds)—oral agreement ineffective to extend duration of expired option or to create new enforceable option]

Cross-refer: For a detailed discussion of the statute of frauds in connection with real property purchase and sale agreements, *see ¶ 4:263 ff.*

FORM: Option Agreement, *see Form 8:A*.

a. [8:76] **"Material" terms:** Broadly, to satisfy the statute of frauds (as well as general contract law), all "material" terms of the option agreement must be identified in the written instrument. Notably, the written option agreement must:

- Identify the *parties* (*Malerbi & Associates v. Seivert* (1961) 191 CA2d 760, 762, 12 CR 852, 853);

- Identify the *property* (*Ganiats Const., Inc. v. Hesse* (1960) 180 CA2d 377, 384, 4 CR 706, 710—option must sufficiently describe the property, "in terms or by reference," so that it can be ascertained without resort to parol evidence; *and see ¶ 4:270.7* re sufficiency of description in purchase and sale agreement);

- Specify the *duration* of the option term;

- State the *purchase price* for the property (*Stockwell v. Lindeman* (1964) 229 CA2d 750, 755-756, 40 CR 555, 558; *see ¶ 8:77*); and

- State the *terms and conditions* of the contemplated purchase and sale (*Roven v. Miller* (1959) 168 CA2d 391, 399, 335 P2d 1035, 1041).

b. [8:77] **Certainty of terms:** The material terms must be sufficiently definite and certain to render the option capable of enforcement by specific performance (see generally, Civ.C. § 3390(e)). Notably, a statement of the *purchase price*, or an *ascertainable standard* for determining the price, is essential (e.g., option stating purchase price to be "fair market value" is sufficiently definite and certain). [See *Goodwest Rubber Corp. v. Munoz* (1985) 170 CA3d 919, 921, 216 CR 604, 605—option enforceable if purchase price specifically stated in agreement *or* if "practicable mode is provided for the court to determine price without any new expression by the parties themselves"]

(1) [8:78] **"To be agreed upon" fatally uncertain:** If all the material terms are not identified or, if material terms are left for future negotiation or agreement (e.g., option offering right to purchase on terms "to be agreed upon"), the option is fatally *uncertain* and thus *not enforceable*. [*Ablett v. Clauson* (1954) 43 C2d 280, 284, 272 P2d 753, 756]

When an essential element is reserved for the parties' *future agreement*, no enforceable contract arises until such future agreement. "Since either party by the terms of the promise may refuse to agree to anything to which the other party will agree, it is impossible for the law to affix any obligation to such a promise." [*Ablett v. Clauson*, supra, 43 C2d at 284, 272 P2d at 756; see *Roven v. Miller* (1959) 168 CA2d 391, 399, 335 P2d 1035, 1041—option agreement leaving essential term to future agreement "is not enforceable"]

For example:

- [8:78.1] Option provisions requiring future agreement as to what improvements would be required in development of property retained by sellers and as to their cost and its apportionment were fatally uncertain. [*Roven v. Miller* (1959) 168 CA2d 391, 399, 335 P2d 1035, 1041]
- [8:78.2] An option to purchase for a sum certain "payable as mutually agreed by both parties" was unenforceable since the payment terms were defectively uncertain. [*Roberts v. Adams* (1958) 164 CA2d 312, 314-320, 330 P2d 900, 901-906]
- [8:78.3] An option agreement leaving the amount of monthly payments "to be agreed upon at the time of the purchase" was fatally "incomplete, uncertain or indefinite in its material terms." [*Bonk v. Boyajian* (1954) 128 CA2d 153, 156, 274 P2d 948, 950-951]

(2) [8:79] **Time and manner of payment:** Like a real estate *purchase and sale agreement* (*see ¶ 4:270.3*), a real estate purchase *option contract* is enforceable even if the time and manner of payment are not specified. Absent express provisions

in the option contract itself, custom and reason determine such nonessential terms. [See *Patel v. Liebermensch* (2008) 45 C4th 344, 346, 86 CR3d 366, 367—straightforward real estate option contract fully enforceable despite fact manner and time of payment left open]

(3) [8:79.1] **Application of option to unidentified after-acquired property:** Property acquired by the optionor after execution of the option agreement may be deemed within its scope, although not specifically described therein, so long as the agreement provides the "means or key" by which the property can be identified through parol evidence. [*Alameda Belt Line v. City of Alameda* (2003) 113 CA4th 15, 22, 5 CR3d 879, 884—contractual provision giving buyer option to purchase property "including all extensions thereof" was sufficient "means or key" by which parol evidence could be used to define subject property (*discussed further at ¶ 4:270.8*)]

5. [8:80] **Assignability:** Generally, options to purchase are fully assignable *unless* (a) the option agreement specifically bars or limits assignability (*see ¶ 8:180*); *or* (b) the optionee's "performance involves elements personal to the parties." [*Masterson v. Sine* (1968) 68 C2d 222, 229-230, 65 CR 545, 549; see also *Altman v. Blewett* (1928) 93 CA 516, 525, 269 P 751, 755]

a. [8:81] **Agreements barring assignment:** An option expressly prohibiting assignment may not be assigned without the optionor's *prior approval* (*Prichard v. Kimball* (1923) 190 C 757, 764-765, 214 P 863, 866) *or* the optionor's *subsequent ratification* (*Ray Thomas, Inc. v. Cowan* (1929) 99 CA 140, 145, 277 P 1086, 1088—ratification when optionor delivered to escrow holder deed executed in favor of assignee).

b. [8:82] **Assignment of tenant's option to purchase:** An option to purchase is sometimes granted in leasing transactions as part of the tenant's benefits under the lease. Unless the lease provides otherwise, the option to purchase may be transferred by the tenant independent of the tenant's leasehold interest. [*Spaulding v. Yovino-Young* (1947) 30 C2d 138, 141, 180 P2d 691, 692]

Of course, unless the parties otherwise agree, a tenant's assignment of its interest in a lease also transfers any option rights the tenant may have within the lease.

Cross-refer: For a detailed discussion of assignability of leasehold interests (Civ.C. § 1995.010 et seq.), *see ¶ 7:60 ff.*

➪ [8:83] ***PRACTICE POINTER:*** A tenant optionee's rights pursuant to an option to purchase are often conditioned on the tenant not being in default under the lease. Therefore, assignees of the option should be aware that the tenant's (assignor's) breach of the lease could effectively terminate the option after it has been assigned.

By the same token, the landlord's acceptance of rent (or of other performance by the tenant) after the tenant's breach may be deemed to *waive* the prior breach; in such event, the option remains fully enforceable despite the prior breach. [See *Jeong Soon v. Beckman* (1965) 234 CA2d 33, 36, 44 CR 190, 192—lessors waived tenants' nonpayment of rent default by continuing to accept tenants' "percentage income" payments and thus could not rest on breach to rescind tenants' option to purchase contained in lease]

c. [8:84] **Effect of assignment:** An effective assignment by the optionee transfers to the assignee all benefits under the option (including the benefit of all payments toward the contemplated purchase made by the optionee-assignor); and, if the optionor breaches, the assignee is entitled to recover the money paid the optionor by the optionee assignor. [*Tatum v. Levi* (1931) 117 CA 83, 88, 3 P2d 963, 966]

6. [8:85] **Exercise of Option to Purchase:** An option to purchase gives the optionee the right to *elect* to purchase the property —i.e., the right to *accept the optionor's offer* to sell on specified terms. Whether to accept the offer lies within the optionee's sole discretion. [*Steiner v. Thexton* (2010) 48 C4th 411, 419, 106 CR3d 252, 259; *Beran v. Harris* (1949) 91 CA2d 562, 564, 205 P2d 107, 108; *see ¶ 8:51*]

By electing to accept the optionor's offer and, thus, to purchase the property, the optionee is said to "exercise" its option. An option to purchase turns into an enforceable bilateral purchase and sale agreement only upon its proper *exercise* within the specified option period (¶ *8:108*). [*Steiner v. Thexton,* supra, 48 C4th at 418, 106 CR3d at 258]

a. [8:85.1] **Contract principles apply:** Proper exercise of an option is determined by reference to the rules of offer and acceptance … which means, under general contract law, the terms of the exercise (optionee's acceptance) must ordinarily be *identical to the terms of the offer*. [*Arden Group, Inc. v. Burk* (1996) 45 CA4th 1409, 1414, 53 CR2d 492, 495]

Consequently, the optionee must give the optionor *unconditional and unqualified* notice of acceptance *on the terms*, *in the manner* and *within the time period* specified by the option provisions (the optionor's offer to sell). [*Erich v. Granoff* (1980)

109 CA3d 920, 928, 167 CR 538, 542; see *Peebler v. Seawell* (1954) 122 CA2d 503, 507, 265 P2d 109, 112—where option required optionee/tenant to pay 1/3 of purchase price down, purported exercise of option without downpayment could not give rise to binding sale contract]

b. [8:86] **Method of exercise:** Generally, the optionee's exercise of its option can occur by any act or words sufficient under the terms of the option contract. [*Murfee v. Porter* (1950) 96 CA2d 9, 17-18, 214 P2d 543, 549-550; *Callisch v. Farnham* (1948) 83 CA2d 427, 430, 188 P2d 775, 777]

(1) [8:87] **Specific contract terms control:** When the option agreement specifically prescribes a method for exercising the option, the optionee's attempted exercise will be effective *only if it complies with the prescribed mechanics* (e.g., prescribed method for giving *notice* of exercise of option). [*Palo Alto Town & Country Village, Inc. v. BBTC Co.* (1974) 11 C3d 494, 498, 113 CR 705, 706-707; see also *United States Postal Service v. Ester* (9th Cir. 2016) 836 F3d 1189, 1195-1196 (applying Wash. state law as applicable federal common law to lease with federal government); *Callisch v. Farnham* (1948) 83 CA2d 427, 430, 188 P2d 775, 777—where contract specifies particular manner of exercising option, optionee's election "must be strictly so made in order to constitute a valid acceptance"; *Landberg v. Landberg* (1972) 24 CA3d 742, 752, 101 CR 335, 341—"The language of the contract itself controls as to what act or acts constitute an election"]

(a) [8:88] **Waiver of contractual terms:** However, the optionor, by words or conduct, can *waive* a contractual provision calling for a specific manner of exercise of the option. [*Collins v. Marvel Land Co.* (1970) 13 CA3d 34, 40, 91 CR 291, 293-294; see also *Lawrence v. Settle* (1960) 182 CA2d 386, 389, 6 CR 49, 51]

For example, an optionor waives specified formalities for invoking the option by *accepting* the exercise of the option *without objection or reservation*. [*Collins v. Marvel Land Co.*, supra, 13 CA3d at 40, 91 CR at 293-294—oral notice of exercise effective despite provision for *written* exercise because optionor did not object]

(2) [8:89] **Effect where contract silent on mechanics:** If the option agreement simply "suggests," but does not explicitly "require," a particular method for exercise of the option, *or* if it otherwise is silent on the mechanics for exercise, any *reasonable method* of exercise will be deemed sufficient (see generally, Civ.C. § 1582). [*Palo Alto Town & Country Village, Inc. v. BBTC Co.* (1974) 11 C3d 494, 498-499, 113 CR 705, 707 & fn. 6; *Riverside Fence Co. v. Novak* (1969) 273 CA2d 656, 661, 78 CR 536, 539; but see *Allen v. Smith* (2002) 94 CA4th 1270, 1281, 114 CR2d 898, 905—absence of terms specifying option period and manner of exercise deemed indicia of parties' intent *not* to create option]

At a minimum, however, some notice or act by the optionee to the optionor is required to the effect that the optionee is in fact electing to exercise the option. "Whatever method the optionee uses to convey to the optionor [that] knowledge …, it must convey the information to the optionor that the option is, in fact, exercised, and the acceptance must correspond with the offer, meeting the offer at all points as it is made." [*Schmidt v. Beckelman* (1960) 187 CA2d 462, 469, 9 CR 736, 740-741]

(a) [8:90] **Manner of giving notice:** Many disputes over the proper method of exercising an option concern the manner in which the optionee gives its *notice* to the optionor:

1) [8:91] **Provision for "notice":** Where the agreement simply requires "notice" of the optionee's election to exercise the option, the optionee need simply *communicate* its election to accept. Unless otherwise required by the agreement, the acceptance may be written *or oral;* "an oral acceptance of a written option to convey real property is valid." [*Riverside Fence Co. v. Novak* (1969) 273 CA2d 656, 661, 78 CR 536, 539; *Lawrence v. Settle* (1960) 182 CA2d 386, 388-389, 6 CR 49, 51]

2) [8:92] **Provision for "written notice":** Where the agreement provides simply that the optionee's notice must be in writing, but neither specifies the manner in which the written notice must be transmitted nor indicates it must be "received" by the optionor within a specified time, the option is properly exercised by *depositing the notice of acceptance in the mail* (i.e., general "effective upon posting" rule under ordinary contract law regarding communication of offeree's acceptance). The optionor's actual receipt of the optionee's notice is not a prerequisite to effective exercise of the option; in other words, the *optionor* bears the risk the optionee's notice (once properly deposited in the mail) might never be received. [See *Palo Alto Town & Country Village, Inc. v. BBTC Co.* (1974) 11 C3d 494, 500-505, 113 CR 705, 708-711 (concerning option to extend lease term); *United States Postal Service v. Ester* (9th Cir. 2016) 836 F3d 1189, 1196-1197—purchase option remained valid despite minor errors in service of earlier renewal options as lease only required notices be given in writing; compare *Wapato Heritage, L.L.C. v. United*

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States (9th Cir. 2011) 637 F3d 1033, 1040 (concerning option to renew lease by giving notice by certified mail, return receipt requested); *Jenkins v. Tuneup Masters* (1987) 190 CA3d 1, 8, 235 CR 214, 217-218 (same)]

3) [8:93] **Compare—conduct not tantamount to "actual notice":** On the other hand, where the agreement calls for "written notice" or "actual notice" of the exercise of the option, the requisite notice cannot be inferred by the optionee's conduct. Even if the optionee has spent substantial sums in contemplation of "accepting" the offer and thus creating a binding purchase and sale agreement, unless *actual notice* is given per the terms and in the manner specified in the option contract, the optionor can refuse to go through with the transaction upon expiration of the option period. [Cf. *Bekins Moving & Storage Co. v. Prudential Ins. Co. of America* (1985) 176 CA3d 245, 251, 221 CR 738, 740-741 (same re exercise of option to renew lease)]

(b) Tender of performance

1) [8:94] **Notice without tender of performance:** Unless the option agreement *specifies* that the optionee buyer's tender of performance (e.g., tender of purchase price or any part thereof) is a condition precedent (or condition concurrent) to exercise of the option, the optionee's *notice* (in proper form and method) of election to accept the offer suffices to create a bilateral purchase and sale contract even though performance has not yet been tendered. [*Abadjian v. Sup.Ct. (Gulf Oil Corp.)* (1985) 168 CA3d 363, 373, 214 CR 234, 240; *Riverside Fence Co. v. Novak* (1969) 273 CA2d 656, 661, 78 CR 536, 539; *Erich v. Granoff* (1980) 109 CA3d 920, 928-929, 167 CR 538, 542-543]

On the other hand, where the option contract expressly makes tender of performance (e.g., payment of the purchase price or a specified downpayment) a condition precedent to exercise of the option, mere notice of exercise cannot give rise to a binding purchase and sale agreement (absent the optionee's tender of performance, the purported "acceptance" is not a valid acceptance under contract law because it varies from the terms of the offer). [See *Wilson v. Ward* (1957) 155 CA2d 390, 395, 317 P2d 1018, 1021—exercise of option expressly conditioned on payment of purchase price on or before specified date; *Peebler v. Seawell* (1954) 122 CA2d 503, 507, 265 P2d 109, 112—exercise of option expressly made subject to 1/3 downpayment]

2) [8:95] **Tender of performance without notice:** Conversely, unless the option agreement expressly requires actual notice of exercise of the option, the optionee's "acceptance" may be made by a tender of actual performance. [*Riverside Fence Co. v. Novak* (1969) 273 CA2d 656, 661-663, 78 CR 536, 539-541]

(3) [8:96] **Impact of optionee's conditional or qualified "acceptance":** Because the law of offer and acceptance applies (¶ *8:85.1*), an option clearly is *not* properly exercised unless the optionee *unconditionally* "accepts" the *terms specified* in the option agreement. [See *Arden Group, Inc. v. Burk* (1996) 45 CA4th 1409, 1414, 53 CR2d 492, 495—"terms of the exercise must ordinarily be identical to terms of the offer"]

However, there is an apparent split of authority on the effect of an optionee's "conditional" or "qualified" acceptance:

(a) [8:97] **View that option terminates:** Viewing the exercise of an option as the optionee's "acceptance" of the optionor's continuing "offer" to sell, one line of authority strictly adheres to general contract law: Like any conditional or qualified acceptance, an attempt to exercise an option upon terms varying from those offered "is tantamount to the rejection of the original offer and the making of a counteroffer" (see Civ.C. § 1585); consequently, the optionee cannot subsequently accept the rejected offer and convert the same into a binding contract. [*Landberg v. Landberg* (1972) 24 CA3d 742, 756-758, 101 CR 335, 345-346 (dealing with option to buy stock)—purported unconditional acceptance *after* prior qualified acceptance, held "a nullity" because prior qualified acceptance constituted rejection of option and "put an end to it"; see also *Niles v. Hancock* (1903) 140 C 157, 161, 73 P 840, 841-842]

The only exception is where the optionor, in its original offer, or the optionee in its counteroffer, expressly states that, despite the counteroffer, the original offer shall not be terminated. [*Landberg v. Landberg*, supra, 24 CA3d at 757, 101 CR at 345]

(b) [8:98] **View that option remains effective for specified option term:** However, arguably better-reasoned authority is contra: A purported exercise of an option that is qualified or made conditional or that introduces new terms, "does *not in and of itself terminate the option*" if there still remains time during the specified option term in which the "unauthorized qualification or condition may be removed and the option exercised absolutely." [*C. Robert Nattress & Assocs. v. CIDCO* (1986) 184 CA3d 55, 67, 229 CR 33, 39 (emphasis added)]

The theory is that, in the case of an option (unlike an offer and acceptance in the formation of contracts generally) a "contract" already exists in the form of the optionor's binding obligation *to keep the "offer" open* for a specified period of time—i.e., "the so-called 'offer' is truly irrevocable during the term of the option." Thus, while an attempted exercise of an option on new or different terms cannot amount to an "acceptance" of the offer, the *irrevocable* offer itself remains in existence unless otherwise expired by its terms. [*C. Robert Nattress & Associates v. CIDCO*, supra, 184 CA3d at 67, 229 CR at 39; see also *Riverside Fence Co. v. Novak* (1969) 273 CA2d 656, 662, 78 CR 536, 540-541—option properly exercised by timely good faith tender of performance (though allegedly at variance with option terms) where optionor purposefully refused to apprise optionee of deficiencies in order to prevent timely exercise of option]

[8:99] ***Reserved.***

c. [8:100] **Time for exercise:** The *time-frame* within which the option must be exercised is as important as the method of exercise (¶ 8:86 ff.) and is considered an *essential term* of the option agreement. [*Allen v. Smith* (2002) 94 CA4th 1270, 1280, 114 CR2d 898, 905] The optionor's continuing, irrevocable offer to sell expires by its own terms on the date specified in the option agreement (or, within a reasonable time if no date is specified; *see ¶ 8:101*).

It follows that the optionee bears the burden of exercising the option both in the manner specified *and within the time permitted* by the option agreement. [*Bourdieu v. Baker* (1935) 6 CA2d 150, 159-161, 44 P2d 587, 590-591]

(1) [8:101] **Effect if no time limit specified:** An option agreement is enforceable despite its failure to specify an expiration date; but in that event, the option must be exercised within a "reasonable time" under the circumstances. [*Bergin v. Van Der Steen* (1951) 107 CA2d 8, 13-14, 236 P2d 613, 617; *Murfee v. Porter* (1950) 96 CA2d 9, 18, 214 P2d 543, 549; but see *Allen v. Smith* (2002) 94 CA4th 1270, 1281, 114 CR2d 898, 905—absence of terms specifying option period and manner of exercise indicia of parties' intent *not* to create option]

(a) [8:102] **Rule against perpetuities no bar:** The Uniform Statutory Rule Against Perpetuities (Prob.C. § 21200 et seq.) generally voids any "nonvested property interest" unless (a) when the interest is created, it is "certain to vest or terminate no later than 21 years after the death of an individual then alive"; or (b) the interest "either vests or terminates within 90 years after its creation." [Prob.C. § 21205]

Nonetheless, as a practical matter, this should not affect the validity of most option agreements:

1) [8:102.1] **Option term rarely exceeds perpetuities deadlines:** First of all, option agreements rarely provide for so extensive a term of exercise as to implicate the perpetuities limitations.

2) [8:102.2] **Statutory exemptions:** Most nonvested property interests arising out of nondonative transfers are *exempted* from the statutory rule against perpetuities (see Prob.C. § 21225).

• [8:102.3] **Comment:** Loose drafting of Prob.C. § 21200 et seq. has raised some question whether, by exempting specified transactions from the *statutory* rule, the Legislature meant for those transactions to remain subject to the *common law* rule against perpetuities. No reported California decision to date has addressed the issue. [Cf. *Shaver v. Clanton* (1994) 26 CA4th 568, 574, 31 CR2d 595, 599—commercial lease granting perpetual options to renew exempt from statutory rule against perpetuities pursuant to Prob.C. § 21225(a) (court never considered whether common law rule should apply)]

3) [8:102.4] **Implied reasonable deadline for exercise:** Moreover, even if no fixed deadline for exercise or termination is specified, the "reasonable time" outside limit (*¶ 8:101*) necessarily will be construed to mandate an option term within the perpetuities period. [See generally, Prob.C. § 21220—court reformation of "disposition" to avoid violating rule against perpetuities]

➪ [8:103] ***PRACTICE POINTER—SPECIFY CALENDAR DATE DEADLINE*****:** While the failure to fix a deadline for exercise is not necessarily fatal to enforcement of an option agreement, it makes sense to specify a *precise outside date* and thereby foreclose the possibility of dispute over timeliness of the optionee's "acceptance"; i.e., what is a "reasonable time" in the circumstances may itself invite litigation.

Prudence suggests that the agreement set forth a specific *calendar date* as the deadline for exercise of the option (rather than expressing the deadline in terms of days or months—e.g., "90 days" or "three months"), after which the option will terminate. This approach will avoid dispute as to whether the first day, last day or a holiday is included when counting days or months for exercise of the option; it also circumvents dispute over arguably ambiguous

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contract language. [See, e.g., *Wilson v. Gentile* (1992) 8 CA4th 759, 760-761, 768, 10 CR2d 713, 718-719—lease required purchase option to be exercised "within 30 days prior to the expiration" of option period: optionor argued such language required exercise of option "no later than" 30 days *before* option period expires (so that optionee's exercise would have been untimely); court concluded language instead allowed exercise of option *during* 30-day period immediately preceding expiration of option (so that option was timely exercised 7 days before option period expired)]

Also, though not legally required, it makes sense to clarify in the agreement that if the option is not exercised within the specified option term, it will expire automatically and without further notice by any party.

(2) [8:104] **Effect of expiration of deadline:** If a specified deadline for exercise of the option passes without the optionee's exercise *or* if, though no deadline is specified, the option is not exercised within a "reasonable time," the option *terminates* and the optionee has *no rights* under the agreement. [*Plaza Freeway Ltd. Partnership v. First Mountain Bank* (2000) 81 CA4th 616, 629, 96 CR2d 865, 874—defendant who failed to exercise option to renew lease within contractually-specified one-year period before termination date guilty of unlawful detainer]

A *tardy* or *belated* attempt to exercise the option is *ineffective* to create a binding bilateral purchase and sale agreement. [*Wightman v. Hall* (1923) 62 CA 632, 634, 217 P 580, 580-581; *Rice Lands & Products Co. v. Blevins* (1923) 61 CA 536, 541, 215 P 402, 405; see also *Chevron U.S.A. Inc. v. Schirmer* (9th Cir. 1993) 11 F3d 1473, 1477 (same under Ariz. law)]

(a) [8:105] **"Minor" delays may be excused:** However, there are cases excusing "minor" delays in the exercise of an option so long as the optionor will not incur any hardship thereby and has been compensated by the optionee for the delay. [*Holiday Inns of America, Inc. v. Knight* (1969) 70 C2d 327, 331, 74 CR 722, 725 (relief from forfeiture, see below)]

This result is consistent with Civ.C. § 3275, which provides that when one party would incur a forfeiture "by reason of his failure to comply with … [the contract's] provisions, he may be relieved therefrom, upon making full compensation to the other party." [*Holiday Inns of America, Inc. v. Knight*, supra, 70 C2d at 329-330, 74 CR at 724]

(b) [8:106] **Waiver of time limit:** In any event, strict compliance with a deadline for exercise of the option will be deemed *waived* if the optionor, by words or conduct, led the optionee to believe the deadline would not be enforced. [See *Leonhardi-Smith, Inc. v. Cameron* (1980) 108 CA3d 42, 47-48, 166 CR 135, 137-138 (option to renew lease)]

[8:106.1 - 8:106.4] *Reserved.*

(3) [8:106.5] **Effect of "time of essence" clause:** A "time of the essence" clause (¶ *4:535 ff.*) is of no legal consequence in an option contract. Rather, on lapse of the option period, the optionor's irrevocable offer to sell terminates (¶ *8:115*), completely ending the matter. [*Allen v. Smith* (2002) 94 CA4th 1270, 1281, 114 CR2d 898, 905]

d. [8:107] **Optionor's interference as defense to defective exercise of option:** An optionor cannot defeat the irrevocable feature of its option contract (irrevocable offer to sell on specified terms) by taking action to preclude or impede the optionee from timely exercising the option. "The optionor's *good faith* is a relevant consideration; his evasion or prevention of exercise of the option may *excuse tender of performance and other conditions precedent* to acceptance." The optionee's remedy in such event is an action for specific performance. [*Riverside Fence Co. v. Novak* (1969) 273 CA2d 656, 662-663, 78 CR 536, 540 (emphasis added)—optionor's evasive conduct calculated to prevent timely exercise of option barred optionor from asserting untimely or improper exercise of option; *Murfee v. Porter* (1950) 96 CA2d 9, 18, 214 P2d 543, 549]

e. Effect of optionee's proper exercise

(1) [8:108] **Bilateral purchase and sale contract created:** Timely and proper exercise of an option (the optionee's unconditional, unqualified acceptance of the offer in accordance with the terms of the option and within the time span stated in the option contract) converts the unilateral option agreement into a *bilateral contract of purchase and sale* under which the optionor is obligated to sell and the optionee is obligated to purchase the property on the terms and conditions set forth in the option agreement (¶ *8:45*). [See *Steiner v. Thexton* (2010) 48 C4th 411, 418, 106 CR3d 252, 258; *Wachovia Bank v. Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 1049-1050, 52 CR3d 168, 175-176; *Auslen v. Johnson* (1953) 118 CA2d 319, 322, 257 P2d 664, 666]

Upon exercise, the option technically ceases to exist and is *merged* into the purchase and sale agreement. [*Schomaker v. Osborne* (1967) 250 CA2d 887, 893, 58 CR 827, 830]

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(2) [8:109] **Payment of purchase price:** Creation of the bilateral purchase and sale agreement obligates the optionee buyer to pay the specified purchase price. However, unless the option agreement expressly provides otherwise (¶ *8:94*), the purchase price is not required to be paid upon exercise of the option. [See *Erich v. Granoff* (1980) 109 CA3d 920, 928-929, 167 CR 538, 542-543] Instead, the option agreement usually contains a provision specifying the mechanics for consummating the purchase and sale—e.g., the creation of an escrow.

(a) [8:110] **"Reasonable time" if no time stated:** If the option agreement does not fix a deadline for tendering the purchase price, a reasonable time is allowed. [*Patel v. Liebermensch* (2008) 45 C4th 344, 346, 86 CR3d 366, 367 & fn. 2—time of payment may be determined by reference to "custom and reason" when contract is silent; *Crocker v. Grandi* (1961) 189 CA2d 431, 437, 11 CR 330, 334—payment must be tendered within "reasonable time after exercise of the option"; see also Civ.C. § 1657—in absence of specified time for performance, reasonable period is allowed]

(b) [8:111] **Waiver of delay:** The burden is on the optionor to *object* to any purported delay in tender of payment. Otherwise, delay in the tender will be deemed *waived*. [*Crocker v. Grandi* (1961) 189 CA2d 431, 436-437, 11 CR 330, 334]

(3) [8:112] **Effect on intervening claimants ("relation-back" rule):** When the option is properly exercised, the optionee's right to purchase relates back to the time the option was granted: Subsequent purchasers and encumbrancers with notice of the option take subject to the optionee's right to complete the purchase; the title received upon consummation of the purchase and sale agreement extinguishes the interests of intervening parties. [*Wachovia Bank v. Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 1050, 52 CR3d 168, 176; *see further discussion at ¶ 8:123 ff.*]

(4) [8:113] **Compare—exercise of option does not pass title:** Proper exercise of the option does not itself pass title to the property and thus does not itself extinguish intervening interests (*see ¶ 8:112*). The optionee/buyer obtains title, and thus the benefit of the "relation-back" rule (¶ 8:112), only when the purchase and sale transaction is completed pursuant to exercise of the option. [*Wachovia Bank v. Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 1053, 52 CR3d 168, 178; *see also ¶ 8:123 ff.*]

[8:114] ***Reserved.***

7. Termination/Expiration of Option

a. [8:115] **Default by optionee or lapse of option term:** The right to exercise an option terminates upon *either* (1) a *default* by the optionee which, pursuant to the terms of the option agreement, extinguishes the optionee's rights; *or* (2) *expiration of the option term* before the optionee's exercise.

In other words, like any "offer" in the formation of a contract, an option expires by its own terms upon the optionee's (offeree's) failure to communicate a timely acceptance. [See generally, Civ.C. § 1587, subd. 2—"A proposal is revoked … [b]y the lapse of time prescribed in such proposal for its acceptance, or if no time is so prescribed, the lapse of a reasonable time without communication of the acceptance"]

(1) [8:116] **Optionor's offer effectively revoked:** Termination/expiration of the option effectively "revokes" the optionor's continuing offer to sell on the stated terms because the offer has not been properly/timely accepted. [*Auslen v. Johnson* (1953) 118 CA2d 319, 322, 257 P2d 664, 666; *Rosenaur v. Pacelli* (1959) 174 CA2d 673, 676-677, 345 P2d 102, 105-106]

(2) [8:117] **No notice required:** Pursuant to the optionee's default or lapse of the option term (¶ 8:115 ff.), the option expires *by its own terms*, *by operation of law*. No special notice need be given by the optionor upon lapse of the option term. [*Auslen v. Johnson* (1953) 118 CA2d 319, 322, 257 P2d 664, 666; *Rosenaur v. Pacelli* (1959) 174 CA2d 673, 676-677, 345 P2d 102, 105-106]

(3) [8:118] **Optionor's remedy to clear title upon expiration:** In the event an option has not been timely exercised and the optionee refuses or fails to remove its option of record, the optionor's remedy to clear title to the property is to maintain a quiet title action (*¶ 11:526 ff.*). [See, e.g., *Krobitzsch v. Middleton* (1946) 72 CA2d 804, 165 P2d 729, 730]

(*See further discussion in connection with removing options of record at ¶ 8:140 ff.*)

b. [8:119] **Compare—option *not terminated by optionor's or optionee's death:*** Unless the option agreement otherwise provides, the optionor's death does *not* terminate the option; the optionee may still exercise the option against the optionor's estate (see Prob.C. § 9860 et seq.). [*Bard v. Kent* (1942) 19 C2d 449, 451, 122 P2d 8, 10—so long as consideration given,

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option "is a contract binding upon the offeror and upon his successors in interest after death"; see also *Bewick v. Mecham* (1945) 26 C2d 92, 95-96, 156 P2d 757, 759-760; *O'Donnell v. Lutter* (1945) 68 CA2d 376, 385, 156 P2d 958, 962]

Likewise, an optionee's rights survive the optionee's death; the option becomes an asset of the deceased optionee's estate and may be exercised by the personal representative. [Prob.C. § 9734; see also Ross & Cohen, *Cal. Prac. Guide: Probate* (TRG), Ch. 13]

c. [8:120] **Damage, destruction or condemnation of property:** Although there appears to be no case law directly on point, presumably the rights of the parties in the event the property is damaged, destroyed or condemned *pending exercise of the option* are governed by the Uniform Vendor and Purchaser Risk Act (Civ.C. § 1662) … *unless the parties have otherwise agreed*. Thus, material damage to or destruction of the property may effectively *terminate* the option agreement, the optionor seller bearing the risk of loss until title or possession is transferred (Civ.C. § 1662(a)). *See more detailed discussion at ¶ 4:475 ff.*

(1) [8:120.1] **Effect of provision authorizing cancellation of optionee's lease?** In an analogous situation, it has been held that a lease provision giving the landowner/lessor the right to *cancel the lease* in the event of damage to or destruction of the property at or near the end of the lease term *prevails* over the tenant's right to exercise an agreed-upon option to extend the term. [*11382 Beach Partnership v. Libaw* (1999) 70 CA4th 212, 216-218, 82 CR2d 533, 535-536; *see ¶ 7:155.5*]

Whether the landowner's contractual right to cancel the lease would also preempt the exercise of a companion *option to purchase* held by the tenant is unclear. (The most prudent step, of course, is to account for such a contingency in the option agreement; *see ¶ 8:121*.)

➪ [8:121] ***PRACTICE POINTER:*** As in drafting a purchase and sale agreement, it always makes sense to expressly account for the possibility of damage, destruction or condemnation and explicitly spell out the parties' respective rights under such circumstances. *See ¶ 4:480 ff.*

(2) [8:122] **Optionee's "compensable" interest in condemnation proceedings (*before exercising option):*** Even if the option agreement does not address the issue, case law indicates an optionee under an *unexercised option* may have a valuable property right that is *compensable* in condemnation proceedings. [See *County of San Diego v. Miller* (1975) 13 C3d 684, 693, 119 CR 491, 496; *and ¶ 8:52*]

(3) [8:122.1] **Optionee's "burden" in condemnation proceedings (*after exercising option):*** In what turned out to be an unusual situation, an optionee sought specific performance of a commercial lease agreement that gave it the option to purchase the underlying property at its fair market value. The optionee and seller disagreed as to the property's value and requested a judicial determination so the transaction could be completed. After years of litigation and an appeal, the trial court determined the property's fair market value, provided the optionee and seller with various credits for rents paid and loss of use of the sale proceeds, and ordered the parties in an amended judgment to complete the transaction. The court's amended judgment also required the seller to deliver title to the property "free and clear of all encumbrances." The optionee filed a second appeal from the amended judgment, arguing it was entitled to certain additional financial reductions and offsets. The court rejected this argument and affirmed the amended judgment. [*Petrolink, Inc. v. Lantel Enterprises* (2022) 81 CA5th 156, 159-160, 296 CR3d 731, 732-733]

Eleven days later, Caltrans filed an eminent domain action against the property and the optionee refused to close escrow unless the seller deposited into escrow *unencumbered* title to the property (an impossibility since the seller had no control over Caltrans' action). The trial court granted the seller's motion to compel performance notwithstanding the encumbrance on title. [*Petrolink, Inc. v. Lantel Enterprises,* supra, 81 CA5th at 160-161, 296 CR3d at 733-734]

In yet a third appeal, the appellate court determined the trial court, by exercising its *equitable* powers, properly modified the amended judgment to require the optionee to complete the transaction despite the encumbrance on title. The optionee had been in possession of the property during the entire litigation, and "if the parties had not been litigating this case for approximately a decade, [optionee] would not only have been in possession of the property, but would also have been the owner of record of the property at the time the Caltrans action was filed." [*Petrolink, Inc. v. Lantel Enterprises,* supra, 81 CA5th at 161, 171, 296 CR3d at 732-734, 742]

8. [8:123] **Priority and Perfection; "Relation-Back":** The optionee's rights as against intervening purchasers, encumbrancers, etc. are fixed as of the date the option is *recorded* (*¶ 8:126*); the intervening claimants take subject to the first-in-time optionee's right to complete the purchase. Thus, the title received pursuant to valid exercise of the option *relates back* and extinguishes the

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interests of intervening parties who (by recordation of the option) had notice of the option. [*Wachovia Bank v. Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 1050, 52 CR3d 168, 176; *Claremont Terrace Homeowners' Ass'n v. United States* (1983) 146 CA3d 398, 406, 194 CR 216, 221; see Civ.C. § 1213]

➪ [8:124] ***PRACTICE POINTER:*** The optionee's priority rights as against subsequent claimants are perfected upon recordation of the option. Technically, therefore, the fact the optionor might have the power to grant subsequent liens or encumbrances should be immaterial to the optionee. Nonetheless, many optionees insist on an express provision in the option agreement barring the landowner from further encumbering the property during the option term. Such a provision will avoid the possibility of dispute with junior encumbrancers as to competing rights of priority.

a. [8:125] **"Relation-back" triggered by title transfer pursuant to option:** Implicit in the "relation-back" rule (¶ 8:123) is the fact that the optionee actually has *received title* to the property *pursuant to proper exercise of the option*. Until title is so transferred, the optionee has only a right to complete the purchase, and intervening interests, while subject to this right (¶ 8:125.1), are not yet extinguished. [*Wachovia Bank v. Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 1050, 1054-1055, 52 CR3d 168, 176, 179-180 (also discussing rationale for "relation-back" rule)]

(1) [8:125.1] **Effect where optionee obtains title outside option purview:** If the optionee takes title to the property *outside the purview of the option* (as where the option had expired, there was a failure of conditions under the option, or there was a material breach by the optionee that would preclude specific performance), the "relation-back" rule does not apply, and the title obtained by the optionee does *not* extinguish the intervening interests. [*Wachovia Bank v. Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 1055-1056, 52 CR3d 168, 180]

b. [8:126] **Recordation to perfect priority:** California recording statutes (Civ.C. § 1213 et seq.) are of the "race-notice" variety (i.e., "first in time, first in right"):

With respect to real property, a conveyance recorded first generally has priority over any later-recorded conveyance. Recordation imparts *constructive notice* "to the world"; and whoever records first in time has priority as against subsequent encumbrancers of record. [Civ.C. §§ 1213, 1214; see *Thaler v. Household Finance Corp.* (2000) 80 CA4th 1093, 1099, 95 CR2d 779, 783]

An *option to purchase* is a "conveyance" under Civ.C. §§ 1213 and 1214. [See Civ.C. § 1215—"conveyance" as used in §§ 1213 and 1214 is "every instrument in writing by which any estate or interest in real property is created, aliened, mortgaged, or incumbered, or by which the title to any real property may be affected, except wills"]

Consequently, it is of paramount importance to optionees that the option agreement, or some memorandum thereof, be recorded *as soon as possible after its execution*.

(1) [8:127] **Priority rights of subsequent "bona fide" encumbrancers who record first in time:** Any purchaser or encumbrancer who takes its interest without actual knowledge of the option and who records its conveyancing instrument prior to the optionee's recordation of the option, is a "bona fide" purchaser/encumbrancer who takes *free and clear of the option.* [Civ.C. § 1214—"Every conveyance of real property … is void as against any subsequent purchaser or mortgagee of the same property … in good faith and for a valuable consideration, whose conveyance is first duly recorded"]

(a) [8:128] **Compare—subordination by actual notice of prior option:** Notwithstanding the optionee's failure to record its interest, any subsequent transferee who has *actual knowledge* of the option is *not* a "bona fide" purchaser/encumbrancer and thus is *subordinated* to the option created first in time. Reason: Once the option is exercised, the optionee's title "relates back" to the date of the giving of the option. [*Anthony v. Enzler* (1976) 61 CA3d 872, 876, 132 CR 553, 557]

➪ [8:129] ***PRACTICE POINTER:*** It is risky for optionees to rely on any other party's "actual notice" of the option. Again, recording imparts constructive notice to *all subsequent purchasers/encumbrancers*, regardless of whether they otherwise have reason to know of a preexisting option agreement affecting the property.

(2) [8:130] **Contents of recorded document:** The optionee's priority rights are perfected by properly recording either the option agreement or a memorandum thereof. In either case, the document should be prepared with the same degree of diligence used in the preparation of any conveyancing instrument. Notably, the optionee should make certain that:

- The purported grantor of the option is, in fact, the holder of the *entire fee interest* in the property and has the *authority* to grant the option (*see ¶ 4:130 ff.*).

- The document *completely and correctly* states the legal description of the property.

• The document contains an *affirmative "grant"* to the optionee.

• The option term is specified.

(a) [8:131] **Subsequent recordation of extensions:** In addition, any agreement to *extend* the option term should be reduced to a signed writing and itself be recorded before expiration of the initial term.

(b) [8:132] **Compare—nonessential terms:** It is not important to perfection of the optionee's priority rights that the recorded option agreement or memorandum specify the purchase and sale terms (price, financing, etc.).

➪ [8:133] ***PRACTICE POINTER—RECORDING OPTION AGREEMENT VS. MEMORANDUM OF AGREEMENT*****:** It is a judgment call whether the optionee should record the entire option agreement or simply a memorandum thereof noting the essential terms mentioned at ¶ *8:130*. The advantage of recording a mere memorandum of the option is that the specific terms of the underlying purchase and sale transaction (set forth in the option agreement) will not become a public record (as they would if the entire option agreement were recorded). As a practical matter, most prospective sellers and buyers do not want the terms of their deal made public.

FORMS

• Option Agreement, *see Form 8:A*.

• Memorandum of Option to Purchase, *see Form 8:B*.

[8:134] ***Reserved.***

9. [8:135] **Title Insurance:** Title insurance insuring the priority of the option is available and, indeed, advisable. (*See detailed discussion of title insurance in Ch. 3*.)

a. [8:136] **Policy limit:** The difficult issue is what *policy limit* the optionee should obtain.

The most logical method for determining an appropriate policy limit is to calculate the optionee's loss should the option be deemed entirely unenforceable. Ultimately, the policy limit amount is subject to negotiation between title insurer and optionee; but, in any event, a title carrier generally will never insure an option for an amount in excess of the stated purchase price.

b. [8:137] **Who pays:** In connection with purchase and sale transactions, who pays the cost of a buyer's title insurance policy is typically a matter of customary regional practice (in Northern California, the buyer pays; in Southern California, the seller pays). However, there is no apparent customary practice in connection with title policies insuring the priority of an option. Consequently, the subject is typically left to negotiation between the parties.

➪ [8:138] ***PRACTICE POINTER:*** Title insurance insures the optionee's priority only as against *subsequent* purchasers, lienholders and encumbrancers; if the option is exercised, the optionee purchaser will acquire the property *subject to preexisting* liens. Thus, the optionee should be satisfied with the *existing* condition of title *before entering into* the option agreement so as to make certain the option will be subject only to those liens and encumbrances that are acceptable to the optionee. (For example, an option may be valueless if it is subject to a senior right of first refusal or a senior option.)

[8:139] ***Reserved.***

10. Removing Options of Record

a. [8:140] **Optionee's quitclaim deed:** For so long as an option remains of record, it clouds the property owner's title; naturally, therefore, the optionor will want the cloud removed as soon as possible after an option expires unexercised. This may be accomplished by the optionee's executing a *quitclaim deed*, or some other form of written relinquishment of the option interest (or written confirmation of termination of the option) which can then be recorded.

(1) [8:141] **Advance execution of quitclaim deed to avoid dilemma of unwilling optionee; drawbacks:** Of course, the optionor may encounter a recalcitrant optionee who delays or refuses to execute the deed or other appropriate instrument

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releasing its interest in a timely manner. In such cases, the optionor may have to file a quiet title action (*see ¶ 8:118*). However, this dilemma can be avoided at the outset when the option is first negotiated:

One approach is to have the optionee execute a quitclaim deed *at the time the option is granted*. The deed could be held by the optionor or some independent third party, such as an escrow, with instructions that it be recorded *upon expiration of the option*.

(a) [8:142] **Comment—escrow impediments to recordation of grant deed:** Even this approach, however, has its drawbacks: In all likelihood, the escrow holder will not record the quitclaim deed should there be some dispute between the parties as to whether the option has expired. In this situation, the escrow holder usually will commence an interpleader action, resulting in increased costs and delays for all parties (*see* ¶ *4:326, 4:576, 4:591 & 4:647*).

➪ [8:143] ***PRACTICE POINTER:*** The parties sometimes ask counsel for one or the other to hold the quitclaim deed. From counsel's standpoint, this is *not advisable, generally:* If any dispute arises between the parties, a lawyer holding the quitclaim deed will become embroiled in the controversy (and, perhaps, made a party to the dispute) and be placed in a conflict of interest position (see generally, CRPC 1.7).

b. [8:144] **Statutory expiration "of record":** In lieu of initiating a quiet title action to remove the option of record, optionors may rely on a statutory mechanism that *automatically* expunges unexercised options from the chain of record title (Civ.C. §§ 884.010 & 884.020):

(1) [8:145] **Six-month expiration of record:** A recorded option *expires* "*of record*" six months after its expiration date, provided that date is ascertainable from the recorded instrument, *or* if no expiration date is specified in or ascertainable from the recorded instrument, then six months following the date the instrument was recorded, unless another instrument extending the option is recorded before such expiration. [Civ.C. § 884.010]

(2) [8:146] **Effect of statutory expiration—"constructive notice" terminates:** Upon expiration of an option to purchase real property pursuant to Civ.C. § 884.010 (¶ 8:144 ff.), the recorded instrument creating the option *ceases to be notice to any person* or to put any person on inquiry with respect to the exercise or existence of the option or any contract, conveyance or other writing that may have been executed pursuant to the now-expired option. [Civ.C. § 884.020]

(a) [8:147] **Compare—rights as between optionee and optionor; extension agreements:** As between optionor and optionee, the *option itself* does *not* terminate under Civ.C. §§ 884.010 & 884.020; rather, the option simply expires "of record" (Civ.C. § 884.010). In effect, the statutes simply provide for a statutory expungement of the *recorded* option, thereby nullifying "constructive notice" as against subsequent "bona fide" purchasers/encumbrancers.

It follows that, if the optionee is able to negotiate an *extension* of the option agreement, written evidence of the extension should be recorded so as to again ensure the optionee's priority rights over subsequent intervening claimants (*see ¶ 8:131*).

➪ [8:148] ***PRACTICE POINTER—TIMELY RECORDATION OF CONVEYANCING INSTRUMENT*:** Bear in mind that once a recorded option is exercised, some instrument (conveyancing instrument, purchase contract or some other document evidencing the purchase and sale agreement) should be *recorded before the Civ.C. § 884.010 expiration date* (*¶ 8:145*). If the termination date is ascertainable from the recorded option (or memorandum), the additional transfer instrument should be recorded within six months after that date. If no termination date is specified in or ascertainable from the recorded option, the additional transfer instrument should be recorded within six months after the option's recordation date. Otherwise, notwithstanding proper exercise of the option, the optionee will not be protected by the recording statutes as against intervening purchaser/lien claimants.

[8:149] ***Reserved.***

11. [8:150] **Tax Concerns—Risk of "Disguised Sale":** In reviewing a proposed option, counsel should carefully consider whether it might be deemed a mere "disguised" or "delayed" *sale* of the property. If a substantial portion of the purchase price is "disguised" as consideration for an option, the transaction might be treated as the consummation of a purchase and sale. This could have a substantial impact on the parties' tax situation. [Cf. *Scarbery v. Bill Patch Land & Water Co.* (1960) 184 CA2d 87, 99-103, 7 CR 408, 415-417—option may be treated as specifically enforceable purchase and sale agreement where optionee paid more than 75% of agreed value for property as "consideration" for option; *see also ¶ 13:50*]

12. [8:151] **Use of Option as Financing Device—Risk of "Disguised Mortgage":** Options to purchase are sometimes structured as mere financing devices:

a. [8:152] **Example—sale and leaseback with option:** One such scenario occurs where an owner sells their property but leases it back with an option to purchase the fee. In this situation, the original owner/seller (who has now become the tenant/optionee) ultimately pays off what is really a loan from the buyer/optionor when the original owner exercises its option and pays the option price.

Under this arrangement, the buyer/optionor ("lender") has ownership of the property (for purposes of securing payment of the "disguised loan"), while the seller (who is really a borrower and becomes the tenant/optionee) can redeem its ownership interest by paying the loan in the form of the option purchase price. Thus, the seller (borrower) obtains the advantage of a loan and the buyer (lender) obtains the advantage of holding fee title to the property as security. (Under a conventional loan, the lender would, of course, only hold the lien of a trust deed on the property.) Upon the borrower's failure to pay the amount due, the lender will not have to go through the burden of a foreclosure to realize on its collateral.

(1) [8:153] **"Disguised mortgage" drawback:** The problem with this arrangement is that the buyer/optionor (lender) runs the risk the transaction will be adjudicated a "disguised mortgage" instead of an option to purchase. In that event, the buyer/optionor will be deemed a *secured creditor*—not an owner. Such claim is typically made by the seller/optionee (borrower) in an effort to hinder or delay the rights of the buyer/optionor (lender). Disputes of this sort can easily escalate into complicated, expensive and time-consuming litigation.

b. [8:154] **Example—lender as optionee:** Another method of using an option to purchase as a financing device is for the borrower to grant the lender an option to purchase at a reduced price, exercisable upon the borrower's default under its loan.

(1) [8:155] **"Disguised mortgage" drawback; risk of invalidity:** Where the option is given to a lender who also has a security interest (under trust deed) in the real property collateral, the lender faces a "disguised mortgage" problem; and, at least where the lender's right to exercise the option is dependent on the borrower's default, there is a risk the option will be declared invalid as impairing the borrower's "equity of redemption" (Civ.C. § 2906). [See *Wachovia Bank v. Lifetime Indus., Inc.* (2006) 145 CA4th 1039, 1057-1059, 52 CR3d 168, 181-183]

Cross-refer: For a detailed discussion of this scenario and its implications under applicable law, *see ¶ 6:425 ff.*

13. Purchase Agreement With Liquidated Damages Clause Compared

a. [8:156] **Distinction:** An option to purchase is conceptually similar to a purchase and sale agreement under which the seller's sole remedy in the event of a buyer's breach is the right to recover stipulated liquidated damages. When the parties have liquidated the seller's damages under a purchase and sale agreement, the buyer effectively has the right to refuse to close and walk away from the deal by paying the specified finite sum (i.e., the "liquidated damages" amount); similarly, under an option to purchase, the optionee has paid a finite amount (the "consideration" for the option) for the right to elect whether to purchase the property. [See *Allen v. Smith* (2002) 94 CA4th 1270, 1278-1279, 114 CR2d 898, 903-904]

Nonetheless, a freely-negotiated option does not constitute liquidated damages in legal effect because the payment obligation does not arise upon a breach of contract by the optionee (prospective buyer) but as an alternative to performance under the option (i.e., the optionee has paid the upfront consideration for the right to purchase instead of entering into a binding bilateral agreement to purchase). [*Allen v. Smith* (2002) 94 CA4th 1270, 1279, 114 CR2d 898, 904]

(1) [8:156.1] **Option vs. purchase and sale agreement tested by "mutuality of obligation":** Whether a particular document is a purchase and sale agreement with a liquidated damages clause or an option to purchase supported by independent consideration depends on the nature and terms of the document and the parties' obligation, regardless of how it is identified or labeled. The test is whether there is "*mutuality of obligation*": If both parties are obligated to perform, it is a purchase and sale agreement; if only one party (the optionor/seller) is obligated to perform, it is an option. [*Allen v. Smith* (2002) 94 CA4th 1270, 1279, 114 CR2d 898, 904]

b. [8:157] **Pros and cons for seller:** From a seller's perspective, there are practical advantages and disadvantages to the use of a liquidated damages purchase agreement as a substitute for an option to purchase:

(1) [8:158] **Disadvantages:** Sellers should consider these drawbacks:

(a) [8:159] **Liquidated damages enforcement dependent on proving buyer's breach:** To realize the benefit of a liquidated damages clause in a purchase agreement, the seller must still prove the buyer *breached* the agreement.

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By contrast, under an option agreement, the seller has already received consideration in payment for its irrevocable offer; and need not prove a breach of contract as a condition to retaining the consideration.

(b) [8:159.1] **Restrictions on validity of liquidated damages:** There are both common law and statutory restrictions on the validity of a liquidated damages provision and the maximum sum that may be liquidated (*see ¶ 4:315 ff.*). The consideration paid for an option, on the other hand, is entirely negotiable; its validity is not tested under the law governing liquidated damages. [See *Allen v. Smith* (2002) 94 CA4th 1270, 1279, 114 CR2d 898, 904—for that reason, many sellers insist on structuring sale agreement as an option]

(c) [8:160] **Escrow impediments to collection of liquidated sum:** Also, whereas a seller optionor usually receives the option consideration by advance cash payment, liquidated damages under a purchase agreement are usually deposited with a third party (typically, an escrow holder). Therefore, even if the buyer breaches, the seller faces the practical obstacle of collecting the liquidated sum from the escrow holder. (*See* ¶ *4:326, 4:633 ff.*)

(2) [8:161] **Advantages:** By the same token, use of a liquidated damages purchase agreement (rather than an option) offers at least one benefit to the seller: Whereas options usually are recorded and thus cloud the seller's title (¶ *8:126 ff., 8:140 ff.*), under a purchase contract, there is customarily no recorded encumbrance on the seller's title. Although the buyer under a liquidated damages purchase agreement could commence a specific performance action and record a lis pendens against the property (CCP § 405 et seq., *see ¶ 11:300 ff.*), unless and until that event occurs, the seller's title remains unclouded.

[8:162 - 8:164] ***Reserved.***

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Chapter 8. Options to Purchase and Preemptive Purchase Rights

C. Option Agreement Provisions

1. [8:167] Property Description
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15. [8:183] Option Extensions
16. [8:185] Execution and Recordation of Exercise of Option
17. [8:186] Confidentiality
18. [8:187] “Boilerplate” Provisions

[8:165] The sections at ¶ 8:167 ff. summarize the more significant provisions that should, as a matter of prudence, be included in options to purchase. The discussion generally tracks the sample option agreement included at the close of this Chapter as *Form 8:A*.

➪ [8:166] ***PRACTICE POINTER:*** Again, counsel drafting or reviewing proposed options to purchase should bear in mind that the agreement should, if accepted, effectively give rise to an *enforceable* bilateral purchase and sale agreement without the need for further negotiation. The goal should be to include *specific* terms, conditions and mechanics applicable to *actual consummation of the purchase and sale*. Thus, everything from the simple designation of an escrow company to potentially complex issues of seller representations and warranties should be covered in the option agreement. Diligent consideration of the issues discussed in *Ch. 4* regarding purchase and sale agreements is therefore equally important when negotiating, structuring and preparing an option agreement.

1. [8:167] **Property Description:** All property—whether real, personal or intangible—should be described with particularity. [See *Ganiats Const., Inc. v. Hesse* (1960) 180 CA2d 377, 384, 4 CR 706, 710; *and* ¶ *8:76*]

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(For recordation purposes, specification of a complete and accurate *legal description* of the real property is essential; ¶ *8:130*.)

2. Option Term

a. [8:168] **Term and date for exercise:** The *option term* should be stated clearly and definitively; and, for the seller's benefit, should provide the option automatically terminates on a *fixed date* without further notice, documentation or act by any party (*see* ¶ *8:103*).

Similarly, the last *calendar (business) day for exercise* of the option should be specified so as to leave no room for debate as to when the option term expires (*see* ¶ *8:103*).

➪ [8:169] ***PRACTICE POINTER:*** Notwithstanding such provisions, it may still behoove the seller to notify the optionee in writing upon expiration of the option term, thereby foreclosing any argument the option was impliedly extended. (But such notice is *not* required by law.)

b. [8:170] **Release of cloud on title upon termination:** Notwithstanding a provision in the option providing for automatic termination, title insurance companies often require that an option be removed of record by a recorded document confirming termination (otherwise, the title company will not issue a title policy). Consequently, for the seller's benefit, the optionee should be required to provide a quitclaim deed, or other written confirmation of termination of the option that can be recorded in the event the option lapses unexercised.

Sellers may want to consider having such a conveyancing instrument held by an independent escrow for recording upon expiration of the option term (although this approach could itself give rise to litigation; *see* ¶ *8:141 ff.*).

3. [8:171] **Option Consideration:** The consideration to be paid for the option should be stated, along with the time for and method of payment (cash or otherwise). (*See* ¶ *8:55 ff.* regarding legally-“sufficient” consideration.)

4. [8:172] **Method of Exercise:** Failure to delineate a precise *method* for exercising the option is one of the most common pitfalls giving rise to optionor-optionee disputes. Therefore, the contemplated manner for exercising the option should be carefully spelled out with particularity (otherwise, any “reasonable manner” of communicating an election to exercise the option will be deemed sufficient; *see* ¶ *8:89 ff.*).

Preferably, the agreement should call for *written notice* to be *delivered* (by private courier, telecopier, mail, etc.) to the optionor by a *designated date*. For example, if mailed noticed is agreed upon, the option should call for delivery by *certified mail, return receipt requested*; and should also specify such notice is deemed received an agreed-upon number of days after mailing.

5. [8:173] **Purchase Price:** The purchase price must be clearly identified; and, if applicable, the agreement should reflect what amount of the option consideration is to be applied toward the purchase price. A provision identifying the time for and manner of tender of the purchase price also is advisable, though not essential (*see* ¶ *8:110*).

6. [8:174] **Optionee's Access to Property:** The optionee's interest in exercising the option will often depend on the results of various tests and studies of the subject property, necessarily requiring extensive and continuing access rights. However, since an option by its nature does not itself give the optionee any interest in or right to possession of the property (¶ *8:53*), the agreement should expressly confer appropriate entry and access rights … with the proviso that the optionee indemnify the seller for damage and against any and all liability attributable thereto.

7. [8:175] **Optionee's Development Work:** Optionees are sometimes interested in obtaining extended option terms in order to commence the processing of various applications for development of the property. The optionee might therefore request the seller's consent and cooperation in applying for various permits and approvals.

For example, since the optionee is not the record owner, the optionee may not be entitled to apply for building permits, zoning variances and other governmentally-issued approvals. The seller may be willing to cooperate by executing appropriate documents to be filed with governmental entities, provided (a) doing so does not bind the seller to any additional obligations and (b) that the mere filing or processing of such applications will not irrevocably commit the property to a particular use or otherwise adversely affect the property's existing use or zoning. (*See also* ¶ *4:423, 4:540*.)

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8. [8:176] **Date for Opening Escrow and Consummating Purchase and Sale:** In addition to fixing the time-frame for exercising the option, the agreement should specify the time within which the escrow must be opened and, ultimately, closed. From the seller's perspective, the escrow term should be fairly short, since the optionee has presumably had sufficient time to make its investigation of the property (including the state of title), arrange financing, and otherwise put the transaction in a position to close.

9. [8:177] **Escrow and Title Insurance:** The escrow company, title insurance company and parties responsible for costs therefor should be identified. The option agreement should also identify those liens and encumbrances to be removed by the seller at the close of escrow. However, the seller may want to reserve the right to encumber the property in any way it desires up until the time the option is exercised.

10. [8:178] **Representations and Warranties:** The parties should negotiate specific representations and warranties and indicate whether those warranties will be effective after exercise of the option—i.e., whether they will "survive" merger of the option agreement into the bilateral purchase and sale agreement, effectively becoming part of the ultimate purchase contract.

Cross-refer: Representations and warranties are discussed at length in *Ch. 4; see ¶ 4:431 ff.*

11. [8:179] **Leases and Other Recorded Encumbrances and Agreements:** Although a recorded option will be senior to *subsequent* recorded and unrecorded agreements affecting the property (*¶ 8:124 ff.*), the optionee may wish to have some control over interim leasing or other encumbrancing of the property. Thus, just as with purchase and sale agreements, the optionee may want the right to approve any new leases or other new liens or encumbrances affecting the property (*see* ¶ *4:410 ff., 4:430*).

12. [8:180] **Assignability:** Generally, an option is freely assignable by the optionee (¶ *8:80*). However, if the transaction will be seller-financed, the seller may wish to limit assignability to an assignee of at least equal financial strength to the optionee. In any event, it is always advisable to specifically state whether, and under what conditions, the option is assignable (otherwise, it will be deemed freely assignable without restriction).

13. [8:181] **Broker's Commission:** The identity of the broker(s) should be disclosed and the parties' respective obligations to pay broker commissions (if any) should be spelled out.

Cross-refer: Listing agreements and broker commissions are treated in detail in *Ch. 2*.

14. [8:182] **Damage, Destruction or Condemnation of Property:** The risk of loss due to intervening damage, destruction or condemnation of the optioned property should be negotiated and addressed in the option agreement (*see* ¶ *8:120 ff., 4:475 ff.*).

15. [8:183] **Option Extensions:** The parties may want to negotiate at the outset for an extension of the option in the event the optionee might still be interested in purchasing the property notwithstanding lapse of the initial option term. In such event, the option agreement should specifically state the *consideration* to be paid for any right of extension; the *method* for noticing exercise of the extension; and the *deadline* for giving notice of such exercise.

Any extension so executed should be *promptly recorded* (*see* ¶ *8:131, 8:147*).

• [8:184] **Comment:** Of course, the failure to address a right of extension in an initial option agreement does not foreclose the execution of a *new* option agreement upon lapse of the former. However, that itself will entail additional negotiations and, undoubtedly, new (and perhaps more onerous) terms. Consequently, it makes sense to address the subject of extension rights at the outset and incorporate appropriate provisions into the initial option agreement.

16. [8:185] **Execution and Recordation of Exercise of Option:** Because anyone who reviews the chain of title will not otherwise know if an option has been exercised, it may be advisable to require the parties to execute and record a written confirmation of the exercise. This will moot problems that might otherwise arise by the mistaken assumption an option of record has expired pursuant to statute (Civ.C. §§ 884.010 & 884.020, ¶ *8:144 ff.*).

17. [8:186] **Confidentiality:** The parties may be interested in keeping the terms of the ultimate purchase and sale confidential; e.g., such secrecy may be important to an optionee who will soon be negotiating for the purchase of adjoining parcels from different owners. In such event, a confidentiality clause should be included in the agreement; and the optionee should be sure to record *only a memorandum* of the agreement (rather than the verbatim option agreement; *see ¶ 8:133 and Form 8:B*).

18. [8:187] **"Boilerplate" Provisions:** Like purchase and sale contracts, option agreements typically incorporate standardized "boilerplate" provisions (e.g., integration, attorney fees, notice, severability, "further acts," governing law and venue, and definitional provisions). *See ¶ 4:525 ff.*

[8:188 - 8:199] ***Reserved.***

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Chapter 8. Options to Purchase and Preemptive Purchase Rights

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1. [8:200] **Nature and Effect of Preemptive Rights:** As noted earlier, a "preemptive" purchase right is a grant from a landowner (seller) giving the grantee the "first opportunity" to purchase the property *provided the landowner elects to sell* (¶ *8:4 ff.*). [*Bill Signs Trucking, LLC v. Signs Family Ltd. Partnership* (2007) 157 CA4th 1515, 1522, 69 CR3d 589, 595 (citing text); *Campbell v. Alger* (1999) 71 CA4th 200, 206, 83 CR2d 696, 699]

a. Option to purchase contrasted

(1) [8:201] **No unilateral right to compel sale:** Unlike an option agreement (where the optionee can trigger a sale by its unilateral election), a preemptive right of purchase does *not* entitle the grantee to unilaterally compel the owner grantor to sell the property. Rather, the preemptive right is triggered only if the *owner* elects to sell. [*Campbell v. Alger* (1999) 71 CA4th 200, 206, 83 CR2d 696, 699; *Hartzheim v. Valley Land & Cattle Co.* (2007) 153 CA4th 383, 389, 62 CR3d 815, 820]

Thus, the grantee loses any preemptive right to purchase if the landowner decides not to sell prior to expiration of the preemptive right term.

(2) [8:202] **Sale terms set by owner upon election to sell:** Moreover, the buyer's preemptive right to purchase is limited to terms and conditions set by (or otherwise acceptable to) the owner *at the time the owner elects to sell* the property (this is in contrast to an option agreement, wherein the sale terms and conditions are negotiated in advance).

(3) [8:203] **Owner's election to sell creates option in effect:** In effect, an option is the next stage after the owner elects to sell its property pursuant to the grant of a preemptive purchase right: i.e., upon the owner's election to sell, the grantee's preemptive right is *converted to an option to purchase* (on terms set forth in the proposed sale). [*Campbell v. Alger* (1999) 71 CA4th 200, 206-207, 83 CR2d 696, 699; see *Bill Signs Trucking, LLC v. Signs Family Ltd. Partnership* (2007) 157 CA4th 1515, 1522, 69 CR3d 589, 595—right of first refusal does not become option to purchase until property owner voluntarily decides to sell and receives bona fide third party offer to purchase (¶ *8:207.8 ff.*); *Hartzheim v. Valley Land & Cattle Co.* (2007) 153 CA4th 383, 389, 62 CR3d 815, 820 (same)]

b. [8:204] **Two types of preemptive purchase rights:** A preemptive purchase right takes one of two forms: either a "right of first refusal" or a "right of first offer." [*Bill Signs Trucking, LLC v. Signs Family Ltd. Partnership* (2007) 157 CA4th 1515, 1523, 69 CR3d 589, 595 (citing text)—ordinarily *both* rights not included in parties' agreement (*but see* ¶ *8:209.1*)]

• [8:205] **Comment:** Preemptive rights may involve *purchase* or *lease* rights; and cases involving preemptive lease rights are generally equally applicable to preemptive purchase rights.

(1) [8:206] **"Right of first refusal":** Under a "right of first refusal," the landowner seller first procures a bona fide offer to purchase from a third party on terms and conditions acceptable to the seller. The seller must then present the third party offer to the grantee of the right of first refusal who, in turn, has a limited period of time to either *match* the offer or reject it. [*Bill Signs Trucking, LLC v. Signs Family Ltd. Partnership* (2007) 157 CA4th 1515,1523, 69 CR3d 589, 595 (citing text); *Smyth v. Berman* (2019) 31 CA5th 183, 192-193, 242 CR3d 336, 344—right of first refusal is "conditional option," entitling holder "to make an offer that meets or beats" third party's acceptable, bona fide offer]

(a) [8:207] **Marketability concerns:** Unlike an option to purchase, the grant of a right of first refusal does not completely tie up marketability of the seller's property. However, property subject to a right of first refusal generally is more difficult to market to other prospective buyers. Indeed, prospective buyers want to know their offers are "first in line" rather than subject to the grantee's review (which essentially provides the grantee with the benefit of the other prospective buyer's negotiating efforts).

Marketability also may be impaired as a practical matter because brokers often are unwilling to market property subject to a right of first refusal (unless they are promised a commission upon sale to the holder of the preemptive right). [See *Enea v. Coldwell Banker/Del Monte Realty* (ND CA 1998) 225 BR 715, 717]

(b) [8:207.1] **Modifies statutory right to partition tenancies in common:** A right of first refusal in a tenancy in common agreement modifies the absolute statutory right to partition afforded co-owners, but does *not* permanently waive it. Thus, if the nonselling owner refuses or fails to exercise their right to purchase within a reasonable period of time after the selling owner first offers to sell on terms as favorable as those offered by a prospective buyer, the selling owner may proceed with partition (¶ *12:40*). [See *LEG Investments v. Boxler* (2010) 183 CA4th 484, 493-497, 107 CR3d 519, 525-528; *Schwartz v. Shapiro* (1964) 229 CA2d 238, 253, 40 CR 189, 199—selling owner must first offer his interest to co-owner "before partition can be had"]

[8:207.2 - 8:207.4] ***Reserved.***

(c) [8:207.5] **Limited to voluntary sales:** A right of first refusal is triggered only when the landowner *voluntarily elects* to sell the property. [See *Campbell v. Alger* (1999) 71 CA4th 200, 206, 83 CR2d 696, 699]

In other words, the right is *conditional* in nature, depending on the property owner's *willingness* to market their property. [*Hartzheim v. Valley Land & Cattle Co.* (2007) 153 CA4th 383, 389, 62 CR3d 815, 820; *Campbell v. Alger,* supra]

1) [8:207.6] **May be triggered by deed in lieu of foreclosure:** Under appropriate circumstances, a transfer by deed in lieu of foreclosure may trigger a right of first refusal. [*Pellandini v. Valadao* (2003) 113 CA4th 1315, 1319, 7 CR3d 413, 416; *but see* ¶ *8:207.9*]

2) [8:207.7] **Not triggered by condemnation:** Because condemnation is an *involuntary* taking of land by a public agency (as opposed to a private sale), it does *not* trigger a private right of first refusal. [*Campbell v. Alger* (1999) 71 CA4th 200, 208, 83 CR2d 696, 701—condemnation preempts private rights of first refusal]

In these circumstances, the sole remedy of the holder of the preemptive right is *just compensation* in the eminent domain proceedings. [*Campbell v. Alger*, supra, 71 CA4th at 210, 83 CR2d at 702; *see also* ¶ *8:52*]

(d) [8:207.8] **"Bona fide" third party offer required:** Unless the agreement creating the preemptive right provides otherwise, a right of first refusal to purchase is triggered only by a *"bona fide" third party* offer to purchase the *entire interest* in the property. [*Pellandini v. Valadao* (2003) 113 CA4th 1315, 1322, 7 CR3d 413, 418; see also *Hartzheim v. Valley Land & Cattle Co.* (2007) 153 CA4th 383, 389, 62 CR3d 815, 820—contract terms dictate particular circumstances that trigger right of first refusal]

Generally, a third party offer is considered "bona fide" only when "marked by *arms' length dealing* and a *change in control* of the property." [*Hartzheim v. Valley Land & Cattle Co.*, supra, 153 CA4th at 393, 62 CR3d at 822-823 (emphasis added; internal quotes omitted)]

• [8:207.9] A right of first refusal on property owned by two tenants in common was *not* triggered when cotenant "A" deeded her interest in the property to cotenant "B" in lieu of foreclosure after cotenant "A" defaulted on a loan secured by the property. Under the terms of the agreement creating the right of first refusal, the preemptive purchase right was triggered *only by a sale of the cotenants' combined interest to a third party*. [*Pellandini v. Valadao*, supra]

• [8:207.10] Similarly, a tenant's right of first refusal under a commercial lease was not triggered by conveyance of an interest in the property between copartners of a family limited partnership that owned the property. "The Lease intends a sale to a third party by all partners of [the family limited partnership], and does not intend to make [tenant] a co-owner of the property with one of the partners." [*Bill Signs Trucking, LLC v. Signs Family Ltd. Partnership* (2007) 157 CA4th 1515, 1528, 69 CR3d 589, 599—transfer merely adjusted co-owners' interests and did not introduce new party with control over lease]

• [8:207.11] A lessee's right of first refusal to purchase property owned by a family partnership was not triggered by transfer of the property to the partners' grandchildren, even though the transfer was made pursuant to a sales contract and was reported to the taxing authorities as a sale. The transfer was not made pursuant to a *bona fide third party offer*, as required by the parties' agreement: The grandchildren never made an offer; the transfer was not marked by arms' length dealing (there were no negotiations and the grandchildren were not even consulted) and did not alter actual control of the property; and the conveyance in reality was made only for legitimate tax and estate planning reasons. [*Hartzheim v. Valley Land & Cattle Co.* (2007) 153 CA4th 383, 390-394, 62 CR3d 815, 820-824]

[8:207.12 - 8:207.14] ***Reserved.***

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(e) [8:207.15] **"One-time right"?** A right of first refusal may be drafted to give the grantee an opportunity to purchase the property the *first time* there is a potential sale, as opposed to the *first opportunity each time* there is a potential sale. [See *San Diego Watercrafts, Inc. v. Wells Fargo Bank, N.A.* (2002) 102 CA4th 308, 317, 125 CR2d 499, 505—triable issue whether lease provision provided only "one-time right" of first refusal]

(f) [8:207.16] **Right of first refusal in expired lease (holdover tenancy):** *See discussion at* ¶ 8:7.1.

(2) [8:208] **"Right of first offer":** Because rights of first refusal can adversely affect an owner's ability to sell its property (¶ *8:207*), a preemptive purchase right often takes the form of a "right of first offer." Here, the seller, upon deciding to market its property, must first make an offer to the grantee of the right of first offer. If the grantee does not accept that offer, the seller is then free to sell to anyone else on the terms rejected by the grantee or on terms that are better—but not worse—for the seller; in other words, no other buyer can get a better deal than that which was presented to the grantee. [*Bill Signs Trucking, LLC v. Signs Family Ltd. Partnership* (2007) 157 CA4th 1515, 1523, 69 CR3d 589, 595 (citing text)]

(a) [8:209] **Pros and cons for seller:** The advantage of using a right of first offer rather than a right of first refusal is that once the grantee has rejected the seller's offer, the seller is free to proceed with a sale to another buyer without having to go back to the grantee (provided the sale is on terms no better than those offered to the grantee). Also, once the grantee elects not to accept the seller's offer, brokers are inevitably more willing to undertake a listing of the property. [*Bill Signs Trucking, LLC v. Signs Family Ltd. Partnership* (2007) 157 CA4th 1515, 1523, 69 CR3d 589, 595 (citing text)]

On the other hand, the seller will (at least theoretically) have to present to the grantee its "rock-bottom" price (and best terms), since the seller will not be able to accept any price lower than that offered to the grantee. If other prospective buyers happen to discover the price offered by the seller to the grantee, they will be in a better negotiating position because they will know the minimum price the seller is willing to accept. [*Bill Signs Trucking, LLC v. Signs Family Ltd. Partnership*, supra (citing text)]

(b) [8:209.1] **Combined with "right of first refusal":** Ordinarily, a preemptive purchase right is *either* a right of first offer *or* a right of first refusal. Occasionally, however, *both rights* are granted simultaneously to the same person (typically, a lessee), each preemptive right having its own distinct purpose and enforcement criteria. [See *Bill Signs Trucking, LLC v. Signs Family Ltd. Partnership* (2007) 157 CA4th 1515, 1523, 69 CR3d 589, 595]

(c) [8:209.2] **Changed conditions and forfeiture doctrine:** In some cases, the right of first offer may set the terms that must be offered, which may be below fair market value. Even if there is a significant difference between the predetermined terms and current fair market value, however, price differences alone are not "changed conditions" that invalidate an otherwise enforceable right of first offer. [*Southern Calif. School of Theology v. Claremont Graduate Univ.* (2021) 60 CA5th 1, 8-9, 274 CR3d 180, 186—right of first offer requiring property owner to offer to sell property for $36 million less than current fair market value not "changed condition"]

Likewise, a significant price difference between a right of first offer's predetermined terms and current fair market value does not result in a "forfeiture." [*Southern Calif. School of Theology v. Claremont Graduate Univ.*, supra, 60 CA5th at 9-10, 274 CR3d at 187—forfeiture doctrine did not apply to right of first offer (property owner "was to bear the risk that the property *either increased in value or decreased* " and "each party would receive that for which they bargained, and that to which they agreed") (emphasis in original)]

c. [8:210] **Preemptive rights usually tied to underlying transaction:** Preemptive purchase rights are almost always a component of a related transaction. For example, they are typically granted to a *tenant* under a lease (to purchase the lessor's fee interest); to a *partner* in a partnership (to buy partnership real property); or to a *co-owner* under a real property co-ownership agreement (to buy the jointly-owned realty).

2. [8:211] **Requirements for Enforceable Preemptive Purchase Rights:** Like options, preemptive purchase rights must satisfy legally required elements of an enforceable contract (¶ *8:41*). In particular, they must be supported by *consideration* (*Mercer v. Lemmens* (1964) 230 CA2d 167, 171-172, 40 CR 803, 806; ¶ *8:55 ff.*); and must satisfy the *statute of frauds* ("material terms" to be in signed writing; ¶ *8:75 ff.*).

Indeed, "[b]ecause they are a species of an option to purchase, rights of first refusal to purchase real property must satisfy the statute of frauds." [*Smyth v. Berman* (2019) 31 CA5th 183, 197, 242 CR3d 336, 348—although "writing" may be cobbled together from various documents, email exchange re right of first refusal did not satisfy statute of frauds due to "equivocal and non-confirmatory responses" that failed to show parties agreed on material contract terms with reasonable certainty]

Theoretically, preemptive purchase rights could also be subject to the statutory *rule against perpetuities* (Prob.C. § 21205); but, like option agreements, perpetuities problems should rarely if ever be an impediment to enforceability (*see* ¶ *8:102 ff.*).

[8:211.1 - 8:211.4] ***Reserved.***

3. [8:211.5] **Holder's Enforcement Remedies:** The landowner's attempt to sell the property to a third party without affording the holder of the preemptive purchase right an opportunity to exercise its preemptive right constitutes a breach of contract enforceable by *specific performance*. [*Campbell v. Alger* (1999) 71 CA4th 200, 207, 83 CR2d 696, 700 (but no breach of contract remedy where condemnation preempts right of first refusal, ¶ *8:207.5*)]

Similarly, a preemptive purchase right normally is enforceable against third persons who enter into a contract to purchase the property with notice of the holder's preemptive right. [*Hartzheim v. Valley Land & Cattle Co.* (2007) 153 CA4th 383, 389, 62 CR3d 815, 820; see also *Campbell v. Alger*, supra, 71 CA4th at 207, 83 CR2d at 700 (but holder's sole remedy against intervening condemning agency is just compensation in the eminent domain proceedings, ¶ *8:207.7*)]

a. [8:211.6] **Statute of limitations; tolling under "delayed discovery" rule:** The four-year statute of limitations for breach of a written contract (CCP § 337(a)) generally runs from the date of the breach. However, the "delayed discovery" rule applies to *toll* the statute where the breach and resulting harm are not reasonably discoverable by plaintiff until some future time because the breach was "committed in secret." [*April Enterprises, Inc. v. KTTV* (1983) 147 CA3d 805, 832, 195 CR 421, 436-437]

Under this authority, the statute of limitations is tolled on an action for breach of a right of first refusal to purchase where the landowner (grantor of the right) fails to notify the preemptive right holder of a third party offer, concluding the conveyance to the third party without giving the holder the opportunity to purchase on the same terms (*see* ¶ *8:212 ff.*). Here, the limitations period does not commence to run until the plaintiff holder knows of, or reasonably should have discovered, the breach of the right of first refusal. [*Gryczman v. 4550 Pico Partners, Ltd.* (2003) 107 CA4th 1, 4-6, 131 CR2d 680, 681-682—preemptive right holder did not learn of "secret" conveyance to third party until he "chanced to drive by the property and noticed the store which had been there was closed" (triable issue whether P exercised due diligence in discovering the breach)]

(1) [8:211.7] **Delayed discovery despite constructive notice:** The result is the same even though the grantor *recorded* a document evidencing the breach: The delayed discovery rule applies when the wrongful act (the breach) is *difficult*, not necessarily "impossible," to detect; and, unless the contract otherwise provides, the holder has no duty to continually monitor public records to determine if the holder's preemptive right has been breached. [*Gryczman v. 4550 Pico Partners, Ltd.* (2003) 107 CA4th 1, 6, 131 CR2d 680, 683 (grantor had recorded option agreement with third party to purchase property)]

4. [8:212] **Exercising Right of First Refusal:** A right of first refusal is triggered when the owner (grantor of the right) elects to sell and obtains a third party offer to buy (¶ *8:206*). The grantee's right of first refusal then becomes exercisable and is properly exercised by the grantee's *matching* the purchase terms proposed by the third party offer.

a. [8:212a] **Third party terms must be presented to grantee:** The grantee must be presented with the opportunity to match the *same offer* made by the third party. If the landowner (grantor) proposes terms to the grantee that are *different* from those offered by the third party, the landowner's offer is in "bad faith" and the grantee's right of first refusal is not extinguished by a failure to match the third party proposal. [*San Diego Watercrafts, Inc. v. Wells Fargo Bank, N.A.* (2002) 102 CA4th 308, 317, 125 CR2d 499, 505]

(1) [8:212b] **Application:** A commercial tenant sought to exercise its right of first refusal to purchase the brewery portion of a large commercial parcel after discovering its landlord agreed to sell the property to a third party. In addition to initiating legal action against its landlord, the tenant filed a notice of lis pendens. The trial court granted the landlord's motion to expunge the lis pendens and the tenant filed a writ petition challenging the court's ruling. [*J&A Mash & Barrel, LLC v. Sup.Ct.* (*Tower Theater Properties*) (2022) 74 CA5th 1, 10, 289 CR3d 110, 118]

On appeal, the expungement motion was deemed flawed "in several respects," including the fact that evidence presented below indicated the landlord engaged in "bad faith." Among other things, the landlord's bad faith involved (i) failing for months to disclose that a third party sale of the entire parcel was in escrow; (ii) refusing to provide the commercial

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tenant with the purchase agreement or the amount of the third party's offer even after the tenant became aware of the sale; (iii) overstating the sales price; (iv) only setting unilateral terms of sale for the brewery premises; (v) ignoring the language in the commercial tenant's right of first refusal regarding a matching price; and (vi) asserting the price it was offering was "fair and reasonable." [See *J&A Mash & Barrel, LLC v. Sup.Ct. (Tower Theater Properties)*, supra, 74 CA5th at 10, 37-38, 41-42, 289 CR3d at 118, 140-141, 143-144 (also concluding tenant's right of first refusal was neither invalid nor unenforceable based on (i) difficulty in determining property's value and (ii) trial court's unsupported conclusion parcel split was unlikely to occur)]

b. [8:212.1] **Exercise by mirror image terms not necessarily required:** On the other hand, unlike an option to purchase, a right of first refusal may be exercised *without a literal matching of terms.* "Because the party exercising a right of first refusal is stepping into a contract made by a third party, the court must *consider commercial realities* and allow modifications consistent with the intent of the parties whose contract created the right of first refusal." [*Arden Group, Inc. v. Burk* (1996) 45 CA4th 1409, 1414-1415, 53 CR2d 492, 495 (emphasis added)]

(1) [8:212.2] **Different buyers:** Obviously, were identical matching required, a grantee of the right could never properly exercise its right of first refusal because it would be substituting itself for the third party as named buyer. "We reject that notion as absurd …" [*Arden Group, Inc. v. Burk* (1996) 45 CA4th 1409, 1415, 53 CR2d 492, 496]

(2) [8:212.3] **Different conditions precedent:** Where consistent with the parties' intent, a grantee of the right may be deemed to have unconditionally exercised its right of first refusal although its offer to purchase omits certain conditions precedent proposed by the third party deal:

• [8:212.4] **Example:** Third Party offered to purchase property that had been used as a gas station for the past 50 years; Tenants in possession of the property, who themselves were operating a gas station, had a right of first refusal. Landowner/Seller's agreement with Third Party required hazardous waste clean-up (removal of the gas tanks). Tenants were deemed to have unconditionally exercised their right of first refusal even though their purchase terms did *not* require removal of the gasoline tanks. [*Arden Group, Inc. v. Burk* (1996) 45 CA4th 1409, 1415, 53 CR2d 492, 496]

"Here, the *only* differences in the two deals are those made necessary by the fact that the [Tenants] are buying as tenants in possession who will continue to use the property in the same manner it has been used for more than 50 years. The removal of the tanks … became non-issues when the [Tenants] became the buyers, and the modification of the [Third Party] deal acknowledged that fact, no more and no less …" [*Arden Group, Inc. v. Burk*, supra, 45 CA4th at 1415, 53 CR2d at 495-496 (emphasis in original)]

(3) [8:212.5] **Terms impossible to match:** There are also situations where it is not only *impractical* (as in *Arden*, supra) but also *impossible* for the grantee of a right of first refusal to *literally* match the terms of the third party offer. For example:

• The third party submits a purchase offer conditioned on seller financing. If the grantee of the right of first refusal is not as creditworthy as the third party, the grantee cannot *literally* match the third party's offer.

• Or, the third party is willing to give security for a seller-financed loan which is different—and better—than the security the grantee of the right of first refusal is able to offer. Here again, the grantee cannot *literally* match the third party's offer.

[8:212.6 - 8:212.9] ***Reserved.***

c. [8:212.10] **Comparing unidentical offers:** In determining whether a right of first refusal has been properly exercised by a nonmatching offer, it becomes necessary to compare the offers to determine if the third party terms are "better."

(1) [8:213] **"Reasonable person" standard:** In determining which offer is better, for purposes of triggering or defeating the grantee's preemptive purchase rights, the seller must apply a "reasonable person" standard. [*McCulloch v. M & C Beauty Colleges, Inc.* (1987) 194 CA3d 1338, 1346, 240 CR 189, 194]

Thus, e.g., where a grantee cannot offer security identical to that offered by a third party buyer for a seller-financed loan, the grantee must be permitted to offer *reasonably comparable* security; otherwise, the right of first refusal would be "illusory." [*McCulloch v. M & C Beauty Colleges, Inc.*, supra, 194 CA3d at 1346, 240 CR at 194]

(2) [8:214] **Net proceeds approach:** Similarly, when comparing the two offers, a court may pierce through the particular details and look to the *net proceeds* to be paid the seller to ascertain which offer is better. For example, if the third party offer entails the payment of a broker's commission by the owner, an offer made by the grantee of a right of first refusal

which has a lower purchase price but does *not* require the seller to pay a broker's commission is arguably a better "net" offer which the seller must accept. [See *C. Robert Nattress & Assocs. v. CIDCO* (1986) 184 CA3d 55, 70-72, 229 CR 33, 42-43]

(3) [8:214.1] **"Social benefits" as factor:** Where the two offers are otherwise matching, the fact the third party offer contains a condition that might benefit society at large, but which is impractical or impossible for the grantee of the right of first refusal to meet, does *not* make the third party offer "better"—at least where that condition was not within the owner's and grantee's reasonable expectations when they negotiated the right of first refusal. [*Arden Group, Inc. v. Burk* (1996) 45 CA4th 1409, 1415, 53 CR2d 492, 496]

• [8:214.2] For example, a third party offer to purchase gasoline station property was not "better" than the present tenants' offer to purchase even though the third party offer provided for clean-up and removal of the gasoline tanks whereas the tenants' offer did not. The property had been operated as a gas station for over 50 years; it would have been unreasonable to require such a matching condition from the grantee of the right, buying as tenant in possession who would continue to use the property in the same manner it had been used for decades.

"[W]e reject as self-serving nonsense [third party's] suggestion that its proposal was 'better' because it has an element of social utility by requiring the immediate clean-up of the property. There is absolutely nothing illegal, unlawful or immoral about the [tenants'] exercise of a right they bargained and paid for, and the fact that they will not be replacing the existing tanks until they are required by law to do so … has nothing to do with the price of tomatoes." [*Arden Group, Inc. v. Burk* (1996) 45 CA4th 1409, 1415, 53 CR2d 492, 496]

5. [8:215] **Priority, Recordation and Title Insurance:** Just like optionees, the grantee of a preemptive purchase right has a valuable, *insurable* interest. Therefore, the following steps are important to preserve the value of preemptive purchase rights:

a. [8:216] **Title review:** The grantee should review the current state of title to determine (1) that the grantor is, in fact, the holder of the entire fee interest in the property; and (2) what liens and encumbrances will be senior to the preemptive right.

b. [8:217] **Recordation:** The grantee should protect its interest by *recording* the preemptive right agreement (or a memorandum thereof). Like an option agreement, the recorded instrument of preemptive purchase right should include a complete and correct *legal description;* contain an *affirmative "grant"* of the preemptive right; and state the *term* of the preemptive right. (*See ¶ 8:130 ff.*)

FORMS

• Right of First Refusal/Right of First Offer, *see Form 8:C*.

• Memorandum of Preemptive Purchase Right (Right of First Refusal or Right of First Offer), *see Form 8:D*.

c. [8:218] **Title insurance:** The grantee should obtain appropriate title insurance insuring the priority of its preemptive right.

[8:219] ***Reserved.***

6. [8:220] **Removing Preemptive Right of Record:** Civ.C. §§ 884.010 and 884.020 (regarding automatic termination of record) refer exclusively to *options* to purchase real property; the statutes do not specifically cover preemptive purchase rights. Consequently, there is no statutory mechanism by which expired/terminated *preemptive rights* will automatically be removed from record title, thereby clearing the cloud on the seller's title.

To fill the gap, sellers should consider obtaining a quitclaim deed or other appropriate recordable release from the grantee of the preemptive right *in advance* (when the preemptive right agreement is executed), to be held by an escrow or other third party for recordation in the event the preemptive right lapses. This approach will give the seller assurance the recorded preemptive right will be cleared from title upon its expiration; and should circumvent the potential need to bring a quiet title action in the event of a recalcitrant grantee. (*See ¶ 8:140 ff.*)

7. [8:221] **Drafting Preemptive Purchase Rights:** Unlike an option to purchase, which should include all of the terms and conditions of the potential sale (¶ *8:25 ff., 8:46, 8:166*), a preemptive purchase right necessarily cannot be drafted to identify all possible sale terms since none of them are fixed at the time the right is granted (¶ *8:202*). However, the terms and conditions of the grant itself should be precisely stated.

FORM: Right of First Refusal/Right of First Offer, *see Form 8:C*.

➪ [8:222] ***PRACTICE POINTERS:*** When negotiating, drafting or reviewing a preemptive right of purchase agreement, keep these general points in mind:

• A well-drafted preemptive purchase right agreement usually provides that the right may not be exercised by the grantee if the grantee is in *default* on its obligations in the underlying transaction (e.g., under a lease, or a partnership or co-ownership agreement).

• Clearly state the *duration* of the preemptive right, after which it will expire by its own terms. Use a *calendar date* as the outside deadline (rather than specifying the term by weeks or months) so as to preclude room for dispute over the exact day of its expiration (*see ¶ 8:103*).

Also delineate a specific time period within which the grantee must *notify* the seller of its intent to accept the proposed offer (after which the offer will be deemed to have expired and the seller can sell on the same or better terms to a third party free of the preemptive right restriction).

• Likewise, specify a *precise method* by which the grantee must notify the seller of its intent to accept the proposed offer (*see ¶ 8:86 ff.* in connection with drafting option agreements).

• For so long as the term has not otherwise lapsed, the grantee's preemptive right should continue to be revived if the seller does not consummate a purchase with a third party offeror. For example, if a grantee of a right of first refusal does not match a third party offer, but the seller does not actually consummate a sale with such third party, the right of first refusal should continue in existence for any subsequent third party offers made during the term of the preemptive right.

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Chapter 8. Options to Purchase and Preemptive Purchase Rights

Forms

[Form 8:A] Option Agreement

OPTION AGREEMENT

This **OPTION AGREEMENT** ("this Agreement") is made as of ___________, by and between, ___________ a ___________ (hereinafter called "Optionor" and ___________, a ___________ (hereinafter called "Optionee").

RECITALS:

This Agreement is entered into with reference to the following facts:

A. Optionor is the owner of all that certain real property (hereinafter called the "Property"), located in the County of ___________, State of California, described as follows:

____
____
____

B. Optionee desires to obtain an option to purchase the Property from Optionor on the terms and conditions set forth herein and Optionor is willing to grant such option to Optionee.

NOW, THEREFORE, in consideration of the mutual covenants and promises of the parties, and other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties hereto agree as follows:

1. **Grant of Option to Purchase.** Optionor grants to Optionee an option to purchase (this "Option") the Property from Optionor for the term and upon all of the terms, covenants and conditions hereinafter set forth.

2. **Option Consideration.** As consideration for this Option, Optionee has delivered to Optionor the sum of _____ Thousand Dollars ($________), and Optionor acknowledges the receipt thereof.

3. **Memorandum of Option to Purchase.** Optionor has duly executed, acknowledged and delivered to Optionee a Memorandum of Option to Purchase in the form attached hereto as Exhibit "A," and agrees that Optionee may cause such Memorandum of Option to Purchase to be recorded. Optionee agrees to execute, acknowledge and deliver to Optionor a Quitclaim Deed to the Property promptly at the request of Optionor if Optionee does not exercise the option hereunder if such is necessary to clear Optionor's title. Optionor shall bear any expense of recording such instrument.

4. **Term of Option and Exercise.** The term of this Option shall commence upon the date of this Agreement and expire at midnight on ___________, _____. If not exercised during the term of this Option, this Option shall automatically and without further

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notice, act or documentation by any party expire on the date aforesaid. Optionee may exercise this Option at any time during the term of this Option by giving Optionor written notice of its intention to exercise the Option. **[OPTIONAL: In the event this Option is exercised, the consideration paid by Optionee for this Option (as stated in Paragraph 2, above) shall be applied against and be deemed to be a payment credited against the purchase price.]** In the event that Optionee does not exercise this Option, the consideration paid by Optionee for this Option may be retained by Optionor without deduction or offset. As soon as reasonably practicable after exercise of this Option, the parties shall execute and cause to be recorded a Notice of Exercise of Option, in the form as Exhibit "B" attached hereto.

5. Existing Leases. Optionee acknowledges that the following leases (hereinafter called the "Leases"), have been entered into between Optionor with the following named tenants. This Option and Optionee's purchase of the Property shall be subject to the rights of the tenants thereunder:

Name of Tenant	Property Affected	Date of Expiration of Lease
1. ____________	____________	....
2. ____________	____________	....
3. ____________	____________	....
4. ____________	____________	....
5. ____________	____________	....

Optionee acknowledges receipt from Optionor of a copy of each of the Leases and that Optionee has read the same. Optionor agrees not to enter into or permit any extension of the term of any of the Leases or any modification of any terms thereof, or waive or otherwise relinquish any optional right of termination thereof during the term of this Option, or after exercise thereof, without the prior written consent of Optionee.

6. **Purchase Price.** The purchase price which Optionee agrees to pay for the Property upon the exercise of this Option is the sum of _____ Dollars ($________). Said price payable as follows:

a. _____ Dollars ($________) deposited in escrow upon the opening thereof. **[Optional: The consideration paid for the Option shall be credited against the purchase price.]**

b. The balance due shall be paid in full on the Closing Date.

7. **Escrow.** Within ten (10) calendar days after exercise of this Option, Optionee and Optionor shall open an escrow for this transaction at ____________. The purchase and sale shall be consummated at the aforesaid escrow within _____ (_____) days after the exercise of this Option by Optionee (the "Closing Date").

This transaction shall be consummated and the escrow closed in the following manner:

(1) Optionor shall deposit (a) a duly executed and acknowledged Grant Deed conveying the Property to Optionee in the form attached hereto as Exhibit "C," and (b) a duly executed and acknowledged Assignment of Lessor's Interest in Leases in the form attached hereto as Exhibit "D."

(2) Optionee shall deposit the portion of the purchase price to be paid pursuant to Paragraph 6, above in cash.

(3) Escrow shall close when the escrow is in a position to issue the title insurance policy described in Paragraph 8, below, showing title to the Property vested of record in Optionee (or its assignee or nominee). Escrow shall be consummated by delivering the cash deposited by Optionee to Optionor after deduction of Optionor's share of escrow costs and prorations. Closing shall be deemed to have occurred when the Grant Deed is recorded.

(4) Real estate taxes and any cash rentals accruing from the Property shall be prorated between the parties as of the Closing Date.

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8. **Condition of Title Upon Closing Date.** Optionor shall deliver marketable title to Optionee on the Closing Date subject only to (i) the then current real estate taxes and assessments constituting liens not then due or payable; and (ii) those exception nos. _____-_____, as shown on that certain preliminary title report issued by ___________, dated _____, attached hereto as Exhibit "E." Optionee's title shall be insured by a **[ALTA or CLTA]** policy of title insurance insuring that as of the Closing Date the Property is vested of record in Optionee (or its assignee or nominee).

9. **Possession.** Possession of the Property shall be delivered to Optionee upon the Closing Date, subject to the rights of any tenants under the Leases.

10. **Extensions of Option Term.** Optionee may extend the term of this Option for a first extension period of _____ (_____) months by paying to Owner additional option consideration in the amount of _____ Dollars ($________), and Optionee may further extend the term of this Option for _____ (_____) additional extension periods of _____ (_____) month(s) each by paying to Owner additional option consideration of _____ _____ Dollars ($________), for each of the _____ extensions; each such payment to be delivered before the expiration of this Option or the expiration of any extension period of this Option that may then be in effect, and by concurrently providing to Owner written notice of Optionee's intent to extend the term of this Option. As soon as practicable after Optionee's election to extend the Option term (and payment of the corresponding amount due), Optionor and Optionee shall promptly execute and cause to be recorded a written notice of the extension of the term of this Option.

11. **Damage or Destruction.** Except for any damage or destruction attributable to the activities of Optionee or Optionee's agents, employees or contractors, in the event that prior to Closing Date the Property or any improvements thereon are destroyed or materially damaged, Optionor shall bear the risk of loss therefor, and Optionee may elect to cancel this Agreement and receive back from Optionor all consideration previously paid to Optionor for this Option or may purchase the Property at the purchase price set forth herein less the amount by which such damage or destruction has decreased the fair market value of the Property.

12. **Condemnation.** If, before the Closing Date, either Optionor or Optionee receives notice of any condemnation or eminent domain proceeding, the party receiving the notice shall promptly notify the other party of that fact. Optionee may elect either to proceed with the purchase contemplated by this Option or to terminate this Option within _____ (_____) days after the date the notice is received. If Optionee proceeds with the purchase in accordance with all the terms of this Option, all condemnation proceeds shall be paid to Optionee (or assigned to Optionee if not then yet collected).

13. **Right to Enter.** During the term of this Option and prior to the Closing Date, Optionee and its designated agents and independent contractors shall have the right to enter upon the Property to the extent necessary for the purpose of conducting soils tests and engineering studies and planning Optionee's development of the Property. Optionee agrees to repair any damage it or its agents or independent contractors cause to the Property and further agrees to indemnify and hold Optionor harmless from any and all costs, expenses, losses, attorney's fees, and liabilities, including, but not limited to, claims of mechanic's liens, incurred or sustained by Optionor as a result of any acts of Optionee, its agents or independent contractors pursuant to this Paragraph. Optionee further agrees that in the event Optionee fails to exercise this Option, any and all soils tests, engineering studies, environmental reports, and any other documentation developed, prepared or submitted for the purpose of obtaining rezoning or development of the Property, tentative subdivision maps, tentative parcel maps or other development approvals, shall be delivered to Optionor at no expense to Optionor and shall become Optionor's property. Optionee further agrees to submit all development proposals to Optionor during the term of this Option or any extension thereof and obtain Optionor's written approval of such proposals prior to presenting same to any governmental agency, which approval shall not be unreasonably withheld. Optionor agrees to assist Optionee in any reasonable manner to obtain any necessary rezoning, maps, or other necessary permits for Optionee's proposed development as long as such assistance is in no way at any cost or expense to Optionor and in no way commits or binds the Property to a change in the use or zoning of the Property.

14. **Time of Essence; Failure To Exercise Option.** Time is of the essence of this Option agreement. If this Option is not exercised in the manner provided in Paragraph 4, above, before expiration of the Option term, Optionee shall have no interest whatever in the Property and this Option may not be revived by any subsequent payment or further action by Optionee.

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15. **[Add any specific representations and warranties by the parties.]**

16. **Boilerplate Provisions.** (See Chapter 4 for a complete list of additional provisions to consider. The following are the more basic boilerplate provisions.)

(1) Attorney Fees.

(2) Assignment.

(3) Integration (Entire Agreement) Provision.

(4) Notice Provision.

(5) Severability Provision.

(6) Governing Law and Venue.

(7) Further Acts.

(8) Incorporation of Exhibits.

(9) Broker Provision.

(10) No Waivers.

(11) Counterparts.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement the day and year first above written.

OPTIONOR

....

a ....

By ....

its ....

OPTIONEE

....

a ....

By ....

its ....

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Chapter 8. Options to Purchase and Preemptive Purchase Rights

Forms

[Form 8:B] Memorandum of Option to Purchase

Recording requested by
And When Recorded Return to:

____
____
____

Memorandum of Option to Purchase

This Memorandum of Option (this "Memorandum") is made this _____ day of ___________, _____ by and between ___________ ("Optionor") and ___________ ("Optionee").

1. Optionor hereby grants to Optionee an option to purchase all of that certain real property located in the County of ___________, State of California, more particularly described on Exhibit "A" attached hereto and incorporated herein (the "Property").
2. The specific terms and conditions of Optionee's option to purchase are set forth in that certain Option Agreement dated ___________. All of the terms and conditions of the said Option Agreement are incorporated herein by this reference.
3. The term of the option expires on ___________, _____.
4. Any party who is interested in acquiring an interest in the Property should contact the Optionor and Optionee. The Optionor's address is ___________; and the Optionee's address is ___________.

IN WITNESS WHEREOF, this Memorandum has been executed this _____ day of ___________, _____.

OPTIONOR	**OPTIONEE**
___________	___________

[ATTACH NOTARY ACKNOWLEDGMENTS]

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Chapter 8. Options to Purchase and Preemptive Purchase Rights

Forms

[Form 8:C] Right of First Refusal/ Right of First Offer

[Because most preemptive purchase rights emanate from an underlying transaction and are incorporated in the underlying transactional document (such as a lease), the following provisions should be incorporated in the appropriate related transactional document. However, in those situations when the preemptive purchase right is not related to any other transaction, the following can simply be embodied in an agreement complete with appropriate recitals, recitation of consideration, boilerplate and other provisions.]

SAMPLE RIGHT OF FIRST REFUSAL:

Grantor hereby grants to Grantee a right of first refusal to purchase the Property as hereinafter set forth in this Paragraph. Upon Grantor's receipt of a bona fide offer to purchase (“Offer”) from a party who is not affiliated with Grantor (“Third Party”), which Offer Grantor is willing to accept, Grantor shall give notice to Grantee (“Notice”) that Grantor intends to accept the Offer, and concurrently therewith provide Grantee with a copy of the Offer. If Grantee elects to exercise its right of first refusal, it shall do so by delivering to Grantor written notice of its election to purchase the Property on terms and conditions identical to those set forth in the Offer, within ___________ (___) days after the receipt of the Notice. If the Grantee does not so notify Grantor within said ___ days, Grantee shall be deemed to have rejected the Offer and Grantor may proceed to sell the Property (free and clear of this right of first refusal) to the Third Party on the terms and conditions set forth in the Offer, or on terms which are better for Grantor, but not worse for the Grantor. Upon the consummation of such purchase and sale to the Third Party, this right of first refusal shall automatically and without further notice terminate. If, however, Grantor does not consummate a sale to the Third Party as aforesaid, this right of first refusal shall not terminate, but shall be revived and continue for the then remaining balance of term of this right of first refusal. The term of this right of first refusal commences on the date of this agreement and terminates on ___________. **[OPTIONAL: If the right of first refusal is part of an underlying transaction, the Grantee's rights under the right of first refusal should be conditioned upon Grantee not being in default in its obligations under the underlying transaction (e.g. if the Grantee is a tenant under a lease, the Grantee must not be in default under the lease).]**

SAMPLE RIGHT OF FIRST OFFER:

Before Grantor offers the Property for sale to any Third Party or on the open market, Grantor shall first offer the Property for sale to Grantee in writing upon all terms and conditions which Grantor is willing to offer to any third person or on the open market (“Notice”). Grantee shall notify the Grantor of its acceptance of the offer to purchase set forth in the Notice within _____ (___) days after delivery of the Notice (“Deadline Date”). If Grantee fails to so notify Grantor of its acceptance by the Deadline Date, Grantee's right of first offer shall be deemed to have automatically and without further notice expired and Grantor shall thereafter have the right to offer the Property to any third person or on the open market on terms and conditions stated in the Notice (or on terms which are better, but not worse, for the Grantor). If Grantor does not consummate a sale of the Property on the terms and conditions set forth in the Offer (or on terms which are better, but not worse, for the Grantor) within ___________ (_____) days

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after the Deadline Date, this right of first offer shall revive. If, however, Grantor consummates the sale of the Property to a Third Party within said ___________ (_____) days after the Deadline Date, this right of first refusal shall thereupon automatically without further notice terminate. **[OPTIONAL: If the right of first offer is part of an underlying transaction, the Grantee's rights under the right of first offer should be conditioned upon Grantee not being in default in its obligations under the underlying transaction (e.g. if the Grantee is a tenant under a lease, the Grantee must not be in default under the lease).]**

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Chapter 8. Options to Purchase and Preemptive Purchase Rights

Forms

[Form 8:D] Memorandum of Preemptive Purchase Right (Right of First Refusal or Right of First Offer)

Recording requested by
And When Recorded Return to:
____
____
____

Memorandum of Preemptive Purchase Right
[Right of First Refusal or Right of First Offer]

This Memorandum of Preemptive Purchase Right **[Right of First Refusal or Right of First Offer]** (this "Memorandum") is made this _____ day of ___________, _____ by and between ___________ ("Grantor") and ___________ ("Grantee").

1. Grantor hereby grants to Grantee a **[right of first refusal/right of first offer]** to purchase all of that certain real property located in the County of ___________, State of California, more particularly described on Exhibit "A" attached hereto and incorporated herein (the "Property").

2. The specific terms and conditions of Grantee's purchase rights are set forth in that certain Agreement dated ___________. All of the terms and conditions of the said Agreement are incorporated herein by this reference.

3. The term of the Grantee's **[right of first refusal/right of first offer]** expires on ___________, _____.

4. Any party who is interested in acquiring an interest in the Property should contact the Grantor and Grantee. The Grantor's address is ___________; and the Grantee's address is ___________.

IN WITNESS WHEREOF, this Memorandum has been executed this _____ day of ___________, _____.

GRANTOR	**GRANTEE**
___________	___________

[ATTACH NOTARY ACKNOWLEDGMENTS]

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Chapter 9. Opinion Letters

A. Introduction

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    a. [9:3] Points of friction
    b. [9:4] No settled law
    c. [9:5] Necessity and purpose unclear
    d. [9:6] Extent of attorney's liability unclear
2. [9:7] “Opinion letter” defined
    a. [9:8] Real estate bar's commonly-accepted definition
    b. [9:9] Not contractual
3. [9:10] Customary Practice
    a. [9:11] “Customary practice” defined
    b. [9:12] General applicability

[9:1] The delivery of a formal legal opinion by one party's counsel to other interested parties is increasingly becoming a customary requirement in certain kinds of real estate transactions.

Theoretically, opinion letters may be appropriate to many different phases of a real estate purchase and sale transaction. However, as discussed in this Chapter, they are most commonly utilized in connection with commercial loan transactions, wherein a third party institutional lender requires an opinion letter by borrower's counsel. (Opinion letters are not required in single family residential loan transactions.)

1. [9:2] **Practical Considerations:** Many clients and lawyers are apt to view the subject of opinion letters as a mere inconsequential detail. This can be a serious misjudgment; in practice, opinion letters are frequently one of the most controversial and frustrating aspects of a real estate transaction.

a. [9:3] **Points of friction:** The opinion letter process can be a fertile source of disagreement between the lawyer issuing the opinion (the “opinion giver”) and the other party to the transaction (the “opinion recipient”), and also between the opinion giver and their own client.

• Opinion letter issues often arise after the client has fully negotiated the business terms of the transaction and the client therefore feels the opinion letter is simply a drafting concern or closing detail. In any event, clients tend to view the matter as a lawyer-to-lawyer issue with which they need not be involved.

• Most clients do not understand the purpose or contents of an opinion; nor can they appreciate the cost, timing and difficulty associated with the negotiation, preparation and issuance of an opinion letter.

• Because clients regard the opinion letter process as a matter between lawyers, they often view counsel as holding up consummation of the transaction if disputes arise over counsel's willingness to issue an opinion.

• By issuing a third party opinion, attorneys subject themselves and their firms to a new dimension of liability (*see* *¶ 9:215 ff.*).

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b. [9:4] **No settled law:** The subject of opinion letters constitutes an emerging area of the law yet to be fully formed.

To date, there are no California statutes or cases defining a third party legal opinion letter, and no settled law as to when it is appropriate to request an opinion or what should or should not be included in an opinion.

Indeed, few cases deal with opinion letters; and only a handful of articles offer instructive analysis and interpretation. (Although various bar associations have promulgated reports on opinion letters, those reports are not law and are somewhat conflicting. *See ¶ 9:15 ff.*)

c. [9:5] **Necessity and purpose unclear:** There is considerable debate among practitioners and legal scholars as to whether opinion letters are necessary to a purchase and sale transaction; and there is little consensus over what useful purpose they should serve.

d. [9:6] **Extent of attorney's liability unclear:** While case law offers some guidance, the legal theories under which attorney opinion givers might incur liability, and the extent of such liability, are not well defined. *See ¶ 9:215 ff.*

2. [9:7] **“Opinion letter” defined:** Although there is no formal statutory or judicial definition of an “opinion letter,” the term is commonly understood as a document that contains a lawyer's “understanding of the law that applies to a particular case.” [Black's Law Dictionary (11th ed. 2019) (also defining “legal opinion” as “[a] written document in which an attorney provides [their] understanding of the law as applied to assumed facts”); see also Rest.3d Law Governing Lawyers § 95(1) (“In furtherance of the objectives of a client in a representation, a lawyer may provide to a nonclient the results of the lawyer's investigation and analysis of facts or the lawyer's professional evaluation or opinion on the matter”); Corporations Committee, State Bar of California, *1989 Report of the Committee on Corporations of the Business Law Section of the State Bar of California Regarding Legal Opinions in Business Transactions*, 45 Bus. Law. 2169, 2173 (1990) (defining “legal opinion” as “a formal writing prepared by a lawyer, expressing the lawyer's informed understanding of the legal principles generally applicable to a specific transaction or applicable to a particular aspect of such a transaction”)]

a. [9:8] **Real estate bar's commonly-accepted definition:** The general understanding among the real estate bar is that an opinion letter is a formal, written opinion (usually in letter form) from an attorney for one party to a transaction that is delivered to or for the benefit of another party to the transaction (i.e., not the opinion giver's client) regarding certain aspects of the opinion giver's client and/or the transaction.

Also note that the terms “legal opinion,” “written opinion” and “opinion letter” are used interchangeably by practitioners.

b. [9:9] **Not contractual:** Opinion letters are *not* bilateral contracts. Rather, they may be viewed as an inducement to the opinion recipient in consummating a transaction.

3. [9:10] **Customary Practice:** Because so little law exists on the subject of opinion letters, and because the various bar association reports discussed at *¶ 9:15 ff.* are not binding authority (and, indeed, are rarely relied upon by practitioners), the opinion-giving process has been guided principally by customary practice. [See Legal Opinions Committee, American Bar Association, and Working Group on Legal Opinions Foundation, *Statement of Opinion Practices (and Related Materials)*, 74 Bus. Law. 801, 807 (2019) (the “2019 Statement of Opinion Practices,” ¶ 9:19)—opinion letters “are prepared and understood in accordance with the customary practice of lawyers who regularly give those opinions and lawyers who regularly review them for opinion recipients”]

a. [9:11] **“Customary practice” defined:** “Customary practice” generally refers to (i) “the work lawyers are expected to perform to give opinions” (i.e., “customary diligence”), and (ii) “the way certain words and phrases commonly used in closing opinions are understood” (i.e., “customary usage”). [2019 Statement of Opinion Practices, supra, 74 Bus. Law. at 807]

b. [9:12] **General applicability:** Customary practice applies to an opinion letter regardless of whether the opinion letter refers to it. [2019 Statement of Opinion Practices, supra, 74 Bus. Law. at 807, 811—“An opinion giver is entitled to presume that the opinion recipient is familiar with, or has obtained advice about, customary practice as it applies to the opinions it is receiving from the opinion giver”]

Comment: Based on the foregoing (¶ 9:10 ff.), much of what follows in this Chapter is not a summary of binding law but, rather, an admixture of conventional wisdom on the subject. (However, to the extent law develops on this subject, third party legal opinions may change dramatically.)

[9:13 - 9:14] ***Reserved.***

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Chapter 9. Opinion Letters

B. Bar Association Reports

1. [9:15] Value as Analytical/Resource Tools
a. [9:16] Applicability to real property transactions
b. [9:17] Persuasive authority only
2. [9:18] Applicable California reports
3. [9:19] Applicable national reports

1. [9:15] **Value as Analytical/Resource Tools:** Various bar associations and committees have published reports on third party legal opinion letters. The reports represent attempts at attaining broad consensus and common understanding on key aspects of third party legal opinion letter practice. In the absence of governing statutory or case law regulating the practice (¶ 9:4), these reports offer the best guidance on negotiating, preparing and interpreting third party legal opinion letters. [See Rest.3d Law Governing Lawyers § 95, Comment "a." ("Custom and practice determining the scope of diligence in represented situations is articulated in bar-association reports, treatises, and articles")]

Indeed, by specifically adopting a particular bar report in an opinion letter, the parties can incorporate definitions of certain terms; create rules regarding due diligence and other standards of care; define the scope of the opinion giver's liability; incorporate certain qualifications and limitations in the opinion; include assumptions permitted to be made by the opinion giver; and cover a host of other matters.

a. [9:16] **Applicability to real property transactions:** Third party legal opinion letters are requested and delivered in a wide range of business transactions. While reviewing bar association reports (which often emphasize corporate law issues), it is important to keep in mind that opinion letters in real property transactions are different from those issued in other kinds of transactions. Although certain principles are generally applicable, others may not apply.

b. [9:17] **Persuasive authority only:** Bar association reports are *not law*, but merely compromise analyses and suggestions. Nor are they dispositive of issues relating to opinion letters. Legal opinions comprise an evolving area in both customary practice and legal precedent. There is great diversity of thought on opinion letters and even the various bar association reports are not entirely consistent. Still unsettled are such questions as which kinds of opinions are appropriate, the scope of opinions, the due diligence the opinion giver must conduct, the reliance the opinion recipient may place on an opinion, the standard of care applicable to the opinion giver, the extent of the opinion giver's liability, etc.

2. [9:18] **Applicable California reports:** The following bar association reports are most directly applicable to California law and practice. Copies of the California reports can be ordered from the California State Bar Association.

• Corporations Committee, State Bar of California, *Legal Opinions in Business Transactions (Excluding the Remedies Opinion)* (2005) (2007 revision), *available at www.americanbar.org* (the "2005 Corporations Report").

— This report focuses on corporate law issues. The 2005 Corporations Report states that it "supersedes" the 1989 Business Law Report (below), but adds that "specific issues relating to real estate. . . are beyond the scope of this Report." [2005 Corporations Report at iii, 94]

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• Joint Committee of Real Property Law Section, State Bar of California, and Real Property Section, Los Angeles County Bar Association, *California Real Property Legal Opinion Report*, Cal. Real Property Journal, Vol. 13, No. 3 (1995) (the "1995 Real Property Report"). See also *First Supplement to 1995 California Real Property Legal Opinion Report*, Cal. Real Property Journal, Vol. 16, No. 1 (1998) (the "1998 Supplement").

— This report focuses on enforceability and remedies opinions in real property transactions.

• Business Law Section, State Bar of California, *Report on the Third-Party Legal Opinion Report of the ABA Section of Business Law* (1992) (the "1992 Business Law Report").

— This report discusses both corporate and real property law issues.

• Corporations Committee, State Bar of California, *1989 Report of the Committee on Corporations of the Business Law Section of the State Bar of California Regarding Legal Opinions in Business Transactions*, 45 Bus. Law. 2169 (1990) (the "1989 Business Law Report").

— This report focuses on corporate law issues.

• Uniform Commercial Code Committee, State Bar of California, *Report Regarding Legal Opinions in Personal Property Secured Transactions*, 44 Bus. Law. 791 (1989) (the "1988 UCC Report").

— This report focuses on corporate law issues.

• Joint Committee of Real Property Law Section, State Bar of California, and Real Property Section, Los Angeles County Bar Association, *Legal Opinions in California Real Estate Transactions*, 42 Bus. Law. 1139 (1987) (the "1987 Real Property Report"). See also *Legal Opinions in California Real Estate Transactions: An Addendum* (1990) (the "1990 Real Property Addendum").

— This report focuses on real property law issues.

3. [9:19] **Applicable national reports:** The bar association reports listed below were published by national bar associations and multi-jurisdictional bar committees. Several of the reports have been approved by California bar associations and bar committees.

Additional national reports are available on the American Bar Association's website at *www.americanbar.org*.

• Legal Opinions Committee, American Bar Association, and Working Group on Legal Opinions Foundation, *Statement of Opinion Practices (and Related Materials)*, 74 Bus. Law. 801, 807 (2019) (the "2019 Statement of Opinion Practices").

— This report does not focus on a specific type of business transaction and is intended to be broadly applicable.

• Committee on Legal Opinions in Real Estate Transactions, American Bar Association; Opinions Committee, American College of Mortgage Attorneys; and Attorneys' Opinions Committee, American College of Real Estate Lawyers: *Local Counsel Opinion Letters in Real Estate Finance Transactions, a Supplement to the Real Estate Finance Opinion Report of 2012*, 51 Real Prop. Tr. & Est. L.J. 167 (2016) (the "2016 ABA Supplement").

• Joint Drafting Committee, American Bar Association, *Real Estate Finance Opinion Report of 2012*, 47 Real Prop. Tr. & Est. L.J. 213 (2012) (the "2012 ABA Report").

• American Bar Association, *Statement on the Role of Customary Practice in the Preparation and Understanding of Third-Party Legal Opinions*, 63 Bus. Law. 1277 (2008) (the "2008 Statement").

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- Attorneys' Opinion Committee, American College of Real Estate Lawyers; and Committee on Legal Opinions in Real Estate Transactions, American Bar Association: *Real Estate Opinion Letter Guidelines*, 38 Real Prop. Prob. & Tr. J. 241 (2003) (the "2003 Real Estate Opinion Guidelines").

- Legal Opinions Committee, American Bar Association, *Guidelines for the Preparation of Closing Opinions*, 57 Bus. Law. 875 (2002) (the "2002 Guidelines").

- Legal Opinions Committee, American Bar Association, *Legal Opinion Principles*, 53 Bus. Law. 831 (1998) (the "1998 Principles").

- Joint Committee of the American College of Real Estate Lawyers and the Real Property, Probate and Trust Law Section, American Bar Association, *Report on Adaptation of the Legal Opinion Accord of the Section of Business Law of the American Bar Association for Real Estate Secured Transactions* (the "1994 ACREL-ABA Report").

  — This report discusses how the 1991 Accord (below) can be adapted to real estate practice.

- Joint Committee of the American College of Real Estate Lawyers and the Real Property, Probate and Trust Law Section, American Bar Association, *The Attorney's Opinion Letter in Real Estate Transactions* (1992) (the "1992 ACREL-ABA Report").

- Legal Opinions Committee, American Bar Association, *Third-Party Legal Opinion Report, Including the Legal Opinion Accord*, 47 Bus. Law. 167 (1991) (the "Accord").

  — This report focuses on corporate law issues.

[9:20 - 9:29] ***Reserved.***

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Chapter 9. Opinion Letters

C. Purpose of Opinion Letters

1. [9:31] Ascertaining and Solving Problems
    - a. [9:32] Example—entity's authority to engage in transaction and signer's authority to bind entity
2. [9:33] Shifting “Due Diligence” Onus Between Parties
    - a. [9:33.1] Due diligence concerning parties
    - b. [9:33.2] Due diligence concerning subject property
3. [9:35] Educating Out-of-State Parties
    - a. [9:35.1] Limited to law covered in opinion letter
    - b. [9:35.2] Customary diligence caveat
4. [9:36] Confirming Contract Formation, Parties' Legal Relationship and Mutual Agreement
5. [9:38] Confirming Remedies/Enforceability
6. [9:39] Confirming Legal Status of Property
7. [9:40] Impact of Other Contracts and Obligations
8. [9:41] Creating Estoppel Against Borrower
9. [9:42] Satisfaction of Regulatory Requirements
10. [9:43] Satisfaction of Lender's Internal Requirements
11. [9:44] Creating Source of Recovery in Event of Litigation

[9:30] Opinion recipients may have a variety of reasons for requiring an opinion letter in real property transactions. As developed at ¶ 9:31 ff., some reasons are rational, justifiable and fair; occasionally, however, the stated (or unstated) reason may be unfair and entirely inappropriate.

1. [9:31] **Ascertaining and Solving Problems:** Parties to a transaction intend and assume certain factual and legal matters. Requiring counsel to render an opinion on particular matters forces the attorney to carefully examine those issues. In the course of that examination, unknown or unanticipated problems can be identified and rectified.

a. [9:32] **Example—entity's authority to engage in transaction and signer's authority to bind entity:** For example, each party assumes it and the other party have the ability to enter into the contemplated transaction and that the individuals signing the documents have the authority to bind their respective entities. Therefore, when a corporation, partnership, limited liability company, trust or other entity enters into a contract, it is important to make certain (a) the transaction is within the permissible parameters of the entity's governing documents (i.e., that the partnership agreement, limited liability articles of organization or operating agreement, trust instrument or corporate articles and bylaws permit the entity to engage in the contemplated transaction); and (b) the individuals signing the transactional documents have been properly granted the authority to do so.

An attorney compelled to issue an opinion on these issues will presumptively verify these matters; and, if the particular entity's governing documents need to be amended (or specific resolutions need to be adopted to grant individuals the authority to sign), the attorney will prepare the appropriate paperwork.

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2. [9:33] **Shifting "Due Diligence" Onus Between Parties:** Each party to a transaction usually wants to conduct a certain amount of "due diligence" about the other party and the property involved. Requiring the other party's counsel to give an opinion letter on these matters can effectively *shift the cost and burden* of conducting the pertinent due diligence.

a. [9:33.1] **Due diligence concerning parties:** For example, one party might be concerned whether the other party is a defendant in any litigation or subject to any contracts which might preclude it from entering into and performing the contemplated agreement. If the other party is an entity, due diligence may also require investigation whether the entity is properly formed, whether it has the authority to enter into the transaction under its governing documents, and whether the individuals signing the transactional documents have authority to bind the entity (*¶ 9:32*).

b. [9:33.2] **Due diligence concerning subject property:** A contracting party in a real estate transaction might also be concerned about matters pertaining to the subject realty—e.g., whether the property is the subject of a condemnation proceeding and whether it is in compliance with zoning or other applicable laws.

➪ [9:34] ***PRACTICE POINTER:*** Sometimes it is appropriate for the opinion giver to undertake such due diligence and sometimes it is completely inappropriate.

If the opinion is limited to matters about the opinion giver's client—e.g., whether the client is a properly-formed legal entity authorized to enter into the particular transaction—it is reasonable to presume the opinion giver (who knows more about their client than does the other party) will be the most efficient in conducting the appropriate investigation. Disputes between opinion givers and opinion recipients typically arise, however, when the opinion recipient asks for factual or other opinions which the opinion giver is not qualified to give. (*See ¶ 9:94 ff.*)

3. [9:35] **Educating Out-of-State Parties:** In certain instances, an out-of-state party (usually, an institutional lender) will have specific questions about California law that it will want borrower's counsel to address. (Of course, borrowers typically argue the out-of-state party should hire its own California counsel.)

a. [9:35.1] **Limited to law covered in opinion letter:** If an opinion letter states that it covers a specific jurisdiction's laws or particular laws, the opinion does not cover any other laws. [2019 Statement of Opinion Practices, 74 Bus. Law. 807, 810, § 6.1]

b. [9:35.2] **Customary diligence caveat:** An opinion letter on a jurisdiction's laws covers only those laws that lawyers practicing in that jurisdiction and exercising customary diligence (¶ 9:11) would reasonably recognize as applying to the client or transaction that is the subject of the opinion letter. [2019 Statement of Opinion Practices, supra, 74 Bus. Law. at 810, § 6.2]

4. [9:36] **Confirming Contract Formation, Parties' Legal Relationship and Mutual Agreement:** Parties to a transaction contemplate they are entering into a binding contract that creates a particular kind of legal relationship and represents their mutual intent and agreement. The opinion recipient wants the opinion giver to confirm the contract is a binding expression of the parties' mutual assent.

➪ [9:37] ***CAVEAT:*** Rendering an opinion confirming contract formation, the parties' legal relationship and their mutual agreement may seem straightforward. However, it should be approached *cautiously*, as there are several potential adverse consequences for both the opinion giver and the client. *See ¶ 9:71 ff.* re conflicts of interest.

5. [9:38] **Confirming Remedies/Enforceability:** One party's counsel is often asked to render an opinion that the other party has certain rights or remedies. This is one of the most controversial aspects of an opinion letter. *See ¶ 9:156 ff.*

6. [9:39] **Confirming Legal Status of Property:** Some opinion requests are directed at confirming whether a particular piece of property is in compliance with building, zoning, environmental and other laws. Though such opinions are occasionally given, this is *not an appropriate subject for an opinion letter*. *See ¶ 9:147 ff.*

7. [9:40] **Impact of Other Contracts and Obligations:** The opinion recipient wants to know whether the other party is subject to contracts or other restrictions which might prohibit or limit its ability to perform its obligations under the transactional agreements. *See ¶ 9:136 ff.*

8. [9:41] **Creating Estoppel Against Borrower:** Conceivably, when an attorney renders a particular opinion, the attorney's client could subsequently be deemed to have *waived* certain rights or defenses and/or be *estopped* from taking a position in

subsequent litigation with the opinion recipient that is contrary to that stated in the opinion letter. (Although opinion recipients rarely admit this, one of their goals is to create such a waiver or estoppel.)

Whether a third party opinion can bind the client to a waiver or estoppel has not been addressed by the courts. Nonetheless, an opinion letter might at least be used as evidence of certain matters which could weaken the client's case. *See* *¶ 9:73*.

9. [9:42] **Satisfaction of Regulatory Requirements:** Certain regulatory agencies require the issuance of an attorney's opinion as a condition to the transaction. For example, legal opinions are sometimes required in securities transactions; or in loan transactions if the lender intends to sell the loan in the secondary mortgage market.

10. [9:43] **Satisfaction of Lender's Internal Requirements:** Many institutional commercial lenders require an opinion from borrower's counsel as part of their required closing documentation. This is often a nonnegotiable requirement and the lender will provide neither reasons nor logic for its insistence on the matter. (In such situations, the analysis is simple: Either issue the opinion or look for another lender.)

11. [9:44] **Creating Source of Recovery in Event of Litigation:** Perhaps the most *improper* reason for requiring an opinion is to make the opinion giver a potential liability target. Although opinion recipients rarely acknowledge this, some view the attorney rendering the opinion as a source of recovery if that attorney's client is somehow able to lawfully avoid its obligations under the transactional agreements. In other words, if a particular agreement (or provision therein) is unenforceable against the client, the opinion recipient believes it might nevertheless be able to recover against the opinion giver.

For example, the attorney might render an opinion that a contract is valid, binding and enforceable. If the opinion giver's client is subsequently able to prove the contract is not binding, or is invalid or unenforceable, the opinion giver might have liability to the opinion recipient even though its own client would not. *See* *¶ 9:215 ff.* re attorney liability.

[9:45 - 9:49] ***Reserved.***

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Chapter 9. Opinion Letters

D. Prenegotiation/Predrafting Considerations

- 1. [9:51] Propriety of Opinion
  - a. [9:52] Custom
  - b. [9:53] Materiality
  - c. [9:54] Size of transaction
  - d. [9:55] Cost
  - e. [9:56] Timing
  - f. [9:57] Reason for opinion
  - g. [9:59] Necessity of opinion
- 2. [9:60] Your Policy
- 3. [9:62] Your Role in the Transaction
- 4. [9:63] Feasibility
- 5. [9:64] Competence to Render Opinion
- 6. [9:65] Ethical Concerns
  - a. [9:66] ABA Model Rule
    - (1) [9:67] Comment
  - b. [9:68] Competence
  - c. [9:69] Breach of client confidences
  - d. [9:71] Conflicts of interest
    - (1) [9:72] Inherent conflicts
      - (a) [9:72.1] Compromising duty of loyalty to *client*
        - 1) [9:72.2] Compare—advancing client's interests
        - 2) [9:72.3] Compare—lawyer's duty to third-party recipients
        - 3) [9:72.4] Reliance by third-party recipients
      - (b) [9:72.5] Potential liability when client's position contradicts counsel's opinion
    - (2) [9:73] Opinions resulting in client waivers or estoppel
    - (3) [9:74] Other potential conflicts
- 7. [9:76] Limiting Scope of Opinion
  - a. [9:77] Corporate certificates and resolutions
  - b. [9:78] Client representations and warranties
  - c. [9:79] Government certificates
  - d. [9:80] “Best knowledge” limitations
- 8. [9:81] Time for Negotiating Opinion
- 9. [9:83] Multiparty Opinions
  - a. [9:84] Global opinion
    - (1) [9:85] Concerns for lead opinion giver

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b. [9:86] Sum-of-the-parts opinion

[9:50] Before negotiating or drafting an opinion, attorneys should keep in mind several preliminary practical considerations:

1. [9:51] **Propriety of Opinion:** The threshold issue is whether an opinion is even *appropriate* for the contemplated transaction. Consider these points:

a. [9:52] **Custom:** Is it *customary* to render an opinion in the transaction at hand? And even if customary, does the nature of the transaction *justify* the requirement of an opinion? (An opinion is not always necessary simply because customarily requested.)

b. [9:53] **Materiality:** Is there a *material legal issue* that requires an opinion? No opinion should be requested or given if there is no legal issue of material significance to the transaction.

c. [9:54] **Size of transaction:** Does the *size of the transaction* justify the requirement of an opinion?

d. [9:55] **Cost:** Is the *cost* of the opinion manageable or would it be prohibitive? Bear in mind that additional legal fees will be incurred to negotiate and draft the opinion, as well as to conduct the due diligence necessary to support the opinion.

e. [9:56] **Timing:** Is there sufficient *time* within which to negotiate and prepare the opinion, as well as complete the underlying due diligence?

f. [9:57] **Reason for opinion:** Are the proffered *reasons* for the desired opinion *sufficiently clear?* All too often, opinions are requested and given without the parties or their counsel fully understanding the underlying reasons. If the purpose of the opinion is vague, everything from scope of the opinion giver's due diligence to the quality of the opinion itself will be compromised.

➪ [9:58] ***PRACTICE POINTER:*** If you're uncertain about the purpose of the requested opinion, ask the other side to *explain its specific concerns*. Your opinion should then be responsive *only* to those specific concerns, and no other issues.

Of course, it is sometimes overly optimistic to assume the requesting party will provide a rational justification. In many transactions, the response is either: (i) "Receipt of an opinion letter is simply one of our required closing documents and the matter is not negotiable"; or (ii) "What's your problem? We customarily get opinion letters in these kinds of transactions." Where no concrete reasons are given, you and your client should carefully decide how to proceed—if at all—in rendering an opinion.

g. [9:59] **Necessity of opinion:** As early as possible in the negotiations, attempt to ascertain whether an opinion letter is an absolute requirement of the other party (without which the other party will not close the transaction) or simply desirable. If an opinion is required (and many institutional lenders of commercial loans adamantly insist on an opinion by borrower's counsel), quickly resolve the issue of whether you are willing and able to issue the requested opinion.

On the other hand, if the opinion is not a "make or break" requirement in the deal, whether to give it and, if so, the scope of the opinion, simply become a matter of negotiation.

2. [9:60] **Your Policy:** Evaluate your firm's policy regarding the issuance of opinion letters. Some attorneys issue opinion letters only in very limited circumstances (if at all). Their argument is that the party requesting the opinion should get it from its own counsel. Moreover, many attorneys feel the potential liability exposure incurred in the opinion process is not worth the fee.

If it is your policy not to issue the requested opinion, your client (and perhaps the intended opinion recipient) should be advised of your position at the earliest possible stage of the transaction.

➪ [9:61] ***PRACTICE POINTER:*** Even if no opinion is initially requested, but you know (or even suspect) the other party will require an opinion as a condition to closing the transaction, advise your client accordingly. Discuss with your client whether you would be willing to issue an opinion and, if so, what kind of an opinion you would render (as well as the additional fee for doing so).

You will have a very unhappy client if, shortly before the transaction is scheduled to close, the other side suddenly insists on an opinion and your client then first learns you won't issue the requested opinion.

3. [9:62] **Your Role in the Transaction:** Whether it is appropriate for you to render an opinion will depend in part on the scope of your representation. If your role is peripheral to the transaction—e.g., you are retained only to work on one aspect of the transaction, or you only occasionally represent the client, or you are simply acting as local counsel in the transaction—all or a portion of the opinion might more properly be the responsibility of the client's outside (or in-house) general counsel.

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For example, an opinion relating to the client's due organization, power to enter into the contemplated transactions and authority of designated individuals to sign documents, is central to most opinion letters. If the client's general counsel is familiar with the entity's books and records (and you have only been retained to document and/or consummate one particular transaction), it is perhaps more appropriate to have the general counsel render the opinion.

Other pertinent factors are cost and timing. If you would need to conduct expensive and time-consuming due diligence to render an opinion, whereas the client's general counsel would not, it may make better sense to have the general counsel issue the opinion. (*See* *¶ 9:83 ff.* re multiparty opinions.)

4. [9:63] **Feasibility:** Some requested opinions simply are not *feasible* to give.

For example, lenders sometimes request an opinion from borrower's counsel that the property is in compliance with all environmental laws, zoning laws and building codes. For an attorney to conduct the due diligence necessary to render such an opinion, a legion of environmental, land use and construction experts would have to be hired, and counsel would have to review almost *all* applicable laws relating to zoning, environmental standards, construction and real property development. Such an investigation could take months and involve astronomical fees. To issue an opinion of such magnitude is simply not feasible.

5. [9:64] **Competence to Render Opinion:** If the requested opinion is outside the area of your expertise, or involves the law of a jurisdiction you are not qualified to analyze, you owe it to your client (and yourself) to advise your client you cannot issue the opinion. (*See also* *¶ 9:65 ff.* re ethical issues; *and* *¶ 9:83 ff.* re multiparty opinions.) [See 2019 Statement of Opinion Practices, 74 Bus. Law. 807, 811, § 7.2—"Opinion givers should not be expected to give opinions on matters that are not within the expertise of lawyers" (e.g., financial statement analysis, economic forecasting, and valuation)]

6. [9:65] **Ethical Concerns:** Opinion letters raise several important *ethical* issues:

a. [9:66] **ABA Model Rule:** The California Rules of Professional Conduct (CRPC) do not specifically address attorney opinion letters. However, the American Bar Association Model Rules of Professional Conduct ("ABA Model Rules") provide an explicit rule dealing with "[a]n evaluation … performed at the client's direction … for the primary purpose of establishing information for the benefit of third parties …" [See ABA Model Rule 2.3, Comment [1]]

Rule 2.3 ("Evaluation for Use by Third Persons") states:

> "(a) A lawyer may provide an evaluation of a matter affecting a client for the use of someone other than the client if the lawyer reasonably believes that making the evaluation is compatible with other aspects of the lawyer's relationship with the client.
>
> (b) When the lawyer knows or reasonably should know that the evaluation is likely to affect the client's interests materially and adversely, the lawyer shall not provide the evaluation unless the client gives informed consent.
>
> (c) Except as disclosure is authorized in connection with a report of an evaluation, information relating to the evaluation is otherwise protected by Rule 1.6." [ABA Model Rule 2.3]

(1) [9:67] **Comment:** Complying with ABA Model Rule 2.3(b) (mandating the client give *informed consent* before counsel can provide an opinion that is likely to materially and adversely affect the client's interests) is not difficult. Making certain a third party opinion is "compatible with other aspects of the lawyer's relationship with the client" (ABA Model Rule 2.3(a)), however, can be more problematic.

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Indeed, "… since such an evaluation involves a departure from the normal client-lawyer relationship, careful analysis of the situation is required. The lawyer must be satisfied as a matter of professional judgment that making the [opinion] is compatible with other functions undertaken in behalf of the client." [ABA Model Rule 2.3, Comment [3]]

Thus, for example, the opinion should not take a position incompatible with that taken on behalf of the client in some other aspect of the lawyer's representation. (*See ¶ 9:69* re confidentiality rules alluded to in ABA Model Rule 2.3(c).)

b. [9:68] **Competence:** It is a breach of both the CRPC and the ABA Model Rules for a lawyer to accept (or continue) employment in a matter that the lawyer is not competent to handle by reason of legal knowledge and skill. [See CRPC 1.1(a) & (b); ABA Model Rule 1.1; *and more detailed discussion at ¶ 1:46 ff.*] Therefore, issuing an opinion letter you are not competent to render risks both malpractice exposure *and* professional discipline.

c. [9:69] **Breach of client confidences:** Rule 1.6(a) of the ABA Model Rules provides "[a] lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is [otherwise] permitted. . ." (e.g., to prevent reasonably certain death or substantial bodily harm, etc.). [See ABA Model Rule 1.6(b) for complete list of permitted disclosures; CRPC 1.6(a) & (b)]

This Rule could create problems in the context of opinion letters if the client refuses to give the attorney access to information pertinent to the requested opinion; or if the client refuses to allow the attorney to disclose information essential to rendition of the opinion. [See Rest.3d Law Governing Lawyers § 95, Comment "d."—if disclosure in opinion letter is "reasonably likely to affect the client's interests materially and adversely," lawyer must consult with client and obtain client's consent before "undertaking or continuing the evaluation" ("Alternatively, the lawyer and client may determine it appropriate to negotiate with the intended addressee of the evaluation to modify its scope or terms, thus removing the adverse effect to the client")]

➪ [9:70] ***PRACTICE POINTER:*** Although Comment [5] to ABA Model Rule 1.6 states lawyers generally are impliedly authorized to make disclosures about their clients in order to carry out their representation, it is always better practice to specifically advise your client of, and obtain the client's consent to, the issuance of an opinion letter. If the opinion might involve the disclosure of specific confidential information, discuss that with your client as well.

d. [9:71] **Conflicts of interest:** Both the CRPC and the ABA Model Rules deal extensively with conflict of interest issues (*see detailed discussion at ¶ 1:70 ff.*). Several potential conflicts of interest could arise in connection with opinion letters.

(1) [9:72] **Inherent conflicts:** Issuing an opinion letter to third parties raises certain *inherent* potential conflicts of interest.

(a) [9:72.1] **Compromising duty of loyalty to *client:*** Counsel's duty of *undivided loyalty* to an existing client precludes the attorney from assuming any relation that would prevent the attorney from devoting their entire energies to the client's interest. [*Flatt v. Sup.Ct. (Daniel)* (1994) 9 C4th 275, 289, 36 CR2d 537, 545; see also CRPC 1.7] Counsel therefore cannot assume any duty to a nonclient third party—e.g., by issuing an opinion letter with the intent the third party rely thereon—when the third party is in an actual or potentially adverse position to the client. [*B.L.M. v. Sabo & Deitsch* (1997) 55 CA4th 823, 838-839, 64 CR2d 335, 344-345; see also *Freedman v. Brutzkus* (2010) 182 CA4th 1065, 1070, 106 CR3d 371, 375 (citing *B.L.M.* with approval)—"An attorney cannot approve an agreement or give a legal opinion on behalf of an opposing party"]

1) [9:72.2] **Compare—advancing client's interests:** Generally, an attorney's duty of loyalty to a client (¶ 9:72.1) should not prevent the attorney from delivering an appropriate opinion letter to a third party in a real property transaction. Indeed, the attorney would be advancing the client's interests "by making it possible for the third person to proceed with the transaction on the basis of the evaluation." [Rest.3d Law Governing Lawyers § 95, Comment "b."]

2) [9:72.3] **Compare—lawyer's duty to third-party recipients:** In delivering an opinion letter, the attorney's duty is to provide "a fair and objective opinion." By doing so, the third-party recipient of the attorney's opinion letter "does not thereby become the client of the lawyer, and the lawyer does not thereby undertake all duties owed to a client. . ." [Rest.3d Law Governing Lawyers § 95, Comment "c."; *see* ¶ 9:111 ff.]

3) [9:72.4] **Reliance by third-party recipients:** In California, there is precedent holding that a third-party recipient is not entitled to rely on an attorney's opinion letter: "In light of the fact that an attorney is prohibited from representing one who holds a position adverse or antagonistic to an existing client, it would be anomalous to hold that a person in an adverse or antagonistic position could nonetheless rely on a legal opinion of the attorney … This would in fact amount to creating a duty of professional care on the part of the attorney toward a person with whom the attorney would be prohibited from maintaining a professional relationship." [*B.L.M. v. Sabo & Deitsch* (1997) 55 CA4th 823,

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838, 64 CR2d 335, 344-345—attorney cannot be held liable to third party for legal opinion that third party could not, under CRPC, have contracted to obtain from attorney]

Compare—Restatement and ABA's approach: Both the Restatement and the ABA's 2019 Statement of Opinion Practices allow third-party recipients to rely on an attorney's opinion letter. [See Rest.3d Law Governing Lawyers § 95, Comment "b." (recognizing instances where parties intend for opinion letter to be "relied on by the addressee"); 2019 Statement of Opinion Practices, 74 Bus. Law. 807, 808, § 4.5 ("An opinion recipient is entitled to rely on an opinion, without taking any action to verify the opinion, unless it knows that the opinion is incorrect or unless its reliance on the opinion is otherwise unreasonable under the circumstances"); *and see* ¶ 9:111 ff.]

(b) [9:72.5] **Potential liability when client's position contradicts counsel's opinion:** Arguably, an inherent conflict of interest is also implicated because the attorney opinion-giver might draw a lawsuit from the third party recipient if the client subsequently takes a position contrary to that stated in the attorney's opinion. (E.g., counsel renders an opinion that a contract is valid, binding and enforceable, but the client thereafter contends it has a defense to the validity or enforceability of the agreement.)

• [9:72.6] **Comment:** No known reported decisions deal explicitly with this situation. Indeed, the trend in case law seems to be moving away from any such liability—i.e., the third party nonclient is *not justified in relying on* the attorney's opinion as a statement of fact because ethical rules bar the attorney from assuming any professional duty to the third party (¶ *9:72.1, 9:228*). [See *B.L.M. v. Sabo & Deitsch* (1997) 55 CA4th 823, 838-839, 64 CR2d 335, 344-345]

Nonetheless, having taken a position now adverse to the client, the lawyer who issued such an opinion might be barred from representing the client in the client's dispute with the opinion recipient. [See generally, CRPC 1.7]

(2) [9:73] **Opinions resulting in client waivers or estoppel:** No known reported cases to date hold an attorney's opinion letter will constitute a waiver of the client's rights or defenses or estop the client from subsequently taking a position contrary to that stated in the opinion. But this does not mean a court would not hold a client bound (estopped) by its lawyer's opinion. [Cf. *Lakeview Meadows Ranch v. Bintliff* (1973) 36 CA3d 418, 424-425, 111 CR 414, 418—borrower's lawyer drafted loan modification, which in turn estopped borrower from later arguing loan was usurious (court held borrower's counsel had obligation to advise lender if lawyer believed it was usurious and, failing to do so, lawyer's conduct "created an estoppel against [client] to claim that the modification agreement was usurious")]

In any event, the opinion letter might be admissible as evidence against the client; and the opinion giver could likely be called as a witness against their own client, itself creating a potential conflict of interest. [See CRPC 3.7]

(3) [9:74] **Other potential conflicts:** Other less obvious conflict issues should also be considered. For example:

• There may be a conflict of interest if the attorney has taken a position on behalf of other, unrelated clients in other matters (but involving similar issues) that is inconsistent with the opinion issued in the transaction at hand.

• By rendering an opinion that a contract is enforceable, the attorney may increase malpractice exposure for not discovering (in advance) the client might have a defense to enforceability.

• Conceivably, there could be a conflict of interest if the lawyer's fee is dependent upon issuance of the opinion.

➪ [9:75] ***PRACTICE POINTER:*** While there are no definitive answers to many of the conflict of interest issues, it is prudent to explain to your client the *potential* adverse impact of your opinion on the client's subsequent rights and/or defenses. Indeed, prudence suggests you put these disclosures *in writing* and obtain the client's signed acknowledgment that the client has been fully informed. [See CRPC 1.7 generally re conflicts of interest and client's "informed written consent"]

7. [9:76] **Limiting Scope of Opinion:** Whenever you are called upon to issue an opinion, always be mindful of possible methods of *limiting the scope of your opinion*. The most effective approach is to tailor the opinion to the requesting party's specific concerns. Indeed, the other party's specific concerns often can be satisfied without the issuance of an opinion, or by crafting an extremely narrow opinion. For example, consider the following alternatives:

a. [9:77] **Corporate certificates and resolutions:** If you do not want to issue an opinion about the legal status of your corporate client, perhaps you can obtain a "Certificate of Status" (so-called "good standing certificate") from the office of

the California Secretary of State. Additionally, the delivery of appropriate corporate resolutions will sometimes mollify the other party's concern about the authority of the individuals who sign the transactional documents (*see* ¶ *9:133 ff.*).

b. [9:78] **Client representations and warranties:** In lieu of giving an opinion on a specific issue, you might be able to provide *representations and warranties by your client*. For example, if you are asked for an opinion about pending or threatened claims and litigation against your client, perhaps you can provide your client's written declaration (signed under penalty of perjury) stating the client is not aware of any pending or threatened claims or litigation (other than those specifically disclosed). (*See* ¶ *9:138 ff.; see also* ¶ *4:444 ff., 4:456* re inherent ambiguities concerning "threatened" litigation.)

c. [9:79] **Government certificates:** With respect to whether the subject property complies with applicable law, some governmental entities will issue so-called "compliance certificates" confirming the property is in compliance with zoning and certain other laws. (As the 1987 Real Property Report states, at fn. 23, "[d]epending on the nature of the project and the legal issues involved, additional comfort to the lender may be provided by certificates from architects and engineers, letters from city officials, [etc.] …")

d. [9:80] **"Best knowledge" limitations:** Another method of limiting the opinion is to state it is given on your "best knowledge," "current actual knowledge" (or similar language). But this approach is not foolproof; such terms are inherently vague and there is always a question of not only what you knew, but what you should have known. (*See* ¶ *9:185 ff.*)

8. [9:81] **Time for Negotiating Opinion:** Although an opinion letter is typically delivered concurrent with closing of the transaction, it is best to negotiate the opinion as *early as possible*. If the last remaining unsatisfied condition to closing is the issuance of your opinion, your client's negotiating leverage will be severely diminished on the eve of the closing. Additionally, every opinion involves a certain amount of due diligence and, therefore, lead time for both conducting due diligence and drafting the opinion must be factored in.

#. [9:82] ***PRACTICE POINTERS:***

- Try to prevent your client from committing to an opinion letter until you have discussed it with your client.

- If possible, obtain a copy of the other side's proposed form (or description) of the required opinion. (However, it is sometimes better to present your own form of opinion than to negotiate for a modification of the other side's form.)

- Clients have little patience, understanding or interest in the opinion letter process and any controversy or frustration about your opinion may be directed at you by your own client. Therefore, keep your client apprised of major issues concerning your opinion.

9. [9:83] **Multiparty Opinions:** Multiparty opinions are commonly rendered in complex transactions and those involving multijurisdictional law. For example, specialized counsel are sometimes required to deal with unique issues relating to tax, securities, bankruptcy, environmental laws and the like; or it may be necessary to rely on the client's in-house counsel's opinion with respect to issues such as due organization, good standing, power and authority, etc. Sometimes these different counsel will render separate, independent opinions. In other instances, one counsel will be the lead opinion giver and will issue a "global" opinion based on the other opinions of counsel.

Whether a multiparty opinion is appropriate for the transaction and how the various opinions will be coordinated should be considered at the inception of the opinion-giving process.

a. [9:84] **Global opinion:** A "global opinion" typically states the lead counsel has specifically relied on the legal opinions of other lawyers (and copies of those other opinions are usually attached).

(1) [9:85] **Concerns for lead opinion giver:** Although use of a multiparty opinion may often be less expensive, faster and easier if you are the lead opinion giver (and your opinion thus relies on other legal opinions), you may nevertheless have certain obligations with respect to the opinions upon which you rely. The 1987 Real Property Report suggests reliance on other opinions implies a certain amount of due diligence by the lead opinion giver with respect to those other opinions; and indicates three possible areas of concern for the lead opinion giver:

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- By relying on other opinions, the lead opinion giver might be impliedly representing it is reasonable to do so. (This may be particularly true if the lead opinion giver selected the other opinion givers.)

- The lead opinion giver might be implicitly representing that the other opinion givers understand the transaction and the legal issues covered in the opinion.

- The lead opinion giver need not independently investigate the legal conclusions in any other opinion; however, the opinion giver should at least evaluate assumptions, limitations and qualifications in the other opinions to make certain they are reasonable and consistent with the facts.

b. [9:86] **Sum-of-the-parts opinion:** In a "sum-of-the-parts" opinion format, the various opinion givers render their opinions independent of each another. There is no lead opinion giver and no opinion giver necessarily relies on another lawyer's opinion. It is then up to the opinion recipient to piece together the various opinions to determine if they are responsive to the requested opinion.

[9:87 - 9:90] ***Reserved.***

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Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 9. Opinion Letters

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1. [9:91] **Form of Opinion:** "There is no prescribed form for a legal opinion." [1989 Business Law Report, pg. 9]

a. [9:92] **Typically by letter:** Opinions need not necessarily be given in letter form. However, that is the commonly-preferred method for issuing third party legal opinions.

FORM: Sample Opinion Letter (by Borrower's Counsel), *see Form 9:A*.

2. [9:93] **Kinds of Opinions:** Before undertaking to draft an opinion, it is important to understand the *generic kind* of opinion you have been asked to prepare:

a. [9:94] **Factual opinions:** A "factual opinion" relates solely to factual matters and generally is *not an appropriate form of legal opinion*.

"Lawyers should be cautious in agreeing to render opinions as to purely factual issues … Such opinions are often requested in an effort to force the lawyer to make a more thorough investigation than the client may be inclined to make and thereby place the lawyer in the uncomfortable position of potentially becoming an additional warrantor of the facts as represented." [1989 Business Law Report, pg. 6; see also 2019 Statement of Opinion Practices, 74 Bus. Law. 807, 810, § 5.6 ("An opinion giver ordinarily should not be asked to confirm factual matters, even if the confirmation is limited to the knowledge of the opinion preparers")]

While scholars can argue at length whether something is a factual matter or a legal conclusion, the opinion giver's job should be to present "informed judgment and analysis regarding matters of law, not factual statements which the parties are in a better position to verify." [1989 Business Law Report, pg. 6; see also 2005 Corporations Report, pg. 15]

➪ [9:95] ***PRACTICE POINTER:*** Absent some unique ability to verify the accuracy of factual matters, counsel should *avoid* giving factual opinions. Indeed, representations of *fact* in an opinion letter may open the door to professional liability to the third party recipient where such liability would not otherwise exist. [See *B.L.M. v. Sabo & Deitsch* (1997) 55 CA4th 823, 839, 64 CR2d 335, 345—"A review of cases suggests that courts … have limited recovery by a third party against an attorney under a negligent misrepresentation theory to those *cases* involving *misrepresentations of fact rather than legal opinions*" (emphasis added)]

(1) [9:96] **Examples:** The most commonly requested factual opinions are those relating to the client's representations and warranties; the status of certain documents and reports (e.g., financial reports, statistical information, the client's filing of tax returns, etc.); and the existence of pending or threatened claims or litigation against the client or which affect the subject property (*see ¶ 9:138 ff.*).

(2) Limiting factual opinions

(a) [9:97] **"Best knowledge" approach:** Some attorneys attempt to qualify their factual opinions by stating such portions of the opinion are to their "best knowledge" (or similar standard). However, this approach may offer minimal protection for the opinion giver (*see ¶ 9:185 ff.* re knowledge).

(b) [9:97.1] **Statement of "belief":** Representing the opinion as a reasonable statement of "belief" rather than an assertion of fact may provide greater protection. "Under certain circumstances, expressions of professional opinion are treated as representations of fact. When a statement, although in the form of an opinion, is not a casual expression of belief but a deliberate affirmation of the matters stated, it may be regarded as a positive assertion of fact." [*Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 408, 11 CR2d 51, 74 (internal quotes omitted); see *B.L.M. v. Sabo & Deitsch* (1997) 55 CA4th 823, 834, 64 CR2d 335, 342]

(c) [9:97.2] **Discounting superior expertise:** To the extent possible, the opinion giver should not represent the opinion is offered from a position of specialized knowledge or expertise on the subject. "[W]hen a party possesses or holds itself out as possessing superior knowledge or special information or expertise regarding the subject matter and a plaintiff

is so situated that it may reasonably rely on such supposed knowledge, information, or expertise, the [opinion giver's] representation may be treated as one of material fact." [*Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 408, 11 CR2d 51, 74]

(d) [9:98] **Reliance on independent certificates/declarations:** Alternatively, some opinion givers will render a factual opinion, but state it is based *solely* on written statements or certificates issued by others (such as the client or a public official). Sometimes those statements/certificates might take the form of declarations under penalty of perjury (either attached to or specifically identified in the opinion letter). This approach is likewise problematic:

• If the declaration is wrong, the opinion giver might nonetheless be deemed to have had an obligation to investigate the basis upon which the declarant made such a statement. (There is no known law on this issue, but a court might hold the opinion giver impliedly represents it is reasonable to rely on the declaration.)

• Of what value is your opinion to the opinion recipient if it is based *solely* on a representation made by someone else? An opinion based exclusively on a third party declaration or certificate (without any express or implied representation that it is reasonable to do so) is really no opinion at all. It would make more sense simply to deliver the declaration or certificate to the opinion recipient and not opine on the issue in any way.

b. [9:99] **Reasoned opinions:** A so-called "reasoned opinion" renders an analysis of a legal issue and the likelihood of a certain outcome if the issue were to be adjudicated by a court. This form of opinion involves situations in which the parties are uncertain about the applicability or consequence of particular laws to the transaction at hand; it usually concludes by stating a court either (1) "would" hold a particular way; (2) "should" hold a particular way; or (3) "is more likely than not" to hold a certain way.

Reasoned opinions are among the most difficult to give because (among other things) if the particular issue is in any way legally uncertain, then by definition the opinion giver is probably not in a position to offer the other side much assurance that a particular legal result will follow. (Reasoned opinions are rarely required in connection with commercial real property loan transactions.)

c. [9:100] **"Negative assurance" statements (comfort opinions):** In a "negative assurance" statement (also referred to as a "comfort opinion"), a lawyer represents (usually to a "best knowledge" standard) that the lawyer is not aware of any misstatement or omission in the client's disclosure document. When providing a negative assurance statement, the opinion giver commonly includes express limitations on the statement's scope based on the opinion giver's role in the transaction and the extent of their factual investigation. The negative assurance statement is often provided in a separate letter instead of in the text of the opinion letter itself. [See 2005 Corporations Report, pgs. 16-17 (¶ 9:18, 9:185 ff.)]

d. [9:101] **Perfection opinions:** A "perfection opinion" is basically an opinion that the security interest (typically, the deed of trust) is in appropriate form for recordation and, when recorded, will create a lien on the encumbered property.

e. [9:102] **Priority opinions:** A "priority opinion" opines as to the priority of a particular lien or encumbrance. Because California lawyers do not render title opinions (and the opinion recipient relies instead on *title insurance coverage* for title and priority matters), a priority opinion should *never be given*. (*See ¶ 9:149*.)

[9:103 - 9:104] ***Reserved.***

3. [9:105] **Identifying Transaction, Parties and Documentation:** Opinion letters should always be created and interpreted with reference to the specific factual circumstances, transactions and documents involved. It is therefore essential that the opinion giver carefully describe the factual and legal matters pertinent to the opinion. Specifically, the opinion letter should delineate:

• the pending *transactions;*

• the *parties* involved;

• the particular *documentation* pertinent to the opinion; and

• any other material information that has a bearing on the opinion.

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It is sometimes beneficial to attach the particular documentation to which you refer but, in any event, all relevant documents should be clearly identified (preferably by title, date and the parties thereto).

4. Your Client and Your Role in Transaction

a. [9:106] **Identifying client:** Typically, the identity of your client is an elementary matter; but there can be situations where, for purposes of the opinion, the client's identity is unclear.

Examples

(1) [9:107] **Partnership and individual partners:** For example, when you represent a partnership, you might want to clarify you do not represent any of the partners individually (i.e., the partnership *entity* is your client). You might also find yourself in a situation where you have previously represented one of the partners, but you are now being asked to render an opinion on behalf of the partnership entity. (This commonly happens when the lawyer's representation has historically been of the general partner of a limited partnership and the limited partnership itself has never had occasion to hire separate counsel.) Under those circumstances it may be more expedient (and yet still ethical, *see Ch. 1*) for the general partner's lawyer to undertake representation of the partnership for the limited purpose of rendering the opinion. You may therefore need to disclose that, for purposes of the opinion, your client is only the partnership.

(2) [9:108] **Borrower and guarantor:** The identity of your client can be problematic when you represent the borrower but a guaranty of the loan is issued by a nonclient third party. Here, the lender usually wants the opinion to cover not only the borrower's obligations under the loan documents, but the guaranty as well. Because your opinion letter might include an opinion about the guaranty, it might be beneficial to clarify you do not represent the guarantor.

b. [9:109] **Disclosing your role:** The opinion giver's specific role in the transaction should be identified: e.g., whether the opinion giver has acted as general counsel, special counsel, local counsel, or in some other capacity in rendering the opinion.

c. [9:110] **Disclosing special relationship with client:** Also consider disclosing any special relationship you or anyone in your firm has with the client.

For example, it may be advisable to disclose that a lawyer in your firm is a director or officer of the corporate client involved, that you or a lawyer in the firm has some close family relationship with an officer, director or equity holder, that the opinion giver has a direct financial interest in the client, or that there is some other significant business relationship between the client and opinion giver. [See 1989 Business Law Report, pg. 23; 2005 Corporations Report, pg. 38 (¶ 9:18)]

5. [9:111] **Opinion Recipient(s):** The parties must decide to whom the opinion will be issued—i.e., who is to be the beneficiary of, and be entitled to rely upon, the opinion letter.

➪ [9:112] ***PRACTICE POINTER:*** The opinion is usually issued to the other party (or parties) to the transaction. However, keep in mind that an opinion appropriate for one recipient may be inappropriate or unnecessary for another recipient. Strive to limit the number of opinion recipients and, to the extent there will be multiple recipients, consider whether it is more prudent to issue separate, different opinions to each of them.

a. [9:113] **Other counsel:** One of the most frequently negotiated issues regarding opinion recipients is whether *counsel* for the opinion recipient should also be an opinion recipient. Opposing counsel often want to be opinion recipients because they are sometimes required to issue opinions to their own clients and may want to expressly rely on your opinion in doing so.

b. [9:114] **Other third parties:** Carefully consider the extent to which the opinion recipient intends to use or rely on your opinion. For example, if the recipient will cite or rely on your opinion in a prospectus to sell securities, each of the investors might conceivably claim to be a third party beneficiary of your opinion. (Under certain circumstances, opinion givers may owe a duty of care to third party intended beneficiaries of the opinion. *See ¶ 9:219 ff.*)

Section 20 of the Accord provides some clarification by stating (1) *only* the opinion recipient is entitled to rely upon or assert any legal right based on the opinion letter; and (2) the opinion recipient is permitted to rely on the opinion *only* for the purpose contemplated by the transactional documents. Section 20 further provides that if a different arrangement is intended, the opinion letter should specify any other person who is so entitled to rely on the opinion and under what circumstances, and to what extent, they may so rely. [See 2019 Statement of Opinion Practices, 74 Bus. Law. 807, 812, § 11—opinion letter “may be relied on only by its addressee and any other person the opinion giver expressly authorizes to rely”]

➪ [9:115] ***PRACTICE POINTERS:*** When deciding on the number and identities of the opinion recipients, keep the following points in mind:

• It is sometimes beneficial to specifically state in the opinion (i) who may rely on the opinion; (ii) the permissible extent of such reliance; (iii) that *no one other than the named opinion recipient* may rely on the opinion; and (iv) that you have no obligation to update the opinion. [See Accord § 9; *and ¶ 9:191* re obligation to update opinions]

• Be careful how you describe the addressee of the opinion. It is one thing to deliver your opinion to the other party "in care of" opposing counsel. It is something else to actually address your opinion to opposing counsel. By addressing your opinion to opposing counsel, you might inadvertently imply you have rendered an opinion *to* opposing counsel.

6. [9:116] **Scope of Opinion Giver's Inquiry:** The extent to which the opinion giver has reviewed documents, conducted an investigation or performed a factual or legal analysis should be explicitly stated in the opinion. Whenever possible, identify the specific documents, certificates, statutes, cases and information upon which you relied in rendering your opinion. You may even want to state you relied on certain documents or information with the opinion recipient's express permission.

7. [9:117] **Assumptions:** Every opinion makes certain express or implied assumptions. As a general rule, the broader the assumptions, the narrower the opinion.

Moreover, under customary opinion letter practice, stated assumptions shift to opinion recipients the responsibility for confirming the assumed facts for themselves or taking the risk that the assumptions may turn out to be untrue. [See *GemCap Lending, LLC v. Quarles & Brady, LLP* (CD CA 2017) 269 F.Supp.3d 1007, 1035 (applying Calif. law)]

a. [9:118] **Unstated assumptions:** The specific assumptions opinion givers should make will be determined by the facts of each transaction. Some factual assumptions do not need to be stated because they generally apply in all types of transactions, regardless of their nature or the parties. Examples of ordinary unstated assumptions include:

• the documents reviewed are accurate, complete, and authentic;

• copies are identical to the originals;

• signatures are genuine;

• the parties to the transaction other than the opinion giver's client (or a non-client whose obligations are covered by the opinion) have the power and have taken the necessary action to enter into the transaction; and

• the agreements those parties have entered into with the opinion giver's client (or the non-client) are enforceable against them. [2019 Statement of Opinion Practices, 74 Bus. Law. 807, 809, § 5.5]

b. [9:119] **Impact:** Section 4 of the Accord enumerates many assumptions which may automatically be made by the opinion giver without investigation. However, § 5 of the Accord states reliance on assumptions may be *unwarranted* if you have in-formation that is contrary to the assumptions you have made. [See also 2019 Statement of Opinion Practices, supra, 74 Bus. Law. at 809-810, § 5.5—"An opinion should not be based on an unstated assumption if the opinion preparers know that the assumption is incorrect or know of facts that they recognize make their reliance under the circumstances otherwise unwarranted"]

8. [9:120] **Entity Status:** One of the most basic aspects of an opinion letter concerns the status of an entity. Lenders commonly require an opinion that the borrower has been "duly organized," is "validly existing" and is in "good standing."

a. [9:121] **Corporate entity "duly incorporated":** "Duly incorporated" means that "at the time the corporation was formed, the legal steps necessary to perfect its formation were completed (that is, its articles were signed and filed with the Secretary of State) and that the articles contained all information required to perfect its formation (and did not contain any provisions prohibitive) under the applicable corporate law as then in effect." [1989 Business Law Report, pg. 25]

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Since the "duly incorporated" opinion only covers the company's status at the time of incorporation and does not cover the company's subsequent actions, it "never stands alone." Instead, it is routinely paired with an opinion about the company's current status—e.g., "validly existing" (¶ 9:124) or "good standing" (¶ 9:125). [2005 Corporations Report, pg. 40 (¶ 9:18)]

b. "Duly organized"

(1) [9:122] **Corporations:** With respect to a corporation, "duly organized" means steps beyond the mere execution and filing of the articles have been taken—e.g., directors have been elected, officers have been appointed, and the directors have authorized initial issuance of the corporation's capital stock.

(Because a "duly organized" corporation has, by definition, been "duly incorporated," the opinion as to due organization subsumes an opinion as to "due incorporation.")

(2) [9:123] **Partnerships and other entities:** The 1989 Business Law Report does not deal directly with the issue of due organization of partnerships, limited liability companies, limited liability partnerships or other entities. Even so, one can fairly conclude due organization with respect to such other entity means the entity has been lawfully formed under applicable law.

For example, with respect to limited partnerships, due organization would mean at least a Certificate of Limited Partnership has been filed with the California Secretary of State (Corps.C. § 15902.01; *see* ¶ *4:209*). And due organization of a limited liability company would minimally mean the entity has filed executed Articles of Organization with the California Secretary of State (Corps.C. § 17702.01; *see* ¶ *4:214*).

c. [9:124] **"Validly existing":** An opinion that a corporation is "validly existing" means the corporation has not dissolved (and no proceedings for dissolution have been commenced) and it has not ceased to exist by reason of merger or otherwise. The adverb "validly" means that the corporation is a "de jure" corporation, and not a "de facto" corporation. [1989 Business Law Report, pg. 26; 2005 Corporations Report, pg. 41 (¶ 9:18)]

With respect to other entities, "validly existing" should mean they likewise exist and dissolution proceedings have not been commenced.

d. [9:125] **"Good standing":** A corporation is in "good standing" if its charter has not been suspended or forfeited. Customarily, this can be determined by obtaining a "Certificate of Status" from the Secretary of State, or a good standing certificate from the Franchise Tax Board (if time permits and/or there is reason to believe the company may be delinquent on its tax filings). [See 2005 Corporations Report, pg. 42 (¶ 9:18)]

➪ [9:126] ***PRACTICE POINTER:*** When issuing an opinion as to good standing, many attorneys rely solely on the Secretary of State's Certificate of Status (so-called "good standing" certificate). Indeed, whenever possible, the good standing certificate should be delivered to the other party to the transaction in lieu of an opinion.

e. [9:127] **Compare—other jurisdictions:** The issue of due incorporation, organization, valid existence and good standing in other jurisdictions is a delicate subject because you should not be rendering an opinion on the law of another jurisdiction unless you are qualified to practice in that jurisdiction (or unless you rely on local counsel's opinion or have some other satisfactory basis for your opinion).

[9:128 - 9:129] ***Reserved.***

9. [9:130] **Entity Power and Individual Authority:** Another central element of most opinion letters is an opinion that the entity has the power and authority to conduct business, and to enter into the contemplated agreements and transactions; and that the individuals executing and delivering the documents have the authority to bind their respective entities.

a. [9:131] **Power to conduct business:** This is a fairly rudimentary opinion that simply states the entity has the power to carry on its business.

b. [9:132] **Power and authority re agreement and contemplated transactions:** This is a more substantial opinion to the effect that entering into the agreement and consummating the contemplated transactions are not outside the entity's permissible scope of activity. With respect to a corporation, such an opinion means the agreement and contemplated transactions would not be *ultra vires*. With respect to a partnership or trust, this opinion means the agreement and contemplated transactions are not outside the business contemplated by the partnership or trust agreement.

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c. [9:133] **Authorization:** Opinions as to authorization relate to the entity's specific authority to engage in the contemplated transaction and the authority of the individuals who purport to bind the entity.

(1) [9:134] **Entity authority:** Such an opinion means all entity action required to have taken place before execution and delivery of the documents has in fact taken place.

Specifically, with respect to a corporation, this opinion means any required corporate resolutions have been adopted by the board of directors. With respect to a partnership, it means any required vote or consent of the partners has been obtained.

(2) [9:135] **Individual authority:** With regard to the authority of the individuals who sign and deliver documents, this opinion means those individuals have been properly authorized by their entities to bind the entity (either pursuant to the governing documents, specific resolutions or otherwise).

10. [9:136] **No-Conflict Opinion:** The purpose of a "no-conflict" opinion is to assure one party (usually, the lender) that the other party (the borrower) is not legally bound in a manner inconsistent with the transactions at hand. In particular, the lender is concerned the borrower might be subject to an agreement, court order or law that would prohibit the borrower from entering into or performing its obligations under the agreements. Therefore, an opinion covering the following issues is sometimes requested:

• The execution and delivery of the agreements, and the performance by the client of its obligations thereunder, will not conflict with or result in a violation of:

— the corporation's articles of incorporation (or, in the case of a different kind of entity, that entity's governing documents);

— any judgment, order or decree of any court or arbitrator to which the client is a party; or

— any law, rule or regulation applicable to the client.

• The execution and delivery of the agreements, and performance by the client of its obligations thereunder, will not constitute a material breach under the terms of any agreement or obligation to which the client is bound.

• No governmental or other consent is required as a condition to the client entering into, or performing its obligations under, the agreements.

➪ [9:137] ***PRACTICE POINTER:*** These "no-conflict" opinions are the subject of much controversy because of their breadth. Conceivably, such an opinion would require the opinion giver to review virtually all of the client's contracts and files and analyze almost all applicable laws.

One method for avoiding an overly broad no-conflict opinion is to identify and limit your opinion to the specific agreements, court orders and laws which you have reviewed and to which the opinion is limited. [See Accord §§ 15 & 16, with particular reference to § 15.3 Commentary]

11. [9:138] **Litigation, Condemnation and Other Claims and Proceedings:** One of the most often requested factual opinions relates to the existence of pending or threatened litigation, proceedings (such as condemnation proceedings) and claims against the client or concerning the subject property. However, the opinion giver is not necessarily the most competent person to render an opinion on such matters. Although the opinion giver will be familiar with certain specific pending or threatened litigation, proceedings and claims for which it is then providing representation, the opinion giver does not necessarily have any unique, expedient ability to determine what *other* pending *or threatened* matters exist.

a. Pending litigation affecting client

(1) [9:139] **Litigation against client:** The only certain way of ascertaining litigation pending against your client is to conduct a search of court records. (You cannot safely rely on what your client supposedly knows because your client may have been sued but not yet served; or, your client might have been lawfully served by way of service upon an authorized third party who accepted the summons but forgot to advise the client—e.g., as where an employee accepts service upon an entity employer without telling the supervisor.)

In any event, it seems that if the opinion recipients want to know what litigation is pending against the client, they (or you) can simply conduct a search of the court records and the opinion recipients can then review the pleadings in the pending litigation and draw their own conclusions.

(2) [9:140] **Litigation against client's principals:** Another difficulty in rendering an opinion concerning matters “affecting” the client is determining whether a claim that involves one of the client's principals also “affects” the client.

For example, if the general partner of a limited partnership (who owns a majority interest in the partnership) is a defendant in a major piece of litigation, does that “affect” the limited partnership? Such a suit against an individual should not be relevant to an opinion about claims affecting the entity, but the opinion recipient might disagree.

b. [9:141] **Pending litigation affecting property:** It is also difficult to render an opinion regarding litigation that “affects the property.” You could obtain a title report from a title insurance company (which would show actions filed against the subject property); but there seems no reason why you should issue an opinion when a title insurance policy can be purchased.

Another problem arises when there is litigation that could affect the property, but neither the property owner nor the property is the direct subject of the lawsuit. For example, the 1987 Real Property Report presents the hypothetical of when a citizen's group has filed a lawsuit against a governmental entity, contending the applicable general plan is invalid. The outcome of such a suit could certainly affect the subject property, but neither counsel nor the client would necessarily be aware of such litigation and a title company's title report would not necessarily reflect the suit.

c. [9:142] **Threatened claims and litigation:** Crafting an opinion with respect to “threatened” claims and litigation is exceptionally difficult. (As discussed in *Ch. 4*, it is very difficult to define a “threatened” claim; *see* ¶ *4:444 ff., 4:456*.)

(1) [9:143] Among many other issues is the question of how current a threat must be to qualify as a “threatened” claim. (For example, is a threat made four years ago too dated? What about one made a year ago?)

(2) [9:144] An opinion regarding threatened claims is also problematic because of the scope of investigation the opinion giver might have to undertake on the matter. Presumptively, the opinion giver would have to review many of the client's files and perhaps interview many of the client's employees to ascertain what threatened third party claims have been made.

d. [9:145] **Your knowledge:** Most opinion recipients will tell you they do not expect you to review your client's files or otherwise undertake a massive investigation with respect to pending or threatened claims and litigation. Instead, they often say they are only interested in “your knowledge.” Unfortunately, there is no clear definition of “knowledge” in this context (*see ¶ 9:185 ff.; see also ¶ 4:456*).

e. [9:146] **Limiting opinion by “materiality” standard:** One way of limiting opinions in this area is to utilize a “materiality” standard. However, this approach can also create problems:

• The parties might disagree as to what is “material” (unless a fixed dollar amount is identified as a threshold).

• The claim or litigation may not be for money damages and, therefore, not readily quantifiable on a materiality scale.

12. [9:147] **Compliance With Law:** Lenders often request an opinion that the subject property is in compliance with all zoning, subdivision, building code, environmental and other laws. However, borrower's counsel typically will have a very difficult time satisfying such a request:

• Because they are so voluminous, it is virtually impossible to identify all laws applicable to the property.

• Likewise, it is almost impossible to determine whether the property is in compliance with the law without investigating every aspect of the property.

• Also, certain laws (particularly environmental laws) are complex, in a state of flux and subject to varying interpretations (*see Ch. 5*).

➪ [9:148] ***PRACTICE POINTER:*** The best approach for counsel asked to render a “compliance with law” opinion is to determine whether some form of *compliance certificate* is available from a governmental entity having jurisdiction over the property.

Alternatively, consider providing the opinion recipient with some written certification from the client that, to the client's best knowledge, the property is in compliance (or at least materially in compliance) with applicable laws; and/or that the client has not received any formal written notice of violation of law from any public authority.

Because you cannot know with certainty whether the property is in fact in compliance with all applicable laws, either (or both) of these methods should preferably be used in lieu of (and not in addition to) a legal opinion on the issue.

13. [9:149] **Title and Transferability:** California lawyers should *not* issue opinions with respect to title or transferability of real property. Though the practice may be different in other jurisdictions, California lawyers neither research the state of title nor issue opinions regarding title, transferability or priority of liens. Instead, the opinion recipient's *title insurance policy* should provide sufficient comfort on these issues. (*See Ch. 3*.)

14. [9:150] **Usury:** A usury opinion is often an important part of borrower's counsel's legal opinion. When the interest rate (and various other charges that may be construed as interest, *see* *¶ 6:283 ff.*) is well within the usury limit, the opinion giver should have little difficulty in rendering the opinion. However, it may be more difficult to render a usury opinion when the loan appears subject to a usury exemption (*¶ 6:290 ff.*).

For example, many loan transactions are exempt from the usury laws by virtue of the status of the lender (e.g., the lender is exempt because it holds a particular kind of license; *see* *¶ 6:291 ff.*). If the loan is exempt by reason of the *lender's status*, it seems unfair to require borrower's counsel to render an opinion on the usury issue (after all, the lender knows the status of its own license better than does borrower's counsel).

➪ [9:151] ***PRACTICE POINTER—CHOICE OF LAW IMPLICATIONS*:** If the parties have selected the law of *another jurisdiction* to govern the loan transaction, your usury opinion necessarily must reflect the governing out-of-state law. In those circumstances, you should obtain *local counsel's* opinion on the issue, and your opinion should state you have assumed a court would uphold the parties' choice of foreign law.

15. [9:152] **Opinion Qualifications:** Every opinion is qualified (conditional) in some fashion and the specific qualifications must be stated with clarity.

In addition to any unique qualifications applicable to the transaction at hand, there are at least three commonly-accepted general qualifications:

a. [9:153] **Jurisdictional scope of opinion:** The opinion should delineate the jurisdictional law under which the opinion is rendered and further state no opinion is expressed with respect to any other law.

b. [9:154] **Bankruptcy and creditors' rights:** A "bankruptcy and creditors' rights exception" excludes from the opinion the effect of bankruptcy and insolvency laws (which would include fraudulent transfer issues) and similar laws affecting the rights and remedies of creditors generally.

This exception is regularly permitted by opinion recipients because "[t]he area of federal bankruptcy and state creditors' rights law is complex and makes the giving of a bankruptcy-related opinion a perilous task." [1988 UCC Report; 44 The Business Lawyer 803 (1989); see also Accord § 12]

c. [9:155] **Equitable principles limitation:** Almost every opinion is expressly qualified by, and subject to, general principles of equity. Both the 1992 Business Law Report (at pg. 16) and the Accord (§ 13) discuss the propriety of an "equitable principles limitation."

An equitable principles limitation recognizes there are certain judicially-developed rules concerning the rights of one party to enforce an agreement. (For example, laches, estoppel, waiver, breach of the implied covenant of good faith and fair dealing, materiality and reasonableness standards, are all subject to judicial discretion.)

The equitable principles limitation most often relates to an "enforceability" (or "remedies") opinion (*see* *¶ 9:156 ff.*). However, some form of qualification with respect to equitable principles is important in every opinion regardless of whether an enforceability opinion is included.

16. [9:156] **"Enforceability" ("Remedies") Opinion:** One of the most intensively negotiated issues in an opinion letter relates to enforceability of the agreements and the opinion recipient's remedies. This portion of the opinion is popularly referred to as the "enforceability" or "remedies" opinion.

In loan transactions, an enforceability opinion is probably the most important section of borrower's counsel's opinion letter. The lender typically requests an opinion to the effect that "the agreement(s) constitute legal, valid, binding obligations of the borrower, enforceable in accordance with its (their) terms."

a. [9:157] **Justifications:** Lenders usually recite one or more reasons for asking for an enforceability opinion:

• To advise the lender of any material limitations on enforcement of the lender's rights which the opinion giver believes exist. (Opinion recipients are often of the belief that opinion givers will be less inclined to draft agreements which include a hidden "escape hatch" for their clients if the opinion giver is required to issue an enforceability opinion.)

• To confirm that the documents reflect the parties' mutual agreement and that they are binding agreements.

• To confirm the legal relationship between the parties—i.e., that the relationship is between a lender and borrower and that the loan documents do not create a joint venture or partnership between the parties.

• To comply with the lender's underwriting practice (i.e., an enforceability opinion may be one of the lender's required closing documents whether or not there is a good reason for it).

b. [9:158] **Fundamental problems:** There are several reasons why an enforceability opinion is difficult to render:

• Lawyers do not agree on the meaning of "enforceable." (Even the various bar association reports differ on this issue.) Indeed, most lenders will admit that certain provisions in their loan agreements are onerous and not enforceable under many circumstances.

• Because lender's counsel most likely drafted the agreements (and may have litigated those documents over the years), it seems rather odd, if not unnecessary, to require borrower's counsel to render an opinion as to their enforceability. After all, the author of the documents should know better than anyone else whether the agreements are enforceable.

• Future circumstances are not predictable. Therefore, defenses, exceptions and limitations affecting enforceability which are not contemplated at the time of the making of the contract might subsequently apply.

• Although various bar associations have crafted different proposals for a standard remedies opinion, each one suffers from ambiguity.

➪ [9:159] ***PRACTICE POINTER—IMPLIED USURY OPINION*:** An enforceability opinion can be construed as including an opinion that the loan is not usurious.

[See Accord, Commentary § 18.1] Therefore, be aware that, by adopting the Accord, you may unintentionally issue an implied opinion the loan is not usurious.

c. [9:160] **Bankruptcy/creditors' rights and equitable principles limitations:** As noted at *¶ 9:154 ff.*, the bankruptcy exception and equitable principles limitation are standard exceptions to an enforceability opinion. The 1990 Real Property Addendum provides that the equitable principles limitation includes at least the following three concepts with respect to enforceability opinions:

• No opinion is intended with respect to whether performance includes traditional equitable remedies (e.g., specific performance, injunction, etc.);

• No opinion is intended with respect to whether enforcement may be limited by traditional equitable defenses (e.g., waiver, laches, estoppel, etc.); and

• No opinion is intended with respect to whether enforcement may be limited by other substantive or procedural rules affecting enforcement of contractual obligations generally (without regard to whether such limitations arise out of traditional "equitable" principles).

d. [9:161] **"Accord remedies opinion":** Section 10 of the Accord provides that a "remedies opinion" means (1) a contract has been formed; (2) a remedy will be available with respect to each agreement; and (3) any remedy expressly provided for in the contract will be given effect as stated.

➪ [9:162] ***PRACTICE POINTER—INAPPROPRIATE FOR SECURED LOAN TRANSACTIONS*:** An "Accord remedies opinion" takes the approach that *each and every obligation of the agreement is enforceable*. However, the Accord

is not specifically designed for real estate transactions, much less real property secured loan transactions. Thus, the Accord approach would be inappropriate when rendering a borrower's counsel's opinion in a commercial loan transaction.

The better practice is to render an opinion that the lender generally will have the right to enforce the agreement, but no opinion should be rendered to the effect that any particular (or all) provision(s) are enforceable (*see ¶ 9:167 ff.*).

e. [9:163] **"California Understanding":** The "California Understanding" of the Accord § 10 remedies opinion is published in the 1992 Business Law Report. It expressly *excludes* certain kinds of legal issues from an Accord remedies opinion. However, although the 1992 Business Law Report discusses some aspects of real estate secured loan documentation, it is primarily a business law (not a real estate law) report. (Indeed, the 1992 Business Law Report notes it is not intended to preempt any analysis the Real Property Law Section of the State Bar of California might publish in the future as a supplement to the Accord.)

More specific recommendations for remedies opinions in California real property secured transaction are discussed in the 1995 Real Property Report (*¶ 9:18*).

f. [9:164] **Qualification by "laundry list approach":** One method of qualifying an enforceability opinion is to describe specific exceptions to enforceability. This is popularly known as the "laundry list approach."

(1) [9:165] **Drawbacks:** Unfortunately, the laundry list approach makes opinions long and sometimes confusing; it implies that those exceptions which are not excluded are fully enforceable; and it causes much negotiation over which exceptions are permissible and the precise wording of those exceptions. For these reasons, "the laundry list approach appears to be increasingly disfavored." [See 1990 Real Property Addendum at p. 5]

(2) [9:166] **Typical exceptions:** Among the many exceptions typically enumerated in a laundry list approach are: the right to enforce late charges and penalties; enforceability of due-on-sale and due-on-encumbrance clauses; provisions for indemnification of the lender by the borrower; subordination clauses; provisions conflicting with California's antideficiency, fair value, right of redemption and one-action rules; materiality standards; the requirement of reasonableness, etc.

g. [9:167] **"Generic" approach:** A "generic" enforceability opinion basically opines that, while certain rights and remedies of the lender may not be enforceable, the loan documents are not unenforceable as a whole and the lender is not precluded from (1) enforcing the borrower's obligation to pay the principal and interest, and (2) foreclosing its security interest. The 1995 Real Property Report (¶ 9:18) refers to the generic opinion as the "essential benefits approach."

(Note that there are two fundamentally different forms of generic opinion; *see ¶ 9:169 ff.*)

(1) [9:168] **Drawback:** Although a generic enforceability opinion avoids the agony of negotiations over specific exceptions (which are endemic to the laundry list approach), it suffers from ambiguity. [See 4 The ACREL Papers 165 (1992)—generic opinion "is vague and does not provide certainty or specifics"]

(2) [9:169] **ACREL generic remedies opinion:** In July, 1991, the Attorneys' Opinions Committee of the American College of Real Estate Lawyers issued a Draft Statement of Policy on Enforceability Opinions in Mortgage Loan Transactions. That Draft Statement proposes the following generic qualification to a borrower's counsel's enforceability opinion:

> "Certain remedies, waivers, and other provisions of the Loan Documents may not be enforceable, but such unenforceability will not render the Loan Documents invalid as a whole or preclude (i) the judicial enforcement of the obligation of the borrower to repay the principal, together with interest thereon, as provided in the note (to the extent not deemed a penalty), and (ii) the foreclosure of the mortgage (or deed of trust) [and/or any security agreements]."

(a) [9:170] **Advantage:** The advantage of the ACREL proposal is that it essentially limits the scope of the opinion to two remedies—enforcement of the note and foreclosure of the security interest.

(3) [9:171] **"Practical realization of principal benefits of loan documents":** Another generic approach to an enforceability opinion opines that the lender's remedies are adequate for the "practical realization of the principal benefits" intended to be provided by the loan documents. Such a generic qualification would be similar to the following:

> "Certain rights, remedies and waivers contained in the loan documents may be limited or rendered ineffective or unenforceable by applicable laws and judicial decisions governing such provisions, but such laws and judicial decisions do not make the loan documents legally inadequate for (or substantially

interfere with) the practical realization of the principal benefits and/or security intended to be provided by the loan documents."

(a) [9:172] **Ambiguity issues:** There are problems with this form of generic qualification. For example, what is "practical" realization of the "principal" benefits? (Some believe the word "substantial" should be substituted for the word "practical.")

In addition, this generic qualification speaks of the security "intended" to be provided by the loan documents. Whose intent is envisioned? Thus, this form of generic enforceability opinion also lacks clarity.

[9:172.1 - 9:172.4] ***Reserved.***

(4) [9:172.5] **1995 Real Property Report generic exception:** The 1995 Real Property Report, as modified by the 1998 Supplement (*¶ 9:18*), also includes language for a generic exception to an enforceability opinion (which is somewhat longer than the ACREL language). (This optional language is included in the sample opinion letter included at the end of this Chapter; *see Form 9:A*.)

[9:173] **Comment:** Inevitably, borrower's counsel will be required to issue enforceability opinions. Nonetheless, there is still no consensus among lawyers as to the purpose or meaning of such an opinion. It is difficult to conceive of how there can ever be a meeting of the minds between opinion giver and opinion recipient when the real estate bar does not even have a definitive understanding of the scope of an enforceability opinion.

[9:174] ***Reserved.***

17. [9:175] **Opinion Giver's "Due Diligence":** The kind and quantity of "due diligence" investigation that should be conducted by the opinion giver is one of the most problematic issues in the opinion process. Generally, the quantity and quality of your investigation should be tailored to the specific opinion to be given. While there is no formalized approach, the following should be considered.

a. [9:176] **Entity formation documents:** Any opinion with respect to the formation of your client as a legal entity or its power and authority to enter into the transactions (*see ¶ 9:120 ff.*) requires your review of the entity's governing documents (e.g., articles of incorporation, bylaws and directors' resolutions for corporations; partnership agreements for partnerships; operating agreements for limited liability companies, etc.).

b. [9:177] **Certificates/declarations by public officials and private parties:** Determine what certificates and/or written statements you need to obtain from public officials or private parties to support your opinion.

➪ [9:178] ***PRACTICE POINTER:*** Section 3 of the Accord permits the opinion giver to rely on information from public entities without further investigation and without conducting any analysis of underlying data supporting a public official's certificate. Even so, if you have knowledge the information received or assumptions you have made are incorrect, you may have engaged in unwarranted reliance. [See Accord § 5]

c. [9:179] **Laws and regulations:** Determine what case law, statutes and administrative regulations are implicated by the requested opinion and thus essential to review before rendering your opinion.

d. [9:180] **Your firm's files/lawyers in your firm:** Your "knowledge" may extend to all of the lawyers in your firm (*see ¶ 9:185 ff.*). Consequently, you may need to canvas all lawyers in your firm before rendering an opinion. You may also need to review your firm's files with respect to your client to make certain nothing therein conflicts with your opinion.

e. [9:181] **Transactional documents:** Your opinion will relate primarily to the transactional documents. Thus, the most important part of your investigation is understanding all aspects of the transactional documents and making certain your opinion is consistent with them. (If the transactional documents refer to or incorporate other documents, you may need to review those as well.)

[9:182 - 9:184] ***Reserved.***

18. [9:185] **Opinion Giver's "Knowledge":** The opinion giver's "knowledge" is an important element in every opinion. Many attorneys try to narrow their opinions by limiting certain aspects to their "best," "actual" or "current" knowledge. Unfortunately, the use of a "best knowledge" (or similar) standard is dangerous because it defies clear definition (*see ¶ 4:456*).

a. [9:186] **1989 Business Law Report "current actual knowledge" standard:** The 1989 Business Law Report "recommends that the phrase 'current actual knowledge' be used"; and includes a paragraph that attempts to define "current actual knowledge." [See 1989 Business Law Report, pgs. 20-21] However, even the language suggested by that Report is unclear and potentially subject to differing interpretations.

b. [9:187] **Accord "conscious awareness" standard:** Section 6-A of the Accord provides that the term "opinion giver's actual knowledge or a phrase having equivalent wording … means the conscious awareness of facts or other information …" This "conscious awareness" concept recognizes that "what is 'known' at one time may not be in the mind or may be forgotten altogether at another time." [See Accord Commentary § 6.2(iv)]

This definition of actual knowledge appears to be the most narrow because it does not require the opinion giver to canvas all lawyers (or review all files) in the opinion giver's organization. [See Accord Commentary § 6.2(i) & (ii)]

c. [9:187.1] **ABA 2012 Report standard:** The sample Real Estate Finance Opinion contained in the ABA 2012 Report recommends including a definition specifying whose knowledge is relevant and incorporates sample language. [See ABA 2012 Report, pgs. 257-258.]

19. [9:188] **Adopting Accord or Other Bar Reports:** Because there is little binding authority on the subject of opinion letters, the analysis or language used in one of the bar association reports might be beneficial in explaining or interpreting your opinion. If your opinion references a particular bar report, the discussion in that report might be admissible as evidence to explain any ambiguity in the opinion or otherwise interpret the scope of the opinion.

However, of the various bar association reports, only the *Accord* (*¶ 9:19*) specifically contemplates it can be adopted by the opinion giver. (The provisions and definitions of the Accord can be adopted by using the language set forth in § 22 of the Accord.)

The 1991 ACREL Statement of Policy on Mortgage Loan Enforceability Opinions (*see ¶ 9:169*) can also be specifically adopted. But keep in mind the ACREL Statement relates only to the *enforceability* portion of the opinion.

20. [9:189] **Tactic to Avoid Opinions by Implication:** To avoid the implication of *unintended* opinions (e.g., a usury opinion implied by an enforceability opinion), it may be advisable to specify that no opinions may be inferred *other than those expressly stated* in your opinion. (Section 18 of the Accord specifically states there are no implied opinions unless (i) an underlying opinion is essential to the legal conclusion reached by the express opinion; or (ii) it is reasonable to imply an opinion under the circumstances, based on prevailing norms among experienced lawyers in the applicable jurisdiction.)

21. [9:190] **Effective Date of Opinion:** Most real estate opinions are signed, delivered and effective as of the *closing* of a particular transaction (usually a commercial loan). Therefore, the opinion letter should either state the date upon which it becomes effective or specify the conditions precedent to the opinion becoming effective.

In a loan transaction, the opinion typically is not effective until all parties have executed and delivered certain documents (the promissory note, deed of trust, etc.); the security interests have been perfected by the lender as required by law; and the transaction has otherwise closed.

22. [9:191] **Updating Opinion:** Opinion givers have *no* implied obligation to update their opinions to advise the opinion recipients of any changes in law or fact that may subsequently render any portion of the opinion incorrect. (Section 9 of the Accord expressly provides the opinion giver has no obligation to update the opinion.)

Some attorneys, however, prefer to specifically state they have no obligation to update the opinion. (The sample Real Estate Finance Opinion contained in the ABA 2012 Report suggests including a specific disclaimer of any obligation to advise the opinion recipient of any changes; see pg. 273.)

23. [9:192] **Signature and Internal Procedures:** If the opinion letter is rendered by a law firm (rather than a sole practitioner), it should be signed by an individual lawyer on behalf of the firm.

Before executing the opinion, any internal procedures of the law firm should be followed. Some firms have extensive internal procedures and policies regarding opinion letters—e.g., that the opinion must be approved by at least two lawyers; that only certain kinds of opinions may be given; or that certain specific due diligence must be conducted prior to issuance of an opinion (and that the supporting, backup research and documentation must be contained in the opinion letter file).

[9:193 - 9:199] ***Reserved.***

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California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 9. Opinion Letters

F. Special Concerns Re Ground Lease Opinions

1. [9:201] Assignment/Subletting Provisions
2. [9:202] Landlord's Remedies
3. [9:203] Rent Control
4. [9:204] Tax Treatment
5. [9:205] Use Restrictions
6. [9:206] Indemnifications
7. [9:207] Other Enforceability Issues

[9:200] Although rare, tenant's counsel under a ground lease (*Ch. 7*) may occasionally be asked to issue an opinion on the leasehold transaction. These are some of the particular issues tenant's counsel should be concerned with:

1. [9:201] **Assignment/Subletting Provisions:** The opinion should be *qualified* and *limited* with respect to the enforceability of *assignment and subletting* provisions (which are often governed by standards of reasonableness but subject to Civ.C. § 1995.210 et seq. and applicable case law; *see ¶ 7:60 ff.*).

2. [9:202] **Landlord's Remedies:** Enforcement of the landlord's remedies will be subject to the limitations set forth in Civ.C. § 1951.2 et seq. (see detailed treatment in Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Chs. 7, 8 & 9).

3. [9:203] **Rent Control:** Existing rent control laws and regulations may adversely impact or supersede the landlord's rights under the lease. (See detailed discussion in Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 5.)

4. [9:204] **Tax Treatment:** No opinion should be rendered with respect to the tax treatment of the transaction. (Long-term leases with options to purchase can sometimes be construed as delayed sales; *see Ch. 13*.)

5. [9:205] **Use Restrictions:** The enforceability of use restrictions in the lease are subject to statutory limitations (Civ.C. § 1997.010 et seq.; *see ¶ 7:170 ff.*).

6. [9:206] **Indemnifications:** Provisions requiring the tenant to indemnify the landlord can be limited. (For example, as a matter of public policy, an indemnitor cannot be required to indemnify the indemnitee for the indemnitee's own fraud or negligence. *See generally, ¶ 4:461 ff.*)

7. [9:207] **Other Enforceability Issues:** In all other respects, tenant's counsel asked to issue an “enforceability opinion” should be concerned with the limitations regarding enforceability of contracts and documents generally. *See ¶ 9:156 ff.*

[9:208 - 9:214] ***Reserved.***

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California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 9. Opinion Letters

G. Liability for Issuing Third Party Opinions

1. [9:215] In General
2. [9:216] Legal Standard of Care
3. [9:217] To Whom Duty of Care Owed; Actionable Third Party Claims
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        (1) [9:219] Compare—third party beneficiary as “client”
            (a) [9:220] Not extended to incidental beneficiaries
    b. [9:225] Liability for negligent misrepresentation
        (1) [9:226] Essential elements of third party cause of action
            (a) [9:227] Intended beneficiaries
            (b) [9:228] Intent to influence
                1) [9:229] Knowledge of plaintiff's specific identity not required
                2) [9:230] Direct communication between attorney and third party not required
                3) [9:231] Compare—no liability where attorney ignorant of intended purpose/use
            (c) [9:235] Justifiable reliance
                1) [9:235.1] Plaintiff's knowledge; burden of proof
                2) [9:236] Effect where opinion recipient represented by counsel
                3) [9:237] Effect of adversarial position
        (2) Application
            (a) Negligent misrepresentation liability upheld
            (b) No negligent misrepresentation liability
        (3) [9:250] Effect of bar against professional negligence liability to nonclients?
            (a) [9:251] Comment
    c. [9:260] Fraud liability
        (1) [9:261] Elements of third party fraud claim
        (2) [9:262] Misrepresentation of fact vs. nonactionable opinion
            (a) [9:263] Relevant factors
        (3) [9:264] Affirmation of client's misrepresentations

1. [9:215] **In General:** The introduction to the Accord states “[a] third-party legal opinion is an expression of professional judgment on the legal issues explicitly addressed. By rendering a professional opinion, the opinion giver does not become an insurer or guarantor of the expression of professional judgment, of the transaction or of the future performance of the client.” (*Lucas v. Hamm* (1961) 56 C2d 583, 15 CR 821, essentially confirms this statement.)

Nevertheless, as developed in this section, there are theories under which an opinion recipient might pursue a claim against the opinion giver (including negligence, misrepresentation or fraud).

Cross-refer: For further discussion of an attorney's liability for professional malpractice, see Tuft, Peck & Mohr, *Cal. Prac. Guide: Professional Responsibility & Liability* (TRG), Ch. 6.

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2. [9:216] **Legal Standard of Care:** Attorneys owe a general duty of care in providing opinion letters, as well as a duty to disclose facts that materially qualify their representations. [*GemCap Lending, LLC v. Quarles & Brady, LLP* (CD CA 2017) 269 F.Supp.3d 1007, 1030-1031 (applying California law) (¶ 9:235.1, 9:246)]

"There is currently no case law or Bar canon that clearly articulates the standard of care imposed upon attorneys under California law in rendering opinions. Generally speaking, a lawyer is expected to be well informed and to exercise 'such skill, prudence and diligence as lawyers of ordinary skill and capacity commonly possess and exercise in the performance of the tasks which they undertake.' In addition, a lawyer is expected to discover 'rules of law which, although not commonly known, may readily be found by standard research techniques.'" [1989 Business Law Report, pgs. 3-4; see also *Kirsch v. Duryea* (1978) 21 C3d 303, 308, 146 CR 218, 222—"[t]he attorney is not liable for every mistake he may make … he is not, in the absence of an express agreement, an insurer of the soundness of his opinions"; *Davis v. Damrell* (1981) 119 CA3d 883, 889, 174 CR 257, 260-261; *Metzger v. Silverman* (1976) 62 CA3d Supp. 30, 39, 133 CR 355, 361-362; ***and*** *¶ 1:46 ff.* re attorney competence]

3. [9:217] **To Whom Duty of Care Owed; Actionable Third Party Claims:** An attorney's duty of care in the rendition of professional services extends to clients and also, under certain circumstances, to *nonclients*. [*Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 411-412, 11 CR2d 51, 77; *Pavicich v. Santucci* (2000) 85 CA4th 382, 395, 102 CR2d 125, 135]

Whether nonclients can prevail in an action against an attorney depends upon the underlying circumstances and the theory of recovery:

a. [9:218] **No professional negligence (malpractice) liability to nonclients:** An attorney's liability for *professional negligence* is confined to the *client*—i.e., the person who contracted for the attorney's services. Third party *nonclients* therefore cannot prevail against counsel on a pure negligence theory. [See *Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 411-412, 11 CR2d 51, 77; *B.L.M. v. Sabo & Deitsch* (1997) 55 CA4th 823, 830-831, 64 CR2d 335, 339; and *Mariani v. Price Waterhouse* (1999) 70 CA4th 685, 694, 82 CR2d 671, 676]

(1) [9:219] **Compare—third party beneficiary as "client":** A nonclient can state a professional negligence cause of action against the attorney if the nonclient *is the practical and legal equivalent of a client.* For example, an *express third party beneficiary* of the attorney-client contract may be considered the equivalent of a "client" if the attorney's services were sought for the purpose of creating a benefit in favor of the nonclient. [See *Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 406-407, 11 CR2d 51, 73-74 & fn. 16; *Mariani v. Price Waterhouse* (1999) 70 CA4th 685, 697, 82 CR2d 671, 678]

(a) [9:220] **Not extended to incidental beneficiaries:** It is not enough, however, that third parties "incidentally" stood to benefit from the attorney's services.

Courts will not impose a duty in favor of a third party *unless* the third party can show that the "*prime purpose*" for retaining the attorney was to create a benefit in favor of the third party. [See *Johnson v. Sup.Ct. (Sheppard, Mullin, Richter & Hampton)* (1995) 38 CA4th 463, 472, 45 CR2d 312, 317—no duty of professional care owed to limited partners on third party beneficiary theory where general partner hired attorney for purpose of "swindling his partners" rather than to create benefit in their favor; *B.L.M. v. Sabo & Deitsch* (1997) 55 CA4th 823, 832-833, 64 CR2d 335, 340-341—attorney appointed special bond counsel in public housing development project for city owed no professional duty on third party beneficiary theory to project's developer]

[9:221 - 9:224] ***Reserved.***

b. [9:225] **Liability for negligent misrepresentation:** Under certain circumstances, "expressions of *professional opinion* are treated as representations of fact" and may give rise to liability for negligent misrepresentation, a species of the tort of deceit (see Civ.C. § 1572(2)). [*Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 407-408, 11 CR2d 51, 74 (emphasis added); *B.L.M. v. Sabo & Deitsch* (1997) 55 CA4th 823, 834-835, 64 CR2d 335, 342]

(1) [9:226] **Essential elements of third party cause of action:** An attorney may be liable for negligent misrepresentations made to nonclients who, as *intended beneficiaries*, *justifiably rely* on the misrepresentations in a particular transaction or type of transaction that the attorney *intended to influence*. [See *Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 376, 11 CR2d 51, 53]

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(a) [9:227] **Intended beneficiaries:** There must have been some manifestation on the part of the attorney who offers the opinion, information, or advice "that [they are] acting to benefit a third party or defined group of third parties in a specific and circumscribed transaction." [*Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 411-412, 11 CR2d 51, 77; see *B.L.M. v. Sabo & Deitsch* (1997) 55 CA4th 823, 835, 64 CR2d 335, 342]

(b) [9:228] **Intent to influence:** *Intent to influence* the third party is a threshold issue. In its absence, there can be no negligent representation liability notwithstanding the third party's reliance on the attorney's opinion and *even if that reliance was reasonably foreseeable*. [See *Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 412, 11 CR2d 51, 77; *B.L.M. v. Sabo & Deitsch* (1997) 55 CA4th 823, 835, 64 CR2d 335, 342-343]

Where intent to influence is present, the attorney's duty of care arises because the third party's anticipated reliance upon the opinion or legal advice is *"the end and aim of the transaction."* [See *Goodman v. Kennedy* (1976) 18 C3d 335, 343, 134 CR 375, 381, fn. 4 (emphasis added); *Bily v. Arthur Young & Co.*, supra, 3 C4th at 411, 11 CR2d at 76; *Pavicich v. Santucci* (2000) 85 CA4th 382, 395, 102 CR2d 125, 135]

1) [9:229] **Knowledge of plaintiff's specific identity not required:** It need not be shown that the attorney, when hired, knew the names or specific identities of the third parties. Liability may be imposed where the attorney "knows with substantial certainty that plaintiff, or the particular class of persons to which plaintiff belongs, will rely on the representation in the course of the transaction." [*Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 414, 11 CR2d 51, 78 (emphasis added); see also Rest.2d Torts § 552, comm. "h"]

2) [9:230] **Direct communication between attorney and third party not required:** Nor is it essential that the opinion or legal advice be communicated directly from the attorney to the third party. Attorneys may be liable if they *knew their client* would forward the opinion or advice to a particular class of persons. [See *Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 393, 11 CR2d 51, 64]

3) [9:231] **Compare—no liability where attorney ignorant of intended purpose/use:** On the other hand, there can be no misrepresentation liability to third persons where there is no evidence indicating the attorney knew what purpose their opinion or advice was intended to serve. [See *Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 408, 11 CR2d 51, 74]

[9:232 - 9:234] ***Reserved.***

(c) [9:235] **Justifiable reliance:** The gravamen of a cause of action for negligent misrepresentation is *actual, justifiable reliance* on the information supplied by the attorney. Without such reliance, there can be *no recovery* for negligent misrepresentation. [See *Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 413, 11 CR2d 51, 78; *Mariani v. Price Waterhouse* (1999) 70 CA4th 685, 694, 82 CR2d 671, 676, fn. 2—"in a negligent misrepresentation action, justifiable reliance on the false statement is indispensable"]

1) [9:235.1] **Plaintiff's knowledge; burden of proof:** Reasonable reliance is judged in light of the plaintiff's intelligence and experience. If the plaintiff knows facts demonstrating that a representation is "patently and obviously false," reliance is "manifestly unreasonable" and the misrepresentation was not the cause of the plaintiff's injury. [*GemCap Lending, LLC v. Quarles & Brady, LLP* (CD CA 2017) 269 F.Supp.3d 1007, 1038-1039 (internal quotes omitted)—attorneys did not breach duty to lender in opinion letters by misrepresenting or concealing pending or threatened litigation against borrower because lender received reports and warning that such litigation was ongoing (¶ 9:246)]

It is the plaintiff's burden to prove justifiable reliance. [*GemCap Lending, LLC v. Quarles & Brady, LLP*, supra, 269 F.Supp.3d at 1039]

2) [9:236] **Effect where opinion recipient represented by counsel:** It is not enough for third parties to establish their reliance on the attorney's legal opinion. The reliance must have been *justifiable* under the circumstances. This can be a particularly difficult hurdle where third parties are represented by their own counsel in the transaction (especially if that counsel has offered their own legal opinion on the subject). [*B.L.M. v. Sabo & Deitsch* (1997) 55 CA4th 823, 836-837, 64 CR2d 335, 343—reliance on defendant attorney's opinion not justified where third party had been given contrary legal opinion from own counsel]

3) [9:237] **Effect of adversarial position:** Moreover, reliance can rarely be justified where the third party is in an adverse or antagonistic position to the attorney's client. "This would in fact amount to creating a duty of professional

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care on the part of the attorney toward a person with whom the attorney *would be prohibited from maintaining a professional relationship* … We conclude that it would be inappropriate to hold an attorney liable to a third party for a legal opinion which the third party could not, under the Rules of Professional Conduct, have contracted to obtain from that attorney." [*B.L.M. v. Sabo & Deitsch* (1997) 55 CA4th 823, 838-839, 64 CR2d 335, 344-345 (emphasis added)]

[9:238 - 9:239] ***Reserved.***

(2) Application

(a) Negligent misrepresentation liability upheld

• [9:240] Lender loaned money to a partnership. When the loan was not repaid, Lender sued partnership's lawyers, alleging they had negligently prepared and delivered to their client for transmission to Lender an opinion letter expressing the erroneous view that the partnership was a general partnership composed of 14 general partners. The lawyers did not disclose, however, that a large number of the partners believed they were limited partners.

Lender's complaint, alleging that the lawyers "knew and understood that [the opinion letter] was to be shown to [Lender] in order to induce [it] to make loans to [the partnership]" stated a viable negligent misrepresentation cause of action against the lawyers. [*Roberts v. Ball, Hunt, Hart, Brown & Baerwitz* (1976) 57 CA3d 104, 107-108, 128 CR 901, 903-904—"legal opinion intended to secure benefit for the client … must be issued with due care"]

• [9:241] Similarly, Attorney who prepared a franchise prospectus that failed to disclose material information was held liable to prospective franchisees because Attorney "knew that the prospectus would be shown to prospective franchisees and that the information contained in it would be used to induce these persons to purchase … franchises." [*Courtney v. Waring* (1987) 191 CA3d 1434, 1443-1444, 237 CR 233, 239]

• [9:242] Borrower sued Mortgage Broker and Mortgage Broker cross-complained against Borrower's Attorney, alleging negligent misrepresentation and seeking indemnification. Attorney was held to owe a duty to Mortgage Broker because Attorney knew Broker would rely upon Attorney's representation that Borrower understood the transaction. [*Home Budget Loans, Inc. v. Jacoby & Meyers Law Offices* (1989) 207 CA3d 1277, 1284-1285, 255 CR 483, 486-487]

[9:243 - 9:244] ***Reserved.***

(b) No negligent misrepresentation liability

• [9:245] Attorney erroneously informed corporate officer clients they could sell stock without jeopardizing the corporation's exemption from securities laws. Plaintiffs purchased the stock and were damaged when the exemption was suspended, resulting in a loss in the stock's value. Plaintiffs could *not* state a negligent misrepresentation cause of action against Attorney because there was no allegation Attorney's opinion was given with the intention that it be communicated to plaintiffs (i.e., no intent to influence). [*Goodman v. Kennedy* (1976) 18 C3d 335, 343-344, 134 CR 375, 381, fn. 4; see *Koehler v. Pulvers* (SD CA 1985) 606 F.Supp. 164, 172 (construing Calif. law)—no intent to influence nonclient plaintiffs where advice affecting trust deed transactions not communicated to investors]

• [9:246] Attorneys were not liable for failing to disclose in opinion letters to lender that borrower was subject to multiple pending lawsuits (in which the attorneys allegedly represented the borrower). Attorneys' opinion letters only required attorneys to disclose lawsuits affecting the "validity or enforceability" of the lender's loan to the borrower. The pending lawsuits did not have any effect on the loan's validity or the lender's ability to enforce it, despite potentially subjecting the borrower to significant monetary damages that might adversely impair the loan's collateral. [*GemCap Lending, LLC v. Quarles & Brady, LLP* (CD CA 2017) 269 F.Supp.3d 1007, 1016, 1037 (¶ 9:235.1)]

[9:247 - 9:249] ***Reserved.***

(3) [9:250] **Effect of bar against professional negligence liability to nonclients?** At least one case suggests that recognizing a *nonclient's* negligent misrepresentation cause of action based solely on an attorney's *legal opinion* violates the bar against *professional negligence* liability to third party nonclients (¶ *9:218*):

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"Extending liability for legal opinions under [a negligent misrepresentation] theory seems to us to undercut the holding of *Bily* [*v. Arthur Young & Co.* (1992) 3 C4th 370, 11 CR2d 51] that liability for legal malpractice extends only to clients and to those identified as third party beneficiaries of the professional employment agreement. [¶] To hold that reliance by a nonclient on an attorney's professional opinion, in combination with an inference that the attorney intended such reliance, is sufficient to hold the attorney liable for unknown errors in that opinion, seems to extend professional liability beyond what was approved in *Bily*." [See *B.L.M. v. Sabo & Deitsch* (1997) 55 CA4th 823, 839, 64 CR2d 335, 345, fn. 8 (dictum)]

The *B.L.M.* court found apparent support in existing case law: "A review of cases suggests that courts already make this distinction and have limited recovery by a third party against an attorney under a negligent misrepresentation theory to those cases involving misrepresentations of fact rather than legal opinions." [*B.L.M. v. Sabo & Deitsch*, supra, 55 CA4th at 839, 64 CR2d at 345 (emphasis added)]

(a) [9:251] **Comment:** *B.L.M.'s* observations seem contrary to the Cal. Supreme Court's conclusion that where attorneys give their clients a *written opinion* intending that it be transmitted to and relied upon by a third party, the attorneys owe the third party a *duty of care in providing the advice* and, under such circumstances, may be held liable for negligent misrepresentation. [See *Bily v. Arthur Young & Co.* (1992) 3 C4th 370, 411, 11 CR2d 51, 76 (approving *Roberts v. Ball, Hunt, Hart, Brown & Baerwitz* (1976) 57 CA3d 104, 107-108, 128 CR 901, 903-904, *discussed at ¶ 9:240*)]

Also, the *B.L.M.* criticism seems to ignore the principle, which the court itself stated elsewhere in its decision, that expressions of opinion by persons with special knowledge of the subject may be *treated as representations of fact* (¶ *9:7, 9:97.1, 9:225*).

[9:252 - 9:259] ***Reserved.***

c. [9:260] **Fraud liability:** The general rule that an attorney's professional duty of care extends only to clients and intended beneficiaries of the legal work performed limits an attorney's liability for *negligence* (*¶ 9:218 ff.*); it does not relieve an attorney from *fraud* (*intentional* misrepresentation) liability to nonclient third parties when the elements of that tort are otherwise established. "Responsibility for a fraudulent act is independent of any contractual relation between the guilty party and the one injured." [*Shafer v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2003) 107 CA4th 54, 69-72, 131 CR2d 777, 789-791 (internal quotes omitted); see also *Vega v. Jones, Day, Reavis & Pogue* (2004) 121 CA4th 282, 291, 17 CR3d 26, 31-32]

(1) [9:261] **Elements of third party fraud claim:** The normal elements of the tort of fraud apply:

- defendant's misrepresentation of material fact;
- defendant's knowledge of the falsity (i.e., "scienter," which distinguishes the tort of fraud from the tort of negligent misrepresentation);
- defendant's intent to defraud (to induce reliance);
- plaintiff's justifiable reliance; and
- resulting damage (*see ¶ 11:354 ff.*). [*Shafer v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2003) 107 CA4th 54, 74, 131 CR2d 777, 792; *Vega v. Jones, Day, Reavis & Pogue* (2004) 121 CA4th 282, 291, 17 CR3d 26, 32]

(2) [9:262] **Misrepresentation of fact vs. nonactionable opinion:** A knowing misrepresentation of *fact*, as opposed to an opinion reflecting the speaker's state of mind, is required for a viable fraud cause of action. Whether a particular statement should be characterized as an actionable misrepresentation of fact or a nonactionable opinion depends on "whether it is reasonably apparent that the person to whom the statement is addressed would regard [it] as one of fact[,] or based on the speaker's knowledge of facts reasonably implied by the statement[,] or as merely an expression of the speaker's state of mind." [*Shafer v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2003) 107 CA4th 54, 75, 131 CR2d 777, 793 (emphasis omitted)]

(a) [9:263] **Relevant factors:** Courts consider the following factors in determining whether a particular statement made by a lawyer during negotiations is an actionable misrepresentation of fact or a nonactionable opinion:

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- The negotiating parties' past relationship and apparent sophistication;
- The plausibility of the statement on its face;
- The phrasing of the statement;
- Related communications between the persons involved;
- The known negotiating practices of the community where the negotiations occurred; and
- Other "similar circumstances." [See Rest.3d Law Governing Lawyers § 98, Comm. "c"; *Shafer v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2003) 107 CA4th 54, 75, 131 CR2d 777, 793]

(3) [9:264] **Affirmation of client's misrepresentations:** Actionable misrepresentations by an attorney can occur through the attorney's direct statements *or* the attorney's *knowing affirmation* of their client's false statements. [Rest.3d Law Governing Lawyers § 98, Comm. "c"; *Shafer v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2003) 107 CA4th 54, 69, 131 CR2d 777, 789]

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Cal. Prac. Guide Real Prop. Trans. Form 9:A

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Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 9. Opinion Letters

Forms

[Form 9:A] Sample Opinion Letter (By Borrower's Counsel)

_____*(Date)*_____
___________ Bank
____
___________, California ___
Attention: ___________
RE: Loan in the amount of $________ (the “Loan”), by _____ (the “Bank”) to ___________ (the “Borrower”)
Ladies and Gentlemen:

We have acted as _ *[state scope of representation; e.g., special, local, etc.]* counsel for the Borrower in connection with the above-referenced Loan and have examined the documents prepared by you or on your behalf and listed on Exhibit A attached hereto in connection with the Loan. (The documents listed on Exhibit A are collectively referred to herein as the “Loan Documents.”) We have also examined such _ *[state kind of entity: corporate, partnership, etc.]* records, documents and instruments of the Borrower and certificates of public officials as we have deemed necessary for the purpose of rendering the opinions set forth herein.

The opinions hereinafter expressed are subject to the following qualifications:

(i) You have informed us that Bank is an “exempt” lender as that term is defined and used in Article XV of the California Constitution and § 1916-1 et seq. of the California Civil Code, and therefore is not bound by the usury restrictions set forth therein, that the Loan Documents to be signed by the Bank have been duly-executed on behalf of the Bank, and that we may rely on such information without any independent investigation of same;

(ii) The effect of bankruptcy, insolvency, reorganization, moratorium or other similar laws now or hereafter in effect, affecting generally the enforcement of creditors' rights;

(iii) The opinions rendered in this letter are subject to the general principles of equity, whether applied by a court at law or in equity, and the use of the term “enforceable” in this opinion shall not imply any opinion as to the availability of equitable remedies.

(iv) We do not express any opinion as to the enforceability of any particular provision or provisions in any of the Loan Documents; nevertheless, subject to the limitations set forth herein and provided the Bank proceeds in accordance with California law _ ***[set forth your generic enforceability opinion at this point; either (a), (b) or (c), below]*:**

(a) Certain remedies, waivers and other provisions of the Loan Documents may not be enforceable, but such unenforceability will not render the Loan Documents invalid as a whole or preclude (i) judicial enforcement of the Borrower's obligation to repay the principal, together with interest thereon, as provided in the Note (to the extent not deemed a penalty), and (ii) foreclosure of the mortgage (or deed of trust) **[*and/or any security agreement*].**

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[*OR*]

(b) Certain rights, remedies and waivers contained in the Loan Documents may be limited or rendered ineffective or unenforceable by applicable laws and judicial decisions governing such provisions, but such laws and judicial decisions do not make the Loan Documents legally inadequate for (or substantially ***[or materially]*** interfere with) the practical realization of the principal benefits and/or security intended to be provided by the Loan Documents.

[*OR*]

(c) Certain remedies, waivers and other provisions of the Loan Documents may not be enforceable; nevertheless, subject to the limitations expressed elsewhere in this opinion or incorporated by reference into this opinion, upon a material default by the Borrower in the payment of principal or interest thereon as provided in the Note or upon a material default by the Borrower in the performance of any other material covenant of the Loan Documents, such unenforceability will not preclude (i) acceleration of the Borrower's obligation to repay such principal and interest, (ii) enforcement in accordance with applicable law of the assignment of rents set forth in the Loan Documents, (iii) foreclosure in accordance with applicable law of the security interest in the collateral created by the Loan Documents, and (iv) judicial enforcement in accordance with applicable law of the Borrower's obligation to repay such principal or such interest as provided in the Note. **[*Ed. Note:* This language in (c) is suggested by the 1995 Real Property Report, as modified by the 1998 Supplement (¶ 9:18).]**

Without limiting any aspect of the foregoing limitation, we caution that a California court may not enforce certain covenants in the Loan Documents or allow acceleration of the maturity of the indebtedness evidenced by the Promissory Note if the court concludes it would be unreasonable under the then-existing circumstances.

(v) We have not made or undertaken to make any investigation of the state of title to the subject property, either real or personal, described in the Loan Documents and we express no opinion with respect to the title thereto or the priority of any liens thereon or security interests therein.

(vi) We have assumed that the Loan Documents will be recorded and/or filed as contemplated and that the closing of the Loan will otherwise occur as contemplated by the Loan Documents and the various agreements executed by the parties in connection therewith.

(vii) We express no opinion as to the validity or enforceability of any provisions of the Loan Documents that:

(a) require a borrower to provide hazard insurance coverage against risks in an amount exceeding the replacement value of any improvements to real property;

(b) impose requirements respecting impound accounts in conflict with applicable law;

(c) provide for the application of insurance or condemnation proceeds to reduce indebtedness;

(d) purport to assign rents, issues and profits absolutely and not as security;

(e) contain a waiver of any party's statutory right to reinstate a secured obligation by paying the delinquent amounts of the fully accelerated debt at any time prior to the time provided by statute;

(f) are in conflict with any laws governing foreclosure and disposition procedures regarding any collateral or in conflict with any limitations on attorneys' or trustees' fees;

(g) indemnify any party against its own negligence or willful misconduct;

(h) are in conflict with the real property antideficiency, fair value, and one form of action provisions of California law; **[*Ed. Note:* The 1995 Real Property Report (¶ 9:18) suggests that it may be useful to provide a general description of California's**

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“one action rule” and antideficiency laws, especially when the opinion recipient is from out of state. If so, additional paragraphs should be added discussing CCP §§ 580b, 580d, 726, 726.5, 736 and Civ.C. § 2924c.

(i) provide for the acceleration of any indebtedness upon any transfer or further encumbrance of any of the collateral for any loan, or upon a change of ownership of any entity which directly or indirectly owns any interest in any such collateral, except to the extent that (i) such provisions are made enforceable pursuant to the federal preemption afforded by the Garn-St. Germain Depository Institutions Act of 1982, as set forth at 12 USC § 1701j-3 and the regulations adopted pursuant thereto or (ii) enforcement is reasonably necessary to protect against impairment of lender's security or an increase in the risk of default;

(j) select any jurisdiction's laws to govern any of the Loan Documents;

(k) provide for penalties, liquidated damages, acceleration of future amounts due (other than principal) without appropriate discount to present value, late charges, prepayment charges, and increased interest rates upon default;

(*l*) provide that time is of the essence;

(m) provide for the confession of judgment;

(n) contain a waiver of (i) broadly or vaguely stated rights, (ii) the benefits of statutory, regulatory or constitutional rights, unless and to the extent the statute, regulation or constitution explicitly allows waiver, (iii) unknown future defenses, and (iv) rights to damages;

(o) attempt to change or waive rules of evidence or fix the method or quantum of proof to be applied in litigation or similar proceedings;

(p) select the forum for the resolution of any disputes or provide for a consent to the jurisdiction of any jurisdiction (both as to personal jurisdiction and subject matter jurisdiction);

(q) appoint one party as an attorney-in-fact for an adverse party.

Based upon and subject to the foregoing, WE ARE OF THE OPINION THAT:

(1) Borrower is a _ *[corporation, partnership, etc.]* duly formed and validly existing under the laws of the State of California, _ *[in good standing]* with authority to conduct its business in the State of California.

(2) Borrower has full power, authority and legal right to execute and deliver and to perform its obligations under the Loan Documents.

(3) The Loan Documents have each been duly authorized, executed and delivered by the Borrower.

(4) Subject to the limitations and qualifications set forth elsewhere in this letter, the Loan Documents constitute legal, valid and binding obligations of the Borrower, enforceable in accordance with their respective terms, and no registration with, or consent or approval of, or notice to, or other action by any person or entity with respect to the execution, delivery or enforceability of the Loan Documents is required ***[or, if required, such registration has been made, such consent or approval given, such notice given, or such other appropriate action taken].***

This opinion is rendered solely to the Bank in connection with this Loan, and may not be relied upon for any other purpose or furnished to, used, circulated, quoted or referred to by any other party. This opinion applies only insofar as the existing laws of the State of California may be concerned, and we express no opinion with respect to the laws of any other jurisdiction. We shall have no obligation to advise you of any facts, circumstances and/or changes in the law which would in any way subsequently render any portion of this opinion incorrect, or to otherwise update this opinion in any way. No opinions shall be implied or

inferred from this letter and the only opinions rendered by us are those expressly stated herein. This opinion shall be effective upon the closing of the Loan.

Very truly yours,
[LAW FIRM]

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Cal. Prac. Guide Real Prop. Trans. Ch. 10-A

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 10. Management of Real Property

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1. [10:1] **Necessity for Experienced Property Manager:** Property management skills are highly specialized and unique. Consequently, many (if not most) larger income-producing real property developments—residential, office, retail and industrial—are managed and operated by a professional property manager who holds no equity interest in the property.

Quality property management can often make the difference between an economically successful project and an unsuccessful one. But the advantages to be realized by competent property management are not limited to large-scale projects. Every real property development must be well managed.

This Chapter principally focuses on the use of an independent property manager. However, most of the issues discussed are important for the effective and profitable self-ownership and operation of income-producing properties.

a. [10:2] **Relevant factors:** Generally, the decision to utilize an outside property manager should turn on consideration of the following factors:

• The time and energy savings for the owner;

• The owner's lack of management expertise;

• The owner's absenteeism from the project; and

• The staffing, services, technology and materials resources a professional manager can bring to the project.

2. [10:3] **Purchaser's Considerations re Existing Management Agreements:** If recorded, an existing property management agreement may operate as an encumbrance upon the property and thus be construed as a "covenant running with the land"; in such event, a purchaser would be subject to the seller's ongoing obligations under the agreement (*see* ¶ *4:63 ff.*). Prospective purchasers should keep this point in mind; notably, counsel representing the buyer must carefully *review the preliminary title report* to ascertain whether a property management agreement has been recorded (*see* ¶ *4:334 ff., 4:404 ff.*).

3. [10:4] **Specific Property Management Issues—Checklist:** Many buyers do not think about management issues until after the closing. This is unfortunate because some management or operational plan should be in place well before ownership changes hands in order to accurately evaluate the economics of the project. In fact, a good property manager can be helpful in reviewing various aspects of a project during the buyer's due diligence period (e.g., reviewing leases; determining insurance requirements; analyzing income and expenses, etc.).

The sections set forth at ¶ 10:5 ff. provide a checklist of the more significant management issues and manager functions, which are equally applicable to self-managed and independently-managed properties.

a. Property maintenance

• [10:5] **Itemizations:** Prepare list of various components requiring maintenance, the type of maintenance, and the frequency with which each procedure is to be conducted.
• [10:6] **Inspections:** Conduct inspections and prepare and maintain ongoing inspection reports.
• [10:7] **Preventive maintenance programs:** Propose and implement preventive maintenance programs.
• [10:8] **Repairs:** Make repairs required by law (or otherwise).

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• [10:9] **Emergency services:** Have 24-hour capacity for emergency repairs.

• [10:10] **Service contracts and claims:** Select maintenance contractors; negotiate maintenance contracts; supervise maintenance work; and process claims under maintenance or construction warranties.

• [10:11] **On-site management:** Maintain on-site maintenance staff (if necessary).

b. Accounting for rents, other revenues and expenses

(1) [10:12] **Calculating and collecting rents, operational expense and other charges due:** Tenants in office, retail and other commercial projects are often required to pay more than a simple "base" (fixed monthly) rent. Their leases typically also require the payment of a specified share of project operating costs (utilities, common area maintenance, janitorial services, taxes, insurance, etc.), as well as parking and other miscellaneous charges.

The property manager should calculate all such operating expenses and other charges and properly allocate them among the various tenants in accordance with the terms of their respective leases. This task will also entail giving the tenants timely notice of the amounts due and collecting those sums.

(2) [10:13] **Accounting for security deposits:** The property manager must account for all tenant security deposits, credit appropriate security deposit deductions (e.g., for cleaning/repairs, rent defaults, etc.), and return security deposits as required by law. (This obligation includes giving statutorily-required notice to departing tenants. See Civ.C. §§ 1950.5(g) & 1950.7(d); *and ¶ 4:421*.)

(3) [10:14] **Monitoring periodic rent increases:** Leases often provide for fixed periodic increases in base rent, or periodic adjustments commensurate with changes in the Consumer Price Index. The property manager should monitor all leases, calculate the increases and timely notify tenants of rent adjustments.

(4) [10:15] **Monitoring rent and other lease defaults; initiating appropriate eviction steps:** The property manager should monitor tenant compliance with lease obligations and notify the owner upon the occurrence of rent or other lease defaults. Frequently, the manager and owner will agree upon a general timetable and procedure for commencement of eviction proceedings by the manager (service of notice of termination and commencement of ensuing unlawful detainer action) against defaulting tenants, perhaps in coordination with the owner's legal counsel.

(5) [10:16] **Preparing income, expense and other reports for owner, owner's accountant, prospective lenders and prospective buyers:** Periodic income statements (usually accompanied by expense statements and other operational reports) will be required by the owner on an ongoing basis and may also be required by various third parties—e.g., lenders, accountants, prospective buyers and prospective lenders. The property manager may be required to compile these reports in varying formats for delivery to such parties.

(6) [10:17] **Creating capital reserves:** It is often prudent to have the property manager set up a fund (or reserve) for payment of future major capital improvements or repair work.

c. Marketing/leasing plans and tenant management

(1) [10:18] **Comparability studies:** Prepare market analyses of comparable properties.

(2) [10:19] **Marketing and leasing proposals:** Make recommendations concerning leasing, marketing and/or development of the property. This might include suggestions for rental rates, "tenant mix" (in shopping center/retail projects) and related market planning.

(3) [10:20] **Advertising:** Create and conduct advertising programs for leasing of space.

(4) [10:21] **Leasing, lease management and terminations:** Screening prospective tenants; negotiating and preparing leases; monitoring lease defaults; and taking appropriate steps to terminate (and evict) for a tenant's breach of lease.

(5) [10:22] **Preparing rental units for new occupants:** Ordinarily, several steps must be taken to prepare vacated rental units for reletting—including cleaning and repairs. This is particularly important in residential projects (vacated apartments must be cleaned, painted and refurbished before a new tenant moves in).

(6) [10:23] **Supervising tenant improvement construction:** Commercial leases usually contemplate considerable tenant improvement work to conform to the tenant's particular usage, space and layout needs (construction of walls and partitions, electrical, utility and phone access placements, etc.). The lease will address how the improvement costs are to be allocated. (The landlord may agree to a "tenant improvement allowance" or otherwise to absorb the expense; or might allocate all or part of the cost to the tenant.)

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Regardless of how the expense is apportioned, the landlord is concerned that the tenant improvement work be completed as specified and in accordance with agreed-upon deadlines. (Delay may postpone inception of the tenant's rent obligations and excessive delay might even give the tenant a basis for terminating its lease.) The property manager may be required to supervise (or hire a construction supervisor) to oversee or monitor timely and proper improvement construction.

(7) [10:24] **Obtaining tenant estoppel certificates:** Tenant "estoppel certificates" are often required by prospective buyers or lenders (*see* ¶ *4:418 ff., 6:120, 6:143, 7:292 ff.; and Form 4:J*). The property manager usually is best equipped to expeditiously obtain these documents.

(8) [10:25] **Acting as tenant liaison:** A property manager performs an invaluable function by serving as liaison between tenants and project owner (which may also include interfacing with tenant or merchant associations). In particular, the manager should be prepared to address periodic tenant complaints and settle tenant disputes.

(9) [10:26] **Overseeing tenant "goodwill" activities:** Shopping centers and other large commercial developments frequently plan community and cultural events which promote goodwill and advertising for the project. A property manager should assist in organizing these programs.

d. Preparation of budgets and payment of expenses

(1) [10:27] **Preparing project operational budget:** A complete and realistic operational budget is key to a successful project. This is perhaps one of the property manager's most important functions.

(2) [10:28] **Reconciling and paying operating expenses:** A property manager is also indispensable to the tedious process of overseeing, reconciling and paying project operating expenses—including:

• Utility, water and sewer service bills.

• Landscaping, groundskeeping, rubbish removal and other maintenance, service and supply bills.

• Project personnel salaries.

• Mortgage and other loan payments.

• Property taxes and assessments.

• Insurance premiums (*see* ¶ *10:133*).

• Advertising and promotional costs.

• Legal, accounting, administrative and management fees.

e. [10:29] **Overseeing insurance coverage and claims:** The property manager can perform several insurance-related activities for the project:

• Analyzing various insurance packages and recommending appropriate coverage and carriers.

• Procuring appropriate policies and keeping them current.

• Acting as liaison with the carrier on insurance claims.

f. [10:30] **Brokerage services:** Many property managers are licensed under the California Real Estate Licensing Law to act as leasing and/or sales agent and can offer a project owner important brokerage services on an ongoing basis. If the owner wants to contract for a property manager's brokerage services, the applicable terms and conditions should be set forth in the management agreement or in a separate listing agreement. (*See generally, Ch. 2; and* ¶ *10:113 ff.*)

(In larger residential projects, the property manager frequently acts as the exclusive leasing agent.)

g. [10:31] **Other issues:** A variety of other services and functions can be performed by an experienced property manager. For example, many property managers are skilled at conducting modernization programs for the project and cost-benefit

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analyses in contemplation of possible project modifications; and otherwise are able to take a so-called “proactive” (instead of a “reactive”) approach to property management, ownership and operational issues.

[10:32 - 10:34] ***Reserved.***

4. [10:35] **Selecting a Property Manager:** General considerations bearing on the selection of any professional apply as well to the process of choosing an appropriate real property manager: The owner should focus fundamentally upon *reputation*, *experience*, *responsiveness*, *staffing* and *fee structure*.

More particularly, however, the owner should evaluate the following characteristics peculiar to a good property manager:

a. [10:36] **Cost effectiveness:** The decision to hire a particular property manager should of course make good *economic sense*. Therefore, the owner should consider whether the proposed services *justify the cost;* i.e., an overall *cost-benefit* approach to the decision is recommended.

b. [10:37] **Trustworthiness:** A property manager will be collecting substantial sums of money on behalf of the owner, accounting for and keeping operational income and expense records, and paying insurance and operational expenses. Thus, it is crucial that the manager chosen be *trustworthy*.

c. [10:38] **Interrelational skills:** The property manager represents the owner in dealings with third parties. Thus, a good property manager must be skilled in dealing with others—including, in particular, the tenants.

d. [10:39] **Experience:** The manager selected should have experience with the owner's particular type of project. For example, a manager whose experience has been limited to residential projects is probably not well-suited to oversee a shopping center or office building.

Bear in mind that retail and other commercial projects require computation and allocation of various kinds of rent and operational charges among the tenants, and also require expertise in supervising tenant improvement work. These features are not common to residential apartment projects.

e. [10:40] **On-site vs. off-site management:** Certain kinds of projects require *full-time on-site* management; e.g., large apartment projects usually require a resident manager.

Conversely, some projects can be competently managed entirely off-site, or may only require the presence of on-site maintenance personnel during business hours (e.g., a smaller office building or retail project).

f. [10:41] **Size of management organization:** The support staff backing up the property manager may be an important concern.

(1) [10:42] **Advantages of large-firm organizations:** A larger management organization naturally has a larger staff to attend to the owner's immediate needs. Moreover, the larger the staff, the greater the likelihood of a broader range of skills that can be brought to the project.

Large-firm management organizations also offer these features not likely to be matched by small-firm counterparts:

(a) [10:43] **Technological support:** Larger organizations usually have better infrastructures and more sophisticated technology at their disposal (e.g., state-of-the-art computer equipment). The analysis and administration of leases (calculation of common area maintenance costs, etc.) may require a larger organization with greater technical capabilities.

Similarly, full-service technical support facilitates the ability to generate complete reports for accountants, lenders and prospective buyers (although the owner will have to assess whether such sophisticated services makes sense from a cost-benefit perspective).

(b) [10:44] **Supplier and resource discounts:** Larger management organizations tend to regularly and extensively deal with the same suppliers and contractors; in turn, they are often in a position to obtain better, faster service at a quantity-volume (discount) price.

(c) [10:45] **Brokerage services:** Larger management organizations can often provide a broader range of real estate brokerage services for leasing and sale.

[10:46] Simply put, the more complex the project, the more complicated are the management issues and legal relationships (with tenants and other third parties), and the more likely the project will require a highly specialized, *full-service* management team.

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(2) [10:47] **Disadvantages of large-firm organizations:** Of course, hiring a large-firm property manager poses the same disadvantages encountered in dealing with any large organization. Unless the owner is one of the firm's biggest accounts, it can get "lost in the shuffle."

More importantly, however, many projects simply do not require the full range of services offered by a large management firm; therefore, the owner might end up "overpaying" for services rendered. For example, small (or medium) office and residential projects are not necessarily management-intensive, and use of a larger management company may not make good economic sense.

(a) [10:48] **Resident manager alternative:** Depending on the extent of management responsibility the owner is willing to undertake, many residential projects can be managed quite effectively simply by providing a tenant with free (or reduced) rent in return for certain management services (such as coordinating maintenance and repair and handling tenant complaints). If additional services are needed (such as the collection of rents, payment of expenses, screening of tenants, arranging for landscaping and cleaning of the project), an additional fee might be added to the free rent given to a resident custodian-manager.

➪ [10:49] ***PRACTICE POINTER—TAX CONCERNS RE RESIDENT MANAGERS*:** Owners utilizing a resident manager should consult with their accountants to make certain the resident manager will not be deemed an "employee" for income tax purposes. Hiring a resident manager as an employee (as opposed to an independent contractor) may require the owner to withhold income tax and social security tax, as well as pay unemployment insurance and carry workers' compensation insurance. (These concerns also apply to the staff of an outside management company; *see ¶ 10:71*.)

5. [10:50] **Institute of Real Estate Management (IREM):** The Institute of Real Estate Management (IREM) is the leading property management organization in the United States. IREM is an affiliate of the National Association of Realtors and maintains close ties with local realty associations.

IREM has various designations which acknowledge experience and professional achievement:

a. [10:51] **"Certified Property Manager" (CPM):** The most notable designation is that of "certified property manager" (CPM). To receive a CPM designation, a manager must satisfy several requirements—including the completion of various property management courses; working as a property manager for a prescribed number of years; maintaining a minimum size portfolio; and adhering to a Code of Professional Ethics.

b. [10:52] **"Accredited Management Organization" (AMO):** An AMO designation accredits management firms (as opposed to individuals) and, among other things, requires that at least one executive of the firm be a CPM (¶ 10:51).

c. [10:53] **"Accredited Residential Manager" (ARM):** An ARM designation by IREM recognizes expertise and achievement in residential property management.

[10:54] ***Reserved.***

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California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 10. Management of Real Property

B. Regulation of Real Property Managers and Legal Relationship Between Manager and Owner

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d. [10:81] General management issues

1. [10:55] **Licensing Requirements:** California has no special regulatory scheme for the regulation or licensing of property managers per se. Rather, whether property management activities require a license is determined by the Real Estate Licensing Law and regulations promulgated thereunder (Bus. & Prof.C. § 10130 et seq.; *see Ch. 2*).

a. [10:56] **Management activities requiring real estate license:** Bus. & Prof.C. § 10130 sets forth certain acts that may be performed *only by real estate licensees*. A property manager who *solicits tenants*, *negotiates leases* or *collects rents* is performing brokerage activities for which a real estate license is required. [Bus. & Prof.C. § 10131; *see* ¶ *2:24*]

On the other hand, property managers do not need to hold a real estate brokerage license if they do not engage in either leasing activities or the collection of rents. However, other than managers for community associations, it is difficult to imagine any owner hiring a property manager who, minimally, will not be responsible for collecting rents. (*See* ¶ *10:75* regarding issues unique to community association management.)

b. [10:57] **Exceptions to licensing requirements:** Certain exemptions from the real estate licensing requirements (¶ *2:86 ff.*) are germane to real property managers:

(1) [10:58] **Resident managers:** The licensing requirements do not apply to "the manager of a hotel, motel, auto and trailer park, to the resident manager of an apartment building, apartment complex, or court, or to the employees of that manager …" [Bus. & Prof.C. § 10131.01(a); ¶ *2:97*]

Also exempt from the real estate licensing law are certain activities of employees of a licensed property manager in connection with residential apartment projects. [Bus. & Prof.C. § 10131.01(a)] Those activities include:

• showing rental units and common areas to prospective tenants;

• providing or accepting preprinted rental applications, or responding to inquiries from prospective tenants concerning completion of rental applications;

• accepting deposits or fees for credit checks or administrative costs and accepting security deposits and rents;

• providing information about rental rates and other terms and provisions of a lease or rental agreement as set out in a schedule provided by an employer; or

• accepting signed leases and rental agreements from prospective tenants. [See Bus. & Prof.C. § 10131.01(a)(3)(A)-(E); ¶ *2:97.3*]

(These particular exemptions are directed at lower-level employees who engage in activities marginally related to leasing activities. Nonetheless, a licensed broker or salesperson is required to exercise "reasonable supervision and control" over persons performing these exempt activities. See Bus. & Prof.C. § 10131.01(b).)

(2) [10:59] **Other exemptions:** There are various other statutory exemptions from the real estate broker licensing requirements, although these will rarely apply to property management (*see* ¶ *2:86 ff.*).

For example, attorneys at law rendering legal services to a client (Bus. & Prof.C. § 10133(a)(3), ¶ *2:91*); a receiver, trustee in bankruptcy or other person acting under order of a court of competent jurisdiction (Bus. & Prof.C. § 10133(a)(4), ¶ *2:92*); a regular officer of a corporation or a general partner of a partnership in connection with real property owned or leased by the corporation or partnership if the acts are not performed in expectation of special compensation (Bus. & Prof.C. § 10133(a)(1), ¶ *2:88*); a person holding a duly executed power of attorney (Bus. & Prof.C. § 10133(a)(2), ¶ *2:89*); and clerical exemptions for bookkeepers, receptionists and other clerical help (Bus. & Prof.C. § 10133.2, ¶ *2:96*).

2. Regulatory Requirements

a. [10:60] **Real estate licensing regulations:** Because real estate broker licensing requirements will almost always apply to a property manager (¶ 10:55 ff.), the entire panoply of regulatory requirements applicable to real estate brokers applies as well to brokers acting as property managers (*see Ch. 2*). (*But see* ¶ *10:75 ff.* regarding community association management.)

b. [10:61] **Identification of managers and owners for service of process, etc.—residential structures:** Additionally, the owner of a dwelling structure containing one or more units offered for rent or lease as a residence, or a party signing a rental

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agreement or lease on such owner's behalf, must disclose in the lease or rental agreement the *name* and "*usual street address*" at which personal service may be effected on each person who is (1) *authorized to manage the premises*, and (2) an owner of the premises (or person authorized to act on the owner's behalf for purposes of service of process and receiving and receipting all notices and demands). [Civ.C. §§ 1961, 1962(a)(1) & (2)]

If the rental agreement is oral, the above information must be furnished in writing to all tenants who make a written request for same. [Civ.C. § 1962(b)]

(1) [10:62] **Alternative disclosure methods:** Alternatively, the identifying information described at ¶ 10:61 may be disclosed by (a) posting notice of the information in every elevator in the dwelling structure and "in one other conspicuous place"; or (b) if the structure does not contain an elevator, by posting notice of the information "in at least two conspicuous places"; or (c) in the case of a single unit structure, by either of the former two methods of posting notice. [Civ.C. § 1962.5(a)(1), (2) & (3)]

(2) [10:63] **Duty to update:** The required information must be kept current. Successor owners or managers must comply within 15 days of succeeding to the previous owner or manager. [Civ.C. § 1962(c)]

(3) Effect of noncompliance

(a) [10:64] **Manager deemed owner's agent:** A party who enters into a rental agreement on the owner's behalf and who *fails* to comply with the Civ.C. §§ 1962, 1962.5 disclosure requirements will be *deemed the agent of each owner* for purposes of (i) service of process and receiving and receipting notices and demands; and (ii) performing the owner's obligations "under law and under the rental agreement." [Civ.C. § 1962(d)(1) & (2)]

(b) [10:65] **Service of process at place where rent paid:** Further, if the owner fails to make the requisite disclosures, tenants may properly serve process, with respect to a dispute arising out of the tenancy, by registered or certified mail sent to the address where rent is paid (CCP § 1013 then applies). [Civ.C. § 1962.7]

Cross-refer: For further discussion of service of notices, demands and process on landlords, see Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 2.

3. Manager-Owner Legal Relationship

a. [10:66] **Agency and fiduciary duties:** To the extent the property manager is performing activities requiring a broker's license (¶ *10:56*), and unless the manager is exempt from the licensing requirements (¶ *10:57 ff.*), property managers are bound by the rules of agency and the fiduciary obligations of a broker to its principal (as well as by the corresponding standards of conduct for brokers).

The agency relationship between broker and principal is discussed in detail in *Ch. 2* (*see* ¶ *2:122 ff., 2:155 ff.*). However, there are two fundamental rules to keep in mind:

(1) [10:67] **Owner's liability for manager's acts:** First, the principal (owner) is almost always liable to third persons for the misfeasance of its agent (the property manager). [Civ.C. §§ 2330, 2338, 2339; see also ¶ 2:241 ff., 2:244 ff.; and ¶ 10:73 ff.]

(2) [10:68] **Manager's independent liability:** Second, the property manager is independently liable to third persons for its actions, even if taken on the principal's (owner's) behalf. [Civ.C. § 2343; see also Rest. Torts 2d § 387; *and* ¶ *2:225 ff.*]

[10:69] *Notwithstanding manager's "status":* The foregoing basic principles generally apply even if the property manager is deemed to be an "independent contractor" rather than the owner's "employee" (¶ *10:74*).

b. [10:70] **"Employee" vs. "independent contractor" status:** The owner should make clear that any property manager (or resident manager in a residential project) is not an "employee" of the owner but, rather, an "independent contractor." There are three primary reasons for this distinction:

(1) [10:71] **Minimizing employment taxes and related withholdings:** If the property manager is an employee, the owner will be responsible for withholding federal and state taxes, unemployment insurance, social security taxes, and the like.

(2) [10:72] **Substance over form:** Ordinarily, the substance of the owner's relationship with a property manager is truly that of hirer and independent contractor; the owner rarely supervises (or reserves the right to supervise) a property manager's day-to-day activities the way a true employer would. (Moreover, except for resident managers, most property managers

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generally work for several different clients. Conceptually, therefore, such managers cannot be considered true "employees" of any particular project owner.)

(3) [10:73] **Limiting owner's liability for manager's acts:** Hiring a property manager as an "independent contractor" rather than "employee" may, to a certain extent, also limit the owner's liability for the manager's acts.

As a general rule, one who hires an "independent contractor" is not liable for the acts of the independent contractor. This principle rests on "the want of control and authority of the employer over the work, and the consequent apparent harshness of a rule which would hold one responsible for the manner of conducting an enterprise over which he wants the authority to direct the operations." [*Van Arsdale v. Hollinger* (1968) 68 C2d 245, 250, 66 CR 20, 23 (overruled on other grounds by *Privette v. Sup.Ct. (Contreras)* (1993) 5 C4th 689, 701-702, 21 CR2d 72, 80, fn. 4); see also *Gonzalez v. Mathis* (2021) 12 C5th 29, 37, 57, 282 CR3d 658, 661, 229 (affirming California's "strong presumption" that hirer of independent contractor delegates to contractor "all responsibility for workplace safety")]

(a) [10:74] **Exceptions imposing derivative liability for independent contractor's acts:** Even so, the general rule of nonliability (¶ 10:73) is so riddled with exceptions (e.g., "nondelegable duty" exception, "peculiar risk" exception) that, as a practical matter, it may be next-to-impossible to completely insulate the owner from liability for its property manager's misfeasance notwithstanding the manager's "independent contractor" status. [See *Privette v. Sup.Ct. (Contreras)* (1993) 5 C4th 689, 693, 702, 21 CR2d 72, 74, 81 (concluding "peculiar risk" exception does *not* extend to contractor *employees* who sustain injuries performing inherently dangerous work because workplace injuries are covered by workers' compensation); *Gonzalez v. Mathis* (2021) 12 C5th 29, 41-47, 282 CR3d 658, 663-669 (providing overview of *Privette's* principles and those of its progeny)—landowner not liable for injuries to independent contractor *or its workers* stemming from *known* hazard on premises that neither contractor nor its workers could avoid through adoption of reasonably safety precautions; compare *Van Arsdale v. Hollinger* (1968) 68 C2d 245, 252-253, 255, 66 CR 20, 24-26 (overruled on other grounds by *Privette v. Sup.Ct. (Contreras)* (1993) 5 C4th 689, 701-702, 21 CR2d 72, 80, fn. 4) (concluding *city's* "*nondelegable duty*" applied to independent contractor's employee)—"It is clear that the liability of an employer of an independent contractor for the latter's tortious conduct is broad …"; *Caudel v. East Bay Mun. Util. Dist.* (1985) 165 CA3d 1, 5-6, 211 CR 222, 224 (summary judgment reversed where nature of risk—"*peculiar*" or otherwise—remained triable issue of fact)—general rule "is subject to so many exceptions that … the so-called 'general rule' will be followed only where no good reason is found for departing from it"]

Cross-refer: For a comprehensive discussion of a hirer's liability for the torts of its employees and independent contractors, see Haning, Flahavan, Cheng & Wright, *Cal. Prac. Guide: Personal Injury* (TRG), Ch. 2.

4. [10:75] **Concerns Unique to Community Association Management:** Property management for community associations (condominium associations, etc.) is unique for several reasons:

- The property manager generally is not involved in leasing activities or the collection of rents. Therefore, the manager need not necessarily be a licensed real estate broker (*¶ 10:56*).

- The association's governing board hires the property manager on behalf of the community association. Because individual board members do not own the project but yet have a fiduciary obligation to all community association members, the board members are usually quite concerned about entrusting a property manager with certain matters. (Of course, an individual project owner is also concerned about its property manager's ability and conduct, but the owner generally has no fiduciary obligation to any other owner.)

  Consequently, a few special issues (developed at ¶ 10:76 ff.) should be considered when approaching the subject of property management for a community association.

  a. [10:76] **Board's enabling powers:** As a threshold matter, the governing board must determine whether it has the *authority*—either under its articles of incorporation or the community association bylaws—to retain a management company. On this point, the board must carefully scrutinize the articles and bylaws for provisions making certain duties *nondelegable*.

  b. Scope of duties to be assigned to manager

(1) [10:77] **Board and membership meetings:** It may be desirable for the manager to attend, and take minutes at, board and membership meetings. The board might also find it expedient to delegate to a manager the tasks of sending out meeting notices, handling meeting registration, circulating and processing proxies, and/or perhaps conducting member meetings (e.g., annual homeowner meetings).

➪ [10:78] ***PRACTICE POINTER:*** Department of Real Estate regulations require certain periodic association meetings (subject to specified advance notice and other requirements). Additionally, the meetings should be conducted in accordance with association rules of parliamentary procedure. The articles, bylaws and rules and regulations will typically contain detailed specifications regarding quorum requirements, sufficiency of proxies, voting rights of various classes of association membership and cumulative voting.

Because of these formalities, many board members will prefer to have an experienced property manager assist in conducting association meetings.

(2) [10:79] **Financial records and bank accounts:** It may be beneficial to have the manager retain the association financial records. However, because the board is ultimately accountable to its members, it is probably advisable not to give a property manager exclusive control over bank accounts.

(3) [10:80] **Indemnification, bonding and insurance:** Because board members are exposed to substantial potential liability (without any corresponding compensation), fidelity bonds for the manager, insurance for the board members, and a strong indemnification provision (from the manager to the individual board members) are vitally important.

(Volunteer officers and directors of associations that manage residential and mixed use common interest developments, who are either tenants of residential separate interests or owners of no more than two separate interests and whose ownership in the development consists exclusively of residential separate interests, enjoy limited statutory immunity from liability, subject to specified insurance requirements. See Civ.C. § 5800; see also Civ.C. § 5805.)

[10:80.1 - 10:80.4] ***Reserved.***

c. [10:80.5] **Written disclosure statement by prospective managing agent:** A prospective managing agent of a common interest development must provide a statutorily-prescribed written statement to the board "as soon as practicable," but in no event *more than 90 days before entering into a management agreement*. [Civ.C. § 5375]

(1) [10:80.6] **Which "managing agents":** A "managing agent" subject to the Civ.C. § 5375 disclosure requirements means a person who, for compensation or in expectation of compensation, exercises control over a common interest development's assets. [Civ.C. § 4158(a)]

A "managing agent" for this purpose does *not* include (a) a regulated financial institution operating within the normal course of its regulated business practice; (b) an attorney at law acting within the scope of the attorney's license; or (c) a full-time employee of the association. [See Civ.C. §§ 4158(b) & 5385]

(2) [10:80.7] **Contents of statement:** The statement must contain all of the following information concerning the managing agent (Civ.C. § 5375):

(a) [10:80.8] **Identification of owners/partners:** The names and business addresses of the managing agent's owners or general partners. [Civ.C. § 5375(a)]

If the managing agent is a corporation, the statement must include the names and business addresses of the directors, officers and shareholders holding greater than 10% of the corporation's shares. [Civ.C. § 5375(a)]

(b) [10:80.9] **Licenses:** Whether relevant licenses (such as architectural design, construction, engineering, real estate or accounting licenses) have been issued by the State of California and are currently held by the managing agent's owners or general partners (or, in the case of a corporate managing agent, its directors, officers or more-than-10% shareholders). [Civ.C. § 5375(b)]

If a license is currently held by any of those persons, the statement must also specify:

- What license is held;
- The dates the license is valid; and
- The name of the licensee appearing on the license. [Civ.C. § 5375(b)(1), (2) & (3)]

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(c) [10:80.10] **Professional certifications:** Whether relevant professional certifications or designations (such as architectural design, construction, engineering, real property management or accounting) are currently held by the managing agent's owners or general partners (or, in the case of a corporate managing agent, its directors, officers or more-than-10% shareholders), including, but not limited to, a professional common interest development manager. [Civ.C. § 5375(c)]

If any professional certification or designation is held, the statement must also specify:

• What the certification or designation is and what entity issued it;

• The dates the certification or designation is valid; and

• The names in which the certification or designation is held. [Civ.C. § 5375(c)(1), (2) & (3)]

(d) [10:80.11] **Ownership interests in businesses/companies:** Any business or company in which the common interest development manager or management firm has any ownership interests, profit-sharing arrangements or other monetary incentives provided to the management firm or managing agent. [Civ.C. § 5375(d)]

(e) [10:80.12] **Referral fees:** Whether the common interest development manager or management firm receives a referral fee or other monetary benefit from a third-party provider distributing documents as statutorily specified. [Civ.C. § 5375(e)]

d. [10:81] **General management issues:** The issues unique to community association management supplement, but do not displace, issues central to all property manager-owner relationships—including the property management agreement. Therefore, the sections set forth at ¶ 10:90 ff. should be reviewed when negotiating and preparing community association management agreements.

[10:82 - 10:89] ***Reserved.***

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Chapter 10. Management of Real Property

C. Property Management Agreement

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1. [10:90] **Form of Agreement—Written vs. Oral:** Except to the extent a signed writing is required by law (statute of frauds and "equal dignities rule," ¶ 10:91 ff., 10:94), owner and property manager are free to formalize their arrangement by written or oral agreement. Nonetheless, a comprehensive *written agreement* is always the most prudent approach, as it minimizes room for dispute over the operative terms.

a. [10:91] **Statute of frauds:** So long as the services to be performed consist entirely of *management* functions—*exclusive* of *brokerage* activities—the statute of frauds does *not* apply and an oral management agreement will be enforceable.

(1) [10:92] **Writing required if manager to perform brokerage services:** On the other hand, if the agreement contemplates the manager's performance of brokerage services, it *must* be reduced to a signed *writing* that meets all requirements of the *statute of frauds*. [Civ.C. § 1624(a)(4); *see generally, ¶ 2:281 ff. & 4:263 ff.*]

(2) [10:93] **Additional statutory requirements if listing agreement contemplated:** In addition, if the management agreement includes a listing agreement, it must comply with various other statutory requirements. *See* ¶ *2:173 ff., 2:376 ff.*

b. [10:94] **Evidence of agent's authority—"equal dignities rule":** The so-called "equal dignities rule" is a derivative of the statute of frauds. Specifically, an agent's authority to enter into a contract must be *in writing* whenever the contract itself is required by the statute of frauds to be in writing. [Civ.C. § 2309; *see* ¶ *2:134, 4:226.1*]

2. [10:95] **Compensation:** Perhaps the most important issue in any management agreement is the amount of the manager's compensation.

a. [10:96] **General management fee:** Management fees usually take one of two forms:

• A flat, fixed fee (rarely utilized); or

• A percentage of gross rents or revenues (approximately 5% of gross rents/revenues is probably the norm).

b. [10:97] **Leasing commissions and related fees:** A second component of management compensation arises where the manager will also be serving as a leasing broker.

(1) [10:98] **Commission amount:** The commission amount is of course negotiable. However, because a property manager will be receiving an ongoing management fee, the leasing commission might be somewhat less than would be paid to an independent leasing broker. (*See detailed discussion of broker compensation at ¶ 2:270 ff.*)

(2) [10:99] **Construction supervision fee:** Unlike independent real estate brokers whose job is completed once the lease is executed, a property manager might also be involved in ongoing tenant leasing activities— such as supervising construction improvement work to the let space. Therefore, a manager might receive not only a management fee and a leasing commission, but an "add-on" construction supervision fee as well. (The construction supervision fee generally ranges between 5%-10% of the construction costs.)

3. [10:100] **Specific Management Agreement Provisions:** The sections set forth at (¶ 10:101 ff.) address the particular terms of a well-drafted property management agreement. The discussion generally tracks the sample form at the close of this Chapter.

• ***FORM:*** Sample (Attorney Drafted) Property Management Agreement, *see Form 10:A*.

a. [10:101] **Parties and property:** The parties should be identified and the property subject to the agreement carefully described.

➪ [10:102] ***PRACTICE POINTER:*** Be precise about the scope of property within the purview of the management agreement. For example, if the parking area is on a separate lot or in a separate structure, care must be taken to include (or exclude) the parking area from the scope of the manager's obligations.

Or, if the owner owns two adjacent parcels which are subject to a reciprocal easement (or parking) agreement, but the manager will be hired to manage only one parcel, the agreement should identify the scope of the manager's responsibility for the easement area and/or administration of the terms of the easement agreement.

b. [10:103] **Retention and status of manager:** The specific hiring of the manager and the manager's acceptance of the appointment should be clearly stated. Also include a recital whether the manager is an "employee" or "independent contractor" (*see ¶ 10:70 ff.*).

c. [10:103.1] **Management fees:** *See discussion at ¶ 10:95 ff.*

d. [10:104] **Term of agreement:** The agreement should have a definitive termination date. In addition, the owner should reserve the right to terminate the agreement if (1) the manager does not meet specified performance standards (¶ 10:104 ff.); or (2) the property is sold. (In the latter event, it may be necessary to pay the manager a so-called "buy-out" fee; *see ¶ 10:154*.)

e. [10:105] **Management performance standards:** The manager should agree to furnish their services (or, if applicable, the services of the management organization) in a competent and professional manner.

➪ [10:106] ***PRACTICE POINTER:*** Though commonly found in legal documents, language referring to standards of "first-class" or "professional" competence generally defies any objective measurement and thus rarely provides meaningful definitions of the anticipated standards of conduct. Therefore, a preferable approach might be to carefully set forth in the management agreement specific, identifiable criteria for the definition of "first class" or "professional," or refer to specific buildings as examples of "first-class" standards.

By the same token, a property manager should not be expected to *improve* or *upgrade* the owner's property. While the anticipated *management services* should be "first class," the manager should not be required to maintain as "first-class" property an owner's building that is not currently in "first-class" condition. (This may seem like a distinction without a difference, but an owner's right to terminate a manager frequently hinges on whether the manager is fulfilling its function in accordance with the specific contract standards of professional competence.)

➪ [10:107] ***FURTHER PRACTICE POINTER:*** It sometimes makes sense to base performance standards on *economic* levels of achievement (e.g., gross rents or net profitability). However, because a property can be profitable in spite of the manager's incompetence, such economic benchmarks should be only *one of several* yardsticks by which to measure a manager's performance.

(1) [10:108] **Compliance with law:** Apart from issues of competence, the manager should specifically undertake to conduct its business, and manage and operate the property *in accordance with all laws, statutes and regulations*.

f. [10:109] **Scope of manager's authority:** The scope of the manager's authority over project operations and any particular restrictions on the manager's powers should be stated in the agreement (such as limiting the right to execute certain kinds of contracts or otherwise restricting the right to take certain actions).

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(1) [10:110] **Entering into contracts:** Management agreements commonly prohibit the manager from executing any contract, other than a lease, that lasts more than one year, absent the owner's prior written consent. In any event, the agreement should prohibit the manager from unilaterally entering into contracts that will last longer than the term of the management agreement (*¶ 10:104*).

(2) [10:111] **Advertising and promotion:** If the manager will be expected to plan, implement and/or oversee advertising and promotional activities, the particular activities, and a corresponding suitable budget, should be specified. Where appropriate or desirable, the agreement might identify the scope of advertising, the particular media, the advertising brochures, and perhaps even a particular advertising agency.

➪ [10:112] ***PRACTICE POINTER:*** Advertising and promotion are generally most important in retail projects such as *shopping centers*, and some agenda for such activities should be outlined in the agreement. (A tenants or merchants association is often involved in promotional activities for such projects.)

The advertising and promotion provisions of the management agreement require special attention. The owner and manager may want to delineate the “target market,” how much advertising will physically occur on the project site, and how much advertising will be placed through various media (newspapers, radio and television, etc.).

(3) [10:113] **Leasing:** If the manager is also to serve as a leasing broker, all terms and conditions of a *listing agreement* should be included in the management agreement (*see detailed discussion at ¶ 2:350 ff.*).

(a) [10:114] **Residential projects:** In residential projects, the property manager customarily handles virtually all leasing activities—from initial showing of units, through screening of prospective tenants (credit checks, etc.) and ultimate execution of leases. (The owner should have already provided the manager with the rental rates and an appropriate form lease.)

(b) [10:115] **Commercial projects:** On the other hand, the owner of a commercial project will usually want to take a more personally active role in lease negotiations. Typically, lease terms are intensely negotiated in commercial projects; indeed, the entire leasing process is usually quite complex because commercial leases involve several issues neither encountered nor negotiated in residential rental agreements. For example, commercial leases usually involve varying lengths of term, the grant of tenant rent concessions (e.g., rent-free periods), the lessor's payment of certain improvement allowances, etc.

➪ [10:116] ***PRACTICE POINTER:*** In addition to the leasing activities set forth at ¶ 10:113 ff., the owner may want the manager/broker to provide various market surveys and analyses to assist in pricing rental rates, analyzing demographics, structuring an appropriate “tenant mix” (most important in shopping centers) and conducting related tenant planning.

(4) [10:117] **Handling tenant defaults and evictions:** A manager who is to be responsible for monitoring and following through on tenant defaults should be vested with the power to deliver formal tenant default notices (three-day notices to “pay or quit,” etc.). In addition, the owner and manager may want to work out an arrangement whereby the manager coordinates directly with the owner's legal counsel for the processing of unlawful detainer actions or other lawsuits against defaulting tenants.

Cross-refer: For a comprehensive treatment of notice of default, notice to terminate, and eviction procedures, see Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Chs. 7, 8 and 9.

(5) [10:118] **Dealing with tenants/merchants association:** Tenants in larger projects (particularly large shopping centers) often form a tenants (or merchants) association; the manager should be the party delegated to interface with any such association.

The collection of dues for association members should also be the manager's responsibility.

g. [10:119] **Employment of personnel:** The manager should be required to hire all managerial and executive personnel necessary for efficient discharge of the manager's duties; and the manager should be required to pay all such employees.

Likewise, the manager should be required to hire, pay, supervise and discharge custodians, security and maintenance personnel, and such other personnel as are reasonably necessary to properly operate and maintain the project.

The subject of personnel may raise a variety of issues to be addressed in the agreement. For example:

(1) [10:120] **Particular employees; on-site managers:** Any particular employees the owner wants involved in management or operation of the project should be identified. Likewise, contemplated on-site managers should be identified, along with the specific time periods they will be required to be on-site.

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• [10:121] **Comment:** Tenants tend to favor consistency in personnel and frequently develop fruitful ongoing relationships with on-site managers. Thus, specifying a *particular* on-site manager offers the advantage of promoting continuity in on-site management, thereby facilitating good owner/manager-tenant relations.

➪ [10:122] ***PRACTICE POINTER:*** To narrow the owner's liability exposure for management misfeasance, management personnel should be specifically characterized as *employees of the manager*, not employees of the owner.

(2) [10:123] **Fidelity bonds; licenses:** The owner should consider whether it wants the employees to be bonded; and, if so, the surety and bond amount should be stated. (Appropriate fidelity bonds are particularly important where management personnel will be handling project rents and other revenues.) A fidelity bond will typically cover employee theft, embezzlement and/or other fraudulent acts.

Similarly, the owner may want any contractors which the manager might use to be bonded.

In any event, all contractors and employees of the manager should be licensed as required by law.

(3) [10:124] **Employee taxes and benefits:** Federal and state employment taxes and any employee benefits—e.g., workers' compensation, unemployment insurance, disability benefits and social security—should be the manager's responsibility in regard to personnel who are the *manager's* (rather than the owner's) employees.

(4) [10:125] **Affiliates of manager:** A prohibition against the use of "affiliates" of the manager is ordinarily included … except when the fees, terms and conditions for the use of any such affiliates are consistent with community standards based on arm's-length negotiations.

h. [10:126] **General rights of approval and control in management affairs:** The owner should reserve ultimate authority and control with respect to management affairs generally and, in particular, over leasing, marketing and promotional plans and activities. Indeed, specific parameters for the manager should be set forth in the budget or some annual (or other periodic) plan incorporated in the management agreement.

➪ [10:127] ***PRACTICE POINTER:*** On the other hand, the owner generally should not reserve the right to control and supervise the manager's *day-to-day* responsibilities; reserving detailed control is more likely to clothe the manager with "employee" rather than "independent contractor" status—broadening the owner's exposure for taxes, withholdings and management misfeasance (*see ¶ 10:70 ff.*).

i. [10:128] **Maintenance, repair and capital improvements:** The manager should be responsible for ongoing maintenance, repair and operational matters, including: arranging for utility services, pest extermination, security, trash removal; elevator maintenance, window washing, landscaping/groundskeeping, parking, and all other services essential to efficient operation of the project.

(1) [10:129] **Responsibility for service charges:** Typically, utility services will be in the owner's name, as the manager does not want legal responsibility for such charges. However, contracts for other services are often more efficiently arranged in the manager's name. (But the manager may insist otherwise out of concern over the risk of personal exposure on the service contracts: i.e., should the property be operating at a loss, the manager would be independently responsible to contractors and trades with whom it personally contracted because the property will not be generating sufficient monies to pay the bills.)

(2) [10:130] **Preapproval of capital improvements:** Minor and emergency repairs can be (and almost always should be) handled by the property manager without owner involvement. On the other hand, capital improvements should only be permitted subject to a preapproved budget.

➪ [10:131] ***PRACTICE POINTER:*** Some expenses fall between the category of routine repairs/maintenance and capital improvements. So as not to make management operations unrealistically cumbersome, the agreement should include some arrangement empowering the manager to make certain expenditures not exceeding a specified sum within a stated period of time; and, conversely, requiring the owner's prior written approval for expenditures in excess of such amounts.

j. [10:132] **Inspections and reports:** The manager should be required to make periodic project inspections, maintain service reports and deliver periodic inspection and maintenance reports to the owner. If appropriate, the manager might also be required to institute preventive maintenance programs.

k. Insurance

(1) [10:133] **Procuring/maintaining appropriate coverage:** During the course of a term, a property manager is often required to purchase and maintain casualty and liability insurance in specified amounts for specified risks. Automobile, workers' compensation and rental loss insurance might also be advisable.

If there is a trust deed encumbering the property, the trust deed holder will need to be named as a loss payee under at least the casualty portion of the insurance policies.

➪ [10:134] ***PRACTICE POINTER:*** The property manager may want to be named as a coinsured on certain policies. It is unclear whether the manager has any insurable interest but, in any event, all insurance coverage and the provisions in the management agreement relating to insurance should be *reviewed by the owner's insurance broker*.

It may also be advisable to include coverage for the manager's contractual indemnification obligations (arising from damage or loss caused by management misfeasance; *¶ 10:149*).

➪ [10:135] ***FURTHER PRACTICE POINTER:*** If the manager fails to obtain necessary insurance, the owner will bear the ultimate (potentially devastating) economic consequences. Hence, it is crucial that the *owner keep tabs on insurance coverage*. In all events, the owner should make certain that *it receives the original insurance certificates and policies*.

(2) [10:136] **Claims handling:** The manager should be required to investigate all accidents or damage claims relating to project operations or management; submit a written investigation report to the owner; and cooperate with, and make any reports required by, the insurance company (but such reports should *first be submitted to the owner* for its written approval before submission to any insurance company).

(3) [10:137] **Subrogation waivers:** The manager might insist on a requirement that the respective insurance carriers waive subrogation rights. This is because the manager will want the insurance proceeds to be the sole source of recovery. The owner will not care so long as the insurance carrier is willing to agree.

By agreeing to a subrogation waiver, the carrier gives up its right to pursue covered claims against third parties. For example, if the owner's insurance policy covers damages caused by the manager, the carrier generally has the right to be “subrogated to” the owner's claim against the manager (or manager's insurer)—i.e., the owner's carrier stands in the owner's shoes with the concomitant right to file the claim in its own name. A waiver of subrogation forfeits the carrier's right to pursue the manager or (or manager's carrier).

(4) [10:138] **Monitoring tenant insurance compliance:** The owner might also want the manager to monitor compliance with *tenant* insurance obligations under the respective leases, ensuring that tenants procure and maintain required coverage.

l. [10:139] **Expense reimbursements:** The manager will, of course, be entitled to reimbursement for certain management and operational costs advanced.

Routine operational expenses usually are paid directly from property income revenues and thus will not create issues of reimbursement (*see ¶ 10:140*). However, the owner may require the rendition of certain services that involve additional expenses—such as travel, messenger charges, etc. Therefore, it is important to specifically designate any miscellaneous expenses to be reimbursed to the manager.

There may also be an issue of manager “add-on” administrative or supervision fees (e.g., for overseeing tenant improvement work), which should be addressed in the compensation section of the agreement. *See ¶ 10:99*.

m. [10:140] **Payment of expenses:** Those expenses which the manager is required to pay directly should be itemized in the agreement.

The manager will also want to receive its management fee in advance. The issue of when the fee should be deducted by the manager from gross revenues should be negotiated (i.e., at the beginning of the month or end of the month; and whether it is to be paid before other expenses are paid). However, if the management fee is based on a percentage of rents received or net income, it cannot be calculated until the end of each month.

n. [10:141] **Allocation (pass-through) of management fee:** Depending on the terms of the various leases, the property management fee can often be passed on to commercial tenants as part of the project operating costs; indeed, commercial leases often call for such pass-throughs.

If the manager is given an on-site office, the rent the owner otherwise would have received for that space is sometimes included in management fees to be passed on to the tenants.

o. [10:142] **Financial records and reports; periodic statements:** The manager should be required to keep accurate, complete and separate records in accordance with generally-accepted bookkeeping procedures and standards, showing income and expenditures, accounts payable, cash, accounts receivable and other assets. The owner should reserve the right to inspect and audit these records.

The manager should also be required to prepare whatever periodic (monthly, quarterly and/or annual) financial reports and statements the owner desires. Typically, monthly statements should be prepared detailing all receipts and disbursements

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for the preceding month; itemizing all delinquent accounts, vacant space, amounts held in security deposits and amounts held for capital reserves. To the extent the manager is to create a capital reserve, the parameters should be specified.

➪ [10:143] ***PRACTICE POINTER:*** If a particular form of report or statement is anticipated, a sample form should be attached as an exhibit to the management agreement.

p. [10:144] **Time-frame for excess income remittance to owner:** A time-frame for payment to the owner of the excess income after payment of expenses (including a capital reserve) should be stated. Typically, the excess income is remitted monthly.

q. Maintenance of bank accounts

(1) [10:145] **Owner's concerns:** The owner may want to specify where the manager will maintain project bank accounts; and may want to require that separate accounts be kept for tenant security deposits and reserve funds (the latter being for future unanticipated expenses).

All bank accounts should be federally insured and the owner will want to be informed if the balance in any account exceeds the federally-insured limit. In no event should the manager be entitled to commingle funds pertaining to the subject property with funds pertaining to any other property.

It is also prudent to expressly provide that all funds earned (directly or indirectly) in respect of the property belong solely to the owner and no party claiming by or through the manager shall be entitled to any interest on such accounts.

Finally, all accounts to which the manager has access should be closed upon termination of the management agreement.

(2) [10:146] **Manager's concerns:** The manager will want the owner to advance the first month's expenses. In addition, the manager may require that the owner maintain a minimum balance in the operating account at all times (so as not to deplete the availability of operating funds).

(3) [10:147] **Late fee and nsf charges:** Both manager and owner may want to authorize fee assessments against tenants for late payments or checks returned for non-sufficient funds (nsf). (Indeed, these fees might be additional compensation for the manager, since the manager has to engage in additional administrative work to process late payments and bounced checks.)

r. [10:148] **Miscellaneous manager cooperation:** The manager should be required to cooperate in connection with any audit of the owner's project; proposed sale or refinance of the property; and any other matter as to which the owner will require additional assistance from the manager.

s. [10:149] **Indemnification:** Both parties will want indemnification agreements from the other: The manager will want to be indemnified for any liability not caused by its own gross negligence or willful acts; and the owner will want to be indemnified for any loss or damage caused by the manager's negligence or willful misconduct.

Indemnification provisions usually are the subject of intense negotiation (*see generally, ¶ 4:461 ff.*). It may facilitate negotiations on the subject to consider conditioning indemnification rights and obligations on "comparative negligence" concepts (apportionment of liability according to fault).

t. [10:150] **Notification procedures:** The agreement should provide generally for the mechanics of giving required notices between manager and owner (addresses, manner of delivery, etc.). In addition, the manager should be required to expedite delivery to the owner of certain kinds of notices (such as notification by governmental entities for condemnation, abatement orders, new assessments and the like; threats of litigation; service of process at the project site; notice of cancellation of insurance, etc.).

u. Renewals and termination

(1) [10:151] **Mechanics for renewal:** If the parties wish to provide for renewal of the agreement upon expiration of its term, the renewal mechanics and deadlines should be specifically set forth.

(2) [10:152] **Automatic termination upon sale:** In addition, it is to the owner's advantage to expressly provide for automatic termination of the agreement upon a sale of the property (also specifying the property may be sold at any time in the owner's sole discretion).

➪ [10:153] ***PRACTICE POINTER:*** Owners should in all events *avoid* granting a property manager ongoing "exclusive" management rights (although it is questionable whether any such "exclusive" would be enforceable against a new owner unless it constitutes a "covenant running with the land"; *see ¶ 4:63 ff.*).

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(3) [10:154] **“Buy-out” fee:** If the manager is concerned the owner might sell the property shortly after commencement of the management agreement (resulting in automatic termination, ¶ 10:152), the parties might want to agree to a so-called “buy-out” or “termination” fee to be paid the manager. The buy-out clause would be triggered if the owner sells the property before a certain period of time has elapsed.

(4) [10:155] **Return of books and records:** The agreement should require that, upon its termination, all books, records, reports, studies, advertising materials, equipment, property, supplies, computer disks and tapes, leases and other project documents be delivered to the owner.

v. [10:156] **Restriction on assignment:** Since the owner is contracting for a particular manager's (or management firm's) *personal services*, it behooves the owner to include a provision expressly *precluding* assignment of the management agreement (or, at least, barring assignment without the owner's prior written consent).

w. [10:157] **No recordation of agreement:** If recorded, the management agreement will become an encumbrance on the property and impede its marketability. Consequently, the owner usually will want to specify that the agreement is not to be recorded. (In any event, unless a subsequent owner is to be bound by the agreement, there is no reason to record it.)

x. [10:158] **No obligations of future owner:** Unless the parties intend that a future owner be bound by the management agreement, the agreement should expressly state the manager will not make any claim against the property or a subsequent owner. In turn, any claims the manager might have under the agreement will not adversely affect sale of the property to a prospective buyer.

• [10:159] **Comment:** It is rare that a subsequent owner would be bound by a former owner's property management agreement. Such a scenario would occur only if the new owner expressly *assumed* the existing property management agreement (¶ 4:60 ff.); or, if the agreement was recorded and amounted to a “covenant running with the land” (¶ 4:63 ff.).

y. [10:160] **Boilerplate:** The “boilerplate” provisions in a management agreement are typically similar to those found in a purchase and sale agreement (attorney fee recovery provisions, “entire agreement” and “severability” clauses, choice of law provisions, etc.). *See discussion at ¶ 4:513 ff.*

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Cal. Prac. Guide Real Prop. Trans. Form 10:A

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 10. Management of Real Property

Forms

[Form 10:A] Sample Property Management Agreement (Attorney-Drafted)

Property Management Agreement

This Property Management Agreement (this "Agreement") is made this _____ day of _____, _____, by and between ___________, a ___________ having an office at ___________, California, _____, ("Owner"), and _____, a ___________ having an office at ___________, California, _____ ("Manager").

RECITALS

I. **WHEREAS,** Owner is the owner of that certain real property, together with improvements thereon, located in the County of _____, State of California, commonly known as ________________ (the "Property").

II. **WHEREAS,** Manager is a duly licensed real estate broker under the laws of the State of California (License No. _____) and engages in the business of managing, operating and maintaining property similar to the Property; and

III. **WHEREAS,** Owner desires to engage and appoint Manager as its exclusive managing agent for the Property and Manager desires to accept such appointment, all upon and subject to the terms and conditions set forth in this Agreement.

NOW, THEREFORE, in consideration of the mutual covenants and agreements set forth below, Owner and Manager agree as follows:

1. **Appointment.** Owner hereby hires and appoints Manager as the exclusive managing agent for the Property, and Manager hereby accepts such appointment.

2. **Term.**

2.1. Initial Term. Subject to the renewal provisions set forth in Paragraph 2.2, below, this Agreement shall commence as of _____, ___ and shall remain in full force and effect until the sooner of (i) _____, ___; (ii) the date Owner sells its interest in the Property (whereupon this Agreement shall immediately terminate); or (iii) upon the termination of this Agreement pursuant to the provisions of this Agreement hereinafter provided.

2.2. Automatic Renewal Term. If this Agreement shall be in full force and effect on ___________, _____, the term of this Agreement shall automatically be renewed on a calendar quarter-to-quarter basis, until either party shall terminate this Agreement on at least thirty (30) days written notice to the other.

3. **Manager's Duties and Powers.**

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3.1. <u>General.</u> Manager shall manage, coordinate and supervise the ordinary and usual business and affairs pertaining to the operation, maintenance and management of the Property. Without limiting the foregoing or any other provision in this Agreement, Manager shall have such responsibilities and obligations, and shall perform and take, or caused to be performed or taken, all services and actions customarily performed or taken by property managers of properties which are similar in nature, location and character to the Property. Manager shall perform all of its duties in an efficient and economical manner, subject to Owner's direction and pursuant to the terms and provisions of this Agreement.

3.2. <u>Collections of Rents and Other Monies.</u>

(a) Manager shall prepare and deliver to all parties occupying space in the Property ("Tenants") bills which set forth all base rent, common area charges and other amounts payable by Tenants under their respective leases or licenses, occupancy agreements or similar agreements ("Leases"). All such monthly bills shall be accompanied by such other information and materials as Owner is required or elects to furnish such Tenants under their respective Leases. Manager shall use its best, diligent efforts to collect all rents and other charges due from Tenants and shall promptly pay over such collections to Owner or, to the extent directed by Owner, deposit such monies in one or more bank accounts.

(b) Except as otherwise directed in writing by Owner, Manager shall take all such actions as Manager shall deem necessary or advisable to collect the aforesaid rents and other charges and to enforce all rights and remedies of Owner under the Leases or to protect the interests of Owner, including, without limitation, the preparation and delivery to Tenants of all "late payment", default and other appropriate notices, requests, bills, demands and statements. Manager may retain legal counsel, collection agencies and such other persons and firms as Manager shall deem appropriate or advisable to enforce (after notification to Owner), the rights and remedies of Owner against any Tenant in default in the performance of its obligations under a Lease. Manager shall periodically (but not less frequently than monthly), notify Owner of the progress of any such legal action.

3.3. <u>Tenant Relations.</u> Manager shall develop and maintain good relations with Tenants in the Property. Manager shall receive and respond to all Tenant complaints and shall attempt in good faith to resolve and settle such complaints subject to the parameters set forth in this Agreement. Manager shall also coordinate the moving in and moving out of Tenants from the Property. In addition, Tenant shall oversee all construction, alteration and decoration which Owner is required to perform under its Leases so as to ensure a minimum of disruption to the operation of the Property and to other Tenants of the Property.

3.4. <u>Compliance with laws.</u> Manager shall, at Owner's expense, use its diligent best efforts to see to it that the Property is at all times in compliance with applicable laws, rules and regulations and Manager shall renew, as necessary, all permits and licenses which are legally required for the operation and maintenance of the Property.

3.5. <u>Personnel.</u>

(a) Manager shall, at _____'s expense, employ, retain, supervise and discharge such employees as may be necessary for the proper and efficient management and maintenance of the Property. [ALTERNATE: If any employee does not work exclusively for the benefit of the Property, the expense of such employee will be prorated accordingly.] All such employees shall be employees of the Manager and not the Owner. Owner agrees that at no time will Owner attempt to employ an employee of Manager during the term of this Agreement, or within one hundred eighty (180) days thereafter.

(b) Manager shall (i) pay all wages and other benefits properly payable to the employees hired by Manager under subparagraph 3.5(a), above; (ii) maintain adequate payroll records; (iii) remit to the proper authorities all required income and social security withholding taxes, unemployment insurance payments, workmen's compensation payments and such other amounts with respect to the wages and other benefits payable to such employees as may be required under applicable laws, together in each case with all required reports or other filings; and (iv) obtain, maintain and administer all medical, disability and other insurance benefits and other fringe benefits as may from time to time be required under any union or other agreements or arrangements applicable to the Manager's employment of such personnel. Manager shall cause all of Manager's employees who handle or are responsible for Owner's monies to be bonded by a fidelity bond, which bond shall be in an amount sufficient to totally cover loss or theft of said monies.

3.6. Professionals and Contractors. Manager shall (i) identify and, upon the prior approval of Owner, enter into contracts with architects, engineers, accountants, attorneys, tradesmen and other independent contractors to perform services; and (ii) supervise the administration and monitor the performance of all work to be performed and services to be rendered under all such contracts. Manager shall use due care in the selection of all such professionals and other independent contractors. Manager shall not enter into any agreement with any such professional or other independent contractor which would require the payment of more than ___________ Dollars ($________) in any twelve (12) month period unless such agreement is provided for in the Approved Budget. In addition, each such agreement shall be terminable upon thirty (30) days prior written notice by Owner and, in any event, such agreements shall automatically terminate upon Owner's sale of the Property.

3.7. Equipment and Supplies. Manager shall, at Owner's expense, purchase all maintenance, janitorial supplies, equipment and tools (such as restroom supplies, light bulbs, paint and office supplies) necessary for the proper and efficient operation and management of the Property. All such equipment and supplies shall be delivered to and stored at the Property and may only be used in connection with the Property. Manager shall attempt to purchase all goods, supplies or services at the lowest cost available from dependable sources in the city in which the Property is located.

3.8. Maintenance.

(a) Manager shall cause the Property to be maintained in good and safe condition, comparable to that of other properly maintained properties similar in type and location to that of the Property.

(b) To the extent of the capacity of all equipment and systems located in or servicing the Property, Manager shall cause all such equipment and systems to be operated effectively and maintained in good repair and Manager shall cause to be provided or made available to Tenants those services which Owner is required to provide or make available under the Leases.

(c) Manager shall enter into such service and maintenance contracts as Manager shall deem necessary or appropriate for the operation and maintenance of the Property, including the equipment and systems located in or servicing the Property, contracts for utilities, elevator maintenance, telephone service, office cleaning, window cleaning, landscape maintenance, rubbish removal, fuel, security, food vending and vermin extermination.

3.9. Repairs. Manager shall cause such ordinary and necessary repairs to be made to the Property and all equipment and systems located in or servicing the Property, and shall cause such interior alterations and decorations to be made to the Property, as Manager shall deem necessary or advisable for its proper operation and maintenance. Notwithstanding the cost limitations set forth in this Agreement, Manager may cause to be made all repairs which are immediately necessary for the preservation or protection of the Property or the safety of Tenants and other persons in or on the Property or which repairs are otherwise required to avoid the suspension of any necessary services in the Property. Manager may take such steps without Owner's prior approval and without limitation as to cost; provided, however, that in each such instance Manager shall, before causing any such emergency repair to be made, use reasonable efforts under the circumstances to notify Owner of the emergency situation and obtain its approval of such repair. In any event, Manager shall conduct all repairs so as to involve the least amount of disturbance to Tenants in the Property.

3.10. Tenant Disputes.

(a) Manager shall receive, and use its best efforts to attend to and resolve, all complaints of Tenants and shall attempt to resolve any complaints, disputes or disagreements by or among Tenants, but shall not expend more than ___________ Thousand Dollars ($________) to settle any dispute with a Tenant without the prior written consent of Owner.

(b) Manager shall monitor the occupancy of all Tenants to insure their compliance with the terms and provisions of their respective Leases, including, without limitation, the rules and regulations of the Property from time to time established by Owner. Manager shall notify the respective Tenants and Owner of any violations of such Leases and use reasonable efforts to cause such Tenants to correct such violations promptly.

3.11. Insurance. Manager shall obtain and maintain all such insurance coverage as required under Paragraph 8 of this Agreement, as well as such other insurance as is provided for by the Approved Budget. Manager shall prepare and file all reports, claims, notices and other documents required in connection with such policies of insurance and any claims thereunder.

3.12. Advertising—Public Relations.

(a) Manager, at the expense of Owner and with the prior written approval of Owner, shall hire such advertising services, shall place such advertisements and shall generally supervise and attend to all promotional matters pertaining to the operation of the Property as Manager shall deem advisable.

(b) Manager shall represent Owner in connection with all matters of general public interest which pertain to the Property and shall attempt to amicably resolve any complaints, disputes or disagreements in connection therewith as promptly as is reasonably possible; all of the foregoing actions to be taken by Manager after notice to and discussion with Owner.

3.13. Payment of Expenses. Manager shall pay, with funds from the Property Account (defined below), all expenses which Manager properly incurs under the terms of this Agreement including, without limitation, Manager's compensation under this Agreement. Manager shall at all times use its best efforts to obtain for Owner, and shall credit to the account of Owner in each case, all discounts, rebates and other favorable financial terms which may be available in connection with any costs or expenses Manager shall incur under this Agreement.

3.14. Property Account. Manager shall, within ____________ (_) days after execution of this Agreement, open a commercial checking account at _____ Bank (“Property Account”). The Property Account shall be in the name of Manager, but shall be designated as a trust account in favor of Owner. Upon the opening of such Property Account, Owner shall advance to Manager the sum of ____________ Dollars ($_________) for deposit in said Property Account to be used for working capital. All expenses of the Property paid by Manager shall be paid from the Property Account, except that Manager shall have the right to maintain petty cash funds not in excess of ____________ Dollars ($_________). Manager shall pay (out of the funds of Owner) all expenses and costs of operating the Property which under the terms of this Agreement it is authorized to pay, by check, drawn on such Property Account. In addition, Manager shall remit to Owner at the end of each calendar month, all unexpended funds, except for a reserve for contingencies which shall remain in the Property Account in an amount determined by the Manager, but in no event exceeding ____________ Dollars ($_________). The designation of those employees of Manager authorized to sign checks on said account shall be subject to the written approval of Owner, which shall not be unreasonably withheld. Owner agrees that the following sequence of payments is acceptable: payroll; compensation of Manager; utilities; vendor invoices; construction; and any remaining invoices. If at any time the amount in the Property Account shall exceed the federally-insured limit, an additional account shall be opened at a local, federally-insured bank acceptable to Owner. Should the expense of operating the Property at any time show that the sums deposited by Manager in the Property Account are less than the amount needed to provide sufficient cash on hand to pay all recurring expenses, plus any known nonrecurring expenditures anticipated to occur within the next thirty (30) days, Manager will give written notice to Owner of the sum actually needed. Owner shall, as soon practicable thereafter, advance said sum to Manager.

3.15. Payroll and Other Taxes and Contributions. Manager shall be solely responsible and liable for payment of all federal, state and local payroll taxes and for contributions for unemployment insurance, social security and other benefits imposed or assessed under any provision of law or by regulation, and which are measured by salaries, wages or other remuneration paid or payable by Manager to its employees engaged in any work in connection with this Agreement or the Property. Manager shall be solely responsible for the withholding and payment of any income tax required to be withheld from the wages and salaries of said employees under any applicable law or regulation. Manager agrees to save and hold Owner harmless from all claims, penalties, interest or costs which may be assessed under any law, rule or regulation with respect to Manager's failure or inability to perform the aforesaid responsibilities.

3.16. Miscellaneous Expenditures. At Owner's expense, Manager shall pay the following expenses: cost of collection of delinquent rentals collected through an attorney or collection agency; cost of printed checks for each bank account required by Owner; cost of an on-site office (if required) including, but not limited to, office furniture and equipment; cost of reproduction, telephone,

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postage or express mail service, supplies, and printed forms required to manage the Property; mileage reimbursement for on-site personnel as stated in the Approved Budget; reasonable travel costs and incidental expenses necessitated through the normal or routine management of the Property or due to request by Owner which requires travel; cost of any other item or items associated with the operation of the Property not specifically set out herein but which are consistent with the Approved Budget.

3.17. Financial Services. Manager shall: i) calculate and bill rent and other tenant charges; ii) maintain accounts receivable and delinquency records; iii) maintain rent rolls; iv) process and pay operating and capital invoices; v) record activity and compare such activity to Approved Budget amounts; vi) reconcile the Property Account; vii) remit excess funds to Owner and request needed funds from Owner (as provided in Paragraph 3.13, above); viii) process payroll for personnel employed in the discharge of the contract and compliance with taxing authorities and other reporting requirements associated with that payroll; ix) maintain books of account for Owner's funds (as more specifically provided elsewhere in this Agreement); and x) submit periodic financial reports to Owner (as more specifically provided in this Agreement).

4. Limitations of Manager's Powers and Authority.

4.1. Expenditures. Except to the extent provided for in the Approved Budget or as otherwise specifically provided for in this Agreement with respect to emergency situations or otherwise, Manager shall not, without the prior written approval of Owner, incur any single expense for a repair, alteration, service, supply or other matter whatsoever which would involve a cost in excess of _____ Thousand Dollars ($________).

4.2. Debt Service, Refinancings and Sale of the Property. Manager shall not be responsible for the payment of any debt service, ground lease rents or other amounts due under mortgages or ground leases which may from time to time affect the Property. In addition, Manager shall not be required to represent Owner in connection with any refinancings or sale of the Property. Any capital expenditure must be specifically authorized by Owner in writing. With respect to purchase and installation of major items of new or replacement equipment, the Manager shall recommend that Owner purchase these items when Manager believes such purchase to be necessary. All new or replacement equipment or other capital expenditures exceeding ___________ Thousand Dollars ($________) shall be awarded on the basis of competitive bidding. If Owner requires, Owner may communicate to Manager its acceptance or rejection of bids; otherwise Manager shall accept or reject applicable bids. Owner may pay capital expenses from its own resources or may authorize payment by Manager out of the Property Account.

5. Budgets.

5.1. Budget for first Operating Year. Manager shall prepare and submit to Owner prior to _____, ___ for Owner's written approval a pro forma budget for the operation and maintenance of the Property covering the period from _____ through _____. Manager shall manage the Property consistent with and subject to the cost limitations set forth in such budget as the same may be adjusted in accordance with the provisions of this Paragraph 5.

5.2. Annual Budgets after First Operating Year. Manager shall prepare and submit to Owner for its approval at least thirty (30) days prior to the beginning of each Operating Year (defined below) a proposed pro forma budget for all costs pertaining to the operation and maintenance of the Property during such Operating Year. Each such budget shall be substantially in the same form as the Approved Budget (defined below) in effect for the prior Operating Year. Each such budget shall set forth expenditures on an annual and a monthly basis and shall not, except for informational purposes, include estimates for costs and expenses for which Owner will be reimbursed by Tenants under Leases. Manager shall make such reasonable modifications to each proposed pro forma budget it prepares in accordance with this Paragraph 5.2 until Owner shall have approved such budget in writing. Owner agrees not to unreasonably withhold or delay its review and approval thereof.

5.3. Approved Budgets and Operating Years. Each pro forma operating budget approved by Owner in accordance with Paragraph 5.2, above, and the pro forma budget referred to in Paragraph 5.1, above, together with any adjustments thereto, is referred to in this Agreement and shall be deemed to be the “Approved Budget” for the period covered by such budget. Each Approved Budget shall cover a period which shall begin on ___________ and end ___________, which is referred to in this Agreement as an “Operating Year.”

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5.4. Limitations of Approved Budgets. Except as otherwise specifically provided in this Agreement, Manager shall incur costs and expenses in connection with the operation and maintenance of the Property during any Operating Year within the limitations established by the Approved Budget for such Operating Year. Further, Manager shall not, without Owner's prior written consent, incur costs and expenses with respect to any calendar month which would result in the budget for such month, (or in any major category thereof) as shown in the Approved Budget then in effect being exceeded by more than _____ percent (____%). The calculation of any such overage shall not take into consideration any costs and expenses for which Owner shall be reimbursed by Tenants or any additional costs and expenses of which Owner shall have approved. Notwithstanding the foregoing, Manager shall not be required to obtain Owner's prior approval with respect to, and the calculation of any Approved Budget overages shall not take into consideration, the following: costs and expenses relating to utility charges, real estate taxes, insurance or otherwise which are not within Manager's reasonable control and which, if not incurred, would or might, in Manager's reasonable judgment, adversely and materially affect the operation and maintenance of the Property. In addition, if any Operating Year shall commence before Owner shall have approved the proposed pro forma budget for such year, Manager shall use its reasonable judgment in incurring costs and expenses relating to the operation and maintenance of the Property until an Approved Budget for such Operating Year shall be in effect and in doing so shall be guided by the Approved Budget for the prior Operating Year. In such a case, Manager shall be subject to the same financial limitations established by the last effective Approved Budget as if such budget had been in effect for the then current Operating Year, increasing, however, the amount of funds set aside for each category of such budget by _____ percent (____%).

6. Books, Records, Reports and Accounting.

6.1. Books and Records. Manager shall establish and maintain such books of account, records and other documentation pertaining to the operation and maintenance of the Property as are customarily maintained by managing agents of properties similar in location and size to that of the Property. Manager shall prepare or cause to be prepared and file all returns and other reports relating to the Property (other than income tax returns and any reports or returns which may be required of any foreign owner of United States real property) as may be required by any governmental authority or as otherwise may be required under this Agreement.

6.2. Security Deposits. Manager shall deposit and maintain in separate accounts approved by Owner in accordance with applicable laws and Leases all security deposits, if any, of Tenants.

6.3. Monthly Reports. Manager shall prepare and deliver to Owner a monthly report setting forth detailed statements of collections, disbursements, delinquencies, uncollectible accounts, balances of account, accounts payable and other matters relating to the management and operation of the Property. Such statements shall, upon Owner's request, be accompanied by appropriate documentation of all expenditures made by Manager under this Agreement.

6.4. Quarterly Statements. Manager shall prepare and deliver to Owner on a quarterly basis Manager's written estimates of the amounts, if any, by which any major categories of the Approved Budget must be adjusted to adequately fund the operation and maintenance of the Property for the then current quarter. Manager shall also furnish Owner with such further information covering the operation and maintenance of the Property as Owner may reasonably require.

6.5. Year-End and Final Reports. As soon as practicable after the end of each Operating Year and after the expiration or termination of this Agreement, Manager shall prepare and deliver to Owner statements pertaining to the operation and maintenance of the Property during the preceding Operating Year (or applicable portion thereof).

6.6. Inspection and Audit of Records. Owner shall have the right during reasonable business hours and upon reasonable notice to inspect, audit, examine and make copies of or extracts from the books of account and records maintained by Manager pursuant to this Agreement. Such rights may be exercised through an employee of Owner or qualified agent designated by Owner, and Owner shall bear all expenses in connection with such examination.

6.7. Accounting Matters. The books of account will be maintained on a _____ **[CASH OR ACCRUAL]** basis.

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6.8. Property of Manager. The records, reports, books of account and other documents and materials relating to the management, operation and maintenance of the Property shall be the property of Manager and, upon the termination of this Agreement, Owner may make copies of all or portions thereof as Owner shall deem pertinent to Owner's future operation and ownership of the Property.

6.9. Final Accounting. Within thirty (30) days after the date of termination of this Agreement, Manager shall deliver to Owner a final accounting for all Owner funds handled by Manager and shall pay to Owner the balance of all monies in the Property Account or in the possession of Manager.

7. **Owner's Duties.**

7.1. Plans, Specifications and Documents. Owner shall make readily available to Manager copies of the plans and specifications of the Property and a recent survey of the Property (if available) and shall provide Manager with such information and materials pertaining to the layout and construction of the Property, the elevators and lighting of the Property and the heating, air conditioning, ventilating, plumbing, electrical and other mechanical systems and equipment in or servicing the Property as Manager may reasonably request. Owner also shall provide Manager with copies of or convenient access to all agreements, licenses, certificates, contracts, bills, notices and other documents pertaining to the Property.

7.2. Office and Other Space. Owner shall provide Manager, on a rent-free basis, suitable space in the Property. Owner shall provide such space with such furniture and furnishings, including office machines, furniture, equipment and supplies as may be reasonably required for Manager to properly perform its duties. Notwithstanding the foregoing, with the exception of a small staff as Manager may reasonably deem necessary to be located on the Property for the proper performance of the Manager's duties under this Agreement, Manager shall, to the extent practicable, perform administrative, clerical and accounting functions pertaining to the management of the Property in Manager's own general offices.

8. **Insurance.**

8.1. Manager shall procure and maintain during the term of this Agreement, comprehensive public liability insurance in amount specified by Owner and fidelity bonds in amounts specified by Owner covering all personnel of Manager.

8.2. Manager shall procure and maintain during the term of this Agreement all other forms of insurance as may be required by (i) law, (ii) Owner, or (iii) the holder of any mortgage or deed of trust covering the Property; all with such companies, in such amounts and with such beneficial interests appearing therein as may be required.

8.3. All policies of insurance required pursuant to Paragraph 8 of this Agreement shall be procured and maintained in the name of and at the sole expense of Owner. Owner may elect by notice in writing to Manager to procure and maintain any of such policies directly in which event Manager shall have no obligation to procure and maintain the insurance which Owner has so elected to procure and maintain.

8.4. Manager shall investigate all accidents or claims for damage relating to the operation and maintenance of the Property, submit a written report of the results of such investigation to Owner, and cooperate with and make any reports required by any insurance company; provided, however, that such reports shall be submitted to and approved by Owner in writing prior to being submitted to any insurance company.

8.5. Without in any way limiting the other provisions of this Paragraph 8 regarding insurance, Manager shall maintain worker's compensation insurance and all other insurance necessary to meet federal and state requirements in accordance with the laws of the State of California and employer's liability insurance applicable to and covering all persons engaged in performance of the work to be performed under this Agreement.

8.6. Manager shall secure and maintain such other insurance policies as Owner may desire such as elevator liability, steam boiler insurance and the like.

8.7. Manager shall be named as co-insured in all policies of insurance required pursuant to this Paragraph 8. All original certificates evidencing any insurance policy shall be delivered to Owner.

9. **Compensation—Management Fee.**

9.1. Amount and Payment. Owner shall pay Manager an annual fee for its performance of the duties under this Agreement in an amount equal to _____ percent (____%) of the gross income from the operation of the Property for the Operating Year with respect to which such fee shall be payable. Such fee shall be payable in monthly installments in arrears in accordance with Paragraph 3.14, above.

9.2. Gross Income. For the purposes of this Paragraph 9, the term “gross income from the operation of the Property” shall mean all sums which Owner derives or is entitled to receive under Leases.

9.3. Construction and Remodeling Supervision. In addition to the compensation set forth above, Manager shall receive a fee for the supervision of all remodeling and construction in excess of ___________ Dollars, ($________) in any Operating Year which occurs on the Property (including tenant and common areas). Such fee for supervision of remodeling and construction shall be equal to _____ percent (____%) of the total cost of the work performed. Manager shall have responsibility for the completion of such improvements within the guidelines specified in any bid proposal and Manager shall exercise due diligence so that said construction and/or remodeling is completed within the time frame so specified; however, Manager shall not be financially liable for delays which cause the construction completion date to be exceeded.

10. **Default—Termination.**

10.1. Optional Termination. Owner and Manager may immediately terminate this Agreement at any time if the other shall default in the performance of any of its obligations under this Agreement. In such event, the party declaring the default shall provide the other party (“Defaulting Party”) with written notice thereof setting forth the nature of the default, and the Defaulting Party shall have (i) three (3) days to cure a monetary default or (ii) fifteen (15) days to cure a non-monetary default; provided, however, that if the nature of the alleged default is such that it cannot reasonably be cured within fifteen (15) days, the Defaulting Party may cure such default by commencing in good faith to cure such default promptly after its receipt of such written notice and prosecuting the cure of such default to completion with diligence and continuity within a reasonable time thereafter.

10.2. Automatic Termination. This Agreement shall terminate automatically if:

i) all or substantially all of the Property is condemned or acquired by eminent domain;

ii) all or substantially all of the Property is destroyed by fire or other casualty as a result of which all or substantially all of the Tenants are unable to continue the normal conduct of their business in their respective occupied spaces;

iii) Owner or Manager files a petition for bankruptcy, reorganization or arrangement under any state statute, or makes an assignment for the benefit of creditors, or takes advantage of any insolvency statute; or

iv) The Property is sold or otherwise transferred by Owner, whether voluntarily or involuntarily.

10.3. Survival of Obligations. Upon the expiration or termination of this Agreement, (i) Owner's appointment of Manager hereunder shall cease and terminate and, except as otherwise specifically provided hereunder, Owner and Manager shall have no further obligation or liability to the other; (ii) Manager shall no longer have any authority to represent Owner or take or cause to be taken any actions on Owner's behalf; and (iii) Owner shall pay Manager all fees which shall have accrued through the date of termination.

10.4. Return of Owner's Property. Immediately after the expiration or termination of this Agreement, Manager shall deliver to Owner (i) the balance of any funds then held by Manager on Owner's account pursuant to this Agreement; and (ii) all books,

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records, Leases, agreements and other documents which are necessary or materially pertinent to the management and operation of the Property.

11. **Indemnification.**

11.1. Scope. Owner shall indemnify and hold harmless Manager, its principals, officers, directors, shareholders, partners, employees and agents (individually and collectively, the “Indemnitees”) from and against all liabilities, claims, suits, damages, judgments, costs and expenses of whatever nature, including reasonable counsel fees and disbursements, to which the Indemnitees may become subject by reason of or arising out of any injury to or death of any person(s), damage to property, loss or use of any property or otherwise in connection with the performance of Manager's obligations under this Agreement. **[OPTIONAL: or connected in any way to the existence of Hazardous Materials (defined below) in, or under the Property].** Owner shall promptly reimburse the Indemnitees who become liable for matters indemnified hereunder and Owner shall promptly reimburse the Indemnitees for all amounts, including reasonable attorney fees and disbursements, which they or any of them are required to pay in connection with or in defense of any of the matters for which they or any of them are entitled to indemnification as set forth above.

11.2. **[OPTIONAL: HAZARDOUS MATERIALS].** The term “Hazardous Materials” shall mean (a) any “hazardous waste” as defined by the Resource Conservation and Recovery Act of 1976 (42 U.S.C. Section 6901 et seq.), as amended from time to time, and regulations promulgated thereunder; (b) any “hazardous substance” as defined by the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (42 U.S.C. Section 9601 et seq.), as amended from time to time, and regulations promulgated thereunder; (c) asbestos; (d) petroleum products and polychlorinated biphenyls; (e) any substance the presence of which on the Property is prohibited by any governmental requirement; and (f) any other substance which by any governmental requirement requires special handling in its collection, storage, treatment, or disposal or is declared to be hazardous or toxic under any law or regulation now or hereafter enacted or promulgated by any governmental authority.

11.3. Conditions. The obligations for Owner to indemnify, hold harmless and reimburse the Indemnitees above under this Paragraph 11 are subject to the following conditions:

i) the Indemnitees shall promptly notify Owner of any matter with respect to which Owner is required to indemnify, hold harmless or reimburse the Indemnitees; and

ii) the Indemnitees shall not take any actions, including an admission of liability, which would bar Owner from enforcing any applicable coverage under policies of insurance held by Owner or would prejudice any defense of Owner in any appropriate legal proceedings pertaining to any such matter or otherwise prevent Owner from defending itself with respect to any such matter.

11.4. Excluded Matters. Notwithstanding the foregoing, Owner shall not be required to indemnify, hold harmless or reimburse the Indemnitees with respect to any matter to the extent the same resulted from the gross negligence or willful malfeasance of the Indemnitees or actions taken by the Indemnitees outside of the scope of the Manager's authority under this Agreement or any express or implied direction of Owner.

11.5. Survival. The provisions of this Paragraph 11 shall survive the expiration and any termination of this Agreement.

12. Independent Contractor Status. Manager is and shall at all times remain an independent contractor of Owner and under no circumstance shall Manager be deemed to be the employee of Owner.

13. **Suits and Claims.** Manager shall notify Owner and Owner's insurance carrier in writing as soon as possible after receipt of notice of (i) any injury occurring on the Property; (ii) any claim against Owner and/or Manager; and (iii) any claim which involves said Property. Manager shall take no steps (such as the admission of liability) which would operate to bar Owner from obtaining any protection afforded by any policies of insurance it may hold, or which would operate to prejudice the defense in any legal proceeding involving Owner or said Property, or which would otherwise prevent Owner from protecting itself against any such claims, demand, or legal proceeding. Manager shall fully cooperate with Owner in the defense of any such claim,

demand, or proceeding. Owner shall have the sole and exclusive right to conduct the defense of any such claim, demand, or legal proceeding.

14. **Sale of the Property.** Owner shall inform Manager of its intention to sell the herein described Property and furnish the terms and conditions of such sale before listing the Property with a broker other than Manager. If Owner executes a listing agreement with a broker (other than Manager) for sale of the Property, Manager shall cooperate with such broker to the end that the respective activities of Manager and broker may be carried on without friction and without interference with Tenants and occupants. Manager will permit the broker to exhibit the Property during reasonable business hours. In such case, Owner agrees to notify Manager in writing of the date of closing, the progress of the closing process, and what measures and steps Owner wishes Manager to take in preparation for such closing. Owner agrees to provide written documentation pertaining to the distribution of funds held by Manager and the parties agree that Manager will not release such funds without written authorization from Owner.

15. **No Third-Party Beneficiary Rights/No Interest in Property Account or Other Owner's Funds.** This Agreement is made solely for the benefit of the Manager and Owner and no third party is intended to or shall have any third party beneficiary rights under this Agreement against either Manager or Owner. All funds and revenues relating to the Property, including but not limited to the Property Account, shall solely be those of Owner, and Manager shall have no interest in or lien against any such monies.

16. **No Recordation.** Neither this Agreement nor any memorandum thereof shall be recorded by any party at any time.

17. **Timely Performance.** Owner and Manager shall each perform all of their respective obligations under this Agreement in a proper, prompt and timely manner. Each shall furnish the other with such information and assistance as the other may from time to time reasonably request in order to perform its responsibilities hereunder. Owner and Manager each shall take such actions as the other may from time to time reasonably request and otherwise cooperate with the other so as to avoid or minimize any delay or impairment of either party's performance of its obligations under this Agreement.

18. **Assignment.**

18.1. Permissible Assignments. Neither Owner nor Manager may assign this Agreement without the prior written consent of the other (which may be given or withheld in such party's sole and absolute discretion); provided, however, that either party may assign this Agreement to a successor corporation or partnership, a parent company, a wholly-owned subsidiary corporation or an entity which controls, is controlled by or is under common control with Owner or Manager, as the case may be.

18.2. Assumption and Release. Each permitted assignee of this Agreement shall agree in writing to personally assume, perform and be bound by all of the terms, covenants, conditions and agreements contained in this Agreement, and thereupon the assignor of this Agreement shall be relieved of all obligations hereunder except those which shall have accrued prior to the effectiveness of such assignment.

19. **Notices.**

19.1. General. Any and all notices or other communications given under this Agreement shall be deemed to have been properly given when delivered, if personally delivered, or three (3) days after the date mailed if sent certified or registered mail, return receipt requested and postage prepaid, and addressed to the parties at the following addresses:

i) If to Manager, to:

____

____

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____

ii) If to Owner, to:

____

____

____

Any notices delivered by either party in any manner other than those described above shall be deemed properly given when received. Either party may change its address for the giving of notices under this Agreement by delivering to the other party ten (10) days prior written notice of such change of address.

19.2. Emergency Notices. Either party may give the other notice of emergency situations orally (personally, by telephone or otherwise) or by telecopy, telex, telegram or other method, provided that the party giving any emergency notice as provided above in this Paragraph 19 shall confirm the same by written notice in accordance with Paragraph 19.1, above.

20. **Affiliates.** Manager shall not retain or use any person or entity who is an affiliate of Manager unless such retention is on terms which are arm's-length and no worse than those which would be obtainable from unrelated third parties. The term "affiliate" as used in this Paragraph shall mean and refer to any entity in which the Manager, or any shareholder, partner, officer or director of Manager has a financial interest, or any person who is related by blood or marriage to Manager or any shareholder, partner, officer or director of Manager.

21. **No Obligations of Future Owner.** Notwithstanding anything set forth in this Agreement, no future owner of the Property shall have any obligations under this Agreement, nor shall the Property at any time be subject to any claim by Manager in respect of this Agreement.

22. **Miscellaneous.** **[See also, Boilerplate Provisions Discussed in Chapter 4]**

This Agreement shall be construed and enforced in accordance with and governed by the laws of the State of California. This Agreement embodies the entire agreement and understanding between the parties and supersedes all prior agreements and understandings relating to the subject matter hereof. This Agreement may not be modified, amended or terminated, nor may any term or provision hereof be waived or discharged, except in writing signed by the party against whom such amendment, modification, termination, waiver or discharge is sought to be enforced. All of the terms of this Agreement, whether so expressed or not, shall be binding upon the respective successors and permitted assigns of the parties hereto and shall inure to the benefit of and be enforceable by the parties hereto and their respective successors and permitted assigns. If any of the provisions of this Agreement shall to any extent be invalid or unenforceable, the remaining provisions of this Agreement shall not be affected thereby and every provision of this Agreement shall be valid and enforceable to the fullest extent permitted by law. The headings of this Agreement are for purposes of reference only and shall not limit or otherwise affect the meaning hereof. This Agreement may be executed in several counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument. Any references in this Agreement to any one gender, masculine, feminine or neuter, includes the other two, and the singular includes the plural, and vice versa, unless the context otherwise requires.

[OPTIONAL: PROVISIONS FOR LEASING COMMISSION. These can be set forth within the body of the Agreement or in a separate listing agreement. (See Chapter 2 for requirements for listing agreement.)]

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IN WITNESS WHEREOF, the parties hereto have caused this instrument to be duly executed by their duly authorized officers as of the day and year first above written.

OWNER:	**MANAGER:**
____________	____________
By:____________	By: ____________
Name: ____________	Name: ____________
Title: ____________	Title: ____________

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Cal. Prac. Guide Real Prop. Trans. ¶ 11:1

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 11. Remedies in Purchase and Sale Transactions

[11:1] Scope Note:

Ordinarily, parties do not negotiate a real property purchase and sale transaction with the expectation something will go wrong. Nonetheless, any number of events can, and quite often do, occur after execution of the agreement that either impede or abort the transaction. This Chapter focuses on the various remedies available to buyers and sellers upon the breach (or apparent breach) of a purchase and sale agreement; the Chapter also addresses the parties' potential remedies to avoid their obligations under a legally "imperfect" contract. Other remedies tangentially bearing on the rights of parties aggrieved in a purchase and sale transaction are treated briefly in the final sections of this Chapter.

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Cal. Prac. Guide Real Prop. Trans. ¶ 11:2

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 11. Remedies in Purchase and Sale Transactions

• [11:2] *Compare—land sale contracts*

Compare—land sale contracts: As discussed in *Ch. 4*, land sale contracts are quite different from the typical purchase and sale agreement (*see ¶ 4:112 ff.*). Thus, the remedies addressed in this Chapter do not necessarily apply to installment land contracts. A seller's remedy under an installment land contract is usually to foreclose; and a buyer's remedy is typically to seek specific performance. (As a practical matter however, installment land contracts are rarely used in modern practice.)

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Cal. Prac. Guide Real Prop. Trans. Ch. 11-A

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 11. Remedies in Purchase and Sale Transactions

A. Factors Affecting Choice of Remedies

1. [11:4] General Considerations—Client's Goals and Litigation Posture
2. [11:5] Planning Considerations During Transactional Stages
    - a. [11:6] Create, limit and preclude remedies in transactional documents
        - (1) [11:7] Clarity of terms
    - b. [11:8] Preserve remedies during course of transaction
    - c. [11:9] Act timely
3. [11:10] Affirmance or Disaffirmance of Contract
    - a. [11:11] Pleading inconsistent remedies
        - (1) [11:12] Consistent factual allegations required
    - b. [11:13] Election of remedies
4. [11:20] Determining Whether Enforceable Contract Exists
    - a. [11:21] Essential elements
        - (1) [11:22] Material terms
            - (a) [11:23] Missing terms indicating nonbinding "agreement to agree"
                - 1) [11:23.1] Compare—independent contract to negotiate
            - (b) [11:23.2] Parol evidence
                - 1) [11:23.3] Admissible to establish third-party professional's distinct obligations
        - (2) [11:24] Writing requirement (statute of frauds)
            - (a) [11:24.1] Electronic messages
            - (b) [11:24.2] Distinguish—executed contracts
    - b. [11:25] Consent/acceptance
        - (1) [11:25a] Negotiation not required; objective test
        - (2) [11:25.1] Effect of qualified acceptance or counteroffer
            - (a) [11:25.2] Mistakenly-labeled counteroffers
        - (3) [11:25.3] Signature deemed consent
            - (a) [11:25.3a] Exception—document not presented as contract
            - (b) [11:25.3b] Effect of no signatures
        - (4) [11:25.5] Voidable consent
            - (a) [11:25.6] Compare—ratification by subsequent conduct
    - c. [11:25.10] Lawful and ascertainable purpose
    - d. [11:26] Sufficient consideration
        - (1) [11:27] Mutual obligations
            - (a) [11:28] No mutuality of obligation where unrestricted right to cancel
            - (b) [11:29] Compare—satisfaction clauses
            - (c) [11:29.1] Compare—illusory contract rendered enforceable by partial performance

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(d) [11:29.2] Compare—promissory estoppel
(2) [11:29.10] Challenging sufficiency of consideration
(3) [11:29.11] Limitation—illegal consideration
e. [11:30] Certainty of property description
f. [11:31] Contractual capacity
(1) [11:32] Minors/persons of unsound mind
(a) [11:32.1] Presumption of unsound mind
(2) [11:33] Spouses/domestic partners with regard to community property
(3) [11:34] Partnerships, corporations and other entities
g. [11:35] Failure of conditions precedent
h. [11:35.5] Adhesion contracts
i. [11:36] Unconscionability defense
(1) [11:36.1] Establishing unconscionability
(2) [11:37] Not basis for affirmative relief

[11:3] The basic remedies most directly related to a purchase and sale agreement include damages for breach of contract or fraud, specific performance, reformation and rescission. As discussed at ¶ 11:4 ff., the appropriate choice of remedies depends on several factors, some of which are necessarily personal to the client and others of which are a product of contract law and the terms of the parties' agreement.

1. [11:4] **General Considerations—Client's Goals and Litigation Posture:** In many cases, the type of remedy to pursue will be influenced, in part, by considerations personal to your client, including:

- The client's ultimate goal (e.g., obtaining the property in kind vs. obtaining monetary relief vs. backing out of the transaction altogether);
- The cost of pursuing the particular remedy;
- The length of time necessary to pursue the remedy;
- The likelihood of success; and
- How a particular remedy fits into the client's overall litigation (or arbitration) strategy.

2. [11:5] **Planning Considerations During Transactional Stages:** Negotiations and events that occur in the early stages of the transaction will often have a bearing on available remedies. Counsel for both parties should focus on the need to create and preserve their respective clients' remedies (and limit the other party's remedies) from the inception of the purchase and sale negotiations. In particular, the parties and their counsel should be aware of the following considerations throughout the course of the transaction:

a. [11:6] **Create, limit and preclude remedies in transactional documents:** The parties should negotiate (and counsel should make certain the transactional documents embody) the creation or limitation of certain remedies. For example:

- The parties may wish to agree on *liquidated damages* (*see ¶ 4:310 ff.*);
- The buyer may be required to *waive* its right to seek *specific performance* (*see ¶ 4:506*);
- The parties might agree that any disputes arising out of the transaction be decided by binding *arbitration* instead of litigation (*see ¶ 4:490 ff.*); or
- The parties might otherwise contract for certain exclusive remedies in the event of a breach.

(1) [11:7] **Clarity of terms:** Provisions limiting certain remedies must be *clear and precise*. A contract will not be construed to preclude either party from electing among available remedies unless the language used in the agreement

clearly indicates an intent to make specified remedies exclusive. [*Nelson v. Spence* (1960) 182 CA2d 493, 497, 6 CR 312, 315—provision stating "buyer at his *option may* rescind" agreement for breach of warranty *not* effective to limit buyer's remedies to rescission; see also *Michel & Pfeffer v. Oceanside Properties, Inc.* (1976) 61 CA3d 433, 443, 132 CR 179, 184 (distinguished on other grounds by *Wm. R. Clarke Corp. v. Safeco Ins. Co.* (1997) 15 C4th 882, 891, 64 CR2d 578, 583)—right to rescind foreclosed by language expressly prescribing another remedy as "sole remedy"]

b. [11:8] **Preserve remedies during course of transaction:** The parties should be careful to preserve their remedies during the course of the transaction by avoiding conduct or statements that would be inconsistent with the remedy they seek. For example, a party who ultimately wishes to seek specific performance (an affirmance of the contract) should not engage in conduct that suggests there is no binding agreement or that the party will seek to rescind the contract (a disaffirmance of the contract).

c. [11:9] **Act timely:** The parties should also *act timely to preserve their remedies*. For example, the contract may set deadlines for various actions by a party as a condition to the enforcement of certain remedies. Moreover, a party's right to pursue a particular remedy might be subject to defenses based on that party's untimely conduct (e.g., waiver, laches and estoppel).

3. [11:10] **Affirmance or Disaffirmance of Contract:** One of the threshold issues in assessing the availability of any remedy is whether the contract should be affirmed or disaffirmed. A remedy seeking the benefits of the contract (e.g., an action for specific performance or a damages suit for breach of contract) requires the client to *affirm* the contract. Conversely, if the client's goal is to avoid its obligations under the contract, the remedy is one to *disaffirm* the contract (i.e., rescission). [*Alder v. Drudis* (1947) 30 C2d 372, 381-382, 182 P2d 195, 201; *Akin v. Certain Underwriters at Lloyd's London* (2006) 140 CA4th 291, 296, 44 CR3d 284, 287]

The distinction has important consequences when it comes to damages. Parties who sue for breach of contract (i.e., affirming the contract's existence) may be compensated for the loss of their "expectational interest"—the benefit of their bargain that full performance would have brought. In contrast, a suit for relief based on rescission (i.e., disaffirming the contract's existence) seeks to extinguish the contract, terminate further liability and restore the parties to their former positions by requiring them to return whatever consideration they received; benefit of the bargain damages are not available in rescission cases (¶ *11:508.1*). [*Sharabianlou v. Karp* (2010) 181 CA4th 1133, 1144-1146, 105 CR3d 300, 310-311]

a. [11:11] **Pleading inconsistent remedies:** Disaffirmance and affirmance of a contract are, of course, inconsistent and, therefore, so are the remedies of damages (or specific performance) and rescission (*see* ¶ *11:10*). [*Akin v. Certain Underwriters at Lloyd's London* (2006) 140 CA4th 291, 296, 44 CR3d 284, 287; *Karapetian v. Carolan* (1948) 83 CA2d 344, 347, 188 P2d 809, 811]

Nevertheless, a party may *plead* inconsistent, mutually exclusive theories, some that affirm the contract and others that disaffirm it. [*Karapetian v. Carolan*, supra, 83 CA3d at 351-352, 188 P2d at 813—"it is now well settled that the innocent party may set forth in his complaint against the fraudulent party a cause of action for rescission, and in a second cause of action ask for damages, if for any reason rescission is not granted"; see *Stevens Group Fund IV v. Sobrato Develop. Co.* (1991) 1 CA4th 886, 889, 2 CR2d 460, 461—buyer's action against seller for breach of contract for sale of real property sought damages or, in the alternative, specific performance; *Walton v. Walton* (1995) 31 CA4th 277, 292, 36 CR2d 901, 908 (breach of contract damages and quasi-specific performance)]

Indeed, Civ.C. § 1692 provides that "[a] claim for damages is not inconsistent with a claim for relief based upon rescission." [Civ.C. § 1692; *Sharabianlou v. Karp* (2010) 181 CA4th 1133, 1144, 105 CR3d 300, 309; *see* ¶ *11:461, 11:499*]

(1) [11:12] **Consistent factual allegations required:** However, pursuing remedies based on alternative theories of affirmance and disaffirmance can be difficult because, although inconsistent *remedies* may be sought, the underlying facts to be pled and proved must be consistent. [*Baran v. Goldberg* (1948) 86 CA2d 506, 511-512, 194 P2d 765, 768-769—specific performance cause of action alleging no difference between agreed-upon price and value of property at time of breach precluded breach of contract damages award]

For example, a plaintiff who seeks damages for breach of contract must allege and prove facts evidencing that a binding contract exists. Yet, if the complaint also seeks, in the alternative, relief based upon rescission, plaintiff will have to allege and prove facts evidencing that no valid contract exists. (Nonetheless, though seemingly difficult to conceptualize, such alternative pleading is allowed. See *Williams v. Marshall* (1951) 37 C2d 445, 455-457, 235 P2d 372, 379; *Karapetian v. Carolan* (1948) 83 CA2d 344, 351-352, 188 P2d 809, 813; ¶ *11:11 & 11:461*.)

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b. [11:13] **Election of remedies:** Where the underlying facts support inconsistent remedies, plaintiff is not required to "elect" the appropriate remedy at the pleading stage. Absent plaintiff's waiver or other conduct evidencing an irrevocable election of remedies, plaintiff may pursue inconsistent theories and need not finally elect between the remedies until after the evidence is presented at trial (i.e., prior to judgment). [See *Raedeke v. Gibraltar Sav. & Loan Ass'n* (1974) 10 C3d 665, 671, 111 CR 693, 696; *Denevi v. LGCC* (2004) 121 CA4th 1211, 1218-1221, 18 CR3d 276, 281-284; compare *City of Orange v. San Diego County Employees Retirement Ass'n* (2002) 103 CA4th 45, 58-59, 126 CR2d 405, 415-416—where plaintiffs brought restitution and breach of contract claims in same action but were precluded from pursuing restitution by summary judgment, they effectively had no choice of remedies and election of remedies doctrine not applicable]

Indeed there is even authority that an election of remedies should not be compelled before *satisfaction of judgment* ... unless plaintiff has gained some benefit other than the judgment that would make it inequitable to permit continued pursuit of an otherwise available remedy. [*Denevi v. LGCC*, supra, 121 CA4th at 1221, 18 CR3d at 283-284]

However, once made, the election of one remedy *bars recovery* under the other(s). [*Akin v. Certain Underwriters at Lloyd's London* (2006) 140 CA4th 291, 296, 44 CR3d 284, 287]

• [11:13.1] A buyer's notice of rescission based on the seller's fraud does not preclude pursuing a damages remedy for breach of contract unless the seller has *accepted* the buyer's offer to rescind (or the facts otherwise show the buyer waived a damages remedy by inconsistent conduct following discovery of the fraud); the right to breach of contract damages exists unless and until the transaction is effectively disaffirmed. [*Walters v. Marler* (1978) 83 CA3d 1, 15-16, 147 CR 655, 664 (disapproved on other grounds by *Gray v. Don Miller & Assocs., Inc.* (1984) 35 C3d 498, 507, 198 CR 551, 556); *Karapetian v. Carolan* (1948) 83 CA2d 344, 351-355, 188 P2d 809, 813-815; *see further discussion at* ¶ *11:352, 11:461*]

[11:14 - 11:19] ***Reserved.***

4. [11:20] **Determining Whether Enforceable Contract Exists:** Also fundamental to the appropriate choice of remedies is whether a *binding, enforceable contract* was ever formed. The "existence of a contract is a necessary element to an action based on contract, regardless whether the plaintiff seeks specific performance or damages for breach of contract." [*Roth v. Malson* (1998) 67 CA4th 552, 558-559, 79 CR2d 226, 230; see also *Harris v. Rudin, Richman & Appel* (1999) 74 CA4th 299, 307, 87 CR2d 822, 828—"To state a cause of action for breach of contract, a party must plead the existence of a contract …"]

Some of the issues pertinent to that determination are the same as those relevant to whether there are grounds to disaffirm a contract. For example, failure of consideration is a basis for disaffirmance (i.e., rescission, *see* ¶ *11:477*), but it is also a basis for arguing no binding agreement ever came into existence (¶ *11:21, 11:26*).

a. [11:21] **Essential elements:** The following are the minimal essential elements of a binding contract (Civ.C. § 1550):

• The parties to the contract must have *contractual capacity* (¶ *11:31*);

• The parties must *consent* to the contract (¶ *11:25*);

• The contract must have a *lawful purpose* (¶ *11:25.10 ff.*); and

• The contract must be supported by *sufficient consideration* (see Civ.C. § 1605, defining "good consideration"; *and* ¶ *11:26 ff.*). [Civ.C. § 1550; *Garcia v. World Savings, FSB* (2010) 183 CA4th 1031, 1038, 107 CR3d 683, 690—consideration is necessary for "true breach of contract claim"]

(1) [11:22] **Material terms:** In addition, like any contract, an enforceable purchase and sale contract must set forth with "reasonable certainty" all *material* terms—including, at a minimum, the *identity of the parties* (Civ.C. § 1558), the *purchase price*, and a *sufficient description* of the property. [*Sterling v. Taylor* (2007) 40 C4th 757, 772, 55 CR3d 116, 128; *see further discussion at* ¶ *4:270 ff.*]

Other incidental terms of the transaction—such as opening of an escrow and escrow fees, furnishing deeds, title insurance policies, proration of taxes, etc.—need not be stated with precision or, for that matter, even addressed. The court may determine the nonessential terms based on local custom. [*King v. Stanley* (1948) 32 C2d 584, 589, 197 P2d 321, 324 (disapproved on other grounds by *Patel v. Liebermensch* (2008) 45 C4th 344, 351, 86 CR3d 366, 371, fn.4)]

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(a) [11:23] **Missing terms indicating nonbinding "agreement to agree":** When the resolution of a material term is left to a later date, the purported contract will be deemed a mere "agreement to agree" and thus unenforceable against either party. [*Ablett v. Clauson* (1954) 43 C2d 280, 284-285, 272 P2d 753, 756; see also *Daniels v. Select Portfolio Servicing, Inc.* (2016) 246 CA4th 1150, 1174, 201 CR3d 390, 413 (disapproved on other grounds by *Sheen v. Wells Fargo Bank, N.A.* (2022) 12 C5th 905, 943, 290 CR3d 834, 860, fn.12)—"[p]reliminary negotiations or agreements for future negotiations—so-called agreements to agree—are not enforceable contracts"]

Thus, e.g., a provision in an oral or informal written agreement stating the "agreement" is not intended to be binding until a *formal written contract* is executed is considered a *material* term; and there is no binding contract *until* the formal written contract is executed. [*Harris v. Rudin, Richman & Appel* (1999) 74 CA4th 299, 307, 87 CR2d 822, 828 (settlement letter); see also *Daniels v. Select Portfolio Servicing, Inc.*, supra, 246 CA4th at 1176, 201 CR3d at 414—servicer's alleged oral promise to issue loan modification agreement in exchange for monthly trial payments deemed unenforceable "agreement to agree"; *Elyaoudayan v. Hoffman* (2003) 104 CA4th 1421, 1429-1430, 129 CR2d 41, 46-47 (oral in-court settlement); *and* *¶ 4:264.5*]

1) [11:23.1] **Compare—independent contract to negotiate:** Parties to a contemplated transaction sometimes enter into a separate *contract to negotiate.* Such a contract does not bind the parties to reach an ultimate agreement, but it obligates them to bargain in good faith. [See *Copeland v. Baskin Robbins U.S.A.* (2002) 96 CA4th 1251, 1257, 117 CR2d 875, 880-881; *and* *¶ 4:275.8*]

Cross-refer: "Nonbinding" agreements (letters of intent, memoranda, etc.) are discussed in greater detail at *¶ 4:275 ff.*

(b) [11:23.2] **Parol evidence:** Parol evidence may not be used to supply omitted *essential* terms. However, in appropriate circumstances, extrinsic evidence may be admissible to (i) clarify the terms of an ambiguous agreement, (ii) complete the incidental terms of a purchase contract that otherwise complies with the statute of frauds or (iii) establish illegality or fraud. [See CCP § 1856; *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Ass'n* (2013) 55 C4th 1169, 1172, 1182, 151 CR3d 93, 94-95, 103 (overruling prior contrary authority)—extrinsic evidence of fraudulent promises at variance with writing's terms deemed admissible; see also *Thompson v. Asimos* (2016) 6 CA5th 970, 987-989, 212 CR3d 158, 174-176 (construing two ambiguous standard form independent contractor agreements)—contracts' language combined with undisputed parol evidence supported trial court's implied finding that broker promised to comply with real estate broker regulations and thus breached agreements with founder of highly specialized real estate consulting firm by failing to register firm with DRE; *West v. JPMorgan Chase Bank, N.A.* (2013) 214 CA4th 780, 798, 154 CR3d 285, 299-300 (construing ambiguous HAMP Trial Plan Agreement)—construction given by parties' acts and conduct *before* any controversy arose entitled to "great weight" and "will, when reasonable, be adopted and enforced by the court"; *Marin Storage & Trucking, Inc. v. Benco Contracting & Engineering, Inc.* (2001) 89 CA4th 1042, 1051, 107 CR2d 645, 652 (construing contractual indemnification clause)—parties' prior course of dealings may determine meaning of contract term or add agreed but *unstated* term; compare *Hot Rods, LLC v. Northrop Grumman Systems Corp.* (2015) 242 CA4th 1166, 1175-1177, 196 CR3d 53, 59-61—integration clause stating "no extrinsic evidence whatsoever may be introduced" to interpret contract was fully enforceable as express indication of "sophisticated" parties' intent to bypass general rule; *see also* ¶ *4:270.4, 4:529*]

Parol evidence also is admissible to show whether the parties intended several written instruments to constitute a single contract. [*Versaci v. Sup.Ct. (Palomar Community College Dist.)* (2005) 127 CA4th 805, 814-815, 26 CR3d 92, 98; see also Civ.C. § 1642—several contracts relating to same subject matter between same parties and made as part of substantially one transaction are to be taken together; see also *R.W.L. Enterprises v. Oldcastle, Inc.* (2017) 17 CA5th 1019, 1027-1032, 226 CR3d 677, 683-687—for one agreement's terms to be incorporated into another per § 1642, reference must be "clear and unequivocal" (parties' dealer agreement which contained no attorney fee provision and their subsequent credit application which did were not part of same transaction, could not be construed together and thus prevailing party in breach of dealer agreement action could not rely on credit application's fee provision as basis for fee award); *Vons Cos., Inc. v. Lyle Parks, Jr., Inc.* (2009) 177 CA4th 823, 834-835, 99 CR3d 562, 570-572 & fn. 5—whether Civ.C. § 1642 applies in particular case is question of fact (prevailing party on claim for breach of warranty that contained no attorney fee clause could not rely on related construction contract that did contain attorney fee clause as basis for Civ.C. § 1717 fee award)]

1) [11:23.3] **Admissible to establish third-party professional's distinct obligations:** Parol evidence is admissible to establish a third-party professional's distinct obligations relative to, but separate from, the parties' contractual obligations under a real property purchase and sale agreement. Indeed, while "[t]he parol evidence rule prevents reconstruction of the parties' contractual obligations[,] it does not immunize real estate agents, attorneys, or other professionals from liability arising from their misconduct in drafting a document." [See *Thomson v. Canyon* (2011) 198 CA4th 594, 599, 129 CR3d 525, 528—extrinsic evidence admissible to establish third-party real estate agent/broker's obligation to prepare reconveyance documentation in conjunction with parties' buy/sell agreement]

(2) [11:24] **Writing requirement (statute of frauds):** All material terms of a real property purchase agreement must be reduced to a *writing* that is *signed by the party to be charged.* [Civ.C. § 1624; *Lee v. Lee* (2009) 175 CA4th 1553, 1556, 97 CR3d 516, 519—statute of frauds' purpose is to prevent fraud or perjury by requiring reliable evidence of contract's existence and terms; compare *Daniels v. Select Portfolio Servicing, Inc.* (2016) 246 CA4th 1150, 1176, 201 CR3d 390, 414 (disapproved on other grounds by *Sheen v. Wells Fargo Bank, N.A.* (2022) 12 C5th 905, 943, 290 CR3d 834, 860, fn.12)—complaint alleging oral agreement to modify loan terms not barred by statute of frauds where borrowers included allegations reflecting their "full performance"; see also *Chavez v. Indymac Mortg. Services* (2013) 219 CA4th 1052, 1058, 162 CR3d 382, 386 (noting equitable estoppel may preclude using statute of frauds as a defense); *and see detailed discussion at ¶ 4:263 ff.*]

(a) [11:24.1] **Electronic messages:** Electronic messages of an "ephemeral" nature that are not designed to be retained or to create a permanent record (e.g., text messages and instant message format communications) are insufficient to constitute a contract to convey real property *unless* confirmed in writing as statutorily described. [See Civ.C. § 1624(d)]

(b) [11:24.2] **Distinguish—executed contracts:** The statute of frauds does *not* apply to an *executed* contract—e.g., a deed that is signed by the grantor and delivered to the grantee is an executed purchase and sale contract. [See *Lee v. Lee* (2009) 175 CA4th 1553, 1557-1558, 97 CR3d 516, 519-520—quitclaim deed executed and delivered to grantee before deed was altered by third party was an executed contract outside statute of frauds]

b. [11:25] **Consent/acceptance:** There cannot be a binding contract unless the parties intended by the particular document to create binding obligations and there is a *meeting of the minds*—i.e., a manifestation of *mutual assent* to the *same thing* (ordinarily evidenced by a valid offer and acceptance). [Civ.C. §§ 1550, 1565, 1580; *Bustamante v. Intuit, Inc.* (2006) 141 CA4th 199, 208, 45 CR3d 692, 698-699; *Alexander v. Codemasters Group Ltd.* (2002) 104 CA4th 129, 141, 127 CR2d 145, 151-152 (declined to follow on other grounds by *Reid v. Google, Inc.* (2010) 50 C4th 512, 524, 113 CR3d 327, 337); see *Elyaoudayan v. Hoffman* (2003) 104 CA4th 1421, 1430, 129 CR2d 41, 47—"California law is clear that there is no contract until there has been a meeting of the minds on *all* material points" (emphasis in original; internal quotes omitted); see also Rest.2d Contracts § 26]

(1) [11:25a] **Negotiation not required; objective test:** Actual negotiation of the essential terms is not required. The existence of mutual assent is determined under an *objective* standard applied to the parties' *outward* manifestations or expressions (not their unexpressed intentions or understanding). The test is whether a reasonable person would conclude from the parties' conduct that there was a mutual agreement on the essential terms. [*Alexander v. Codemasters Group Ltd.* (2002) 104 CA4th 129, 141, 150, 127 CR2d 145, 151, 159; *Marin Storage & Trucking, Inc. v. Benco Contracting & Engineering, Inc.* (2001) 89 CA4th 1042, 1050, 107 CR2d 645, 652; *Bustamante v. Intuit, Inc.* (2006) 141 CA4th 199, 208, 45 CR3d 692, 699]

(2) [11:25.1] **Effect of qualified acceptance or counteroffer:** An alleged acceptance forms a binding contract only if its terms *exactly, precisely* and *unequivocally* match the essential terms proposed in the offer. [Civ.C. § 1585; *Roth v. Malson* (1998) 67 CA4th 552, 558-559, 79 CR2d 226, 230; *Marcus & Millichap Real Estate Invest. Brokerage Co. v. Hock Invest. Co.* (1998) 68 CA4th 83, 89, 80 CR2d 147, 150]

A conditional or qualified acceptance, or one that adds additional terms, is a *counteroffer* that, if it materially varies from the original offer, terminates the offer. [*Roth v. Malson*, supra, 67 CA4th at 558-559, 79 CR2d at 230]

Unless the counteroffer is accepted (by the original offeror), there has been no "meeting of the minds" (mutual assent) and no binding contract has been formed. [See *Panagotacos v. Bank of America* (1998) 60 CA4th 851, 855-856, 70 CR2d 595, 597—buyers' purported acceptance of seller's offer never gave rise to binding contract because it proposed payment occur at place other than as specified by offeror (an essential term of the offer); see also *Devereaux v. Harper* (1962) 210 CA2d 519, 524-525, 26 CR 837, 841]

(a) [11:25.2] **Mistakenly-labeled counteroffers:** A purported acceptance written in the section of a form contract labeled "counteroffer" or "changes/amendments" most likely will be treated as a counteroffer—even if the terms match the original offer. Since contract law turns on the parties' *objective* manifestation of intent (*¶ 11:25a*), courts generally are reluctant to compare and contrast terms to determine whether there is a material variance when a response to an offer is *facially* presented as a counteroffer. [*Roth v. Malson* (1998) 67 CA4th 552, 558-559, 79 CR2d 226, 230; *see also ¶ 4:264.3*]

(3) [11:25.3] **Signature deemed consent:** Ordinarily, one who signs a contract is deemed to consent to all of its terms. [*Marin Storage & Trucking, Inc. v. Benco Contracting & Engineering, Inc.* (2001) 89 CA4th 1042, 1049, 107 CR2d 645, 651; *see also ¶ 11:431*]

(a) [11:25.3a] **Exception—document not presented as contract:** The result may be otherwise where the instrument presented for signature does not appear to be a contract and its terms are not called to the other (signing) party's attention. Here, no contract is formed with respect to undisclosed terms. [*Marin Storage & Trucking, Inc. v. Benco Contracting & Engineering, Inc.* (2001) 89 CA4th 1042, 1049, 107 CR2d 645, 651]

(b) [11:25.3b] **Effect of no signatures:** When it is clear from a provision in a proposed written contract and any other relevant evidence that the parties contemplated that acceptance of the proposed contract's terms would be signified by signing the contract, *no* binding contract comes into existence until it is signed. [*Basura v. U.S. Home Corp.* (2002) 98 CA4th 1205, 1215, 120 CR2d 328, 335]

(And even if the contract is legally formed without signatures, it may be unenforceable under the *statute of frauds. See ¶ 4:266 ff.*)

[11:25.4] ***Reserved.***

(4) [11:25.5] **Voidable consent:** Assent to the essential terms of an offer brings about a binding contract so long as it is "free," "mutual" and "communicated" to the other party. [Civ.C. § 1565; *Roth v. Malson* (1998) 67 CA4th 552, 557, 79 CR2d 226, 228]

By contrast, contractual consent is *voidable*, and thus ground for *rescission* (or defense to enforcement of the contract), if induced by duress, menace, fraud, undue influence or mistake of fact or law (*see ¶ 11:469 ff.*). [Civ.C. §§ 1566-1579, 1689(b)(1); *Filet Menu, Inc. v. C.C.L. & G., Inc.* (2000) 79 CA4th 852, 861-862, 94 CR2d 438, 444]

(a) [11:25.6] **Compare—ratification by subsequent conduct:** But the result is otherwise if the contract was thereafter *ratified* by the party who allegedly gave the voidable consent. A contract voidable solely because lacking due consent may be *ratified by subsequent conduct*—e.g., by voluntarily *accepting and retaining the benefits* of the contract. [See Civ.C. §§ 1588, 1589; *Saret-Cook v. Gilbert, Kelly, Crowley & Jennett* (1999) 74 CA4th 1211, 1225-1226, 88 CR2d 732, 742-743; *see also ¶ 11:496 ff.*]

However, subsequent conduct consistent with the contract can amount to an effective ratification only if the "ratifying party" fully knew of the right to void the contract due to lack of consent. "It is an inherent element of ratification that the party to be charged with it must have fully known what he was doing." [*Fergus v. Songer* (2007) 150 CA4th 552, 571, 59 CR3d 273, 289 (internal quotes omitted)]

[11:25.7 - 11:25.9] ***Reserved.***

c. [11:25.10] **Lawful and ascertainable purpose:** The object of a contract must be lawful when made, and possible and ascertainable by the time it is to be performed. [Civ.C. § 1596; see also Civ.C. § 1667—persons not permitted to enter into contracts contrary to public policy and "good morals"; compare *Corrie v. Soloway* (2013) 216 CA4th 436, 439-440, 447, 156 CR3d 709, 712, 718 (noting there is "no bright line rule" that parties' *subsequent* conduct cannot save their intended transaction from illegality)—amended option agreement conditioning property's sale on Subdivision Map Act compliance deemed valid replacement for prior unlawful agreement (*¶ 8:46.1*)]

A contract is void in its entirety when its single object is unlawful or wholly impossible of performance, but only partially void if it has several distinct lawful and unlawful objects. [Civ.C. §§ 1598, 1599; *Kashani v. Tsann Kuen China Enterprises Co., Ltd.* (2004) 118 CA4th 531, 541, 13 CR3d 174, 180; *Yoo v. Jho* (2007) 147 CA4th 1249, 1255, 55 CR3d 243, 247 (contract for purchase of retail business dealing in counterfeit goods)—"no principle of law is better settled than that a party to an illegal contract cannot come into a court of law and ask to have his illegal objects carried out" (internal quotes

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omitted); *Baeza v. Sup.Ct. (Castle & Cooke Calif., Inc.)* (2011) 201 CA4th 1214, 1230, 135 CR3d 557, 568-569 (real estate purchase agreement containing severability clause)—unlawful contractual damages limitation provision did not invalidate entire contract because illegal provision was collateral to contract's main purpose and could be severed without obstructing enforcement of lawful terms (*¶ 4:534*); *see also ¶ 11:29.11* (unlawful consideration)]

(Courts have carved out exceptions, however, enforcing illegal contracts in narrow circumstances—e.g., when defendant would otherwise be unjustly enriched. See *Kashani v. Tsann Kuen China Enterprise Co., Ltd.*, supra, 118 CA4th at 541, 13 CR3d at 180 (discussing cases).)

d. [11:26] **Sufficient consideration:** A written contract is presumptive evidence that it is supported by consideration. [Civ.C. § 1614]

The lack, inadequacy or failure of consideration is ground for rescission of the contract (Civ.C. § 1689(b)(2), (3) & (4), *¶ 11:477*); and is also a defense to an action for specific performance (Civ.C. § 3391(1), *¶ 11:221*). [See *Mussler v. Nash* (1953) 118 CA2d 494, 496, 258 P2d 108, 109] On the other hand, absent fraud, alleged inadequacy of consideration may not itself support an action for damages. [See *Rice v. Brown* (1953) 120 CA2d 578, 582, 261 P2d 565, 567]

(1) [11:27] **Mutual obligations:** A contract may be supported by consideration consisting of the exchange of *promises* (i.e., an expression of commitment to act, or to refrain from acting, in a specified way, or to bring about a specified future result, or to take responsibility that the result has occurred or will occur, communicated in such a way that the promisee may justly expect performance and reasonably rely on it). [*Sully-Miller Contracting Co. v. Gledson/Cashman Const., Inc.* (2002) 103 CA4th 30, 36, 126 CR2d 400, 403-404; see also *Orcilla v. Big Sur, Inc.* (2016) 244 CA4th 982, 1006, 198 CR3d 715, 734—mere submission of HAMP application did not provide adequate consideration for lender's unsolicited promise to delay foreclosure (*¶ 6:511.20*); *Garcia v. World Savings, FSB* (2010) 183 CA4th 1031, 1039-1040, 107 CR3d 683, 690-691—gratuitous oral promises to postpone foreclosure sales or to allow borrowers to delay monthly mortgage payments generally are unenforceable (borrowers in return promise nothing more than lenders are already due under original loan agreements—i.e., monthly payments plus interest and late fees); *compare ¶ 11:29.2 re promissory estoppel*]

However, the promises must impose "*mutuality of obligation*"—i.e., the promises on each side must be *binding obligations* in order to be consideration for each other. If one of the parties is free to perform or withdraw from the agreement at that party's sole option, the contract is *illusory* and voidable by either party for lack of consideration. [*Mattei v. Hopper* (1958) 51 C2d 119, 122, 330 P2d 625, 626; see also *Sully-Miller Contracting Co. v. Gledson/Cashman Const., Inc.*, supra, 103 CA4th at 36, 126 CR2d at 404; *Money Store Invest. Corp. v. Southern Calif. Bank* (2002) 98 CA4th 722, 728, 120 CR2d 58, 62]

An ostensible "contract" that lacks "mutuality of obligation" is often treated as a mere offer, revocable until accepted, but binding if accepted prior to revocation or other termination. [See *Sully-Miller Contracting Co. v. Gledson/Cashman Const., Inc.*, supra, 103 CA4th at 36, 126 CR2d at 404]

(a) [11:28] **No mutuality of obligation where unrestricted right to cancel:** For example, a contract giving the buyer the unilateral right to cancel at the buyer's sole unrestricted discretion is lacking in mutuality of obligation and thus unenforceable as not supported by sufficient consideration. [See *Kowal v. Day* (1971) 20 CA3d 720, 723-724, 98 CR 118, 119-120]

(b) [11:29] **Compare—satisfaction clauses:** On the other hand, a contract is *not* illusory simply because one party's covenant is conditioned on that party's "satisfaction" or "approval" of a specified act or event (e.g., buyer's obligation to pay purchase price conditioned on "satisfactory" inspection and approval of physical condition of the property or on satisfaction with title to the property). There is mutuality of obligation because the "satisfaction"/"approval" condition is subject to the implied covenant of good faith and fair dealing, thereby obligating the covenantor by an objectively reasonable good faith standard. [See *Storek & Storek, Inc. v. Citicorp Real Estate, Inc.* (2002) 100 CA4th 44, 61, 122 CR2d 267, 281; *Converse v. Fong* (1984) 159 CA3d 86, 90, 205 CR 242, 245; *Jacobs v. Freeman* (1980) 104 CA3d 177, 190, 163 CR 680, 687; *see also ¶ 11:80.1*]

(c) [11:29.1] **Compare—illusory contract rendered enforceable by partial performance:** An agreement that is illusory nonetheless may be enforced where the promisor has partially performed under the contract. [*Steiner v. Thexton* (2010) 48 C4th 411, 423-425, 106 CR3d 252, 263-264—optionee's part performance of bargained-for promise to seek parcel split cured initially illusory nature of promise and thereby constituted sufficient consideration to render option to purchase 10-acre parcel irrevocable (*¶ 8:62*); *Money Store Invest. Corp. v. Southern Calif. Bank* (2002) 98 CA4th 722,

728-729, 120 CR2d 58, 62—despite language reserving lender's right to amend contract, contract not illusory because lender provided funds to complete transaction]

(d) [11:29.2] **Compare—promissory estoppel:** The absence of consideration does not defeat a claim based on promissory estoppel. Indeed, a promisor may be bound when the promisor should reasonably expect a substantial change of position, either by act or forbearance, in reliance on the promisor's promise, if injustice can be avoided only by its enforcement. [See *Youngman v. Nevada Irrig. Dist.* (1969) 70 C2d 240, 249, 74 CR 398, 404; *Garcia v. World Savings, FSB* (2010) 183 CA4th 1031, 1040-1041, 1044, 107 CR3d 683, 691-692, 695—promise must be "clear and unambiguous in its terms"; see also *Bustamante v. Intuit, Inc.* (2006) 141 CA4th 199, 209, 45 CR3d 692, 699—promise must be definite enough for court to determine scope of duty and performance limits must be sufficiently defined to provide rational basis for damages assessment]

• [11:29.3] A lender's oral promise to postpone a residential foreclosure sale in order to allow the owners time to procure funds to cure the default was deemed sufficiently clear and unambiguous to support a claim based on promissory estoppel where the owners, in reliance thereon, procured a high cost, high interest loan by using other property they owned as security. [*Garcia v. World Savings, FSB* (2010) 183 CA4th 1031, 1041-1045, 107 CR3d 683, 692-696]

• [11:29.4] Borrowers' detrimental reliance allegations were sufficient to support a promissory estoppel cause of action against their loan servicer for failure to honor its alleged oral promise to modify borrowers' home loan. The allegations included borrowers' repeated contacts with the servicer, their preparation of documents at the servicer's request and the fact they did not avail themselves of other means to avoid foreclosure. [*Daniels v. Select Portfolio Servicing, Inc.* (2016) 246 CA4th 1150, 1179, 201 CR3d 390, 416 (disapproved on other grounds by *Sheen v. Wells Fargo Bank, N.A.* (2022) 12 C5th 905, 943, 290 CR3d 834, 860, fn.12)]

• [11:29.5] *Compare:* A lender's refusal to honor an alleged oral promise to postpone a foreclosure sale did not result in an unconscionable injury sufficient to support a claim based on promissory estoppel where the sale was conducted only 10 days earlier than promised and evidence showed the borrowers' statutory right to cure would have expired before they planned to contact the lender to request another postponement. Indeed, the borrowers failed to show any change in position based on the lender's oral agreement. Instead, they merely claimed they could have brought the loan current had the lender honored the agreement. [See *Jones v. Wachovia Bank* (2014) 230 CA4th 935, 944-948, 179 CR3d 21, 28-31—by choosing to do nothing, borrowers failed to establish detrimental reliance]

• [11:29.6] Similarly, a cause of action for promissory estoppel based on a lender's unsolicited promise to delay foreclosure failed because the borrowers neglected to allege reliance on the lender's promise and any injuries sustained as a result of that reliance. For example, "they do not allege that they could and would have cured their default before the sale had they known it was going to proceed." [*Orcilla v. Big Sur, Inc.* (2016) 244 CA4th 982, 1007, 198 CR3d 715, 735]

[11:29.7 - 11:29.9] ***Reserved.***

(2) [11:29.10] **Challenging sufficiency of consideration:** As long as a contract is supported by *some* consideration, the law will not attempt to measure the amount thereof. [*6 Angels, Inc. v. Stuart-Wright Mortg., Inc.* (2001) 85 CA4th 1279, 1288, 102 CR2d 711, 717]

The burden of showing lack of *sufficient* consideration is on the party seeking to avoid or invalidate the contract. [Civ.C. § 1615]

(3) [11:29.11] **Limitation—illegal consideration:** If any *part* of the consideration is unlawful, the *entire contract* is *void*. [Civ.C. § 1608; *Yoo v. Jho* (2007) 147 CA4th 1249, 1255-1256, 55 CR3d 243, 248—contract for purchase of business substantially involved in sale of counterfeit goods was void (immaterial whether counterfeit goods accounted for 30% or 70% of sales receipts)]

e. [11:30] **Certainty of property description:** An enforceable purchase and sale agreement must describe the subject property with sufficient precision that it can be identified. [*Beverage v. Canton Placer Mining Co.* (1955) 43 C2d 769, 774, 278 P2d 694, 698; *Alameda Belt Line v. City of Alameda* (2003) 113 CA4th 15, 20-21, 5 CR3d 879, 883; *see also* ¶ *4:270.7, 4:286 ff.*]

It is preferable that the written agreement contain a description that is itself definite and certain. But a description meets the test of reasonable certainty, satisfying the statute of frauds, if:

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- it "furnishes the 'means or key' by which the description may be made certain and identified with its location on the ground" (*Alameda Belt Line v. City of Alameda*, supra, 113 CA4th at 21, 5 CR3d at 883);
- a competent surveyor can locate the property and establish its boundaries from the description given (*Carlson v. Richardson* (1968) 267 CA2d 204, 207, 72 CR 769, 771); or
- there is uncontradicted evidence indicating the location of the property (*Vezaldenos v. Keller* (1967) 254 CA2d 816, 823-824, 62 CR 808, 814).

f. [11:31] **Contractual capacity:** The parties must have had the legal capacity to enter into the contract (generally, not a minor, of "unsound mind" or deprived of civil rights). The contract is subject to *disaffirmance* for lack of contractual capacity … *unless* thereafter *ratified* at a time when the party *has* contractual capacity. [Civ.C. §§ 1550, 1556, 1557; see *Saret-Cook v. Gilbert, Kelly, Crowley & Jennett* (1999) 74 CA4th 1211, 1225, 88 CR2d 732, 742—"Ratification when the actor possesses the capacity to contract has the same effect as valid contract formation"]

(1) [11:32] **Minors/persons of unsound mind:** *Minors* (under age 18) lack capacity to contract with regard to real property (Civ.C. § 1556; Fam.C. § 6701(b)) *unless emancipated* pursuant to Fam.C. § 7000 et seq. [See Fam.C. § 7050(e)(2) & (3); *and* ¶ *4:131, 4:215*]

A contract made by a person of "*unsound mind*" before the person's incapacity has been judicially determined is subject to rescission; and, after a judicial determination of incapacity (establishment of a conservatorship), such person "can make no [binding] conveyance or other contract … until his or her restoration to capacity." [Civ.C. § 1556; see Civ.C. §§ 38, 39(a) & 40; *and* ¶ *4:220 ff.*]

(a) [11:32.1] **Presumption of unsound mind:** A person is rebuttably presumed to be of unsound mind if the person is "substantially unable to manage his or her own financial resources or resist fraud or undue influence"; but "substantial inability" cannot be proved solely by "isolated incidents of negligence or improvidence." [Civ.C. § 39(b) (presumption affecting burden of proof)]

(2) [11:33] **Spouses/domestic partners with regard to community property:** A contract for the sale of community real property must be executed by *both spouses or registered domestic partners* (see Fam.C. § 297.5). If lacking both parties' joinder, the contract is subject to avoidance by the nonconsenting spouse/domestic partner. [Fam.C. § 1102; *Droeger v. Friedman, Sloan & Ross* (1991) 54 C3d 26, 33-34, 46-47, 283 CR 584, 587-589, 597; *see* ¶ *4:201 ff.*; and detailed discussion in Hogoboom & King, *Cal. Prac. Guide: Family Law* (TRG), Ch. 8]

(3) [11:34] **Partnerships, corporations and other entities:** A business entity necessarily must act through its principals. Nonetheless, if the persons acting on behalf of partnerships, corporations, limited liability companies or other entities *lack the authority* to bind the entity to a contract, the contract may be voidable by the entity. (*See detailed discussion at* ¶ *4:203 ff.*)

g. [11:35] **Failure of conditions precedent:** A party's obligations under a contract may be excused if material conditions precedent (which were created for that party's benefit) have not been satisfied or waived by that party. [Civ.C. §§ 1436 & 1439; *see further discussion at* ¶ *11:80*]

[11:35.1 - 11:35.4] ***Reserved.***

h. [11:35.5] **Adhesion contracts:** A standardized contract imposed (typically by a party of superior bargaining strength) on the subscribing party without an opportunity to negotiate the terms (i.e., on a "take-it-or-leave-it" basis) is generally considered a contract of adhesion. A contract will not be invalidated, however, solely on the ground that it is a contract of adhesion; indeed, adhesion contracts are commonplace. [*Graham v. Scissor-Tail, Inc.* (1981) 28 C3d 807, 817-818, 171 CR 604, 610; *Intershop Communications, AG v. Sup.Ct. (Martinez)* (2002) 104 CA4th 191, 201, 127 CR2d 847, 855]

However, a finding of "adhesion" begins another inquiry that may well affect a contract's enforceability—whether the contract or a particular provision thereof should be denied enforcement on the ground that it is *unconscionable* (¶ 11:36 ff.). [*Graham v. Scissor-Tail, Inc.*, supra, 28 C3d at 819-820, 171 CR at 611-612; see also *Lennar Homes of Calif., Inc. v. Stephens* (2014) 232 CA4th 673, 688, 181 CR3d 638, 651—unconscionability is comprised of two judicially imposed limitations (i.e., contract may not fall outside weaker party's reasonable expectations or be unduly oppressive)]

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i. [11:36] **Unconscionability defense:** The court may refuse to enforce a contract, or any part thereof, found to be "unconscionable" at the time it was made; or may limit the application of an "unconscionable" clause to avoid an unconscionable result. [Civ.C. § 1670.5; *Lennar Homes of Calif., Inc. v. Stephens* (2014) 232 CA4th 673, 688, 181 CR3d 638, 651]

(1) [11:36.1] **Establishing unconscionability:** Though lacking precise legal definition, "unconscionability" as a defense to enforcement generally is limited to *adhesion* contracts (see ¶ 11:35.5). Both "procedural" and "substantive" unconscionability must be present—i.e., essentially oppression and surprise, plus objectively unreasonable one-sided terms. Ultimately, the issue is to be decided on the basis of evidence of the commercial setting and the purpose and effect of the contract provision. [See generally, *Sanchez v. Valencia Holding Co., LLC* (2015) 61 C4th 899, 910-911, 190 CR3d 812, 820-821; see also *Lennar Homes of Calif., Inc. v. Stephens* (2014) 232 CA4th 673, 688-690, 693, 181 CR3d 638, 651-653, 655 (unconscionable indemnity clause in residential buy-sell agreement; ¶ 7:73.8d, 7:73.10c); *Bruni v. Didion* (2008) 160 CA4th 1272, 1288-1289, 1293-1294, 73 CR3d 395, 409-410, 413-414 (unconscionable arbitration provisions in residential warranty contracts; ¶ 7:73.8b, 7:73.10b)]

Cross-refer: The elements of an unconscionability defense are explored further at *¶ 7:73.5 ff.* in connection with transfer restrictions in a commercial lease.

(2) [11:37] **Not basis for affirmative relief:** Unconscionability is strictly a *defense* to enforcement of a contract. It does not provide a basis for affirmative relief (e.g., damages or rescission). [*Dean Witter Reynolds, Inc. v. Sup.Ct. (Abascal)* (1989) 211 CA3d 758, 766, 259 CR 789, 794]

[11:38 - 11:49] ***Reserved.***

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Cal. Prac. Guide Real Prop. Trans. Ch. 11-B

California Practice Guide: Real Property Transactions | September 2024 Update
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Chapter 11. Remedies in Purchase and Sale Transactions

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1. [11:50] **Nature and Effect of Breach of Contract:** Nonperformance of a contractual obligation, unless justified (¶ *11:55*), *breaches* the contract. The nonperformance may take the form of a *defective* performance as well as an *absence* of performance in whole or in part; and amounts to a breach whether intentional or inadvertent. [*Linden Partners v. Wilshire Linden Assocs.* (1998) 62 CA4th 508, 531-532, 73 CR2d 708, 722 (seller breached purchase and sale agreement by providing buyer with tenant estoppel certificate that overstated tenant's monthly rent)]

However, a breach does not necessarily render the contract a nullity. The nonbreaching party will have a damages cause of action but, depending on the nature of the breach, will not necessarily be relieved of its contractual obligations. [See *Brown v. Grimes* (2011) 192 CA4th 265, 278, 120 CR3d 893, 903—determining whether promise constitutes *independent* covenant so that its breach by one party does not excuse performance by other party is based on parties' intentions as deduced from agreement]

a. Material vs. nonmaterial breach

(1) [11:51] **Material breach:** A buyer's or seller's failure to perform a *material* covenant in the purchase contract constitutes a *breach* of contract. [*Louison v. Yohanan* (1981) 117 CA3d 258, 266, 172 CR 602, 606; see also *Brown v. Grimes* (2011) 192 CA4th 265, 278, 120 CR3d 893, 903—material breach of one aspect of contract generally constitutes material breach of whole contract]

The nonbreaching party may *either* cease performance and assume the contract is avoided or continue its performance and sue for damages (¶ 11:52). Under no circumstances, on the other hand, may the nonbreaching party both stop performance *and* continue to take advantage of the contract's benefits. [*Jay Bharat Developers, Inc. v. Minidis* (2008) 167 CA4th 437, 443, 84 CR3d 267, 272]

(a) [11:52] **Reciprocal performance excused:** One party's material breach of contract gives rise to a damages cause of action and also excuses the performance of the nonbreaching party, giving them a right of rescission. [*Gold Mining & Water Co. v. Swinerton* (1943) 23 C2d 19, 33, 142 P2d 22, 29; *Filet Menu, Inc. v. C.C.L. & G., Inc.* (2000) 79 CA4th 852, 861, 94 CR2d 438, 444; compare *Brown v. Grimes* (2011) 192 CA4th 265, 281, 120 CR3d 893, 906—although attorney A's *partial* breach of fee-sharing agreement was deemed material and excused further performance by Attorney B, it did not entitle Attorney B to rescind and seek restitution of fees previously paid (failure to perform gives rise to restitution claim only when there has been *total* breach)]

(b) [11:53] **Fact question:** Whether a breach is "material" is a question of fact and is determined with reference to the effect of the breach on the nonbreaching party. [*Coughlin v. Blair* (1953) 41 C2d 587, 599, 262 P2d 305, 312; see also *Brown v. Grimes* (2011) 192 CA4th 265, 277-278, 120 CR3d 893, 903—although normally a question of fact, if reasonable minds cannot differ on issue of materiality it may be resolved as "matter of law"; *Associated Lathing & Plastering Co. v. Louis C. Dunn, Inc.* (1955) 135 CA2d 40, 49-51, 286 P2d 825, 830-831—timing of breach also relevant]

(c) [11:53.1] **Partial breach:** Whether a partial breach is material depends on how important or serious the breach is and the probability of the injured party getting substantial performance. [*Brown v. Grimes* (2011) 192 CA4th 265, 278, 120 CR3d 893, 903; see also *Superior Motels, Inc. v. Rinn Motor Hotels, Inc.* (1987) 195 CA3d 1032, 1051, 241 CR

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487, 495—purposes to be served, desires to be gratified, excuses for deviation, etc., all must be weighed in determining whether breach is material]

(2) [11:54] **Nonmaterial breach:** Either party's nonperformance of a *nonmaterial* term of the contract also breaches the contract. The nonbreaching party has a damages cause of action but, unlike the case of a material breach (¶ 11:51 ff.), is *not* excused from performing its obligations under the contract and, hence, is *not* entitled to rescind the contract. [*Karz v. Department of Professional & Vocational Standards* (1936) 11 CA2d 554, 557, 54 P2d 35, 36]

Thus, a nonbreaching party must continue to perform its contractual obligations unless there has been a material breach or repudiation by the other party. [*Sackett v. Spindler* (1967) 248 CA2d 220, 229-232, 56 CR 435, 441-442]

b. [11:55] **Compare—justified nonperformance:** A party's *legally excused* or *justified* failure to perform a material covenant of a contract is *not* a breach of contract and thus does not give the other party any affirmative cause of action. [See *Consolidated World Investments, Inc. v. Lido Preferred, Ltd.* (1992) 9 CA4th 373, 382, 11 CR2d 524, 528-529—seller's cancellation of contract not an anticipatory breach where buyer defaulted under time of essence provision by failing to request opening of escrow; *Fairchild v. Park* (2001) 90 CA4th 919, 933, 109 CR2d 442, 452 (J. Ortega concur. and dissent.opn.)]

However, a justified nonperformance of a material covenant will nonetheless excuse the other party's performance under the contract (*see ¶ 11:80* re conditions precedent).

c. [11:56] **Breach based on time for performance:** If a contract does not specify a time for performance, the obligations must be performed within a "reasonable" period of time. A party's unreasonable delay in performance (without lawful excuse) will thus amount to a breach of contract. [Civ.C. § 1657; *Henry v. Sharma* (1984) 154 CA3d 665, 669, 201 CR 478, 480; *Kersch v. Taber* (1945) 67 CA2d 499, 506, 154 P2d 934, 938]

(1) [11:57] **Question of fact:** What constitutes a "reasonable time" for performance is a question of fact and depends on the circumstances of each case. [*Consolidated World Investments, Inc. v. Lido Preferred, Ltd.* (1992) 9 CA4th 373, 381, 11 CR2d 524, 528]

However, unless the contract clearly specifies that "time is of the essence" (*see ¶ 11:58*), a minimal delay in performance is not likely to be deemed a material breach. [See, e.g., *Katemis v. Westerlind* (1953) 120 CA2d 537, 544-545, 261 P2d 553, 559, appl. after new trial (1956) 142 CA2d 799, 299 P2d 383—buyer's 3-day delay in paying balance due under sale contract held a "technical and unintentional" default that did not defeat buyer's right to specific performance]

So too, even a lengthy delay may be deemed "reasonable" under the facts where the contract contains no "time of the essence" provision. [See *Henry v. Sharma* (1984) 154 CA3d 665, 672-673, 201 CR 478, 483—buyer's *63*-day delay *not* unreasonable where contract called for performance within 30 days of escrow or sooner and buyer's broker was authorized, at broker's discretion, to "extend all time limits, including escrow time limits, 30 days"]

[11:57.1 - 11:57.4] ***Reserved.***

(2) [11:57.5] **Compare—indefinite deadline:** A "reasonable time" provision is read into a contract only where *no time for performance is fixed*. A reasonable time will not be implied simply because the deadline stated in the contract is *indefinite*. [*Resolution Trust Corp. v. First American Bank* (9th Cir. 1998) 155 F3d 1126, 1128—agreement stating act should be done "as soon as possible" was *not* silent as to time for performance and thus did not trigger Civ.C. § 1657 implied "reasonable time"]

(3) [11:58] **Effect of "time of the essence" provision:** Many purchase and sale contracts contain a "time of the essence" clause. Generally, such language is deemed to constitute a material term of the contract, the nonperformance of which breaches the contract and excuses the other party's performance. [*Galdjie v. Darwish* (2003) 113 CA4th 1331, 1337-1338, 7 CR3d 178, 182—where contract specified time was of essence, buyer's failure to deposit funds for purchase price within specified time deprived buyer of right to specifically enforce seller's obligation to convey; *Consolidated World Investments, Inc. v. Lido Preferred, Ltd.* (1992) 9 CA4th 373, 381-382, 11 CR2d 524, 528-529—buyer's failure to request opening of escrow as required by contract within specified 60-day escrow period, coupled with time of the essence provision, extinguished seller's obligation to convey]

However, the failure to promptly object to the other party's untimely performance may be deemed to *waive* a time of the essence clause, precluding rights and remedies for a breach of contract based thereon. [*Chan v. Title Ins. & Trust Co.* (1952) 39 C2d 253, 258, 246 P2d 632, 635; *McCown v. Spencer* (1970) 8 CA3d 216, 222-224, 87 CR 213, 217-218—seller estopped to assert buyer's failure to timely perform]

Cross-refer: "Time of the essence" clauses in a purchase and sale agreement are discussed in greater detail at *¶ 4:535 ff.*

d. [11:59] **Anticipatory breach/repudiation:** A party's *repudiation* of a contract before performance is due ("anticipatory breach") relieves the other party of its contractual obligations. The nonbreaching party need not remain ready and willing to tender performance and may immediately pursue breach of contract remedies (*¶ 11:64*). [*Jeppi v. Brockman Holding Co.* (1949) 34 C2d 11, 18, 206 P2d 847, 851; *Howard S. Wright Const. Co. v. BBIC Investors, LLC* (2006) 136 CA4th 228, 243, 38 CR3d 769, 780; see also *Central Valley Gen. Hosp. v. Smith* (2008) 162 CA4th 501, 516-517, 75 CR3d 771, 783—injured party may immediately seek damages but is *not required* to do so (noting right to treat repudiation as anticipatory breach is not lost unless and until repudiation is nullified; *¶ 11:65*)]

(1) [11:60] **Manner of breach—express or implied:** An anticipatory repudiation can occur *expressly*, where a party unequivocally refuses to perform (i.e., party notifies the other that they do not intend to fulfill their contractual obligations); or *impliedly by conduct*, where the party "puts it out of [their] power to perform so as to make substantial performance of [their] promise impossible" (e.g., seller transfers property to unrelated third person, making it impossible to transfer title to buyer). [*County of Solano v. Vallejo Redevelopment Agency* (1999) 75 CA4th 1262, 1276, 90 CR2d 41, 50; see also *Central Valley Gen. Hosp. v. Smith* (2008) 162 CA4th 501, 514, 75 CR3d 771, 781]

(a) [11:61] **Anticipatory breach by conduct:** A party may safely assume there has been an anticipatory breach by the other party's *conduct* (i.e., an *implied* repudiation) only if it is affirmatively clear from the latter's actions that it will be *impossible* for such party to perform at the time performance is required. [*Crane v. East Side Canal & Irrig. Co.* (1935) 6 CA2d 361, 367, 44 P2d 455, 458; *Lloyd v. Locke-Paddon Land Co.* (1935) 5 CA2d 211, 42 P2d 367, 368-369]

For example, a seller would not necessarily commit an anticipatory breach of contract if, before the closing date, the seller transfers title to an entity that it owns and/or controls; the seller's performance is not "impossible" because the seller can still cause the entity it controls to transfer the property to the buyer.

(b) [11:62] **Fact question:** Whether a party has effectively repudiated a contract so as to relieve the other of its contractual obligations is a question of fact. [*Gold Mining & Water Co. v. Swinerton* (1943) 23 C2d 19, 28, 142 P2d 22, 27]

(2) [11:63] **Consequences:** When repudiation of a contract happens before any breach by nonperformance, the repudiation may (a) give rise to a damages claim for total breach; (b) discharge the other party's duty to render performance; and (c) excuse the nonoccurrence of a condition to a duty of the repudiating party. [*Central Valley Gen. Hosp. v. Smith* (2008) 162 CA4th 501, 514, 75 CR3d 771, 781]

(3) [11:64] **Election of remedies:** The injured party may treat the repudiation as an anticipatory breach and *immediately* seek damages for breach of contract, thereby terminating the parties' contractual relationship. *Or*, the injured party may treat the repudiation as an "empty threat," wait until the time for performance arrives and then exercise the party's remedies for actual breach (assuming a breach in fact occurs). [*Taylor v. Johnston* (1975) 15 C3d 130, 137, 123 CR 641, 646; *Ferguson v. City of Cathedral City* (2011) 197 CA4th 1161, 1168-1169, 128 CR3d 514, 520; *Central Valley Gen. Hosp. v. Smith* (2008) 162 CA4th 501, 515, 75 CR3d 771, 781-782]

(4) [11:65] **Nullification:** An anticipatory breach of contract is *nullified* when (a) the injured party disregards the repudiation; (b) the injured party treats the contract as still in force; *and* (c) the repudiation is *retracted* prior to the time for performance. In this event, the injured party is "left with his [or her] remedies, if any, invocable at the time of performance." [*Taylor v. Johnston* (1975) 15 C3d 130, 137-138, 123 CR 641, 646-647; *Ferguson v. City of Cathedral City* (2011) 197 CA4th 1161, 1168-1169, 128 CR3d 514, 520; see also *Central Valley Gen. Hosp. v. Smith* (2008) 162 CA4th 501, 515-517, 75 CR3d 771, 782-783—all 3 conditions must exist before repudiation is nullified]

(5) [11:66] **Effect of unperformed executory covenants:** Again, one consequence of a repudiation is that it may discharge the other party's duties to render performance (*¶ 11:63*). Thus, a damages claim for anticipatory breach is *not* precluded even if executory covenants in the contract remain unperformed. [See *Central Valley Gen. Hosp. v. Smith* (2008) 162 CA4th 501, 520-521, 75 CR3d 771, 786]

(6) [11:67] **Cancellation of contract by injured party to finalize repudiation and establish claim for damages:** By canceling a contract, the injured party may make its repudiation final and establish a damages claim. Indeed, canceling the contract (or commencing an action claiming damages for total breach) is sufficient to indicate to the repudiating party that the injured party considers the repudiation final. Moreover, notifying the repudiating party of the cancellation serves to discharge the injured party's duties under the contract. [See *Central Valley Gen. Hosp. v. Smith* (2008) 162 CA4th 501, 522, 75 CR3d 771, 787-788; Rest.2d Contracts § 256, p. 294-295]

"The real operation of a declaration of intention not to be bound appears to give the promisee the right … to act upon the declaration and treat it as a final assertion by the promisor that he is no longer bound by the contract, and as a wrongful renunciation of the contractual relation into which he has entered. *If [the promisee] elects to pursue the latter course, it becomes a breach of contract, excusing performance on his part and giving him an immediate right to recover upon it as such.* Upon such election the rights of the parties are to be regarded as then culminating, and the contractual relation ceases to exist …" [*Ferguson v. City of Cathedral City* (2011) 197 CA4th 1161, 1169, 128 CR3d 514, 520-521 (emphasis and brackets in original; internal quotes omitted)]

[11:68 - 11:69] ***Reserved.***

2. Breach Distinguished From Failure of Conditions

a. [11:70] **Nature of conditions:** Unlike the nonperformance of a contractual covenant (which is a promise), the *failure of a condition* (unless it is also a covenant, *¶ 11:79*) is *not* a breach of contract and does not give either party any breach of contract remedies. [*Bennett v. Carlen* (1963) 213 CA2d 307, 310-311, 28 CR 647, 649]

Rather, contractual conditions effectively *qualify* a party's duty to perform its contractual obligations; and a failure of conditions may *excuse* the duty to perform, thereby terminating the contract. [See *Brown v. Grimes* (2011) 192 CA4th 265, 278, 120 CR3d 893, 903—regardless whether Attorney A's promise to compensate third party was viewed as condition or dependent covenant, breach of that promise excused Attorney B's further performance of fee-sharing agreement]

(1) [11:71] **Conditions precedent, concurrent and/or subsequent:** Contractual conditions may be either "precedent," "concurrent," or "subsequent." [Civ.C. § 1435; see *JMR Const. Corp. v. Environmental Assessment & Remediation Mgmt., Inc.* (2015) 243 CA4th 571, 593-595,198 CR3d 47, 65-66 (discussing contractual conditions generally)]

• [11:72] A covenant subject to a *condition precedent* means the party for whose benefit the condition was created (covenantor) is obligated to perform only *if and when* the condition occurs. [Civ.C. § 1436; see also *Richman v. Hartley* (2014) 224 CA4th 1182, 1192, 169 CR3d 475, 483—party's failure to perform condition precedent generally will preclude breach of contract action; *Barroso v. Ocwen Loan Servicing, LLC* (2012) 208 CA4th 1001, 1009, 146 CR3d 90, 97—condition precedent is either a party's act that must be performed or an uncertain event that must occur before a contractual right accrues or contractual duty arises; *Realmuto v. Gagnard* (2003) 110 CA4th 193, 199, 1 CR3d 569, 573 (same); *and ¶ 11:80*]

• [11:73] A covenant subject to a *condition concurrent* means *neither party* is obligated to perform unless and until the other party has performed (or properly tendered performance). Conditions concurrent essentially are conditions precedent that are *mutually dependent* and are to be performed simultaneously (e.g., buyer's covenant to pay purchase price is dependent upon seller's covenant to transfer title; *see ¶ 11:81 ff.*). [Civ.C. § 1437; *Pittman v. Canham* (1992) 2 CA4th 556, 559-560, 3 CR2d 340, 342; see also *Rutherford Holdings, LLC v. Plaza Del Rey* (2014) 223 CA4th 221, 228, 166 CR3d 864, 870 (*¶ 11:82*); *Rubin v. Fuchs* (1969) 1 C3d 50, 53-54, 81 CR 373, 376—absent express language indicating condition precedent, contractual provisions construed as mutually dependent conditions *concurrent*]

"[T]he only important difference between a concurrent condition and a condition precedent is that a condition precedent must be performed before another duty arises, while a tender of performance is sufficient in the case of a concurrent condition." [*Ninety Nine Investments, Ltd. v. Overseas Courier Service (Singapore) Private, Ltd.* (2003) 113 CA4th 1118, 1133, 6 CR3d 891, 902]

• [11:74] A *condition subsequent* gives a party a "way out" of its contractual obligations; i.e., if a specified future event occurs, the party for whose benefit the condition was created is no longer bound to perform under the contract. [Civ.C. § 1438]

(As a practical matter, real estate purchase and sale transactions are rarely made subject to conditions subsequent.)

(2) [11:75] **Occurrence and/or nonoccurrence conditions:** A contractual condition may be the affirmative happening of an act or event *or* the nonoccurrence of an act or event.

• [11:76] For example, a provision obligating the buyer to pay the purchase price only in the event the buyer obtains specified financing is conditioned on the *occurrence* of the specified event. [*Pease v. Brown* (1960) 186 CA2d 425, 427, 8 CR 917, 918—conditions precedent included buyer's obtaining approximate $11,000 construction loan; see also *Sosin*

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v. Richardson (1962) 210 CA2d 258, 264, 26 CR 610, 613—seller's duty to transfer title conditioned on obtaining title by foreclosure; and *Britschgi v. McCall* (1953) 41 C2d 138, 144, 257 P2d 977, 979—seller's duty to convey conditioned on ability to eliminate interest of lessee and option holder]

• [11:77] Conversely, a contractual provision obligating the seller to transfer title only in the event its existing mortgagee does not demand a prepayment penalty conditions the seller's promise upon the *nonoccurrence* of the specified event. [*Whiteman v. Leonard Realty Co.* (1961) 189 CA2d 373, 376, 11 CR 211, 213]

(3) [11:78] **Identifying covenants vs. conditions:** Because the failure of a condition does not itself give rise to breach of contract remedies, contracts should be carefully drafted to clearly identify which provisions are "covenants" (contractual *promises*) and which are simply "conditions." The word "agree" generally signifies that a party has covenanted to perform (or not to perform) the specified action; while the words "subject to," "provided," "on condition that" or "in the event of" generally signify a condition precedent for the benefit of the party referenced in the provision. [*Rubin v. Fuchs* (1969) 1 C3d 50, 54, 81 CR 373, 376; *WYDA Assocs. v. Merner* (1996) 42 CA4th 1702, 1713, 50 CR2d 323, 329; see also *Barroso v. Ocwen Loan Servicing, LLC* (2012) 208 CA4th 1001, 1009, 146 CR3d 90, 97—existence of condition precedent normally depends on parties' intent as determined by words used in their contract]

Thus, contractual provisions generally will be construed as conditions precedent only when the language clearly and unambiguously so indicates; otherwise, the provisions will be construed as covenants. [*Rubin v. Fuchs,* supra, 1 C3d at 53, 81 CR at 376; *Barroso v. Ocwen Loan Servicing, LLC,* supra, 208 CA4th at 1010, 146 CR3d at 97; *Realmuto v. Gagnard* (2003) 110 CA4th 193, 199, 1 CR3d 569, 573]

(4) [11:79] **Compare—conditions as covenants:** A condition for the benefit of one party may also be a *covenant* by the other party (i.e., a *promise* that the specified act or event will occur). Here, failure of the condition *both* excuses the other party from performing its contractual obligations *and* gives the other party *breach of contract remedies*. [See *Britschgi v. McCall* (1953) 41 C2d 138, 144, 257 P2d 977, 980 (distinguishing condition precedent *not* stated as covenant)]

As explained at ¶ 11:81 ff., mutually dependent conditions concurrent in purchase and sale contracts are also covenants.

b. [11:80] **Effect of conditions precedent:** A condition precedent effectively *qualifies* or *suspends* the contractual obligations of the party for whose benefit the condition was created. Until the specified act or event occurs and absent an effective waiver (*¶ 11:85*), the party for whose benefit the condition was created is not obligated to perform its part of the contract and the nonperformance cannot constitute a breach of contract. [*Britschgi v. McCall* (1953) 41 C2d 138, 144, 257 P2d 977, 980; *Pittman v. Canham* (1992) 2 CA4th 556, 559, 3 CR2d 340, 342 (distinguishing concurrent conditions)—condition precedent must be *performed* before another duty arises; see *Consolidated World Investments, Inc. v. Lido Preferred, Ltd.* (1992) 9 CA4th 373, 380-381, 11 CR2d 524, 527-528—where buyer failed to request opening of escrow as required by contract (condition precedent), seller could not be in breach of contract for failure to complete sale]

Similarly, upon the failure of a condition precedent, the party for whose benefit the condition was created is *excused from further performance* under the contract. [*Britschgi v. McCall*, supra; see also *Richman v. Hartley* (2014) 224 CA4th 1182, 1192, 169 CR3d 475, 483—seller's failure to fulfill statutory condition precedent (delivery of real estate transfer disclosure statement) excused buyer's performance as a "matter of law"]

Thus, ordinarily, a party cannot recover for breach of a contract subject to conditions precedent without alleging and proving *performance* or *waiver* of the conditions. [*Consolidated World Investments, Inc. v. Lido Preferred, Ltd.*, supra, 9 CA4th at 380, 11 CR2d at 527; *Pittman v. Canham*, supra, 2 CA4th at 559, 3 CR2d at 342; *Sosin v. Richardson* (1962) 210 CA2d 258, 264, 26 CR 610, 613]

(1) [11:80.1] **"Satisfaction" as condition precedent:** Contracts often condition one party's performance on its "satisfaction" with a certain event or occurrence. Under such circumstances, the promisor may decide that it is "satisfied" under either an objective standard of *reasonableness*, or a subjective *"good faith"* standard, depending on the parties' intent as expressed in the language of the contract. In this context, a decision is unreasonable when it is "arbitrary, capricious, or lacking in evidentiary support," while a decision lacking "good faith" implicates "dishonesty, deceit, or unfaithfulness to duty." [*Storek & Storek, Inc. v. Citicorp Real Estate, Inc.* (2002) 100 CA4th 44, 59, 122 CR2d 267, 279-280]

Absent a specific expression in the contract or one implied from the subject matter regarding how the promisor's satisfaction should be determined, the objective "reasonableness" standard is preferred, particularly when "factors of commercial value or financial concern are involved, as distinct from matters of personal taste." [*Storek & Storek, Inc. v. Citicorp Real Estate, Inc.*, supra, 100 CA4th at 60, 122 CR2d at 280—where loan agreement freely negotiated by

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sophisticated business entities, jury incorrectly instructed to evaluate lender's decision that conditions precedent to its disbursement of funds were not satisfied for *both* reasonableness and good faith (lender only required to act reasonably)]

[11:80.2 - 11:80.4] ***Reserved.***

(2) [11:80.5] **Statutory compliance as condition precedent:** Compliance with a statutory requirement incorporated into a contract may constitute a condition precedent to a party's performance thereunder.

(a) [11:80.6] **Delivery of transfer disclosure statement:** For instance, the seller's delivery to the buyer of a Civ.C. § 1102 et seq. "real estate transfer disclosure statement" (*¶ 4:354 ff.*) has been held to be a condition precedent to the buyer's duty to perform under the purchase contract. [*Richman v. Hartley* (2014) 224 CA4th 1182, 1192, 169 CR3d 475, 483; *Realmuto v. Gagnard* (2003) 110 CA4th 193, 201, 1 CR3d 569, 575; *see also ¶ 11:80* & *11:88.2*]

c. [11:81] **Mutual/concurrent conditions:** A covenant by one party can be a condition to the other party's performance. When each party's covenants are mutually dependent, they are conditions concurrent which must be performed at the same time. [Civ.C. § 1437]

For example, performance of the buyer's covenant to pay the purchase price is a condition to the seller's obligation to convey title and vice-versa. The respective covenants operate as mutually dependent/concurrent conditions. [*King v. Stanley* (1948) 32 C2d 584, 590, 197 P2d 321, 325 (disapproved on other grounds by *Patel v. Liebermensch* (2008) 45 C4th 344, 351, 86 CR3d 366, 371, fn.4); *Diamond v. Huenergardt* (1959) 175 CA2d 214, 220, 346 P2d 37, 41; see *Fogarty v. Saathoff* (1982) 128 CA3d 780, 785, 180 CR 484, 487]

(1) [11:82] **Effect of nonperformance:** When covenants are mutually dependent concurrent conditions, neither party is obligated to perform until the other has performed or properly *tendered* performance; and neither is in breach simply by reason of its nonperformance. [*Rubin v. Fuchs* (1969) 1 C3d 50, 54, 81 CR 373, 376—"neither party can place the other in default unless he is fully able to perform or make a tender of the promised performance"; *Ninety Nine Investments, Ltd. v. Overseas Courier Service (Singapore) Private, Ltd.* (2003) 113 CA4th 1118, 1133-1135, 6 CR3d 891, 902-903]

Thus, e.g., a buyer is not in breach for nonpayment of the purchase price where the seller has not yet performed its mutually dependent covenant by tendering the deed (and other necessary documents specified by the contract). Likewise, a seller is not in breach for failure to convey title until the buyer has deposited the purchase price in escrow or unconditionally tendered payment to the seller. [See *Landis v. Blomquist* (1967) 257 CA2d 533, 539, 64 CR 865, 869-870; *Galdjie v. Darwish* (2003) 113 CA4th 1331, 1340, 7 CR3d 178, 184-185; see also *Rutherford Holdings, LLC v. Plaza Del Rey* (2014) 223 CA4th 221, 228, 166 CR3d 864, 870— buyer could not recover its deposit based on seller's contractual failure to tender deed before closing where buyer also failed to perform its duty to tender full payment]

(a) [11:83] **Discharge of duties to perform:** Where neither party has tendered performance of concurrent conditions *during the time specified for performance* (or within a reasonable time if no time is specified), both parties are *discharged* from their contractual obligations and the *contract ceases to exist*. "Thus where the parties have made *time the essence* of the contract, at the expiration of time without tender by either party, both parties are discharged … Neither party can hold the other in default and no cause of action to enforce the contract arises." [*Pittman v. Canham* (1992) 2 CA4th 556, 559-560, 3 CR2d 340, 342—where purchase and sale contract made time of essence, both parties' failure to tender timely performance of concurrent conditions (seller to deliver recordable deed into escrow and buyer to deposit money, note and deed of trust) terminated contract so that seller could not thereafter be in breach for selling to other buyers; compare *Galdjie v. Darwish* (2003) 113 CA4th 1331, 1342-1343, 7 CR3d 178, 186 (same, but seller ordered to specifically perform because seller *waived* time of essence condition; *see ¶ 11:85 ff.*)]

(2) [11:84] **Performance or tender of performance triggering other party's breach:** Once one party has *performed or unconditionally tendered performance* of that party's dependent covenants, the other party's duty to perform ripens; at that point, the latter's failure to perform within a reasonable time breaches the contract, entitling the party who performed or tendered performance to recover damages or specific performance. [Civ.C. §§ 1437, 1439, 1498; *Diamond v. Huenergardt* (1959) 175 CA2d 214, 220, 346 P2d 37, 41-42; *Groobman v. Kirk* (1958) 159 CA2d 117, 126, 323 P2d 867, 873]

d. [11:85] **Waiver of conditions:** A failure of conditions does *not* excuse performance of contractual obligations if the conditions have effectively been *waived*. [*Pease v. Brown* (1960) 186 CA2d 425, 429, 8 CR 917, 920]

(1) [11:86] **Who can waive:** A contractual condition can be waived only by the *party for whose benefit the condition was created* (hence, the reason why it is prudent for the contract to specifically state for whose benefit conditions precedent

are created; *see ¶ 4:390*). [See *Galdjie v. Darwish* (2003) 113 CA4th 1331, 1339, 7 CR3d 178, 183—trial court properly found seller waived time of essence provision based on communications between parties]

The failure of a condition that is included in a contract for the benefit of *both* parties will excuse both parties' performance *unless* it is waived by *both* of them. [*Britschgi v. McCall* (1953) 41 C2d 138, 143-144, 257 P2d 977, 980; *Isaacson v. G.D. Robertson & Co.* (1948) 85 CA2d 71, 77, 192 P2d 486, 489]

(2) [11:87] **Express or implied waiver:** A waiver of conditions may be *express* (party for whose benefit the condition was created voluntarily elects to eliminate the condition; see, e.g., *Doryon v. Salant* (1977) 75 CA3d 706, 712-713, 142 CR 378, 381-382—buyer's waiver of specified financing condition); or it may be *implied* by a party's actions (*Parsons v. Bristol Develop. Co.* (1965) 62 C2d 861, 868-869, 44 CR 767, 772).

An implied waiver occurs by operation of law where the party for whose benefit the condition was created prevents the occurrence of the condition or makes its occurrence impossible. [See *Orton v. Embassy Realty Assocs.* (1949) 91 CA2d 434, 438-439, 205 P2d 427, 429-430—party who prevents fulfillment of condition of own obligation commits a breach and cannot rely on such condition to defeat liability]

An implied waiver can also occur by conduct inconsistent with insistence on satisfaction of the condition— e.g., where the buyer for whose benefit conditions were created brings an action against the seller for specific performance. [See *Pease v. Brown* (1960) 186 CA2d 425, 429, 8 CR 917, 920]

(3) [11:88] **Effect—unqualified obligation to perform:** Upon a waiver of all conditions, the party (or parties) for whose benefit they were created must perform under the contract (i.e., the contractual obligation becomes *unqualified*) and otherwise is in breach of contract. [*Galdjie v. Darwish* (2003) 113 CA4th 1331, 1339, 7 CR3d 178, 183—party's waiver of condition makes party's contractual duty "independent, binding himself to perform unconditionally" (emphasis and internal quotes omitted); *Wesley N. Taylor Co. v. Russell* (1961) 194 CA2d 816, 828-829, 15 CR 357, 365]

(4) [11:88.1] **Limitation—*nonwaivable conditions:*** Certain conditions precedent rooted in a *statutory* obligation may be deemed *nonwaivable* as a matter of statute.

(a) [11:88.2] **Delivery of transfer disclosure statement:** Notably, the Civil Code expressly makes the seller's delivery of a real estate transfer disclosure statement (a statutory condition precedent to the buyer's contractual performance, *¶ 11:80.6*) *nonwaivable* even in an "as is" sale (Civ.C. §§ 1102(c) (waiver is "void as against public policy"), 1102.1(a)). "[T]he Legislature plainly contemplated that buyers would never be irrevocably committed to performing the contract without having received the required disclosures. This legislative purpose would be defeated if a seller could enforce a contract without having complied with the disclosure requirements." [*Realmuto v. Gagnard* (2003) 110 CA4th 193, 201-202, 1 CR3d 569, 575; see also *Richman v. Hartley* (2014) 224 CA4th 1182, 1192, 169 CR3d 475, 483 (*¶ 11:80.6*)]

[11:88.3 - 11:88.4] *Reserved.*

(5) [11:88.5] **Compare—conditions restored by retracting waiver:** Under general principles of contract law, a waiver of conditions may be *retracted* and the conditions restored at any time. [*Storek & Storek, Inc. v. Citicorp Real Estate, Inc.* (2002) 100 CA4th 44, 58, 122 CR2d 267, 279, fn. 11—lender's exercise of option under loan agreement to waive conditions precedent to disbursing funds to borrower on several occasions did not constitute waiver of conditions precedent to *subsequent* disbursements]

e. [11:89] **Effect of anticipatory breach/repudiation on satisfaction of conditions:** As discussed, one party's anticipatory breach (unequivocal repudiation) of the contract excuses the other party's duty to perform (or to tender performance of) its contractual obligations and entitles the latter (nonrepudiating party) to immediately pursue breach of contract remedies (*¶ 11:59 ff.*). [Civ.C. §§ 1440, 1511; *Beverage v. Canton Placer Mining Co.* (1955) 43 C2d 769, 777, 278 P2d 694, 700; *Harris v. Rudin, Richman & Appel* (2002) 95 CA4th 1332, 1344, 116 CR2d 552, 561—parties were negotiating language of releases when defendants took settlement agreement "off the table," thereby excusing plaintiff's further performance]

3. [11:90] **Statute of Limitations:** The statute of limitations for an action on a written contract is four years, commencing with accrual of the cause of action. [CCP § 337; *Union Oil Co. of Calif. v. Greka Energy Corp.* (2008) 165 CA4th 129, 138, 80 CR3d 738, 744]

The action generally accrues at the time of the breach—i.e., when performance is due under the terms of the contract but is not forthcoming (*but see ¶ 11:59 ff.* re anticipatory breach). [See generally, *Romano v. Rockwell Int'l, Inc.* (1996) 14 C4th 479, 488, 59 CR2d 20, 25]

a. [11:91] **Tolling during settlement negotiations:** The statute may be tolled pending settlement negotiations between the parties. [*Union Oil Co. of Calif. v. Greka Energy Corp.*, supra—statute tolled when oil company filed its claim and defendant requested settlement negotiations (noting defendants who induce plaintiffs not to sue pending settlement discussions may not assert statute of limitations defense if their conduct caused untimely filing of action); see also *Shaffer v. Debbas* (1993) 17 CA4th 33, 43, 21 CR2d 110, 115—unreasonable to expect plaintiff to jeopardize potential settlement by filing suit when potential defendant promises to remedy portion of damages suffered by plaintiff]

b. [11:92] **Contractual provision shortening limitations period:** The parties to a contract may stipulate therein to a limitations period for bringing suit on the contract (or certain provisions therein) shorter than the otherwise applicable statute of limitations. Such stipulations are enforceable under California law so long as "not so unreasonable as to show imposition or undue advantage in some way." But because such stipulations are in derogation of the statutory limitation, they are also disfavored and thus will be construed strictly against the party invoking them. [*Western Filter Corp. v. Argan, Inc.* (9th Cir. 2008) 540 F3d 947, 952 (applying Calif. law) (internal quotes omitted)]

(1) [11:92.1] **Application to representations and warranties "survival clause":** Absent a "survival clause" (below), representations and warranties in a purchase and sale agreement merge into the deed and are thereby extinguished by the closing; after the conveyance, they have no independent existence. [*Linden Partners v. Wilshire Linden Assocs.* (1998) 62 CA4th 508, 524, 73 CR2d 708, 717; *Western Filter Corp. v. Argan, Inc.* (9th Cir. 2008) 540 F3d 947, 952 (applying Calif. Law); but see also *Ram's Gate Winery, LLC v. Roche* (2015) 235 CA4th 1071, 1079-1081, 185 CR3d 935, 940-942 (limiting merger doctrine's applicability to cases where contractual terms are *inconsistent* with deed or where parties clearly intend all contractual obligations to be subsumed in recorded deed's recitals); *and* ¶ 4:16, 4:434]

The parties may specify in their contract that certain representations and warranties will survive the closing for a specified period of time. But language stating only that the representations and warranties "shall survive" for a specified duration operates solely to extend their life past the closing date—i.e. it serves simply to specify *when a breach* of the representations and warranties *may occur*. Such general survival language does *not* also unambiguously disclose an intent to create a shorter statute of limitations for an action alleging a postclosing breach of those representations and warranties—i.e., it does *not* itself specify *when an action must be filed*. [*Western Filter Corp. v. Argan, Inc.*, supra, 540 F3d at 953-954—one-year "survival" provision did not itself shorten applicable 4-year statute of limitations for suit charging breach of representations/warranties that survived closing]

Cross-refer: For a more detailed treatment of the applicable statute of limitations and, in particular, accrual of the cause of action, see Banke & Segal, *Cal. Prac. Guide: Civ. Pro. Before Trial—Statutes of Limitations* (TRG), Ch. 4.

[11:93 - 11:99] ***Reserved.***

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Chapter 11. Remedies in Purchase and Sale Transactions

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(2) [11:163] Complicated enforcement precluding specific performance
3. [11:164] Other Seller Remedies

[11:100] A seller has two basic alternative remedies for a buyer's breach of a real property purchase agreement: a *damages* action for breach of contract, or an action for *specific performance*. As a practical matter however, sellers rarely seek specific performance, because even in the event they were to prevail (which is generally unlikely), the remedy granted probably would not be satisfactory (*see ¶ 11:150 ff.*).

1. Seller's Breach of Contract Damages

a. [11:101] **Amount of damages—in general:** A seller's recoverable damages for the buyer's breach of contract are determined *either* (a) by the *terms of the contract* (a *liquidated damages* clause); *or* (b) pursuant to *Civ.C. § 3307*.

Pursuant to Civ.C. § 3307, for a buyer's breach of a real property purchase agreement, the seller is entitled to recover:

- the *excess* (if any) of the amount that would have been due to the seller under the contract over the value of the property to the seller (this is the seller's "*general damages*," ¶ *11:107 ff.*); *plus*

- *consequential damages* according to proof (¶ *11:116 ff.*); *and*

- *interest* (¶ *11:134*). [Civ.C. § 3307; *Kuish v. Smith* (2010) 181 CA4th 1419, 1425-1426, 105 CR3d 475, 480—seller's main measure of damages is difference between contract price and property's value at time of breach]

(1) [11:102] **Practical considerations for seller:** The "value of the property" to the seller is calculated as of the date of the breach (usually the closing date specified in the contract; *see* ¶ *11:109 ff.*). Therefore, other than consequential damages and interest, a seller can recover damages under Civ.C. § 3307 only in two circumstances: (a) when the purchase price was *higher* than the value of the property at the time the contract was entered into (i.e., buyer agreed to pay an "above-market" price); or (b) when the purchase price equaled the property's fair market value at the time the contract was entered into, but the property has *depreciated* in value as of the time of the buyer's breach. [*Allen v. Enomoto* (1964) 228 CA2d 798, 803-804, 39 CR 815, 819]

(a) [11:103] **Stable or appreciating values foreclose general damages recovery:** Thus, in a stable or appreciating real estate market, a seller is unlikely to have suffered damages by reason of the buyer's breach and will not have a general damages remedy. [*Royer v. Carter* (1951) 37 C2d 544, 550, 233 P2d 539, 543; see *Allen v. Smith* (2002) 94 CA4th 1270, 1278, 114 CR2d 898, 903; *Kuish v. Smith* (2010) 181 CA4th 1419, 1425-1429, 105 CR3d 475, 480-483—in rising market, seller's recovery against defaulting buyer is limited to consequential damages and interest (seller's retention of contractually designated "nonrefundable" deposit constituted invalid forfeiture)]

➪ [11:103.1] ***PRACTICE POINTER:*** It has been suggested that, in a rising market, a seller's best course of action against a breaching buyer may be simply to remarket the property and proceed with an advantageous resale. The seller's consequential damages will often be minimal, and the seller's out-of-pocket expenses typically would have been incurred in the second transaction as well. [See *Kuish v. Smith* (2010) 181 CA4th 1419, 1426, 105 CR3d 475, 480, fn. 3]

(b) [11:104] **Ineffective general damages despite declining values:** Moreover, because general damages under Civ.C. § 3307 are measured by the value of the property as of the date of the buyer's breach (¶ *11:109*), a seller's general damages remedy may be unsatisfactory even in a declining real estate market: i.e., if the seller is unable to consummate a quick resale, the property's value will continue to decline after the intended closing date, yet the seller will be limited under Civ.C. § 3307 to damages measured by the value of the property as of the intended closing date.

(2) [11:105] **Compare—liquidated damages recovery:** If the purchase agreement contains a valid *liquidated damages* provision, the seller's damages remedy is fixed *solely* by the contract; and Civ.C. § 3307 is irrelevant. (This may be a savior for sellers in a declining market where, as indicated at ¶ 11:104, Civ.C. § 3307 general damages may leave the seller with a shortfall. Conversely, in an appreciating market, a liquidated damages provision can be a boon for sellers, who may be able to resell for a premium over and above the liquidated sum.)

Cross-refer: Liquidated damages are discussed in detail at ¶ *4:310 ff.*

(3) [11:106] **Compare—specific performance:** Civ.C. § 3307 does not preempt a seller's right to seek specific performance. Likewise, the seller may have a specific performance remedy notwithstanding a liquidated damages provision (Civ.C. § 1680) … unless the contract states the liquidated damages are the seller's *sole* remedy.

However, while the complaint may seek alternate remedies for specific performance or breach of contract damages, the seller *cannot be awarded* both remedies because that would amount to a "double recovery."

b. [11:107] **General damages:** The seller can recover "general damages" to the extent the contract price (amount buyer was supposed to pay pursuant to the contract) exceeds the "value of the property." [Civ.C. § 3307]

(1) [11:108] **Value of property:** The "value of the property" for this purpose is usually defined as the *fair market value as of the date of the buyer's breach*. [*Askari v. R & R Land Co.* (1986) 179 CA3d 1101, 1106, 225 CR 285, 289; *Major-Blakeney Corp. v. Jenkins* (1953) 121 CA2d 325, 333, 263 P2d 655, 660]

"Fair market value" is the best price obtainable for the property, in cash, from a ready, willing and able buyer. [*Major-Blakeney Corp. v. Jenkins*, supra; *Glendale Fed. Sav. & Loan Ass'n v. Marina View Heights Develop. Co., Inc.* (1977) 66 CA3d 101, 141-142, 135 CR 802, 826]

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(a) [11:109] **Value fixed as of date of breach:** In a seller's damages action, the property's value is fixed as of the date of the buyer's breach—usually the intended closing date. [*Wade v. Lake County Title Co.* (1970) 6 CA3d 824, 829, 86 CR 182, 185] Thus, a decline in the property's value *after* the buyer's breach is not recoverable. [*Royer v. Carter* (1951) 37 C2d 544, 548, 233 P2d 539, 542; *Bouchard v. Orange* (1960) 177 CA2d 521, 525-526, 2 CR 388, 391]

Moreover, despite a decline in value as of the date of the buyer's breach, a *subsequent appreciation* in value may preclude the seller's general damages recovery on the theory the seller has no longer suffered any “loss of bargain” and would otherwise realize a “double recovery.” [*Spurgeon v. Drumheller* (1985) 174 CA3d 659, 664, 220 CR 195, 197; see *Allen v. Smith* (2002) 94 CA4th 1270, 1278, 114 CR2d 898, 903; *Kuish v. Smith* (2010) 181 CA4th 1419, 1426, 105 CR3d 475, 480]

1) [11:110] **Exception—buyer's conduct impeding resale:** The rule fixing the valuation date as of the date of the buyer's breach is premised on the assumption the seller is free to resell the property on that date. If the buyer interferes with the seller's ability to resell (e.g., by withholding possession), the valuation date may be *extended* to the date the buyer's actions no longer impede a resale. [*Honey v. Henry's Franchise Leasing Corp. of America* (1966) 64 C2d 801, 805, 52 CR 18, 21; *Askari v. R & R Land Co.* (1986) 179 CA3d 1101, 1111, 225 CR 285, 292]

For example, if the buyer files an action for specific performance and *records a lis pendens* against the property (*¶ 11:600 ff.*), the valuation date should be extended until either (i) the date the action for specific performance is abandoned (and the lis pendens is removed); or (ii) the date a judgment is rendered in favor of the seller, thus extinguishing the cloud on the seller's title. [See *Askari v. R & R Land Co.*, supra, 179 CA3d at 1111, 225 CR at 292 (dictum)—“If the property is lower in value when the lis pendens is lifted, the buyer may have to pay more damages”]

(b) [11:111] **Evidence probative of value:** In determining the property's value, courts may look to a variety of factors, including: the resale price; the time the property was on the market; expert testimony; the owner's testimony; the rental value of the property; any diminution in value resulting from a resale; any stigma that attaches to the property as a result of the buyer's breach of contract; market activity in the vicinity of the property; the condition of title; and the value of any subsequent improvements made to the property. [See, e.g., *Smith v. Mady* (1983) 146 CA3d 129, 133, 194 CR 42, 45; *Fleischer v. Cosgrove* (1956) 145 CA2d 14, 17-18, 301 P2d 911, 913-914; *Newhart v. Pierce* (1967) 254 CA2d 783, 788-792, 62 CR 553, 558-560; *Bouchard v. Orange* (1960) 177 CA2d 521, 525-526, 2 CR 388, 391-392; *Mathews v. MacArthur* (1953) 119 CA2d 196, 197-198, 258 P2d 1068, 1068-1069; and *Major-Blakeney Corp. v. Jenkins* (1953) 121 CA2d 325, 334, 263 P2d 655, 660-661]

➪ [11:112] ***PRACTICE POINTER—PROMPT APPRAISAL*:** For evidentiary purposes, it behooves the aggrieved seller to obtain an appraisal of the property as soon as possible after the buyer's breach (whether by a qualified appraiser or by a local, knowledgeable real estate broker).

(2) [11:113] **Determining “excess” of contract price over value:** The theory of general damages is to put the seller in the position it would have been in had the buyer not breached the purchase agreement—i.e., to give the seller the “benefit of its bargain.” [Civ.C. § 3307] That is why the seller's general damages are limited to the *excess* of the contract price over the property's value on the date of the breach. (If the property has appreciated in value or its value has remained consistent with the contract price, the seller has not suffered general damages; *¶ 11:103*.) [See Civ.C. § 3358—breach of contract damages cannot exceed what injured party would have received if contract had been fully performed; and generally, *Lewis Jorge Const. Management, Inc. v. Pomona Unified School Dist.* (2004) 34 C4th 960, 967-968, 22 CR3d 340, 344]

(a) [11:114] **Cash basis conversion of contract price required (discounting):** To properly calculate the extent to which the contract price exceeds the property's value, the contract price must be *converted into an all-cash value*. [*Abrams v. Motter* (1970) 3 CA3d 828, 841, 83 CR 855, 864; *Spurgeon v. Drumheller* (1985) 174 CA3d 659, 664, 220 CR 195, 197—seller's loss of bargain damages measured by comparing *cash value* of contract to *cash fair market value* at time of breach]

Therefore, the contract price will be discounted by risks incurred by the seller in connection with the specific transaction. Notably, such discounting will be required where the contract calls for *seller financing*, “including but not limited to the value of the real property securing the note, the amount of prior encumbrances, the terms of the note, risk of economic changes during the term of the note, risk of expense of foreclosure and risk of change in interest rates.” [*Abrams v. Motter*, supra, 3 CA3d at 841, 83 CR at 864 (internal cites omitted)]

This discounting of the contract price may reduce (or possibly even eliminate) the seller's right to a general damages award … because the seller is only entitled to the *excess* of the contract price over the value of the property (Civ.C. § 3307).

(3) [11:115] **Seller's tender of performance:** The buyer's obligation to pay the purchase price and the seller's obligation to convey title are mutually dependent concurrent conditions (¶ *11:81*). Thus, until the closing date arrives, a seller generally should remain in a position to tender the deed (or other conveyancing instrument) and otherwise be ready, willing and able to consummate the transaction. [See *Baird v. Barton* (1958) 163 CA2d 502, 505-506, 329 P2d 492, 495]

However, if the buyer anticipatorily repudiates the contract (e.g., by giving notice of rescission), the seller's tender of performance is excused. A breach of contract occurs with the anticipatory repudiation, giving the seller an immediate breach of contract damages remedy. [*McKinley v. Lagae* (1962) 207 CA2d 284, 293, 24 CR 454, 459; *see* ¶ *11:89*]

c. [11:116] **Consequential damages:** Civ.C. § 3307 also permits a seller to recover "consequential damages according to proof" (¶ *11:101*).

"Consequential damages" are those damages suffered by a seller that result from the "natural consequence" of the buyer's breach *and* that are *reasonable, foreseeable and necessary* to make the seller "whole." [*Royer v. Carter* (1951) 37 C2d 544, 550, 233 P2d 539, 543; see also *Lewis Jorge Const. Mgmt., Inc. v. Pomona Unified School Dist.* (2004) 34 C4th 960, 968, 22 CR3d 340, 345—consequential damages are losses not arising "directly and inevitably" from similar breach of similar agreement, but "secondary and derivative" losses arising from circumstances particular to subject contract or parties]

Such damages are recoverable if the circumstances from which they arise were *actually communicated to or known by* the breaching party (a subjective test), or were matters of which the breaching party *should have been aware* at the time of contracting (an objective test). [*Lewis Jorge Const. Mgmt., Inc. v. Pomona Unified School Dist.*, supra, 34 C4th at 968-970, 22 CR3d at 345-346—such damages are not presumed; see also *Ash v. North American Title Co.* (2014) 223 CA4th 1258, 1270, 168 CR3d 499, 507—consequential (or special) damages are limited to losses either actually foreseen or "reasonably foreseeable" when contract was formed; *Greenwich S.F., LLC v. Wong* (2010) 190 CA4th 739, 751, 754, 118 CR3d 531, 540, 543-544—consequential (or special) damages are "foreseeable" losses "proximately caused" by breach of contract]

(1) [11:117] **Recoverable despite no general damages:** In a stable or appreciating market, the seller will not be able to recover general damages (because the property value on the date of the buyer's breach will equal or exceed the contract price; ¶ *11:103*). Nonetheless, the seller may still be entitled to consequential damages. [*Royer v. Carter* (1951) 37 C2d 544, 550, 233 P2d 539, 543; *Wade v. Lake County Title Co.* (1970) 6 CA3d 824, 830, 86 CR 182, 186]

(a) [11:118] **Buyer's offset rights in event of appreciated value:** However, because the theory of consequential damages is simply to make the seller "whole," any *appreciation* in value after the buyer's breach will be *offset* against the seller's consequential damages to prevent "unjust enrichment" (otherwise, the seller would be reaping a windfall). [*Askari v. R & R Land Co.* (1986) 179 CA3d 1101, 1112, 225 CR 285, 292-293; *Smith v. Mady* (1983) 146 CA3d 129, 133, 194 CR 42, 45]

(2) [11:119] **Limitation—seller's duty to mitigate damages:** The seller is not entitled to recover reasonably avoidable consequential damages. Thus, a consequential damages recovery is dependent on the seller's duty to *mitigate* damages by using *reasonable diligence to resell the property*. [*Nielsen v. Farrington* (1990) 223 CA3d 1582, 1589-1590, 273 CR 312, 317; *Askari v. R & R Land Co.* (1986) 179 CA3d 1101, 1107, 225 CR 285, 289; *Smith v. Mady* (1983) 146 CA3d 129, 132, 194 CR 42, 44]

(3) Items of consequential damages

(a) [11:120] **Expenses incurred in selling to new buyer:** The aggrieved seller is entitled to recover as consequential damages expenses incurred in holding and reselling the property after the buyer's breach. [*Nielsen v. Farrington* (1990) 223 CA3d 1582, 1586-1588, 273 CR 312, 314-315] But such damages are limited to the expenses that exceed the costs the seller otherwise would have incurred under the original contract. [*Barton v. White Oak Realty, Inc.* (1969) 271 CA2d 579, 585, 76 CR 587, 591]

1) [11:121] **Hypothetical sale costs:** If the property is not resold as of the time of trial, despite the seller's reasonable efforts to effect a new sale (¶ *11:119*), such consequential damages may be calculated on the basis of a *hypothetical resale*. [*Barton v. White Oak Realty, Inc.* (1969) 271 CA2d 579, 585, 76 CR 587, 591]

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For example, the seller will be entitled to recover escrow fees, title insurance charges and brokers' commissions based on a hypothetical resale at market value at the time of the buyer's breach, *less* those expenses the seller would have incurred in connection with the original purchase agreement. [*Abrams v. Motter* (1970) 3 CA3d 828, 848, 83 CR 855, 869]

In most cases, courts will conclude that the wasted expenses of the first sale are equivalent to the hypothetical expenses of a second sale. [See *Royer v. Carter* (1951) 37 C2d 544, 551, 233 P2d 539, 543 (but expenses *not* equal); and *Barton v. White Oak Realty, Inc.*, supra, 271 CA2d at 585, 76 CR at 591, fn. 7]

2) [11:122] **Broker commissions:** Following a resale, the seller is entitled to recover from the buyer the amount of any broker's commission the seller paid or owes in connection with the original contract, whether or not the seller pays a commission on the resale. [*Caplan v. Schroeder* (1961) 56 C2d 515, 521, 15 CR 145, 148-149]

(b) [11:123] **Miscellaneous costs:** So long as a "reasonably foreseeable"/"natural consequence" of the buyer's breach, aggrieved sellers may also recover various other types of consequential expenses, including:

• [11:124] *Lost rent* suffered as a result of the seller's eviction of a tenant in reliance upon closing of the purchase transaction. [*McKinley v. Lagae* (1962) 207 CA2d 284, 395, 24 CR 454, 460]

• [11:125] *Other lost income* that would have been generated from the property but for the buyer's breach. [*Yocum v. Taylor* (1920) 50 CA 294, 195 P 62 (profit seller would have realized had crop been planted during growing season)]

• [11:126] *Operating expenses,* including insurance premiums, mortgage payments and real property taxes that would not have been incurred had the transaction closed as intended. [*Allen v. Enomoto* (1964) 228 CA2d 798, 803-804, 39 CR 815, 819]

• [11:127] Expenses of *commuting* between a new house and the property that was to have been sold. [*Jensen v. Dalton* (1970) 9 CA3d 654, 658, 88 CR 426, 428—recoverable to extent reasonably foreseeable at time of contracting]

• [11:128] Attorney fees incurred as a result of the buyer's recordation of a lis pendens (CCP § 405.38). [*Yackey v. Pacifica Develop. Co.* (1979) 99 CA3d 776, 786, 160 CR 430, 435]

[11:129 - 11:133] ***Reserved.***

d. [11:134] **Interest:** "Interest" is expressly recoverable by the seller in a Civ.C. § 3307 damages action (Civ.C. § 3307, ¶ *11:101*). This includes prejudgment interest on the seller's general damages measured by the difference between the contract price and the fair market value of the property. [*Rifkin v. Achermann* (1996) 43 CA4th 391, 396-397, 50 CR2d 661, 664—pre-1983 cases denying prejudgment interest on benefit of bargain damages impliedly overruled by 1983 amendment to Civ.C. § 3307]

The purpose of a prejudgment interest award is to compensate plaintiff for the loss of use of plaintiff's property. [*Bullis v. Security Pac. Nat'l Bank* (1978) 21 C3d 801, 815, 148 CR 22, 30; see also *Great Western Drywall, Inc. v. Roel Const. Co., Inc.* (2008) 166 CA4th 761, 767-768, 83 CR3d 235, 238-239—prejudgment interest on liquidated damages is element of compensatory damages; *North Oakland Med. Clinic v. Rogers* (1998) 65 CA4th 824, 828, 76 CR2d 743, 745; *and* ¶ *11:395*]

(1) [11:134.1] **Subject to Civ.C. § 3287—trial court discretion:** However, the generally applicable provisions of Civ.C. § 3287 regarding prejudgment interest apply. Thus, the seller's recovery of prejudgment interest on Civ.C. § 3307 loss-of-bargain damages (and/or consequential damages) will ordinarily be subject to the trial court's *discretion* (see Civ.C. § 3287(b)—court may, in its discretion, award prejudgment interest on damages based upon contract cause of action, where claim was unliquidated). [*Rifkin v. Achermann* (1996) 43 CA4th 391, 398, 50 CR2d 661, 665; see also *North Oakland Med. Clinic v. Rogers* (1998) 65 CA4th 824, 828-829, 76 CR2d 743, 746]

(a) [11:134.2] **Compare—where damages "certain":** Where plaintiff's damages are "certain" or "capable of being made certain by calculation," the absolute (nondiscretionary) entitlement to prejudgment interest applies; i.e., prejudgment interest *must* be awarded upon timely request. [Civ.C. § 3287(a); see *Thompson v. Asimos* (2016) 6 CA5th 970, 992-993, 212 CR3d 158, 178-180—where plaintiff's damages were "readily ascertainable" but not in amount awarded, case remanded to recalculate damages, including prejudgment interest ordered thereon; *Watson Bowman Acme Corp. v. RGW Const., Inc.* (2016) 2 CA5th 279, 284, 206 CR3d 281, 286—price adjustment owed supplier for change in order deemed "sufficiently certain" for § 3287(a) prejudgment interest award; *Great Western Drywall, Inc. v. Roel Const. Co., Inc.* (2008) 166 CA4th 761, 767, 83 CR3d 235, 238—prejudgment interest allowable under § 3287(a) only where amount is fixed by contract or reference to "well-established market values"; compare *Roodenburg v. Pavestone*

Co., L.P. (2009) 171 CA4th 185, 190-191, 89 CR3d 558, 562-563—prejudgment interest recoverable despite uncertainty as to damages amount when contract expressly provides for such award]

However, the "certainty" standard for § 3287(a) "mandatory" prejudgment interest is not satisfied when damages must be determined by the trier of fact based on conflicting evidence of the property value. That will almost always be the case in a seller's suit seeking damages pursuant to Civ.C. § 3307. [*County of Los Angeles v. Southern Calif. Edison Co.* (2003) 112 CA4th 1108, 1123, 5 CR3d 575, 587; *Great Western Drywall, Inc. v. Roel Const. Co., Inc.*, supra—interest not allowable where damages amount depends upon judicial determination based on conflicting evidence; see also *Rifkin v. Achermann* (1996) 43 CA4th 391, 398, 50 CR2d 661, 665—"The discretionary authority conferred by [Civ.C. § 3287(b)] will ordinarily apply to loss-of-bargain damages"]

(2) [11:134.3] **Accrual rate:** Unless the contract provides for another legal rate of interest, interest on contract damages accrues at the rate of 10% per annum (applicable to contracts entered into after 1/1/86; see Civ.C. § 3289(b)).

(a) [11:134.3a] **Exception—note secured by deed of trust:** By its terms, Civ.C. § 3289(b) does not apply to a note secured by a deed of trust on real property. In such a case, absent a contractual provision setting the rate, the prejudgment interest rate is 7%. [Cal.Const. Art. XV, § 1; *Soleimany v. Narimanzadeh* (2022) 78 CA5th 915, 924, 294 CR3d 191, 197 (deciding case of apparent first impression)]

(3) [11:134.4] **Accrual date:** When awarded under the discretionary authority of Civ.C. § 3287(b), the interest commences to run from whatever date before entry of the judgment that the court, in its discretion, fixes. But the *earliest* date from which § 3287(b) interest may accrue is the date the *action was filed* (*not* the date of the breach). [Civ.C. § 3287(b); *Rifkin v. Achermann* (1996) 43 CA4th 391, 398, 50 CR2d 661, 665; *North Oakland Med. Clinic v. Rogers* (1998) 65 CA4th 824, 829, 76 CR2d 743, 746]

(a) [11:134.5] **Compare—accrual date for § 3287(a) interest:** Prejudgment interest awarded under Civ.C. § 3287(a) (¶ 11:134.2) commences to run from the first day there exists both a breach and a liquidated claim. [See Civ.C. § 3287(a); *North Oakland Med. Clinic v. Rogers* (1998) 65 CA4th 824, 828, 76 CR2d 743, 746; see also *Thompson v. Asimos* (2016) 6 CA5th 970, 992, 212 CR3d 158, 179, fn. 7 (noting one of main difficulties in applying § 3287(a) is determining when sum owed on contract becomes liquidated, i.e., readily ascertainable)—§ 3287(a) interest awardable from date parties settled with third party litigant; *Collins v. City of Los Angeles* (2012) 205 CA4th 140, 150, 139 CR3d 880, 888—§ 3287(a) interest awardable from date right to recover damages arose; *and* ¶ *11:400* (tort actions involving damages "certain, or capable of being made certain by calculation")]

[11:134.6 - 11:134.9] ***Reserved.***

(4) [11:134.10] **Procedure for requesting prejudgment interest:** An entitlement to prejudgment interest does not make the award automatic; plaintiff must make a *timely request* for interest in the trial court. [*North Oakland Med. Clinic v. Rogers* (1998) 65 CA4th 824, 829, 76 CR2d 743, 746; see *County of Los Angeles v. Southern Calif. Edison Co.* (2003) 112 CA4th 1108, 1123, 5 CR3d 575, 587]

A general prayer in the complaint (for "such other and further relief as may be proper") is sufficient to support an award of prejudgment interest. [*North Oakland Med. Clinic v. Rogers*, supra, 65 CA4th at 829, 76 CR2d at 746; see *Jones v. Wagner* (2001) 90 CA4th 466, 481, 108 CR2d 669, 680—prayer in *cross-complaint* for "such other relief as the court deems just and proper" sufficient request for prejudgment interest]

However, a *separate request* for the court to determine whether plaintiff is entitled to CCP § 3287 prejudgment interest is required where damages have been awarded but no interest was included in the verdict and neither the court nor the jury determined whether the damages were liquidated or unliquidated. [*North Oakland Med. Clinic v. Rogers*, supra, 65 CA4th at 829, 76 CR2d at 746]

(a) [11:134.11] **Timing of request:** No statute or rule of court specifies when prejudgment interest must be sought or a particular procedure for making the request. At least one court has concluded, however, that the request must be made *before entry of judgment* or, at the very latest, by way of a timely *motion for new trial* (on the ground of inadequate damages, CCP § 657(c)). [*North Oakland Med. Clinic v. Rogers* (1998) 65 CA4th 824, 830, 76 CR2d 743, 747—prejudgment interest may not be sought postverdict and after postjudgment motions for new trial and to tax costs have been heard and decided; see also *Watson Bowman Acme Corp. v. RGW Const., Inc.* (2016) 2 CA5th 279, 298, 206 CR3d

281, 296—supplier's prejudgment interest request, made less than 15 days after judgment was filed, deemed timely because it fell within time limit for CCP § 657 motions (¶ 11:134.2)]

1) [11:134.12] **Not by cost bill:** On the other hand, since Civ.C. § 3287 prejudgment interest is awarded as an element of *damages*, not as costs, a cost bill is *not* an appropriate vehicle for making the request. [*North Oakland Med. Clinic v. Rogers* (1998) 65 CA4th 824, 830, 76 CR2d 743, 747]

[11:134.13 - 11:134.14] ***Reserved.***

(b) [11:134.15] **Compare—stipulation for postjudgment adjudication:** The important point is that the opposing party be on *notice* that prejudgment interest is in issue. Thus, at least where the *complaint* specifically requested interest, prejudgment interest may be adjudicated in a *postjudgment* hearing pursuant to prejudgment stipulation of the parties. [See *Steiny & Co., Inc. v. California Elec. Supply Co., Inc.* (2000) 79 CA4th 285, 294, 93 CR2d 920, 926 (distinguishing *North Oakland*, supra)—"(t)he present case bears no resemblance to the extreme facts in *North Oakland*"]

(5) [11:134.16] **Objections to prejudgment interest; waiver:** Objections to a prejudgment interest award (the propriety of the award or the amount thereof) must be raised in the *trial court* or are *waived*. The objections cannot be raised for the first time on appeal. [*Jones v. Wagner* (2001) 90 CA4th 466, 481-482, 108 CR2d 669, 680—failure to object to proposed judgment containing prejudgment interest provision waived objections to prejudgment interest award]

e. [11:135] **Compare—punitive damages:** Punitive damages are not recoverable in an ordinary breach of contract action. [See Civ.C. § 3294(a)—authorizing punitive damages only "(i)n an action for the breach of an obligation *not arising from contract* …" (emphasis added)] However, if the aggrieved seller can plead and prove a *tort* cause of action (e.g., fraud), punitive damages might be recoverable upon proof by "clear and convincing evidence" that the buyer acted with "oppression, fraud, or malice" (as defined by Civ.C. § 3294(c)). (*See ¶ 11:390* in connection with damages for fraud.)

f. [11:136] **Attorney fees:** Except as specifically provided by statute, "the measure and mode of compensation of attorneys … is left to the agreement … of the parties." [CCP § 1021; *Jackson v. Homeowners Ass'n Monte Vista Estates-East* (2001) 93 CA4th 773, 778-779, 113 CR2d 363, 366; see also *Mountain Air Enterprises, LLC v. Sundowner Towers, LLC* (2017) 3 C5th 744, 751, 220 CR3d 650, 656—§ 1021 permits parties to "contract out" of the "American rule" by executing agreements that allocate attorney fees]

No statute expressly provides for the recovery of attorney fees in a seller's breach of contract suit. [See Civ.C. § 3307 (defining seller's damages in breach of contract action); and *Jensen v. Dalton* (1970) 9 CA3d 654, 658, 88 CR 426, 428—seller's offer to prove attorney fees as damages caused by buyers' breach properly rejected because no showing of statutory or contractual authority for allowance of fees]

Thus, attorney fees are recoverable in suits on real property purchase agreements only if the *contract includes an attorney fees provision*. [See CCP § 1021; *Xuereb v. Marcus & Millichap, Inc.* (1992) 3 CA4th 1338, 1340, 5 CR2d 154, 156]

(1) [11:137] **Civ.C. § 1717 applies to actions "on the contract":** Contractual attorney fees sought in an action "*on the contract*" or to *enforce the contract* are awarded pursuant to Civ.C. § 1717 (¶ *11:138 ff.*). [*Santisas v. Goodin* (1998) 17 C4th 599, 608, 71 CR2d 830, 836; *Jackson v. Homeowners Ass'n Monte Vista Estates-East* (2001) 93 CA4th 773, 779, 113 CR2d 363, 366—§ 1717 "covers only contract actions, where the theory of the case is breach of contract"; *Exxess Electronixx v. Heger Realty Corp.* (1998) 64 CA4th 698, 706-707, 75 CR2d 376, 382—where action is "on the contract," § 1717 cannot be circumvented by seeking fees under general costs provisions (CCP §§ 1021, 1032-1033.5); see also *Andrade v. Western Riverside Council of Governments* (2024) 99 CA5th 1020, 1029-1030, 318 CR3d 396, 403-404 (distinguishing between § 1717 fees available to party who recovered greater relief in contract action (i.e., party "prevailing on the contract") and CCP § 1032 fees available to party who received net monetary recovery (i.e., "prevailing party," *discussed at* ¶ 11:394.3)]

(a) [11:137.1] **Compare—tort actions:** Civ.C. § 1717 (¶ 11:137) applies *only* where the theory of the case is essentially *breach of contract;* it does not apply when the underlying cause of action rests exclusively in *tort*. [*Santisas v. Goodin* (1998) 17 C4th 599, 615, 71 CR2d 830, 840; see also *Xuereb v. Marcus & Millichap, Inc.* (1992) 3 CA4th 1338, 1342, 5 CR2d 154, 157; *Brown Bark III, L.P. v. Haver* (2013) 219 CA4th 809, 828, 162 CR3d 9, 24—distinction between contract and tort claims is that tort claims are not "on a contract" and therefore are outside § 1717 's ambit]

Even so, agreed-upon attorney fees may still be awardable under the general authority of CCP § 1021 (¶ *11:136*). Nothing in § 1021 limits its application to contract actions; quite the contrary, pursuant to § 1021, "parties may validly agree that the prevailing party will be awarded attorney fees incurred *in any litigation* between themselves, whether

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such litigation sounds in tort or contract." [*Mountain Air Enterprises, LLC v. Sundowner Towers, LLC* (2017) 3 C5th 744, 751, 220 CR3d 650, 656 (quoting *Santisas,* supra, 17 C4th at 608, 71 CR2d at 836, and *Xuereb,* supra, 3 CA4th at 1341, 5 CR2d at 156-157 (emphasis added); Santisas *v. Goodin*, supra, 17 C4th at 608, 71 CR2d at 836, quoting *Xuereb v. Marcus & Millichap, Inc.*, supra, 3 CA4th at 1341, 5 CR2d at 156-157 (emphasis added); see also *Maynard v. BTI Group, Inc.* (2013) 216 CA4th 984, 993, 157 CR3d 148, 153—agreement to award fees based on outcome of "any dispute" encompasses all claims, "whether in contract, tort or otherwise"]

Thus, provided the contractual attorney fees provision is worded broadly enough, "prevailing party" fees may be awardable in tort actions *arising out of the contract* under the general authority of CCP §§ 1021, 1032 and 1033.5 (*see discussion at ¶ 4:518 ff.*). [*Santisas v. Goodin*, supra, 17 C4th at 608, 71 CR2d at 836 (real estate purchase agreement provided for prevailing party fee recovery in actions "arising out of the execution of the agreement or the sale"); *Silver v. Boatwright Home Inspection, Inc.* (2002) 97 CA4th 443, 449, 118 CR2d 475, 479 (same—"in any dispute arising out of this agreement, the inspection, or report(s)"); see also *Maynard v. BTI Group, Inc.,* supra, 216 CA4th at 988, 157 CR3d at 150—party who prevailed on tort rather than contract theory awarded fees pursuant to listing agreement that entitled party who prevailed in "overall dispute" to recover fees; compare *Hasler v. Howard* (2004) 120 CA4th 1023, 1027, 16 CR3d 217, 220—fees *not* awardable in action alleging fraud, breach of fiduciary duty, and breach of duty to disclose where fee provision applied only to actions regarding *obligation to pay compensation* under, instead of any action or lawsuit arising from, broker listing agreement]

1) [11:137.2] **Limitation—no fee recovery "reciprocity" under CCP § 1021:** CCP § 1021, unlike Civ.C. § 1717, does not contain a "reciprocity" provision (where the underlying contract only gives *one party* the right to an attorney fee award, Civ.C. § 1717 establishes a *reciprocal right* to attorney fees in favor of whichever party prevails, *see ¶ 11:138 ff.*). [*Exxess Electronixx v. Heger Realty Corp.* (1998) 64 CA4th 698, 708, 75 CR2d 376, 383]

Thus, where the party claiming fees prevails on a *tort* (rather than a contract) cause of action, so that CCP § 1021 (and not Civ.C. § 1717) applies, the right to an attorney fee award is based on the *terms of the underlying contract*. If reciprocal rights are not provided under the contract, the *unnamed* party will not recover a fee award upon prevailing. [*Exxess Electronixx v. Heger Realty Corp.*, supra, 64 CA4th at 708, 75 CR2d at 383; *Moallem v. Coldwell Banker Comm'l Group, Inc.* (1994) 25 CA4th 1827, 1831-1833, 31 CR2d 253, 255-256—despite attorney fee clause in underlying brokerage agreement, tenant who prevailed only on tort claims in action arising out of real estate transaction could not recover fees against real estate agent because attorney fee clause ran only in named agent's favor]

2) [11:137.3] **Conditions precedent to reciprocal fee recovery:** Even if the contract provides for reciprocal prevailing party attorney fee rights, the party who prevails on a tort claim arising out of the agreement must satisfy any specified condition precedents to a fee recovery.

- [11:137.3a] For example, where a real estate purchase agreement contained a provision requiring the initiation of mediation before filing suit as a condition precedent to the recovery of attorney fees, the prevailing party would have forfeited his right to recover fees if he filed suit *before* commencing mediation. [*Johnson v. Siegel* (2000) 84 CA4th 1087, 1100-1101, 101 CR2d 412, 421]

On the other hand, because the condition precedent (seeking mediation) was expressly attached to the *party who initiated the action*, it was *not* a condition on prevailing party fee recovery by the successful *defendant*. [*Johnson v. Siegel*, supra, 84 CA4th at 1100-1101, 101 CR2d at 421-422—fact plaintiff buyer lost right to recover attorney fees by not initiating mediation before filing suit did not forfeit successful seller's right to prevailing party fee recovery; *see also ¶ 11:138.18*]

[11:137.4] ***Reserved.***

(b) [11:137.5] **Application where contract and noncontract causes of action joined:** Where a cause of action based on a contract providing for attorney fees is joined with other causes of action beyond the contract, prevailing party attorney fees are recoverable under Civ.C. § 1717 *only as they relate to the contract action.* [*Reynolds Metals Co. v. Alperson* (1979) 25 C3d 124, 129-130, 158 CR 1, 3-4; see also *PM Group, Inc. v. Stewart* (2007) 154 CA4th 55, 68, 64 CR3d 227, 238—plaintiffs who prevailed on defendants' contract claim by establishing its nonexistence were entitled to § 1717 attorney fees in addition to their recovery on tort claims, in quasi-contract and on common counts; *Carver v.*

Chevron U.S.A., Inc. (2002) 97 CA4th 132, 147-148, 118 CR2d 569, 581-582—attorney fees incurred to defend against statutory claims should have been deleted from total fees awarded under attorney fees clause in parties' lease]

1) [11:137.6] **No apportionment when fees incurred on common issues:** Attorney fees need *not* be apportioned between contract and noncontract causes of action to the extent the fees were incurred for representation on issues *common to both* causes of action, making it "impracticable, if not impossible" to allocate the attorney's time between the contract and noncontract claims. [*Reynolds Metals Co. v. Alperson* (1979) 25 C3d 124, 129-130, 158 CR 1, 4; see also *Brown Bark III, L.P. v. Haver* (2013) 219 CA4th 809, 829-830, 162 CR3d 9, 25—governing standard is whether issues are so interrelated that it is "impossible to separate them into claims for which attorney fees are properly awarded and claims for which they are not"; *PM Group, Inc. v. Stewart* (2007) 154 CA4th 55, 69, 64 CR3d 227, 238—where plaintiffs' tort theories and defendants' contract claim were completely interrelated, requiring presentation of virtually identical evidence, 10% decrease in total attorney fees awarded deemed sufficient to reflect time attributable to noncontract causes of action]

Cross-refer:

- Recovery of attorney fees in a *tort* action is discussed further at *¶ 11:392 ff.*

- For a discussion of matters to consider when drafting contractual attorney fee provisions, *see ¶ 4:513 ff.*

(2) [11:138] **Civ.C. § 1717 reciprocal prevailing party right of recovery in actions "on the contract":** In any action on a contract specifically providing that attorney fees incurred to enforce the contract shall be awarded to one of the parties, or to the prevailing party, *whichever party prevails* in the contract action is entitled to recover reasonable attorney fees as costs. [Civ.C. § 1717(a); *Santisas v. Goodin* (1998) 17 C4th 599, 610, 71 CR2d 830, 837—primary purpose of § 1717 is to ensure mutuality of remedy under contractual attorney fee provisions; *Wong v. Thrifty Corp.* (2002) 97 CA4th 261, 263, 118 CR2d 276, 277; compare *Khajavi v. Feather River Anesthesia Med. Group* (2000) 84 CA4th 32, 62, 100 CR2d 627, 649, fn. 16—§ 1717 cannot be bootstrapped to provide for attorney fees for breach of contract that has no attorney fees provision]

Moreover, a contractual fee provision in one section of the contract applies to the *entire* contract unless the agreement specifies each party was represented by counsel in the agreement's negotiation and execution and that fact is stated in the contract. [See *Andrade v. Western Riverside Council of Governments* (2024) 99 CA5th 1020, 1026-1027, 318 CR3d 396, 401-402 (finding Civ.C. § 1717's goal is to avoid "lopsided arrangements" where one party can limit the other's attorney fee recovery to particular claims)—error to deny § 1717 fees to homeowner seeking rescission of loan agreements that impermissibly limited fee provisions to judicial foreclosure actions, *discussed further at* ¶ 11:138.2a]

Thus, where the purchase agreement contains an attorney fees recovery provision, whichever party—buyer or seller—successfully pursues a breach of contract suit (or other action "on the contract") against the other is entitled to an attorney fees as costs award. [Civ.C. § 1717(a); CCP § 1033.5(a)(10)(A); *Sessions Payroll Management, Inc. v. Noble Const. Co., Inc.* (2000) 84 CA4th 671, 678, 101 CR2d 127, 131; see also *Pueblo Radiology Med. Group, Inc. v. Gerlach* (2008) 163 CA4th 826, 829, 77 CR3d 880, 882—defendants who prevailed on alter ego issue essential to breach of contract action were entitled to § 1717 attorney fees even though breach itself had yet to be decided (reciprocal prevailing party right triggered once final determination is made in party's favor); see also *Burkhalter Kessler Clement & George LLP v. Hamilton* (2018) 19 CA5th 38, 228 CR3d 154 (citing *Pueblo Radiology* with approval)—sublessee's managing partner who prevailed on alter ego claim in sublessor's breach of contract action entitled to § 1717 attorney fees even though she was not a party to sublease (¶ 11:139.25a); *Pacific Custom Pools, Inc. v. Turner Const. Co.* (2000) 79 CA4th 1254, 1270, 94 CR2d 756, 767—attorney fees provision will be given effect under § 1717 "whether the action is commenced by the obligor or the obligee"; *and ¶ 4:514*]

(a) [11:138.1] **Actions "on the contract":** The Civ.C. § 1717 "reciprocal" right to fees applies only in an *action on the contract* or to *enforce the contract* containing a prevailing party attorney fees provision (Civ.C. § 1717(a)). A *damages* action for *breach* of the agreement clearly is within the contemplation of Civ.C. § 1717. Beyond that, courts construe the term "on the contract" liberally. [See *Hjelm v. Prometheus Real Estate Group, Inc.* (2016) 3 CA5th 1155, 1168, 1170, 208 CR3d 394, 402, 404 (noting courts have found claims "on a contract" in various circumstances extending beyond direct breach of contract claims); *Turner v. Schultz* (2009) 175 CA4th 974, 980, 96 CR3d 659, 663—prevailing party entitled to § 1717 fees for any action "on the contract," whether fees incurred offensively or defensively; compare *California Union Square L.P. v. Saks & Co. LLC* (2021) 71 CA5th 136, 142-144, 286 CR3d 115, 119-121—no attorney fees awarded

tenant for successful judicial challenge to arbitration award setting property's fair market value (FMV) because one fee clause specifically required parties to bear their own costs for *all* FMV proceedings (also, lease's other, general attorney fee provision deemed inapplicable because a judicial challenge to an FMV determination is not an "action or proceeding to enforce the lease" or to obtain a "declaration of rights" thereunder); *Orien v. Lutz* (2017) 16 CA5th 957, 962-963, 224 CR3d 736, 739-741 (noting co-owners of property have absolute, statutory right to partition independent of any agreement restating their right to do so)—plaintiff sibling's statutory right to partition two inherited properties, although reiterated in prior settlement agreement with her defendant siblings, was not a contractual provision she "enforced" through her partition action and therefore did not entitle her to attorney fees per said agreement's reciprocal fee provision]

Whether an action is based on contract or tort depends on the nature of the right sued upon, not the form of pleading or relief demanded. Broadly, "if based on breach of promise, it is contractual; if based on breach of a noncontractual duty, it is tortious." [*Kangarlou v. Progressive Title Co., Inc.* (2005) 128 CA4th 1174, 1178-1179, 27 CR3d 754, 756 (internal quotes omitted); *Turner v. Schultz*, supra, 175 CA4th at 979-980, 96 CR3d at 663—"As long as the action involves a contract it is 'on the contract'" for § 1717 purposes (internal quotes and brackets omitted); see also *Hjelm v. Prometheus Real Estate Group, Inc.*, supra, 3 CA5th at 1168-1170, 208 CR3d at 402-404—although tenants' lawsuit against landlord included both tort and contract claims, coupled with prayer for emotional distress and economic damages, claim for breach of lease agreement's warranty of habitability and for constructive eviction deemed "on the contract" for § 1717 purposes; *Kachlon v. Markowitz* (2008) 168 CA4th 316, 347, 85 CR3d 532, 556—equitable claims based on promissory note and trust deed containing unilateral attorney fee clauses deemed actions "on the contract" (*discussed at ¶ 6:242.2*)]

1) [11:138.2] **Declaratory relief actions:** A declaratory relief action seeking an *interpretation of the contract* is an "action on the contract" triggering a right to Civ.C. § 1717 fees. Such an action is "clearly one to enforce the parties' rights" under the contract. [*Harbour Landing-Dolfann, Ltd. v. Anderson* (1996) 48 CA4th 260, 263, 55 CR2d 640, 642 (declaratory relief action seeking interpretation of lease containing attorney fees clause); *Turner v. Schultz* (2009) 175 CA4th 974, 980, 96 CR3d 659, 663 (declaratory relief action re enforceability of arbitration provision in agreement containing attorney fees clause); *Kachlon v. Markowitz* (2008) 168 CA4th 316, 347-348, 85 CR3d 532, 556-557 (declaratory relief action seeking declaration that trust deed containing attorney fees clause must be reconveyed because foreclosure violated terms of trust deed)]

Rationale: If, instead of bringing the declaratory relief suit, one party refused to perform under the disputed contract provision, and the other party responded with a breach of contract action, the attorney fee clause would "surely apply." That one party preempts a breach of contract suit with a declaratory relief suit "does not defeat the attorney fee clause." [*Harbour Landing-Dolfann, Ltd. v. Anderson*, supra, 48 CA4th at 263, 55 CR2d at 642]

2) [11:138.2a] **Rescission actions:** An action seeking to enforce the rescission of a contract is an action "on the contract" for purposes of Civ.C. § 1717. [*Hastings v. Matlock* (1985) 171 CA3d 826, 840-841, 217 CR 856, 866-867; see *Andrade v. Western Riverside Council of Governments* (2024) 99 CA5th 1020, 1025-1026, 318 CR3d 396, 400—homeowner fraudulently enrolled in Property Assessed Clean Energy (PACE) program could recover attorney fees in action to rescind PACE loan documents because said documents provided for lender's recovery of fees and enforcement costs (¶ 11:138)]

3) [11:138.3] **Action on several contracts:** If the parties entered into several contracts as part of a single relationship or transaction, an attorney fee recovery provision contained in one of the documents may be applied to the other documents in the transaction because the documents will be construed together. [*Mountain Air Enterprises, LLC v. Sundowner Towers, LLC* (2017) 3 C5th 744, 759, 220 CR3d 650, 662-663; *Boyd v. Oscar Fisher Co., Inc.* (1989) 210 CA3d 368, 378-380, 258 CR 473, 478-479; *South Bay Transp. Co. v. Gordon Sand Co.* (1988) 206 CA3d 650, 660-661, 253 CR 753, 759-760]

But the result is otherwise where the several contracts, although related, are entered into by *different parties* (e.g., purchase and sale agreement between buyer and seller and separate escrow instructions with escrow company)—here, an attorney fee provision in one of the contracts does not apply to the other. [See *Paul v. Schoellkopf* (2005) 128 CA4th 147, 153-154, 26 CR3d 766, 770-771—where purchase and sale agreement (between buyer and seller) and escrow instructions (between escrow company and buyer and seller) were executed as part of single transaction,

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but only escrow instructions contained attorney fee provision, buyer could not invoke provision in instructions to recover fees from seller]

4) [11:138.4] **Distinguish—affirmative defenses:** An affirmative defense does *not* equate to or constitute an "action" even though it is encompassed within the latter. Indeed, "while an affirmative defense is a 'real *part of* any action' … , it does not, in and of itself, constitute an 'action' for purposes of recovering attorney fees." [See *Mountain Air Enterprises, LLC v. Sundowner Towers, LLC* (2017) 3 C5th 744, 747, 753, 756-760, 220 CR3d 650, 653, 658, 660-664 (italics in original) (resolving split of authority)—although buyer's affirmative defense of novation based on parties' option contract did not constitute an "action" within the meaning of said contract's attorney fee provision, buyer nonetheless was entitled to its fees pursuant to said provision because seller's action for specific performance and breach of the parties' repurchase agreement was brought "*because of*" an "alleged dispute … in connection with" the option agreement]

5) [11:138.5] **Distinguish—*not pursuant to indemnification clause:*** The inclusion of attorney fees *as an item of loss* in an *indemnity contract* does not constitute a provision for the award of attorney fees in an action on the contract triggering the operation of Civ.C. § 1717. Because an indemnity agreement is intended by the parties to *unilaterally* benefit the indemnitee by holding it harmless against liabilities and expenses incurred in defending against *third-party* claims, "application of reciprocity principles would defeat the very purpose of the agreement." [*Baldwin Builders v. Coast Plastering Corp.* (2005) 125 CA4th 1339, 1344, 24 CR3d 9, 12-13; see *Rideau v. Stewart Title of Calif., Inc.* (2015) 235 CA4th 1286, 1301-1302, 185 CR3d 887, 897-898—buyer could not recover § 1717 fees against escrow holder based on escrow instruction's indemnity provision (clause provided escrow company with "one way" protection against third party lawsuits and did not apply to fees incurred in litigation between buyer and escrow holder based on their contract); *Carr Business Enterprises, Inc. v. City of Chowchilla* (2008) 166 CA4th 14, 22-23, 82 CR3d 128, 134-135—prevailing party contractor not entitled to § 1717 fees pursuant to contract provision stating contractor would indemnify city against claims, including attorney fees, arising out of performance of work (standard indemnity clause obligating contractor to pay litigation expense in third party action arising out of performance of contract); see also *Alki Partners, LP v. DB Fund Services, LLC* (2016) 4 CA5th 574, 600-602, 209 CR3d 151, 170-173 (finding language in parties' indemnity clause indistinguishable from *Carr's* provision)—standard indemnity clause in hedge fund administrator's contract with fund's operator did not grant administrator right to recover attorney fees as prevailing party in operator's breach of contract suit]

a) Application

• [11:138.6] Escrow instructions authorized the escrow holder to withhold and stop all further escrow proceedings without liability and/or to sue in interpleader where conflicting demands were made on the escrow holder or any dispute or controversy arose between the principals or with any third person relating to the escrow. The instructions further required the principals to pay, indemnify and hold the escrow holder harmless against all litigation and interpleader costs, including reasonable attorney fees, incurred by the escrow holder "which arise, result from or relate to this escrow."

Construed together, these sentences provided for attorney fees in the event of litigation arising out of conflicting demands against the escrow holder or any dispute arising between the principals or with any third person regarding the terms of the escrow. The language was a *standard indemnity clause* that did not provide for the recovery of prevailing party attorney fees in actions between a principal and the escrow holder to enforce the general escrow instructions. [*Campbell v. Scripps Bank* (2000) 78 CA4th 1328, 1335-1338, 93 CR2d 635, 642-644 & fn. 5]

• [11:138.7] *Compare:* By the same token, there is "no magic formulation for a fees provision." Indeed, use of the words "promise to reimburse" (for legal fees) does not compel the conclusion the attorney fee clause is simply an indemnity provision. Cases deciding whether given language comprises an indemnity clause consider whether the language was intended to operate between the contracting parties or only as against nonparties. [See *International Billing Services, Inc. v. Emigh* (2000) 84 CA4th 1175, 1183, 101 CR2d 532, 537—"promise to reimburse Company for any legal fees, liability or loss which Company incurs as a result of …" construed as contractual fee recovery provision governed by Civ.C. § 1717]

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b) [11:138.8] **Compare—provision for fees incurred to enforce indemnity agreement:** By contrast, the Civ.C. § 1717 reciprocity principles apply where the indemnity agreement's unilateral attorney fee clause is not included as an item of loss or expense but instead separately provides for the recovery of attorney fees incurred in enforcing the indemnity agreement. [*Baldwin Builders v. Coast Plastering Corp.* (2005) 125 CA4th 1339, 1344-1346, 24 CR3d 9, 13-14; see also *Alki Partners, LP v. DB Fund Services, LLC* (2016) 4 CA5th 574, 602, 209 CR3d 151, 172 (acknowledging such fees are recoverable where contract includes *express language* authorizing same in action to enforce indemnity agreement)]

[11:138.9 - 11:138.13] ***Reserved.***

6) [11:138.14] **No § 1717 fees for successful contract defense to tort action:** The successful assertion of a contract defense to a *tort* action is *not* "an action brought to enforce the contract" for purposes of entitlement to Civ.C. § 1717 prevailing party attorney fees. [*Gil v. Mansano* (2004) 121 CA4th 739, 743-745, 17 CR3d 420, 423-425]

(b) [11:138.15] **Subject to contractual conditions precedent:** Just as a prevailing party's contractual right to a fee award in a *tort* action may be subject to restrictions or conditions precedent specified in the contract (*¶ 11:137.3 ff.*), so may a right to Civ.C. § 1717 fees in a contract action: "[W]e construe … [Civ.C. § 1717] to permit parties to a contract to set forth with specificity the circumstances in which attorney fees are recoverable, provided any such specific contractual provisions do not otherwise conflict with the requirements of section 1717." [*Leamon v. Krajkiewcz* (2003) 107 CA4th 424, 436, 132 CR2d 362, 370]

In other words, conditions restricting the prevailing party's entitlement to a Civ.C. § 1717 fee award are enforceable so long as they do not defeat the statute's underlying "mutuality of remedy" purpose—i.e., so long as the specified restrictions do not favor one party over the other and cannot be manipulated for tactical advantage in the litigation by one of the parties. [*Leamon v. Krajkiewcz*, supra, 107 CA4th at 436, 132 CR2d at 370]

The contractual conditions precedent to a fee award are enforceable even against a party who prevails by establishing the contract itself is invalid. [*Leamon v. Krajkiewcz*, supra, 107 CA4th at 432-433, 132 CR2d at 367-368]

1) Application

• [11:138.16] A standard form residential purchase agreement provided that the prevailing Buyer or Seller in any action, proceeding or arbitration arising out of the agreement "shall be entitled to reasonable attorney's fees and costs … except as provided in Paragraph 21A." Pursuant to Paragraph 21A, *mediation* had to be attempted before resorting to court action on the contract and attorney fees entitlement would be *forfeited* by a party who commenced an action on a dispute arising out of the agreement without first attempting mediation.

Although Seller subsequently prevailed against Buyers in her quiet title suit claiming the contract was not valid, she was properly denied Civ.C. § 1717 attorney fees because she did not satisfy the contractual condition precedent of seeking mediation before filing suit. Enforcing the condition would not conflict with the § 1717 mutuality of remedy concept because Buyers could not have commenced suit and recovered attorney fees without seeking mediation. [*Leamon v. Krajkiewcz* (2003) 107 CA4th 424, 433, 132 CR2d 362, 367-368; see also *Frei v. Davey* (2004) 124 CA4th 1506, 1511-1520, 22 CR3d 429, 433-441—pursuant to provision in standard form residential purchase agreement, fees not awarded in specific performance action to prevailing parties who refused request to mediate]

• [11:138.16a] The prevailing buyer was not entitled to Civ.C. § 1717 attorney fees in an action for failure to disclose, etc., brought against sellers of a lake house where the buyer did *not attempt* mediation *before* commencing litigation, in violation of the parties' residential purchase agreement. The court was not persuaded by the buyer's contention his actions were justified because he was unable to locate the sellers before filing suit:

"After filing his complaint, [buyer] hired an investigator and, two weeks later, when the investigator discovered the sellers' mailing address, [buyer] mailed them the complaint … [Buyer] could have readily complied with the requirements of the [mediation provision] by simply hiring the investigator, learning sellers' whereabouts, and mailing an offer of mediation to them *before* filing his complaint." [*Lange v. Schilling* (2008) 163 CA4th 1412, 1416-1418, 78 CR3d 356, 359-360 (emphasis in original)—because parties' agreement unambiguously required attempt at mediation before filing suit, "doctrine of substantial compliance" inapplicable even though buyer

offered to mediate after locating sellers; see also *Cullen v. Corwin* (2012) 206 CA4th 1074, 1079, 142 CR3d 419, 423—because parties' agreement unambiguously required attempt at mediation before filing suit *or* after a request therefor, fact that buyers initiated court action before requesting mediation did not allow prevailing sellers to reject buyers' subsequent mediation request and still recover fees (nor were sellers entitled to condition mediation on receipt of discovery responses)]

• [11:138.17] *Compare:* A contract provision that required a prevailing party to attempt mediation before filing suit to recover attorney fees specifically *exempted* from the prefiling mediation requirement an action commenced to enable the recordation of a lis pendens. Sellers who prevailed in their premediation specific performance action filed for lis pendens purposes were thus entitled to recover their fees. [*Blackburn v. Charnley* (2004) 117 CA4th 758, 767-768, 11 CR3d 885, 892-893; see also *Greif v. Sanin* (2022) 74 CA5th 412, 455-456, 289 CR3d 484, 517-518; *Frei v. Davey*, supra, 124 CA4th at 1517-1518, 22 CR3d at 438]

• [11:138.18] Seller filed a cross-complaint against Buyer and his broker, later dismissed Buyer from the cross-complaint, and then sought attorney fees incurred only in defending the complaint and not for prosecuting the cross-complaint. Because the condition precedent of seeking mediation was expressly required of the *party who initiated the action* (Buyer), Seller was entitled to a prevailing party fee award. [*Van Slyke v. Gibson* (2007) 146 CA4th 1296, 1299, 53 CR3d 491, 493-494]

[11:138.19] ***Reserved.***

(c) [11:138.20] **Recovery generally not limited to particular kinds of claims under contract:** *See discussion at ¶ 4:516.*

(d) [11:138.21] **Not limited to recovery by individuals:** *See discussion at ¶ 4:517.*

(e) [11:139] **"Prevailing party" determination:** Except where the action has been voluntarily dismissed (*¶ 11:139.10*), the party receiving the "*greater relief*" in a contract action is the "prevailing party" entitled to attorney fees. [Civ.C. § 1717(b)(1); see *Silver Creek, LLC v. Blackrock Realty Advisors, Inc.* (2009) 173 CA4th 1533, 1538, 93 CR3d 864, 868; *Carole Ring & Assocs. v. Nicastro* (2001) 87 CA4th 253, 261, 104 CR2d 519, 524; *Zintel Holdings, LLC v. McLean* (2012) 209 CA4th 431, 439, 147 CR3d 157, 163 (also noting court may determine there is no prevailing party)]

1) [11:139a] **Mandatory application:** For purposes of a Civ.C. § 1717 fee award, the Civ.C. § 1717(b)(1) definition of "prevailing party" is mandatory and cannot be avoided or altered by contract. Conflicting provisions in the parties' contract are void. [*Wong v. Thrifty Corp.* (2002) 97 CA4th 261, 264, 118 CR2d 276, 278—attorney fee provision in lease restricting fee recovery to party who prevails upon a "determination" of liability in action to enforce the lease (thus purporting to preclude § 1717 fee award when action on lease results in judgment by CCP § 998 settlement) void as conflicting with § 1717 "prevailing party" definition; *see also ¶ 11:139.11*]

2) [11:139.1] **Recovery by party establishing "inapplicable, invalid, unenforceable or nonexistent" contract:** A party is entitled to Civ.C. § 1717 attorney fees pursuant to contract when the party "prevails" by establishing the underlying contract is "*invalid, inapplicable, unenforceable or nonexistent,*" so long as the other party would have been entitled to recover attorney fees under the alleged contract had they prevailed. [*Santisas v. Goodin* (1998) 17 C4th 599, 611, 71 CR2d 830, 838 (emphasis added); *Brown Bark III, L.P. v. Haver* (2013) 219 CA4th 809, 819, 162 CR3d 9, 17; see also *Andrade v. Western Riverside Council of Governments* (2024) 99 CA5th 1020, 1025-1026, 318 CR3d 396, 400 (*discussed at* ¶ 11:138.2a); *Douglas E. Barnhart, Inc. v. CMC Fabricators, Inc.* (2012) 211 CA4th 230, 234, 149 CR3d 440, 443—subcontractor entitled to § 1717 fees from contractor after proving contract's nonexistence following bid submission; *Hsu v. Abbara* (1995) 9 C4th 863, 870-871, 39 CR2d 824, 828-829—seller sued by buyer on alleged real estate purchase contract became entitled to § 1717 fees by proving no contract was formed; *and ¶ 11:139.26*]

a) [11:139.2] **Effect of joining contract and noncontract causes of action:** The rule set forth at ¶ 11:139.1 means that a party who *joins* both contract and noncontract causes of action and wins only on the *noncontract* causes of action might end up *paying attorney fees* to the opposing party who otherwise lost the lawsuit. [*Webber v. Inland Empire Investments, Inc.* (1999) 74 CA4th 884, 919, 88 CR2d 594, 617-618]

Although a plaintiff succeeds on a noncontract claim, *defendant* is the "prevailing party" entitled to Civ.C. § 1717 fees if defendant defeated plaintiff's contract claim (provided plaintiff would have been allowed § 1717 fees had plaintiff won on the contract cause of action, ¶ 11:139.1). [See *Douglas E. Barnhart, Inc. v. CMC Fabricators,*

Inc. (2012) 211 CA4th 230, 246, 149 CR3d 440, 453—despite winning promissory estoppel claim (held to be a *noncontract* claim), plaintiff-contractor had to pay § 1717 fees to defendant-subcontractor who prevailed on plaintiff's contract claim by proving its nonexistence (*¶ 11:139.1*); *Korech v. Hornwood* (1997) 58 CA4th 1412, 1419-1422, 68 CR2d 637, 641-643—despite winning mechanic's lien claim, plaintiffs had to pay § 1717 fees to defendants who prevailed on plaintiffs' contract claim by proving they were not parties to contract sued upon]

b) [11:139.2a] **Subject to contractual conditions precedent:** *See discussion at ¶ 11:138.15 ff.*

c) [11:139.2b] **Compare—recovery where contract unenforceable because of illegality:** A different rule ordinarily applies where the contract containing an attorney fee clause is held unenforceable because of *illegality:* "[T]here is no need for a mutual right to attorney fees *since neither party can enforce the agreement.*" [*Yoo v. Jho* (2007) 147 CA4th 1249, 1256, 55 CR3d 243, 248 (emphasis added; internal quotes omitted); *Bovard v. American Horse Enterprises, Inc.* (1988) 201 CA3d 832, 843, 247 CR 340, 346; see also *San Luis Obispo Local Agency Formation Comm'n v. Central Coast Develop. Co.* (2022) 78 CA5th 363, 365, 293 CR3d 471, 473—public agency's contract that exceeds agency's statutory powers is void and therefore cannot support Civ.C. § 1717 fee award]

But the right to invoke the contractual attorney fee clause is defeated only where the contract is *entirely unenforceable* by *either party* due to its *illegal object*. When the *object* of the contract is legal but the contract is "illegal"—and thus voidable (but not void)—only because it does not comply with a statute, the party for whose benefit the statute was meant to protect may "disaffirm" the contract (void it) and yet still enforce the contract's attorney fee clause. [*Yuba Cypress Housing Partners, Ltd. v. Area Developers* (2002) 98 CA4th 1077, 1082-1083, 120 CR2d 273, 277-278—plaintiff choosing to "void" contract to purchase land from defendant who violated Subdivided Lands Act entitled to recover attorney fees under contract's attorney fee clause]

3) [11:139.3] **"Prevailing" without net monetary recovery:** The party receiving the "greater relief" (Civ.C. § 1717(b)(1)) is not necessarily the party receiving the greater *monetary* judgment. The statute vests trial courts with broad equitable discretion to determine the "prevailing party" in particular cases, and thus to determine that one party has "prevailed" for Civ.C. § 1717 purposes even though that party receives no net monetary judgment. [*Sears v. Baccaglio* (1998) 60 CA4th 1136, 1154-1155, 70 CR2d 769, 781; see also *Poseidon Develop., Inc. v. Woodland Lane Estates, LLC* (2007) 152 CA4th 1106, 1120, 62 CR3d 59, 69—"greater relief" does not necessarily mean greater *monetary* relief (also noting "prevailing party" determination can be made only after comparing extent to which each party succeeded and failed in its contentions)]

Thus, a party who pays only a *nominal net judgment* may be the "prevailing" party entitled to Civ.C. § 1717 fees if the party received earlier payments, settlements, insurance proceeds or other *recovery*. [*Sears v. Baccaglio*, supra, 60 CA4th at 1154-1155, 70 CR2d at 781]

a) [11:139.3a] **Compare—fee-shifting statutes:** A party also need not receive a "net monetary recovery" (¶ 11:139.3) to be the "prevailing party" under a fee-shifting statute, unless the statute expressly so provides or the parties otherwise agree. [See *Canyon View Ltd. v. Lakeview Loan Servicing, LLC* (2019) 42 CA5th 1096, 1118, 256 CR3d 233, 251 (rejecting argument that under Mobilehome Residency Law "prevailing party" must receive "net economic recovery")—statute's "plain language" mandates party with "judgment in its favor" is "prevailing party" (¶ 4:518.13)]

b) [11:139.4] **Compare—defendant may "prevail" simply by tendering and depositing full amount owed:** A defendant who does not cross-complain, and therefore is not entitled to monetary or any other affirmative relief, still may "prevail" as a matter of law if defendant (i) alleges in the answer that defendant tendered to the plaintiff the full amount owed; (ii) deposits that amount with the court; and (iii) proves the amount tendered and deposited was the full amount of the contractual debt. [See Civ.C. § 1717(b)(2); *David S. Karton, a Law Corp. v. Dougherty* (2014) 231 CA4th 600, 608, 180 CR3d 55, 60 (applying statute's logic to D who actually paid entire debt to P before trial, including interest, leaving nothing for D to deposit with court)]

4) [11:139.5] **Mixed results—court discretion:** Where the litigation results are otherwise mixed (e.g., victories and losses in the contract action are evenly divided), the court has discretion to decide which party "prevailed" or that neither prevailed for fee recovery purposes. [*Hsu v. Abbara* (1995) 9 C4th 863, 875, 39 CR2d 824, 832; see also *Harris v. Rojas* (2021) 66 CA5th 817, 824, 281 CR3d 452, 457 (noting prevailing party determination requires assessing whether party achieved "litigation objectives")—plaintiff lessee not entitled to $300,000 in prevailing party attorney

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fees where (i) plaintiff was awarded less than $6,000 in damages, (ii) record did not provide basis for assessing plaintiff's litigation objectives, and (iii) defendant lessor was awarded $13,000 in related unlawful detainer action; *Zintel Holdings, LLC v. McLean* (2012) 209 CA4th 431, 439-440, 147 CR3d 157, 164—court obligated to determine whether Civ.C. § 1717 prevailing party even existed when, as between two litigants, there was "no absolute or complete winner"; *Jackson v. Homeowners Ass'n Monte Vista Estates-East* (2001) 93 CA4th 773, 788, 113 CR2d 363, 374—no abuse of discretion in awarding plaintiffs attorney fees where substantial arguments supported both sides' claims of victory; compare *Silver Creek, LLC v. Blackrock Realty Advisors, Inc.* (2009) 173 CA4th 1533, 1540, 93 CR3d 864, 869—abuse of discretion to deny attorney fees to commercial property seller that achieved *main litigation objective* (disposition of subject properties) and thus recovered "greater relief" (buyer prevailed only on secondary claim for return of escrow deposit)]

5) [11:139.6] **Mandatory fee award to clear "winner":** On the other hand, where the results of the litigation on the contract claims are clear—i.e., when the decision is purely good news for one party and bad news for the other—the trial court has *no* discretion to deny attorney fees to the successful litigant. [*Hsu v. Abbara* (1995) 9 C4th 863, 875, 39 CR2d 824, 832; see also *Brown Bark III, L.P. v. Haver* (2013) 219 CA4th 809, 826, 162 CR3d 9, 23—party who obtains "unqualified victory" is entitled to Civ.C. § 1717 attorney fees as a "matter of law"; *Burkhalter Kessler Clement & George LLP v. Hamilton* (2018) 19 CA5th 38, 43, 46, 223 CR3d 154, 158, 160—defendant's managing partner obtained "unqualified victory" by obtaining judgment of dismissal without prejudice, entitling her to Civ.C. § 1717 attorney fees as a "matter of law" (¶ 11:139.25a); *Carole Ring & Assocs. v. Nicastro* (2001) 87 CA4th 253, 261, 104 CR2d 519, 524—defendant seller was prevailing party "as a matter of law" because he defeated broker's claim for commission based on alleged breach of listing agreement]

a) [11:139.6a] **Receiving less than requested relief:** A party who establishes an opposing party's liability and wins a monetary judgment is the "prevailing party" even if they win less relief than they requested. This factor, however, can be relevant in a damages-only trial if the opposing party stipulates to liability. [See *Regency Midland Const., Inc. v. Legendary Structures Inc.* (2019) 41 CA5th 994, 1000, 254 CR3d 624, 629 (citing *Olive v. General Nutrition Ctrs., Inc.* (2018) 30 CA5th 804, 822-829, 242 CR3d 15, 29-34, with approval)]

6) [11:139.7] **No prevailing party pending full resolution of underlying claims:** Section 1717 contemplates that only one side in a lawsuit can be the prevailing party. Thus, the prevailing party determination cannot be made until the parties' requests for relief have been fully resolved. [See *Roberts v. Packard, Packard & Johnson* (2013) 217 CA4th 822, 841-843, 159 CR3d 180, 193-195—error to award interim Civ.C. § 1717 attorney fees to law firm for filing successful petition to compel arbitration in pending lawsuit]

[11:139.8 - 11:139.9] ***Reserved.***

7) [11:139.10] **No prevailing party after voluntary dismissal of contract claim:** There is no *prevailing party* for Civ.C. § 1717 fee recovery purposes if the contract action is voluntarily dismissed or dismissed pursuant to settlement. [Civ.C. § 1717(b)(2); *Santisas v. Goodin* (1998) 17 C4th 599, 615, 71 CR2d 830, 842; see also *CDF Firefighters v. Maldonado* (2011) 200 CA4th 158, 164, 132 CR3d 544, 548-549—§ 1717(b)(2) 's underlying policy is to encourage settlements and discourage maintenance of pointless litigation]

a) Application

- [11:139.10a] A settlement dismissal of a lessee's declaratory relief claim against a broker barred the broker's right to Civ.C. § 1717 fees. [*Exxess Electronixx v. Heger Realty Corp.* (1998) 64 CA4th 698, 707, 75 CR2d 376, 382]
- [11:139.10b] Dismissal of a landlord's action against its tenant's alter ego for breach of a commercial lease while the tenant's motion for judgment was pending barred the tenant's right to Civ.C. § 1717 fees: Section 1717(b)(2) "bars recovery of … attorney fees regardless of when the dismissal is filed." [*Glencoe v. Neue Sentimental Film AG* (2008) 168 CA4th 874, 877, 85 CR3d 800, 803; see also *CDF Firefighters v. Maldonado* (2011) 200 CA4th 158, 164-165, 132 CR3d 544, 549—Civ.C. § 1717(b)(2) provides no temporal limitation]

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• [11:139.10c] A pretrial voluntary dismissal of a buyer's complaint against the seller of a dental practice barred the seller's right to Civ.C. § 1717 fees on the buyer's *contract* claims (but not for his defense against buyer's *tort* claims; *see ¶ 11:394.1 ff.*). [*Khan v. Shim* (2016) 7 CA5th 49, 58, 212 CR3d 292, 299]

b) [11:139.11] **Mandatory application:** Just as the parties cannot alter the Civ.C. § 1717(b)(1) definition of "prevailing party" (¶ *11:139a*), they cannot contract around the Civ.C. § 1717(b)(2) prohibition. Conflicting contractual provisions are *void.* [*Santisas v. Goodin* (1998) 17 C4th 599, 615, 71 CR2d 830, 841-842; *Exxess Electronixx v. Heger Realty Corp.* (1998) 64 CA4th 698, 707, 75 CR2d 376, 383-383; see also *Khan v. Shim* (2016) 7 CA5th 49, 56, 212 CR3d 292, 298—Section 1717(b)(2) "'overid[es] and nullif[ies] conflicting contractual provisions, such as provisions expressly allowing recovery of attorney fees in the event of voluntary dismissal … '" (brackets in original)]

[11:139.12] ***Reserved.***

c) [11:139.13] **Compare—fee recovery after settlement:** Resolution of a contract action by *settlement* does not itself trigger the Civ.C. § 1717(b)(2) bar. So long as there has been *no dismissal*, a settling party may move for contractually-based attorney fees under Civ.C. § 1717 unless the right thereto was waived in the settlement agreement. [*Wong v. Thrifty Corp.* (2002) 97 CA4th 261, 264, 118 CR2d 276, 278 (party prevailed by judgment entered on CCP § 998 settlement); see also *Jackson v. Homeowners Ass'n Monte Vista Estates-East* (2001) 93 CA4th 773, 783-785, 113 CR2d 363, 370-371—Civ.C. § 1717(b)(2) bar inapplicable where parties' agreed settlement would not result in dismissal of case *until* court determined whether there was a prevailing party and, if so, which party prevailed and then awarded Civ.C. § 1717 fees accordingly]

d) [11:139.14] **Compare—invalid voluntary dismissals:** The Civ.C. § 1717(b)(2) bar to prevailing party attorney fees is triggered by a *valid* voluntary dismissal. However, plaintiff's right to voluntarily dismiss an action before commencement of trial is not absolute; exceptions to that right generally arise where the action has proceeded to a determinative adjudication or to a decision that is tantamount to an adjudication. Any purported voluntary dismissal of the action by plaintiff acting unilaterally on and after that point is *invalid* and does not, therefore, bar a Civ.C. § 1717 attorney fees award to defendant. [*Bank of America, N.A. v. Mitchell* (2012) 204 CA4th 1199, 1209-1210, 139 CR3d 562, 569-570 (disapproved on other grounds by *Black Sky Capital, LLC v. Cobb* (2019) 7 C5th 156, 165, 246 CR3d 583, 591)]

• [11:139.14a] Section 1717 attorney fees were properly awarded against a bank that dismissed its contract action after the defendant/debtor's demurrer was sustained without leave to amend: "[T]he Bank sought to dismiss *after* the court made a dispositive ruling against it, not before. To allow the Bank to dismiss at that late stage would permit procedural gamesmanship inconsistent with the trial court's authority to provide for the orderly conduct of proceedings before it." [*Bank of America, N.A. v. Mitchell* (2012) 204 CA4th 1199, 1211-1212, 139 CR3d 562, 570-571 (disapproved on other grounds by *Black Sky Capital, LLC v. Cobb* (2019) 7 C5th 156, 165, 246 CR3d 583, 591) (emphasis in original)—Civ.C. § 1717 fee award to defendant affirmed because Civ.C. § 1717(b)(2) bar inapplicable]

e) [11:139.15] **Compare—voluntary dismissal of less than all distinct contract claims:** Civ.C. § 1717(b)(2) does not bar a prevailing party attorney fees recovery in favor of a party who prevails on one contract claim, even though the remaining claims are voluntarily dismissed, provided the dismissed claims are *separate and distinct* from the adjudicated contract claim. [*CDF Firefighters v. Maldonado* (2011) 200 CA4th 158, 165-166, 132 CR3d 544, 549-550—dismissal of one contract claim did not bar recovery on another claim where claims were separate and distinct, they could have been filed as separate causes of action, and claim on which fees were sought was adjudicated prior to dismissal of other claim]

f) [11:139.16] **Compare—*noncontract causes of action:*** The Civ.C. § 1717(b)(2) bar applies only to *contract* causes of action. [*Santisas v. Goodin* (1998) 17 C4th 599, 622, 71 CR2d 830, 845; *Silver v. Boatwright Home Inspection, Inc.* (2002) 97 CA4th 443, 450, 118 CR2d 475, 479]

Thus, if the contractual fee recovery clause is worded broadly enough to apply to both contract and *noncontract* (tort) causes of action (¶ 11:137), the court has discretion to determine defendant is a prevailing party following plaintiff's voluntary dismissal, entitled to recover fees incurred to defend tort and other *noncontract* claims.

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[*Santisas v. Goodin*, supra, 17 C4th at 622, 71 CR2d at 845 (buyers voluntarily dismissed suit against sellers for breach of contract, negligence and deceit based on alleged defects in home; purchase agreement provided for prevailing party fees in any action "arising out of" the agreement); see also *Khan v. Shim* (2016) 7 CA5th 49, 55, 59-62, 212 CR3d 292, 297, 300-303 (*discussed at ¶ 11:394.1 ff.*); compare *Exxess Electronixx v. Heger Realty Corp.* (1998) 64 CA4th 698, 712-713, 75 CR2d 376, 386—no postdismissal prevailing party fee recovery on noncontract causes of action because underlying contract provided for fee recovery only in *contract* actions]

1/ [11:139.17] **Factors considered in determining "prevailing party" after dismissal:** In deciding "prevailing party" status on *noncontract* claims after a voluntary dismissal, the court first looks to the parties' *contractual* attorney fees provision to determine if it defines who is a "prevailing party" or addresses voluntary pretrial dismissals. When the contract does not provide such guidance, the court "should be pragmatic," examining the reason for the dismissal and the extent to which the parties realized their litigation objectives (dismissed defendants are not automatically "prevailing parties" for fee recovery purposes). [*Santisas v. Goodin* (1998) 17 C4th 599, 621-622, 71 CR2d 830, 845; *Silver v. Boatwright Home Inspection, Inc.* (2002) 97 CA4th 443, 452, 118 CR2d 475, 481—dismissed defendant not prevailing party because plaintiffs attained their litigation objective by recovering settlement moneys from parties *other than* defendant]

[11:139.18 - 11:139.19] ***Reserved.***

g) [11:139.20] **Compare—*statutory fees:*** The Civ.C. § 1717(b)(2) bar likewise does not apply to fees awarded under a fee-shifting statute (not based on contract) that authorizes attorney fee awards regardless of whether the parties had a prior agreement. [*Parrott v. Mooring Townhomes Ass'n, Inc.* (2003) 112 CA4th 873, 878-880, 6 CR3d 116, 120-122 (prevailing party award under statutory action to enforce CC&Rs); *Del Cerro Mobile Estates v. Proffer* (2001) 87 CA4th 943, 948-949, 105 CR2d 5, 8 (Civ.C. § 798.85 prevailing party fee award under Mobilehome Residency Law)]

8) [11:139.21] **Effect of success on appeal:** Civ.C. § 1717 fees awardable in an action on the contract include the prevailing party's fees incurred on appeal. [*Sixells, LLC v. Cannery Business Park* (2008) 170 CA4th 648, 655-656, 88 CR3d 235, 240]

However, a party who prevails on appeal in the action is *not necessarily* the "prevailing party" entitled to a Civ.C. § 1717 attorney fees award. Section 1717 fees are awardable to the party who prevailed *in the lawsuit as a whole.* Thus, where the appeal does not decide *who wins the lawsuit*, but only a separate *issue* in the case, winning the appeal does not ipso facto confer § 1717 prevailing party status warranting a fee award for the successful appeal, and this is so even if no further (post-appeal) trial court proceedings are required. [See *de la Carriere v. Greene* (2019) 39 CA5th 270, 276-277, 251 CR3d 795, 800 (finding defendant recovered "greater amount" on contract action both before and after appeal)—defendant who voluntarily dismissed appeal challenging his damage award remained "prevailing party," resulting in plaintiff losing her bid for appellate attorney fees (¶ 4:514.2); *Wood v. Santa Monica Escrow Co.* (2009) 176 CA4th 802, 804, 97 CR3d 909, 910—plaintiff's success on defendant's appeal of denial of attorney fees in main action did not entitle plaintiff to fees incurred on appeal because appeal did not decide who won lawsuit (defendant was prevailing party in lawsuit because plaintiff had voluntarily dismissed it); *Mustachio v. Great Western Bank* (1996) 48 CA4th 1145, 1149, 56 CR2d 33, 35; *Presley of Southern Calif. v. Whelan* (1983) 146 CA3d 959, 961, 196 CR 1, 2]

[11:139.22] ***Reserved.***

9) [11:139.23] **Recovery by nonsignatories:** A person not a party to the contract containing the attorney fees clause may recover Civ.C. § 1717 fees as the prevailing party in an action on the contract only if *that person would have been liable for the opposing party's fees had that person lost the action*. [*Reynolds Metals Co. v. Alperson* (1979) 25 C3d 124, 128, 158 CR 1, 3; *Loduca v. Polyzos* (2007) 153 CA4th 334, 341, 62 CR3d 780, 784; see also *Cargill, Inc. v. Souza* (2011) 201 CA4th 962, 966, 134 CR3d 39, 42—nonsignatories are entitled to § 1717 fees if they stand "in the shoes" of a party or are third-party beneficiaries of contract]

This rule applies not only where a nonsignatory prevails in the *original* contract action, but also when the nonsignatory prevails in *post-judgment* proceedings by the judgment creditor. [See *Westwood Homes, Inc. v.*

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AGCPII Villa Salerno Member, LLC (2021) 65 CA5th 922, 930-931, 280 CR3d 417, 423-424—third parties entitled to § 1717 prevailing party fees in defending judgment creditor's *motion to amend judgment* to add them as alter ego judgment debtors; *MSY Trading Inc. v. Saleen Automotive, Inc.* (2020) 51 CA5th 395, 402-403, 264 CR3d 901, 906-907—defendant entitled to § 1717 prevailing party fees for defending judgment creditor's *separate action* seeking to hold defendant liable as alter ego judgment debtor]

a) Application

• [11:139.24] A cooperating broker successfully sued to obtain a commission under a listing agreement between the listing broker and seller; the listing agreement contained an attorney fee provision. Although not a party to the listing agreement, the cooperating broker was entitled to a Civ.C. § 1717 prevailing party fee recovery because he would have been liable for fees under the listing agreement had he lost the suit. [*Steve Schmidt & Co. v. Berry* (1986) 183 CA3d 1299, 1315-1317, 228 CR 689, 699-700]

• [11:139.25] Plaintiff entered into a construction contract with defendant, and obtained a line of credit from Bank to finance the construction by executing a promissory note and security agreement in favor of Bank, both of which contained attorney fees clauses. Plaintiff sued defendant and Bank intervened to assert claims against defendant.

Defendant obtained a judgment against Bank on one claim. Even though defendant was not a signatory to the promissory note and security agreement, defendant was entitled to an attorney fee award against Bank because it would have been liable for Bank's attorney fees, consistent with the terms of the security agreement, had Bank prevailed on the claim against defendant. [*Dell Merk, Inc. v. Franzia* (2005) 132 CA4th 443, 450-456, 33 CR3d 694, 699-704]

• [11:139.25a] Plaintiff subleased a portion of its office space to defendant. The sublease provided for a reasonable attorney fee award to the prevailing party in the event of a lawsuit. Plaintiff later filed a lawsuit against defendant for breach of contract and named defendant's managing partner as an alter ego defendant.

Plaintiff prevailed against the defendant sublessee on the breach of contract claim, but the defendant's managing partner prevailed against plaintiff on the alter ego claim (i.e., she was dismissed with prejudice). Thus, although defendant's managing partner was not a party to the contract, she was entitled to recover her attorney fees because plaintiff would have been entitled to recover its attorney fees against her had it prevailed on its alleged alter ego theory. "In some lawsuits involving more than two parties, there may be more than one 'prevailing party' entitled to contractual attorney fees under Civil Code section 1717." [*Burkhalter Kessler Clement & George LLP v. Hamilton* (2018) 19 CA5th 38, 40-41, 46, 228 CR3d 154, 156, 160]

b) [11:139.26] **Recovery despite baseless contract claim against nonsignatory:** A nonsignatory is entitled to a Civ.C. § 1717 prevailing party fee award under the *Reynolds Metals* standard (*¶ 11:139.23*) even if the contractual claim asserted against it is baseless. [*Dell Merk, Inc. v. Franzia* (2005) 132 CA4th 443, 455, 33 CR3d 694, 703 & fn. 13; *Sessions Payroll Management, Inc. v. Noble Const. Co., Inc.* (2000) 84 CA4th 671, 678, 101 CR2d 127, 131-132; see also *Brown Bark III, L.P. v. Haver* (2013) 219 CA4th 809, 819, 162 CR3d 9, 17—nonsignatory company sued on successor liability theory entitled to § 1717 prevailing party fee award after it defeated signatory's efforts to enforce contract; *and ¶ 11:139.1*]

c) [11:139.27] **Nonsignatory fee recovery on successful tort claims:** A nonsignatory's entitlement to Civ.C. § 1717 attorney fees under *Reynolds Metals* (¶ 11:139.23) arises only to the extent the nonsignatory prevails in an *action on the contract* containing the attorney fee clause. The underlying § 1717 "mutuality of remedy" rationale has no application to a nonsignatory who prevails on a *tort or other noncontract* cause of action; and because the nonsignatory is not a party to the contract containing the attorney fees clause, the nonsignatory in such cases is not eligible for a contractual attorney fee award. [*Topanga & Victory Partners, LLP v. Toghia* (2002) 103 CA4th 775, 786-787, 127 CR2d 104, 111-112—shareholder sued by landlord as tenant corporation's alter ego not entitled to attorney fees after prevailing on tort causes of action because attorney fee provision was expressly limited to named landlord and tenant; see also *Brown Bark III, L.P. v. Haver* (2013) 219 CA4th 809, 827-829, 162 CR3d 9, 24-25—nonsignatory who sued for breach of contract, fraud, and conversion as tenant's successor not entitled to attorney fees for defending tort causes of action since Civ.C. § 1717 does not apply to tort actions and attorney fee clause

did not identify nonsignatory as party entitled to benefit therefrom; compare *Hom v. Petrou* (2021) 67 CA5th 459, 471-472, 282 CR3d 209, 219 (distinguishing *Topanga* and *Brown Bark*)—lessee's lenders who had encumbrance on leasehold entitled to recover prevailing party attorney fees on landlord's tort causes of action because (i) lenders were third party beneficiaries of lease, and (ii) lease's attorney fee provision covering "any dispute" arising from lease or tenancy was sufficiently broad and not limited to disputes between contracting parties]

10) [11:139.28] **Recovery against nonsignatories:** A party prevailing in a contract action may enforce an attorney fees provision in the contract *against* a nonsignatory party only if the nonsignatory would have been entitled to recover its fees under the contractual provision had it prevailed. Thus, a court must interpret the underlying contract to determine whether the contracting parties *intended* the attorney fees provision to *benefit* the nonsignatory (i.e., whether the nonsignatory is a third-party beneficiary of the attorney fees clause). [*In re Bennett* (9th Cir. 2002) 298 F3d 1059, 1071 (applying Calif. law); see also *Apex LLC v. Korusfood.com* (2013) 222 CA4th 1010, 1017-1018, 166 CR3d 370, 375-376 (*discussed at ¶ 11:139.28e*); and *Cargill, Inc. v. Souza* (2011) 201 CA4th 962, 967, 134 CR3d 39, 42-43—third-party beneficiary need not be named in contract where agreement reflects contracting parties' intent to benefit unnamed party (*discussed further at ¶ 11:139.28d*)]

• [11:139.28a] A nonsignatory broker was obligated to pay the prevailing party's attorney fees in an action on a real estate purchase agreement where the fee provision therein "unambiguously" included the broker within the ambit of its benefits and performance obligations. [*Pacific Preferred Properties, Inc. v. Moss* (1999) 71 CA4th 1456, 1463, 84 CR2d 500, 504-505]

• [11:139.28b] A nonsignatory plaintiff was obligated to pay attorney fees to the prevailing signatory defendant in an action on a contract where the contract contained a reciprocal prevailing party attorney fee provision that was assigned to the nonsignatory plaintiff by a signatory to the contract. [*California Wholesale Material Supply, Inc. v. Norm Wilson & Sons, Inc.* (2002) 96 CA4th 598, 608, 117 CR2d 390, 396-397]

• [11:139.28c] Decedent's successor in interest was liable for attorney fees in an action he commenced on a contract decedent previously entered into with her bank. The court determined decedent and the prevailing defendant bank intended the contract's reciprocal attorney fee provision to extend to decedent's successor in interest—i.e., her successor in interest effectively "stepped" into decedent's position. [See *Exarhos v. Exarhos* (2008) 159 CA4th 898, 906-907, 72 CR3d 409, 416-417 (also noting court need only determine whether successor in interest would be entitled to fees if he prevailed, *not* whether he could prevail on merits)]

• [11:139.28d] A nonsignatory plaintiff was liable for attorney fees in an action it commenced on a contract previously entered into between the signatory defendants and the nonsignatory plaintiff's debtors. The signatory defendants had made loans to the debtors secured by an interest in their cattle and farm equipment. Upon the debtors' default, the signatory defendants and the debtors entered into an agreement by which the debtors transferred their cattle and equipment to the signatory defendants in exchange for their agreement not to sue and to pay the debtors' creditors as listed on an exhibit to the agreement, although the exhibit was left blank.

The nonsignatory plaintiff (one of the debtors' unnamed creditors) filed a complaint against the signatory defendants to reform and enforce the agreement as a third-party beneficiary. The signatory defendants prevailed on summary judgment and moved for an award of Civ.C. § 1717 fees under the agreement's attorney fees clause. Because the nonsignatory plaintiff would have been entitled to fees as a third-party beneficiary of the agreement had it prevailed, the signatory defendants were entitled to their fees. [See *Cargill, Inc. v. Souza* (2011) 201 CA4th 962, 964-965, 970, 134 CR3d 39, 40-41, 45—even though nonsignatory plaintiff not expressly named in transfer agreement, contract clearly reflected intent to benefit unnamed creditors]

• [11:139.28e] A nonsignatory exporter was bound by an attorney fees provision in a signatory exporter's credit applications with a merchandiser because the nonsignatory exporter formerly did business under the name the signatory exporter currently used and the same person verified the answer to the merchandiser's complaint as an officer of both exporters. [*Apex LLC v. Korusfood.com* (2013) 222 CA4th 1010, 1017-1018, 166 CR3d 370, 375-376—nonsignatory exporter "stepped into the shoes" of signatory exporter]

• [11:139.28f] *Compare:* A nonsignatory to a construction-related subcontract was *not* liable for fees in an action for breach of the contract because the contract expressly disclaimed any third-party rights or benefits. [*Sessions Payroll Management, Inc. v. Noble Const. Co., Inc.* (2000) 84 CA4th 671, 680-681, 101 CR2d 127, 133]

[11:139.29] ***Reserved.***

(f) [11:139.30] **Role of judicial estoppel:** At least where both parties are signatories to the contract, the doctrine of judicial estoppel may preclude one party from defending a Civ.C. § 1717 fee recovery claim on the ground the contract does not contain an attorney fee clause.

Under the doctrine of judicial estoppel, a party who pleads entitlement to contractual attorney fees at the outset of the contract litigation and later loses on that issue may not assert that the contract does not authorize a prevailing party fee award (in an effort to defend against the other party's right to Civ.C. § 1717 fees). "Where a party claims that a contract allows fees and proves it, that party gets fees. Where a party claims that a contract allows fees and does not prove it, the opponent gets fees." [*M. Perez Co., Inc. v. Base Camp Condominiums Ass'n No. One* (2003) 111 CA4th 456, 467-468, 3 CR3d 563, 572—emphasizing that rule requires party claiming fees to *prove* contract allows fees (mere allegation re same not enough); *International Billing Services, Inc. v. Emigh* (2000) 84 CA4th 1175, 1186-1191, 101 CR2d 532, 539-543; see also *Jones v. Union Bank of Calif.* (2005) 127 CA4th 542, 549, 25 CR3d 783, 789]

1) [11:139.31] **Compare—no estoppel vis-à-vis nonsignatories:** The judicial estoppel doctrine will not operate, however, as between a contracting party and *nonsignatories* to the contract who themselves would not have been liable for contractual attorney fees had they lost the litigation nor, conversely, entitled to contractual attorney fees upon winning the litigation. [See *M. Perez Co., Inc. v. Base Camp Condominiums Ass'n No. One* (2003) 111 CA4th 456, 470, 3 CR3d 563, 574; *Sessions Payroll Management, Inc. v. Noble Const. Co., Inc.* (2000) 84 CA4th 671, 681-682, 101 CR2d 127, 134, and cases cited therein—*Reynolds Metals* test (*¶ 11:139.23 ff.*) supersedes estoppel theory in this context]

[11:139.32 - 11:139.35] ***Reserved.***

(g) [11:139.36] **"Fees incurred" requirement:** Civ.C. § 1717 applies when the contract specifically provides that attorney fees "incurred to enforce that contract" shall be awarded to one of the parties or the prevailing party (Civ.C. § 1717(a)). Attorney fees are "incurred" within the meaning of § 1717 when a party "actually pays or becomes liable to pay" for legal representation in the contract litigation. [*Trope v. Katz* (1995) 11 C4th 274, 280, 45 CR2d 241, 245-246; see also *Dzwonkowski v. Spinella* (2011) 200 CA4th 930, 935, 133 CR3d 274, 277—"fees incurred" are evidenced by obligation to pay, existence of attorney-client relationship and distinct interests between attorney and client]

This includes:

• [11:139.37] Parties who retained counsel on a contingent fee basis. [*Gonzales v. Personal Storage, Inc.* (1997) 56 CA4th 464, 480, 65 CR2d 473, 483]

• [11:139.38] Parties whose defense costs are paid by a third party (nonparty or otherwise). [*Staples v. Hoefke* (1987) 189 CA3d 1397, 1409-1410, 235 CR 165, 172—paid by insurer; *International Billing Services, Inc. v. Emigh* (2000) 84 CA4th 1175, 1192-1193, 101 CR2d 532, 543-544—paid by employer]

• [11:139.38a] Parties represented by *in-house counsel*. [*PLCM Group, Inc. v. Drexler* (2000) 22 C4th 1084, 1091-1094, 95 CR2d 198, 203-205]

• [11:139.38b] Attorney litigants represented by other members of their law firms in *personal matters.* [*Gilbert v. Master Washer & Stamping Co., Inc.* (2001) 87 CA4th 212, 220, 104 CR2d 461, 466; *Gorman v. Tassajara Develop. Corp.* (2009) 178 CA4th 44, 96, 100 CR3d 152, 194 (*¶ 11:139.43*)]

• [11:139.38c] Coparty attorneys who hire each other to litigate an action for the recovery of fees from a client they formerly represented as co-counsel. [*Farmers Ins. Exchange v. Law Offices of Conrado Joe Sayas, Jr.* (9th Cir. 2001) 250 F3d 1234, 1238-1239 (applying and predicting Calif. law)]

• [11:139.38d] Attorney litigants represented by "of counsel." [See *Dzwonkowski v. Spinella* (2011) 200 CA4th 930, 936, 133 CR3d 274, 278—retained lawyer's "of counsel" title *not* dispositive of attorney litigant's eligibility to recover fees ("key" factors were nature of relationship and whether fees were incurred); compare *Sands & Assocs. v. Juknavorian* (2012) 209 CA4th 1269, 1273, 147 CR3d 725, 726 (*¶ 11:139.41*)]

1) [11:139.39] **Application to pro per litigants:** A party litigating in *pro per* (whether a nonattorney *or attorney*) ordinarily is *not* entitled to a Civ.C. § 1717 fee award. A self-represented party neither pays *nor becomes liable to pay*

for legal representation in the contract action for § 1717 purposes, significantly because of the absence of an attorney-client relationship. [*Trope v. Katz* (1995) 11 C4th 274, 292, 45 CR2d 241, 254 (attorney pro per litigant)]

It is immaterial that the opposing party, if represented by counsel, would have been entitled to a § 1717 fee award had the opposing party prevailed in the litigation. A pro per litigant "necessarily assumes the risk" of that result. [*Trope v. Katz*, supra, 11 C4th at 289, 45 CR2d at 252]

a) Application

• [11:139.40] A law firm represented by its own employee-associates effectively represented itself and therefore could not recover Civ.C. § 1717 fees after prevailing in an action against its former client: "The teaching of *Trope* and its progeny is that law firms and attorney litigants are precluded from recovering attorney fees for self-representation." [See *Soni v. Wellmike Enterprise Co. Ltd.* (2014) 224 CA4th 1477, 1488, 169 CR3d 631, 639 & fn. 4 (noting firm would have been entitled to recover reasonable prevailing party fees had it *hired* outside counsel)]

• [11:139.41] A law firm could not recover Civ.C. § 1717 fees when represented by its "of counsel" due to their "close, personal, regular, and continuous" relationship that amounted to a "single, de facto firm." [*Sands & Assocs. v. Juknavorian* (2012) 209 CA4th 1269, 1273, 147 CR3d 725, 726 (distinguishing *Dzwonkowski*, where fees actually were incurred, *¶ 11:139.38d*)]

• [11:139.42] Neither an attorney pro per litigant nor his spouse (whose interests were joint and indivisible) could recover fees for legal work performed by the attorney himself even though the fees were billed through the attorney's incorporated law firm, a so-called "separate entity." [*Gorman v. Tassajara Develop. Corp.* (2009) 178 CA4th 44, 93-95, 100 CR3d 152, 191-193]

b) [11:139.43] **Compare—pro pers assisted by counsel:** On the other hand, a pro per litigant (whether a nonattorney *or attorney*) may recover reasonable fees incurred for legal services of *attorneys retained to assist* the pro per in the litigation, notwithstanding that the assisting attorneys did not appear of record in the action. [*Mix v. Tumanjan Develop. Corp.* (2002) 102 CA4th 1318, 1324, 126 CR2d 267, 271-272 (attorney pro per litigant); and see *Gorman v. Tassajara Develop. Corp.* (2009) 178 CA4th 44, 96, 100 CR3d 152, 194—fees for work performed by other members (including paralegals) of pro per attorney's firm were recoverable in a matter involving the attorney's *personal* interests]

[11:139.44] ***Reserved.***

(h) [11:139.45] **Amount fixed by court:** Section 1717(a) vests the trial court with discretion to determine a "reasonable" fee. [Civ.C. § 1717(a); *PLCM Group, Inc. v. Drexler* (2000) 22 C4th 1084, 1095, 95 CR2d 198, 206; see also *Syers Properties III, Inc. v. Rankin* (2014) 226 CA4th 691, 698-699, 172 CR3d 456, 461-462 (noting there is no "required level of detail" counsel must achieve because time records are not required under Calif. law)—court has discretion to award fees based on declarations describing work counsel has performed and court's own view of number of hours "reasonably" spent; *EnPalm, LLC v. Teitler Family Trust* (2008) 162 CA4th 770, 774, 75 CR3d 902, 905—court has broad discretion to determine reasonable fee amount, governed by equitable principles; compare *Walker v. Ticor Title Co. of Calif.* (2012) 204 CA4th 363, 372, 138 CR3d 820, 827—although subject to equitable considerations, contractual attorney fee awards should not be based on losing party's financial condition]

1) [11:139.46] **Effect of fee arrangements with client:** In determining a reasonable attorney fee award, the court may consider the lawyer's fee arrangement with the client as some evidence of the value of the services rendered. [*Vella v. Hudgins* (1984) 151 CA3d 515, 521, 198 CR 725, 729]

But the agreement is not controlling, and the court may properly award a lesser sum. In that event, the victorious client may be obligated to pay their lawyer far more than the court has awarded. [*Vella v. Hudgins*, supra, 151 CA3d at 521, 198 CR at 729—contingency fee agreement obligated client to pay lawyer $100,000 but, after considering all relevant factors, court ordered other party to pay only $50,000]

2) [11:139.47] **Not limited to amount actually "incurred":** "Reasonable" attorney fees awardable under Civ.C. § 1717 are *not* limited to fees the prevailing party actually incurred for legal representation in the contract action. [See *Syers Properties III, Inc. v. Rankin* (2014) 226 CA4th 691, 701, 172 CR3d 456, 463—no requirement that fees awarded

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per "reasonable market rate" mirror actual rate billed; *Walker v. Ticor Title Co. of Calif.* (2012) 204 CA4th 363, 373, 138 CR3d 820, 827—while contractual terms may be considered, they "do not compel any particular award"]

The Cal. Supreme Court's reference in *Trope v. Katz* to attorney fees incurred as being the sum a litigant "actually pays or becomes liable to pay" for legal representation (¶ *11:139.36*) "was not intended to imply that fees can be recovered only when, and to the extent that, a litigant incurs fees on a fee-for-service basis." [See *PLCM Group, Inc. v. Drexler* (2000) 22 C4th 1084, 1097, 95 CR2d 198, 207, fn. 5 (disapproving *San Dieguito Partnership, L.P. v. San Dieguito River Valley Regional Open Space Park Joint Powers Authority* (1998) 61 CA4th 910, 919, 72 CR2d 91, 95-96, to extent it suggests otherwise); *Gilbert v. Master Washer & Stamping Co., Inc.* (2001) 87 CA4th 212, 220-221, 104 CR2d 461, 467]

a) [11:139.48] **Market rate measure for inhouse counsel services:** Thus, e.g., where the prevailing party is represented by *in-house counsel*, a Civ.C. § 1717 award is not limited to the actual salary, costs and overhead of in-house counsel. Rather, the trial court properly applies a *market rate* measure—the reasonable in-house attorney hours multiplied by the prevailing hourly rate in the community for comparable legal services ("lodestar"), which may then be adjusted based on factors specific to the case. [See *PLCM Group, Inc. v. Drexler* (2000) 22 C4th 1084, 1094-1098, 95 CR2d 198, 205-208]

3) [11:139.49] **Lodestar awards; augmentation or reduction based on equitable principles:** Courts normally apply lodestar principles—i.e., a calculation based on the number of hours reasonably expended, multiplied by the lawyer's hourly rate—to calculate reasonable prevailing party contractual fee awards. [See *EnPalm, LLC v. Teitler Family Trust* (2008) 162 CA4th 770, 774, 75 CR3d 902, 905]

The lodestar figure may be adjusted, based on factors specific to the case, in order to fix the fees at the fair market value for the legal services provided. [*PLCM Group, Inc. v. Drexler* (2000) 22 C4th 1084, 1096, 95 CR2d 198, 206-207—factors considered include nature and difficulty of litigation, skill required, attention given, success or failure, etc.; see also *EnPalm, LLC v. Teitler Family Trust,* supra, 162 CA4th at 774, 75 CR3d at 906—necessity for litigation "also a factor to consider"; *Gorman v. Tassajara Develop. Corp.* (2009) 178 CA4th 44, 99, 100 CR3d 152, 196—after performing lodestar calculations, courts must reduce total prevailing party fee award if "under all circumstances" it is deemed "more than reasonable"]

a) [11:139.50] **No lodestar adjustment solely as "punishment":** A fee adjustment may not be imposed *solely* for the purpose of punishing one party's litigation conduct. However, fee awards may be enhanced *or* reduced "if there is some other proper basis aside from 'mere' punishment." [See *EnPalm, LLC v. Teitler Family Trust* (2008) 162 CA4th 770, 775-778, 75 CR3d 902, 907-909—using equitable considerations to reduce lodestar amount deemed proper where majority of prevailing party's attorney fees stemmed from litigation misconduct and thus were *unnecessary*]

(3) [11:140] **Recovery of postjudgment fees:** Attorney fees incurred in *enforcing the judgment* in the contract action are also recoverable where the underlying judgment includes a Civ.C. § 1717 fee award. [See CCP §§ 685.040, 685.070(a)(6); *Berti v. Santa Barbara Beach Properties* (2006) 145 CA4th 70, 76-77, 51 CR3d 364, 368-369; compare *Imperial Bank v. Pim Electric, Inc.* (1995) 33 CA4th 540, 557-558, 39 CR2d 432, 444—absence of fee award in underlying judgment precluded recovery of fees incurred to enforce judgment notwithstanding fact judgment was based on note and guarantees providing for attorney fee recovery; *see also* ¶ *11:140.11*]

[11:140.1 - 11:140.9] ***Reserved.***

(4) [11:140.10] **Procedure—costs of suit (not recoverable "damages"):** Contractual attorney fees (like statutory fees) are recoverable *as costs of suit*—i.e., pursuant to the *noticed motion* procedure prescribed by CRC 3.1702. The fees are not awardable as the prevailing party's general or special "damages." [See CCP § 1033.5(c)(5); CRC 3.1702]

(a) [11:140.11] **Deadline for motion:** Pursuant to CRC 3.1702, the motion must be served and filed within the time for filing a notice of appeal under CRC 8.104 and 8.108. [CRC 3.1702(b)(1); see *Exxess Electronixx v. Heger Realty Corp.* (1998) 64 CA4th 698, 705, 75 CR2d 376, 381-382; *Saben, Earlix & Assocs. v. Fillet* (2005) 134 CA4th 1024, 1029-1031, 36 CR3d 610, 613-615—entry of nonappealable order granting summary judgment, or service of notice of entry of same, as opposed to entry of summary judgment, does not trigger CRC 3.1702(b)(1) limitations period]

The deadline may be extended, however, by stipulation or court order for good cause shown. [CRC 3.1702(b)(2), (d); *Lee v. Wells Fargo Bank, N.A.* (2001) 88 CA4th 1187, 1198, 106 CR2d 726, 735; see also *Robinson v. U-Haul Co. of Calif.* (2016) 4 CA5th 304, 326, 209 CR3d 81, 99—CRC 3.1702(d) deemed remedial in nature and given liberal interpretation]

Compare—postjudgment fees: The CRC 3.1702(b) deadline does *not* apply to motions for postjudgment fees (¶ *11:140*) and no other deadline is specified in the Rules. The motion thus may be made at any time so long as delay does not *unfairly prejudice* the party from whom fees are sought. [See *Crespin v. Shewry* (2004) 125 CA4th 259, 263-271, 22 CR3d 696, 699-705 (motion for recovery of CCP § 1021.5 postjudgment fees)]

(b) [11:140.12] **Memorandum of costs unnecessary:** A party seeking Civ.C. § 1717 contractual attorney fees incurred before judgment need not file a memorandum of costs in addition to its attorney fee motion. [See *Kaufman v. Diskeeper Corp.* (2014) 229 CA4th 1, 4-6, 11, 176 CR3d 757, 758-760, 764]

Cross-refer: For further discussion of the substantive and procedural rules governing recovery of attorney fees under Civ.C. § 1717, see Wegner, Fairbank, Wegner, Wegner & Chernow, *Cal. Prac. Guide: Civil Trials & Evidence* (TRG), Ch. 17.

g. [11:141] **Recourse to buyer's deposit:** Until the court's final determination in the action, the seller may retain the buyer's deposit as a source of funds from which to recover its damages. [*Beason v. Griff* (1954) 127 CA2d 382, 274 P2d 47, 52]

But while the deposit may serve as a fund from which the seller obtains whole or partial reimbursement for *actual* losses, the seller must *refund any excess* over actual damages regardless of whether the buyer's breach is innocent or willful. [*Kuish v. Smith* (2010) 181 CA4th 1419, 1429, 105 CR3d 475, 482; *Wade v. Lake County Title Co.* (1970) 6 CA3d 824, 830-831, 86 CR 183, 186—vendors entitled to portion of defaulting vendee's deposit as compensation for vendor's actual losses, but retention of deposit *in toto* would constitute unauthorized penalty]

h. [11:142] **Third party damages liability:** In the event a third party *induced* the buyer's breach of contract, the seller may have a damages cause of action against the third party in addition to a right to recover Civ.C. § 3307 damages against the buyer. However, the claim against the third party would be a *tort* cause of action (e.g., tortious interference with contractual relations) and thus subject to a broader tort measure of damages (see Civ.C. § 3333—“amount which will compensate for all the detriment proximately caused thereby, whether it could have been anticipated or not”). [See *Crummer v. Zalk* (1967) 248 CA2d 794, 797-798, 57 CR 185, 187-188 (second defendant induced buyer's breach of land sale contract by collusion with buyer); compare *Applied Equip. Corp. v. Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 513-514, 28 CR2d 475, 480—contracting party owes no tort duty to refrain from interference with *own* contractual performance and thus cannot be liable in tort for inducing breach of or interfering with *own* contract (nor, therefore, can party in breach incur tort liability on theory of “conspiracy” to interfere with own contract)]

[11:143 - 11:149] ***Reserved.***

2. Seller's Right to Specific Performance

a. [11:150] **Practical considerations for seller—in general:** At one time, sellers might have been inclined to pursue a specific performance remedy against their breaching buyers because the court also could award ancillary relief in the form of “incidental” damages to make the seller whole, whereas (historically) consequential damages were not separately recoverable in a seller's breach of contract damages suit. [*Ellis v. Mihelis* (1963) 60 C2d 206, 219-220, 32 CR 415, 423; see also *Kassir v. Zahabi* (2008) 164 CA4th 1352, 1357, 80 CR3d 1, 4; *and* ¶ *11:278 ff.*]

However, the above tactic is no longer necessary because Civ.C. § 3307 now expressly authorizes the seller's recovery of consequential damages in a breach of contract damages action (¶ *11:116 ff.*). Indeed, because of the stringent prerequisites to a seller's successful pursuit of a specific performance remedy and the likelihood the ultimate relief will be unsatisfactory, a specific performance action is rarely a seller's preferred remedy.

➪ [11:151] ***PRACTICE POINTER:*** Those *unique* cases in which a seller may prefer specific performance might involve a real property exchange transaction between the parties, or when transfer of the real property is part of another, more complex transaction in which the remedy of specific performance may be more appropriate.

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b. [11:152] **Basic requirements:** A seller may bring an action seeking an order that the buyer perform as required by the real property purchase agreement (specific performance) if *all* of the following requirements are met:

• a *money damages award will not adequately compensate the seller* for the buyer's breach;

• the *buyer received adequate consideration;*

• the *contract is just and reasonable* and would *not subject the buyer to undue hardship*;

• the *contract terms* are sufficiently *certain and enforceable* such that a court can determine with reasonable precision the act required to be performed by each party;

• the performance to be ordered by the court is *substantially similar* to the performance required by the contract;

• the contract is not illegal or the result of fraud, unfair practices or mistake;

• the *seller has performed or tendered performance* under the contract; *and*

• the required performance does not demand multiple acts by the parties over an extended period of time or other complicated performance that would make the court's supervision of its order impractical or impossible. [Civ.C. §§ 3384-3395; see also *Union Oil Co. of Calif. v. Greka Energy Corp.* (2008) 165 CA4th 129, 134, 80 CR3d 738, 741; *and* ¶ *11:211 ff.* re buyer's action for specific performance]

(1) [11:152.1] **Mutuality of remedy not required:** *See* ¶ *11:212*.

c. [11:153] **Adequacy of money damages:** Ordinarily, sellers are deemed to have an adequate legal remedy in the form of money damages, which should preclude specific performance. Nonetheless, a Civ.C. § 3307 remedy may be inadequate, supporting the seller's right to specific performance, where the value of the property has remained consistent with the contract price (thus precluding a general damages award, ¶ *11:103*). [*BD Inns v. Pooley* (1990) 218 CA3d 289, 295-296, 266 CR 815, 818-819 & fn. 12 (relying in part on Civ.C. § 3387 presumption that breach of agreement to transfer real property cannot be adequately compensated by money damages)—Civ.C. § 3307 not intended to eliminate seller's ability to seek specific performance in the alternative; see also *Waratah Oil Co. v. Reward Oil Co.* (1914) 23 CA 638, 139 P 91, 92—seller cannot be denied specific performance simply because subject property can be sold at contract price]

• [11:153.1] Specific performance generally is the appropriate remedy for breach of an oil field clean-up agreement. Oil companies bargain for clean sites to avoid the risk of liability to regulatory agencies and landowners. Moreover, specific performance is the most direct means of remedying a breach and protecting the environment. [*Union Oil Co. of Calif. v. Greka Energy Corp.* (2008) 165 CA4th 129, 135-136, 80 CR3d 738, 741-742—when one party commits multiple breaches of a clean-up agreement, specific performance is preferred over inadequate remedy of repetitive future damage actions]

• [11:153.2] A public port district was properly ordered to specifically perform a covenant to periodically dredge a harbor channel located appurtenant to the original landowners' property. The covenant requiring the district to build and maintain the channel enhanced the value of the land retained by the original owners and was a material factor in their decision to transfer to the district that portion of their land on which a Marina was later built. [*Ellison v. Ventura Port Dist.* (1978) 80 CA3d 574, 579, 145 CR 665, 668; see also *Union Oil Co. of Calif. v. Greka Energy Corp.* (2008) 165 CA4th 129, 135, 80 CR3d 738, 742—"*Ellison* represents the modern view that a party entitled to specific performance of a continuing duty should receive it whenever it is practically feasible" (internal quotes and citation omitted)]

d. [11:154] **Difficulty in concurrently pursuing damages action:** Generally, a party is not precluded from pursuing alternative remedies of breach of contract damages and specific performance (¶ *11:11*). Nonetheless, as a practical matter, a seller may encounter difficulty in proceeding in this fashion:

• [11:155] On the one hand, as stated, plaintiffs seeking specific performance must demonstrate that a legal damages remedy is inadequate. Thus, a seller must be able to plead and prove that Civ.C. § 3307 damages would not fully compensate the seller for its loss—specifically, that the fair market value of the property is basically equal to the contract price so Civ.C. § 3307 general damages would not be recoverable (¶ *11:103, 11:153*).

• [11:156] On the other hand, to recover general damages under Civ.C. § 3307, the seller would have to plead and prove that the fair market value of the property was (as of the date of the breach) *less* than the contract price.

[11:157] Factually, these are almost entirely inconsistent positions and one of the principal reasons why sellers do not pursue an action for specific performance.

e. [11:158] **Seller must remain able to perform:** A seller opting to pursue a specific performance remedy must remain in a position to *perform* all of the terms and conditions of the contract. [Civ.C. § 3392; see *Realmuto v. Gagnard* (2003) 110 CA4th 193, 201, 1 CR3d 569, 575—seller's failure to satisfy condition precedent (delivery of real estate transfer disclosure statement, *¶ 11:80.6*) not entitled to specific performance against buyer; *Schmidt v. Callero* (1950) 97 CA2d 582, 589-590, 218 P2d 80, 84-85—sellers not entitled to specific performance absent compliance with condition calling for completed title search]

Fundamentally, of course, the seller must remain *able to convey* the property to the buyer (retaining marketable title throughout pendency of the action). By selling the property to a third person, the seller terminates the contract and the right to seek specific performance. [*Hollypark Realty Co. v. MacLoane* (1958) 163 CA2d 549, 552, 329 P2d 532, 534; compare *Petrolink, Inc. v. Lantel Enterprises* (2022) 81 CA5th 156, 160-161, 296 CR3d 731, 732-734—no abuse of discretion in ordering tenant to complete sales transaction under purchase option even though title became encumbered by eminent domain action after court entered judgment ordering seller to convey property "free and clear of all encumbrances" (finding court retained equitable power to modify judgment and acted reasonably in concluding buyer should bear burden of encumbrance under circumstances, *discussed further at* ¶ 8:122.1)]

➪ [11:159] ***PRACTICE POINTERS:*** Since continued ability to convey clear title is essential to the seller's right to obtain specific performance, its hands are tied with regard to an outside sale or other transaction that might encumber title (e.g., even a short-term lease might jeopardize the seller's specific performance remedy). In an *appreciating* market, this factor alone should dissuade sellers from pursuing specific performance … because they will not be able to obtain the increased value of the property while the specific performance action is pending and success in the specific performance action will only yield the lower (contract) price. Thus, where real estate values are escalating, sellers are better advised to maximize their gain through a resale of the property, in turn suing the buyer for consequential damages (Civ.C. § 3307).

Even in a *declining* real estate market, a seller's specific performance action may be ill-advised … because, if the seller does not prevail in the action, the value of the property will have tumbled even further during pendency of the lawsuit.

(1) [11:159.1] **Exception—partial performance:** The seller's failure to fully perform its obligations under the purchase agreement is not fatal to a specific performance remedy against the buyer when the partial nonperformance is either "entirely immaterial" or "capable of being fully compensated." In such cases, specific performance may be compelled upon the seller's fully compensating the buyer for the default under the contract. [Civ.C. § 3392; see *Realmuto v. Gagnard* (2003) 110 CA4th 193, 204, 1 CR3d 569, 577—seller's failure to provide Civ.C. § 1102 et seq. transfer disclosure statement *not* an immaterial "partial nonperformance"]

f. [11:160] **Waiver of conditions:** The nonperformance of conditions precedent for the seller's benefit is not a defense to the seller's right to specific performance where the seller has *waived* (or indicates a willingness to waive) those conditions. [*Laske v. Lampasona* (1948) 89 CA2d 284, 289-290, 200 P2d 871, 875—buyer's obligation to provide seller with fire insurance policy as condition to sale transaction waived by seller's acceptance of specific performance judgment]

g. [11:161] **Enforcement issues:** A specific enforcement decree will either (1) order the defaulting buyer to pay the contract price and the seller to convey the property to the buyer (*Laske v. Lampasona* (1948) 89 CA2d 284, 288-289, 200 P2d 871, 874; *Goldsworthy v. Dobbins* (1952) 110 CA2d 802, 809-810, 243 P2d 883, 887-888); or (2) be in the form of a judgment passing title to the buyer with an order for the buyer to pay the contract price and incidental damages to the seller (*Goldsworthy v. Dobbins*, supra).

In either case, enforcement of the buyer's obligation to pay can present problems for a seller.

(1) [11:162] **Judicial sale:** If the judgment directs the buyer to pay the contract price concurrently with the seller's conveyance and the buyer fails to pay, the court may order a judicial sale of the property. The seller may find this remedy to be wholly inadequate because the distress price obtained at a court-ordered sale may not cover the entire contract purchase price. A deficiency judgment would then be rendered against the buyer for the balance, but it may be difficult (or impossible) for the seller to collect. Moreover, if the contract called for credit terms (rather than an all-cash sale), courts may bar attempts to collect a deficiency judgment pursuant to CCP § 580b (*see ¶ 6:563 ff.*). [*Kerrigan v. Maloof* (1950) 98 CA2d 605, 616, 221 P2d 153, 160; *Goldsworthy v. Dobbins* (1952) 110 CA2d 802, 808, 243 P2d 883, 887]

(2) [11:163] **Complicated enforcement precluding specific performance:** If either party's performance under the contract is particularly complex or difficult (e.g., contract gives buyer option to purchase a series of parcels), the court may refuse to grant specific performance in order to avoid onerous and time-consuming court supervision. [See generally, *Ellison v. Ventura Port Dist.* (1978) 80 CA3d 574, 580-581, 145 CR 665, 669, and cases cited therein; *Moklofsky v. Moklofsky* (1947) 79 CA2d 259, 262-263, 179 P2d 628, 630-631 (real property purchase contract also called for construction of staircase)]

3. [11:164] **Other Seller Remedies:** Other remedies—including reformation, rescission and damages for fraud—are available to both a seller and buyer. These are separately discussed at *¶ 11:350 ff.*

[11:165 - 11:179] ***Reserved.***

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Chapter 11. Remedies in Purchase and Sale Transactions

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[11:180] A buyer's basic remedies for the seller's breach of a real property purchase agreement mirror those available to a seller following the buyer's breach: a *damages* action for breach of contract, or an action for *specific performance*. Whereas sellers rarely pursue specific performance, buyers find specific performance to be an important and powerful remedy (*see ¶ 11:210 ff.*).

1. Buyer's Breach of Contract Damages

a. [11:181] **Amount of damages—in general:** Like an aggrieved seller, a buyer's recoverable damages for the seller's breach of contract will be defined either (1) by the terms of the contract (a valid *liquidated damages* clause); or (2) if there is no applicable contract provision, by *statute* (Civ.C. §§ 3306 or 3300).

(1) [11:182] **Civ.C. § 3306 damages for breach of covenant to convey:** Generally, for a seller's breach of contract to *convey* an estate in real property, the buyer is entitled to recover those damages allowed by Civ.C. § 3306, as follows:

- the *price paid;*
- *the expenses “properly incurred”* in examining title and preparing the “necessary papers”;
- the *difference between the agreed-upon price* and the *value of the estate agreed to be conveyed* at the time of the breach—i.e., the “market-contract differential” (*Horning v. Shilberg* (2005) 130 CA4th 197, 206, 29 CR3d 717, 724-725);
- the *expenses “properly incurred in preparing to enter upon the land”;*
- *consequential damages* “according to proof”; *and*
- interest. [Civ.C. § 3306; *Schellinger Bros. v. Cotter* (2016) 2 CA5th 984, 1009-1010, 207 CR3d 82, 103-104 (¶ 11:191); *Residential Capital, LLC v. Cal-Western Reconveyance Corp.* (2003) 108 CA4th 807, 824, 134 CR2d 162, 175, fn. 6; see also *Greenwich S.F., LLC v. Wong* (2010) 190 CA4th 739, 753, 118 CR3d 531, 542—measure of damages is difference between contract price and fair market value at time of breach plus consequential damages]

Civ.C. § 3306 supersedes the more general measure of contract damages (Civ.C. § 3300, ¶ 11:183 ff.) whenever the buyer's action is based on a seller's breach of its *covenant to convey* real property. [*Gorges v. Johnson* (1959) 167 CA2d 349, 353, 334 P2d 621, 624; see also *Greenwich S.F., LLC v. Wong*, supra, 190 CA4th at 751, 118 CR3d at 540—rules governing damages for breach of real property sales contracts are “special and unique”]

(2) [11:183] **Civ.C. § 3300 damages for other breach:** On the other hand, when the seller's breach concerns a covenant *other than the conveyance of title*, the Civ.C. § 3300 general measure of contract damages applies (*Christensen v. Slawter* (1959) 173 CA2d 325, 330, 343 P2d 341, 343-344—damages for delay in conveying):

"[E]xcept where otherwise expressly provided by this code," the measure of damages for breach of contract "is the amount which will compensate the party aggrieved for all the detriment proximately caused thereby, or which, in the ordinary course of things, would be likely to result therefrom." [Civ.C. § 3300; *SCI Calif. Funeral Services, Inc. v. Five Bridges Found.* (2012) 203 CA4th 549, 563, 137 CR3d 693, 705 (damages for failure to convey ornamental signage easement); *see ¶ 11:196 ff.*]

(3) [11:184] **Compare—liquidated damages recovery:** Where a valid liquidated damages provision in the contract fixes the buyer's recoverable damages in the event of the seller's breach of its obligation to convey, the buyer's damages remedy will be defined *solely* by the contract, superseding damages otherwise recoverable under Civ.C. §§ 3300 or 3306. [Cf. *Barlan, Inc. v. Reagan* (1963) 220 CA2d 116, 120, 33 CR 831, 833-834—even assuming validity of liquidated damages clause, statutory measure of damages governed because buyer's action involved a breach *different* from that to which liquidated damages provision applied]

Cross-refer: Liquidated damages are discussed in detail at *¶ 4:310 ff.*

(4) [11:185] **Compare—specific performance:** The aggrieved buyer may have *alternative* remedies of legal damages or specific performance for the seller's breach of contract. Both remedies can be pleaded in the complaint (*¶ 11:11*). However, the buyer ordinarily *cannot be awarded both remedies* because it would constitute a "double recovery"; e.g., the buyer cannot receive both a conveyance of the property itself by a decree of specific performance and Civ.C. § 3306 damages (payments made toward the purchase price, etc.). [*Rogers v. Davis* (1994) 28 CA4th 1215, 1220, 34 CR2d 716, 719]

(a) [11:186] **Incidental compensation:** By the same token, a specific performance decree awarding the buyer the property does not preclude an award of *additional (incidental) compensation* (sometimes incorrectly referred to as "damages") where necessary to fully vindicate the buyer's contractual rights—e.g., rents and profits lost during the time the seller wrongfully refused to convey the property. But, as distinguished from Civ.C. § 3306 or § 3300 damages, such incidental compensation is not for breach of contract and is not "legal damages." [*Rogers v. Davis* (1994) 28 CA4th 1215, 1220-1221, 34 CR2d 716, 720]

Rather, compensation in a specific performance action is more like an *accounting* between the parties that seeks to put them in the position they should have been in had the change in ownership taken place at the time called for in the contract. [*BD Inns v. Pooley* (1990) 218 CA3d 289, 298-299, 266 CR 815, 820; see *Rogers v. Davis*, supra, 28 CA4th at 1220-1221, 34 CR2d at 720; *and further discussion at ¶ 11:278 ff.*]

b. [11:187] **Buyer's tender of performance prerequisite:** Because the buyer's payment of the contract price and the seller's conveyance of title are mutually dependent concurrent conditions, the buyer ordinarily must prove it was ready, willing and able to pay the purchase price as and when required under the contract. [*Diamond v. Huenergardt* (1959) 175 CA2d 214, 220, 346 P2d 37, 41; see *Gaggero v. Yura* (2003) 108 CA4th 884, 890, 134 CR2d 313, 318—past and present ability to perform under purchase agreement is requirement for breach of contract; *see also ¶ 11:81*]

Therefore, unless the seller repudiates the contract or the seller's performance is made impossible, a buyer can be required to *tender its performance* (the purchase price) in order to enforce its remedies. [Civ.C. §§ 1439, 1440; *Beverage v. Canton Placer Mining Co.* (1955) 43 C2d 769, 777, 278 P2d 694, 700; *Katemis v. Westerlind* (1953) 120 CA2d 537, 545-546, 261 P2d 553, 559-560, appl. after new trial (1956) 142 CA2d 799, 299 P2d 383]

(1) [11:188] **Seller's breach ordinarily determined as of contract time for performance:** Absent an anticipatory repudiation (¶ 11:189 ff.), a seller has not breached its obligation to convey the property *until the date required for conveyance under the purchase agreement*. Therefore, the seller's inability to convey title at any time *before* the time specified in the contract ordinarily is *not* itself a breach of contract. [*Fara v. Wells* (1957) 156 CA2d 322, 328, 319 P2d 394, 398—"a person may legitimately contract to sell real property which he does not own, provided that when the time comes to furnish the title as agreed he is able to do so"]

(2) [11:189] **Compare—seller's anticipatory breach:** On the other hand, a buyer need not postpone pursuit of its breach of contract remedies where the seller has taken action before the date its performance is due under the contract that renders its conveyance of title *impossible*. [*Weneda Corp. v. Dispalatro* (1964) 225 CA2d 187, 191, 37 CR 267, 270—buyer's tender not required where seller unable to perform]

For example, the seller's transfer of title to a *completely unrelated* entity over which it has no control prior to the contract closing date would constitute an *anticipatory repudiation/breach;* in that event, the buyer will be excused from performance and will have an immediate right of action against the seller (*see* ¶ *11:59 ff., 11:89* re anticipatory breach).

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(a) [11:189.1] **Limitation—proof of ability to perform required:** Nonetheless, while the seller's anticipatory repudiation excuses the buyer's *tender* of performance, a buyer seeking damages must still offer evidence showing that, but for the breach, the buyer *would have had the ability to perform*. [*County of Solano v. Vallejo Redevelopment Agency* (1999) 75 CA4th 1262, 1276, 90 CR2d 41, 51; *Ersa Grae Corp. v. Fluor Corp.* (1991) 1 CA4th 613, 625-626, 2 CR2d 288, 295-296]

c. Compensatory damages for breach of covenant to convey (Civ.C. § 3306)

(1) [11:190] **Amount paid plus appreciated value:** For a breach of the seller's covenant *to convey*, the aggrieved buyer is entitled to recover any amount already paid toward the purchase at the time of the breach. [Civ.C. § 3306]

Beyond this (and other than incidental damages, ¶ 11:191 ff.), a compensatory damages award for the seller's breach requires the buyer to prove the property was *worth more than the contract price* at the time of the breach (i.e., the time the seller was obligated to effect the conveyance). [Civ.C. § 3306; *Horning v. Shilberg* (2005) 130 CA4th 197, 206, 29 CR3d 717, 724-725—where buyer presented no evidence of property's value on date of breach, market-contract differential damages were zero; see also *Simon v. San Paolo U.S. Holding Co., Inc.* (2005) 35 C4th 1159, 1176, 29 CR3d 379, 390]

If the contract price equaled or exceeded the property's fair market value at the time of the seller's breach, the buyer's recovery will be limited to incidental damages (¶ 11:191 ff.).

(a) [11:190.1] **When property value determined:** For purposes of determining compensatory damages under Civ.C. § 3306, the property's fair market value is determined at the time of the breach, *not* the time of trial. Otherwise, "contract damages would be dependent not on the reasonable expectations of the parties at the time of their contracts, but on the fluctuations in the real estate market, the existence of congestion in the calendars of trial courts, and the success of the parties in delaying or advancing trial dates, depending on which tactic was to their advantage." [*Reese v. Wong* (2001) 93 CA4th 51, 60, 112 CR2d 669, 676—in specific performance action where lis pendens expunged and property sold before trial, "plain language" of § 3306 did not provide exception determining property value at time of trial rather than time of breach; see also *Horning v. Shilberg* (2005) 130 CA4th 197, 206-207, 29 CR3d 717, 725—buyer not entitled to damages representing lost resale profits based on difference between contract price and price seller received from *later sale* of property to another buyer]

(2) [11:191] **Other incidental/consequential damages:** In any case (whether or not the property's fair market value exceeds the contract price), the buyer is entitled to recover its costs of examining title, documentation costs and expenses properly incurred in furtherance of the contract. [Civ.C. § 3306; cf. *Baran v. Goldberg* (1948) 86 CA2d 506, 511-512, 194 P2d 765, 769 (consequential damages properly denied because buyers proffered no evidence of same)]

The buyer also is entitled to recover any other consequential damages that, although not expressly identified in Civ.C. § 3306, are a *reasonably foreseeable consequence* of the seller's breach—i.e., where the circumstances from which the claimed damages arise were *actually communicated to or known by* the seller or were matters of which the seller *should have been aware* at the time of contracting (*see* ¶ *11:116*). [Civ.C. § 3306—"consequential damages according to proof"; *Stevens Group Fund IV v. Sobrato Develop. Co.* (1991) 1 CA4th 886, 892, 2 CR2d 460, 462-463; see also *Schellinger Bros. v. Cotter* (2016) 2 CA5th 984, 1009-1010, 207 CR3d 82, 103-104—developer's costs, including those incurred for extensive local government interaction, were foreseeable and proximately caused by property owner's breach, thus qualifying as both recoverable "expenses properly incurred in preparing to enter upon the land [and] consequential damages" (brackets in original; internal quotes omitted); *Ash v. North American Title Co.* (2014) 223 CA4th 1258, 1270, 168 CR3d 499, 507—consequential (or special) damages for breach of contract are limited to losses either actually foreseen or "reasonably foreseeable" when contract was formed]

(a) [11:192] **Lost profits:** The buyer's lost profits generally are *not* recoverable consequential damages under Civ.C. § 3306 (although such damages may be recoverable under a *fraud* cause of action, ¶ *11:383*; *or* as incidental compensation pursuant to a decree of specific performance, ¶ *11:280*). Unless the buyer purchased the property for resale and the seller was aware of the buyer's intention to resell the property, lost profits are not deemed a reasonably foreseeable, natural consequence of the seller's breach of its obligation to convey. [*Coger v. Wiltsey* (1931) 117 CA 653, 4 P2d 302, 304; see also *Greenwich S.F., LLC v. Wong* (2010) 190 CA4th 739, 751, 118 CR3d 531, 540 & fn. 9 (citing text); *Horning v. Shilberg* (2005) 130 CA4th 197, 207, 29 CR3d 717, 725, fn. 8]

Nor in any event would lost profits be recoverable as consequential damages where the profits have been accounted for in a fair market valuation of the property. "To allow [lost profits] as consequential damages under these circumstances would have permitted a double recovery …" [*Stevens Group Fund IV v. Sobrato Develop. Co.* (1991) 1 CA4th 886, 892, 2 CR2d 460, 463—buyer could not separately recover lost rent as consequential damages because fair market value of property had been determined in part by capitalization of income method (which fixes value based on income property generates)]

1) [11:192.1] **Pleading and proof requirements:** Lost profits damages must be *pleaded with particularity*; and must be *proven* with *certainty* as to their *occurrence* and *extent*, "albeit not with mathematical precision." [*Lewis Jorge Const. Mgmt., Inc. v. Pomona Unified School Dist.* (2004) 34 C4th 960, 975, 22 CR3d 340, 350 (internal quotes omitted); see also *Greenwich S.F., LLC v. Wong* (2010) 190 CA4th 739, 743, 754, 118 CR3d 531, 534, 543—lost profits may be available in appropriate cases but not where "prospect of profits was uncertain, hypothetical and entirely speculative"]

[11:192.2 - 11:192.4] ***Reserved.***

(b) [11:192.5] **Reimbursement of capital gains taxes:** *Upon proper proof*, the buyer also may be able to recover from the seller capital gains taxes paid as a result of the seller's breach. [*Horning v. Shilberg* (2005) 130 CA4th 197, 207-208, 29 CR3d 717, 726]

• [11:192.6] A buyer was *not* entitled to recover capital gains taxes paid for failing to complete a tax-free exchange as a result of the seller's breach where the buyer conceded the exchange was invalid. [*Horning v. Shilberg* (2005) 130 CA4th 197, 207-208, 29 CR3d 717, 726]

• [11:192.7] A seller breached a real estate sales contract with a commercial buyer by causing a slight delay in the close of escrow. The sale (S-1) was part of an IRC § 1031 transaction set up to defer the buyer's capital gains tax on another property (S-2). The buyer deposited money for S-2 in a segregated account with a § 1031 qualified exchange intermediary. A few days after S-1 was originally scheduled to close, the § 1031 intermediary closed on S-2 and then filed for bankruptcy. The bankruptcy court did not release the buyer's deposit until it was too late to qualify for § 1031 deferred tax treatment.

Although loss of the deferred capital gains tax and the expenses incurred in connection with the intervening bankruptcy case constituted consequential damages, *neither were recoverable*. Reason: The bankruptcy and the bankruptcy court's delay in releasing the commercial buyer's deposit were not reasonably foreseeable or within the parties' contemplation at the time they entered into the contracts. [*Ash v. North American Title Co.* (2014) 223 CA4th 1258, 1270, 1273, 168 CR3d 499, 508, 510-511]

d. [11:193] **Interest:** Civ.C. § 3306 expressly authorizes the recovery of *interest* on damages caused by the seller's breach of its agreement. [Civ.C. § 3306]

Prejudgment interest apparently may be added to any component of the buyer's Civ.C. § 3306 damages award—including the buyer's loss of bargain damages (difference between contract price and value of the property at the time of the breach). (To this extent, Civ.C. § 3306 and § 3307 (seller's damages for buyer's breach) "are in pari materia"; *see ¶ 11:134 ff.*) [*Rifkin v. Achermann* (1996) 43 CA4th 391, 396-397, 50 CR2d 661, 664 (buyer awarded prejudgment interest on contract price/market value differential)—pre-1983 cases denying prejudgment interest on benefit of bargain damages impliedly overruled by 1983 amendment to Civ.C. § 3306; see also *Al-Husry v. Nilsen Farms Mini-Market, Inc.* (1994) 25 CA4th 641, 651, 31 CR2d 28, 33 (breach of contract for sale of business together with underlying real estate)—buyers entitled to refund of escrow deposit, together with prejudgment interest thereon]

(1) [11:193.1] **Subject to Civ.C. § 3287:** Whether an award of prejudgment interest is proper under Civ.C. § 3306 requires reference to the more general authority of Civ.C. § 3287. [*Rifkin v. Achermann* (1996) 43 CA4th 391, 398, 50 CR2d 661, 664-665]

(a) [11:193.2] **Absolute entitlement where damages "certain":** Upon timely request, prejudgment interest is awardable as a matter of right on that component of the buyer's damages which, from the defendant seller's perspective, was "certain" or "capable of being made certain by calculation." [Civ.C. § 3287(a); *Great Western Drywall, Inc. v. Roel Const. Co., Inc.* (2008) 166 CA4th 761, 767, 83 CR3d 235, 238; see also *Thompson v. Asimos* (2016) 6 CA5th 970, 992-993, 212 CR3d 158, 178-180—where plaintiff's damages were "readily ascertainable" but not in amount awarded, case remanded

to recalculate damages, including prejudgment interest ordered thereon; *Watson Bowman Acme Corp. v. RGW Const., Inc.* (2016) 2 CA5th 279, 294, 206 CR3d 281, 293—§ 3287(a) “certainty” requirement generally absent when amounts due turn on disputed facts, but *not* when dispute is confined to rules governing liability (¶ 11:134.2); *Collins v. City of Los Angeles* (2012) 205 CA4th 140, 150-151, 139 CR3d 880, 888-889—damages are “certain or capable of being made certain by calculation” if litigant actually knows amount or can calculate same from reasonably available information; compare *Roodenburg v. Pavestone Co., L.P.* (2009) 171 CA4th 185, 190-191, 89 CR3d 558, 562-563—prejudgment interest recoverable despite uncertainty as to damages amount when contract expressly provides for such award]

For example, damages based on the price already paid by the buyer (advance payments or an escrow deposit) are clearly “certain” and thus accrue Civ.C. § 3287(a) interest. [See *Al-Husry v. Nilsen Farms Mini-Market, Inc.* (1994) 25 CA4th 641, 650-651, 31 CR2d 28, 32-33 & fn. 16; *see also* ¶ *11:396 ff.* in connection with § 3287(a) interest in fraud actions]

(b) [11:193.3] **Otherwise, discretionary:** On the other hand, where the damages do not meet the Civ.C. § 3287(a) “certainty” test, prejudgment interest thereon is awardable as an item of Civ.C. § 3306 damages in the court's discretion. This will generally be the case with regard to the buyer's loss of bargain damages measured by the contract price/ market value differential. [Civ.C. § 3287(b); *Rifkin v. Achermann* (1996) 43 CA4th 391, 398, 50 CR2d 661, 665; *Great Western Drywall, Inc. v. Roel Const. Co., Inc.*, supra; see also *Collins v. City of Los Angeles* (2012) 205 CA4th 140, 151, 139 CR3d 880, 889—damages are uncertain if amount depends on disputed facts or if available factual information is insufficient to determine amount]

(2) [11:193.4] **Interest rate:** Prejudgment interest in the contract action accrues at the rate of 10% per annum (applicable to contracts entered into after 1/1/86) unless the contract specifies another legal rate of interest (see Civ.C. § 3289(b)).

(a) [11:193.4a] **Exception—note secured by deed of trust:** By its terms, Civ.C. § 3289(b) does not apply to a note secured by a deed of trust on real property. In such a case, absent a contractual provision setting the rate, prejudgment interest is payable at 7%, except as provided by statute. [Cal.Const. Art. XV, § 1; *Soleimany v. Narimanzadeh* (2022) 78 CA5th 915, 924, 294 CR3d 191, 197]

(3) [11:193.4b] **Accrual date:** The interest commences to run as provided in Civ.C. § 3287. Thus:

(a) [11:193.5] **Section 3287(a) interest—accrual upon breach:** Where Civ.C. § 3287(a) applies (damages “certain” or “capable of being made certain by calculation”), the interest commences to run from the date the buyer's damages are ascertainable by the seller—ordinarily, the date of the seller's breach. [Civ.C. § 3287(a); see also *Thompson v. Asimos* (2016) 6 CA5th 970, 992, 212 CR3d 158, 179, fn. 7 (noting one of main difficulties in applying § 3287(a) is determining when sum owed on contract becomes liquidated, i.e., readily ascertainable)—§ 3287(a) interest awardable from date parties settled with third party litigant; *Collins v. City of Los Angeles* (2012) 205 CA4th 140, 150, 139 CR3d 880, 888—§ 3287(a) interest awardable from date right to recover damages arose; *North Oakland Med. Clinic v. Rogers* (1998) 65 CA4th 824, 828, 76 CR2d 743, 746—§ 3287(a) interest accrues “from the first day there exists both a breach and a liquidated claim”; *and see* ¶ *11:400*]

(b) [11:193.6] **Section 3287(b) interest—accrual from date action filed (court's discretion):** Where prejudgment interest is awarded pursuant to the court's discretionary authority (Civ.C. § 3287(b)), it is up to the judge to determine the date from which the interest runs … but in no event earlier than the *filing of the action*. [Civ.C. § 3287(b); *North Oakland Med. Clinic v. Rogers* (1998) 65 CA4th 824, 828, 76 CR2d 743, 746; see *Rifkin v. Achermann* (1996) 43 CA4th 391, 398, 50 CR2d 661, 665—error to award interest on buyer's loss of bargain damages running from date of seller's breach]

[11:193.7 - 11:193.9] ***Reserved.***

(4) [11:193.10] **Procedure for requesting § 3287 interest:** *See discussion at ¶ 11:134.10 ff.*

e. [11:194] **Compare—punitive damages:** A Civ.C. § 3306 damages recovery is predicated on the seller's *breach of contract;* and punitive damages are *not recoverable* in a breach of contract action. [See Civ.C. § 3294(a)—authorizing punitive damages only “(i)n an action for the breach of an obligation *not arising from contract* …” (emphasis added)] Thus, an aggrieved buyer's entitlement to punitive damages depends on whether the buyer can plead and prove a *tort* cause of action (e.g., fraud) and also show, by “clear and convincing evidence,” that the seller acted with “oppression, fraud or malice” (as defined by Civ.C. § 3294(c)). (*See* ¶ *11:390* re damages for fraud.)

f. [11:195] **Attorney fees:** There is no statutory authority for an attorney fee award in a buyer's action for breach of the seller's obligation to convey. Thus, as in a seller's breach of contract action, the buyer's right to an attorney fee award will depend on whether the underlying *purchase agreement* authorizes a fee recovery in litigation under the contract (if so, the buyer who successfully pursues the breach of contract action will be entitled to reasonable attorney fees as costs pursuant to Civ.C. § 1717 and CCP § 1033.5(a)(10) & (c)(5); *see ¶ 11:136 ff.*).

g. [11:196] **Civ.C. § 3300 measure of damages for seller's breach of obligation other than failure to convey title:** Civ.C. § 3306 (¶ 11:190 ff.) defines the measure of damages only for detriment "caused by the breach of an agreement to *convey an estate* in real property." Sometimes, however, the seller breaches a purchase agreement not by a failure to convey title but by defaulting on some other obligation under the contract. (For example, the seller conveys title, but fails to complete improvements or obtain permits required under the purchase agreement.) Here, the buyer's damages remedy will lie under the more general provisions of Civ.C. § 3300 (measure of damages for breach of contract where not otherwise expressly provided by statute). [*Coughlin v. Blair* (1953) 41 C2d 587, 599, 262 P2d 305, 312; *Christensen v. Slawter* (1959) 173 CA2d 325, 330, 343 P2d 341, 342-343—seller's delay in conveying; see also *Quality Wash Group V, Ltd. v. Hallak* (1996) 50 CA4th 1687, 1693-1695, 58 CR2d 592, 596-598—seller liable to buyer under contractual indemnification provision for seller's false representation of unencumbered title]

Specifically, the buyer is entitled to recover that "amount which will compensate … for all the detriment proximately caused" by the seller's breach of covenant (other than the covenant to convey) "or which, in the ordinary course of things, would be likely to result therefrom." [Civ.C. § 3300; see generally, *Erlich v. Menezes* (1999) 21 C4th 543, 550, 87 CR2d 886, 890; *Poseidon Develop., Inc. v. Woodland Lane Estates, LLC* (2007) 152 CA4th 1106, 1119, 62 CR3d 59, 68; see also *Lewis Jorge Const. Management, Inc. v. Pomona Unified School Dist.* (2004) 34 C4th 960, 963, 22 CR3d 340, 344—goal is to return injured party to position it would have been in absent the breach]

(1) [11:196.1] **Foreseeability limitation:** General contract damages under Civ.C. § 3300 are ordinarily limited to those *within the contemplation of the parties*, or at least *reasonably foreseeable* by them, when the contract was entered into. Unlike tort damages (awarded to fully compensate the victim for all injury proximately suffered), consequential damages beyond the parties' expectations at that time are *not* recoverable under Civ.C. § 3300. [*Erlich v. Menezes* (1999) 21 C4th 543, 550, 558, 87 CR2d 886, 890, 896; see *Vestar Develop. II, LLC v. General Dynamics Corp.* (9th Cir. 2001) 249 F3d 958, 962, fn. 3 (applying Calif. law)—such "expectation damages" might even be recoverable for breach of *preliminary* contract (i.e., agreement to negotiate); *and ¶ 11:191*]

(a) [11:196.2] **Not consequential emotional distress damages:** Except in those rare cases where emotional concerns are the very object (or "essence") of the contract, emotional distress damages are not an ordinarily foreseeable or natural consequence of a breach of contract. Accordingly, emotional distress damages generally are *not* recoverable as consequential damages in an ordinary breach of contract action. [*Erlich v. Menezes* (1999) 21 C4th 543, 558-561, 87 CR2d 886, 896-898—no emotional distress damages for negligent breach of contract to construct a house; see also Rest.2d Contracts § 353]

Comment: Although no known reported California decision expressly applies this principle to a real property purchase and sale contract, it seems clear from cases cited in *Erlich*, supra, that the same result should obtain. A contract for the purchase of real property (whether a home or commercial building) is not essentially tied to the buyer's mental or emotional well-being, and its breach is not particularly likely to result in serious emotional disturbance. [See cases cited in *Erlich v. Menezes*, supra, 21 C4th at 559-561, 87 CR2d at 897-898]

(b) [11:196.3] **Not speculative damages:** "No damages can be recovered for a breach of contract which are not *clearly ascertainable* in both their nature and origin." [Civ.C. § 3301 (emphasis added)]

Moreover, proof of damages must be established with reasonable certainty and probability. [See *Greenwich S.F., LLC v. Wong* (2010) 190 CA4th 739, 754, 118 CR3d 531, 543—per Civ.C. § 3301, damages may include lost profits where same are "natural and direct consequence" of breach, amount can be established with reasonable certainty and seller knew of buyer's intent to use property for profit; compare *Copeland v. Baskin Robbins U.S.A.* (2002) 96 CA4th 1251, 1263, 117 CR2d 875, 885—no recovery of lost profits resulting from breach of agreement to negotiate because no way of knowing if parties would have reached ultimate agreement or what its terms would have been; *Vestar Develop. II, LLC v. General Dynamics Corp.* (9th Cir. 2001) 249 F3d 958, 961-962 & fn. 5 (applying Calif. law)—alleged lost

profits from *planned* shopping center resulting from breach of agreement to negotiate too speculative since terms of contract did not provide "starting point" to calculate them with reasonable certainty; *see also* ¶ *11:192.1*]

(2) [11:197] **Delayed performance:** Where the contract fixes a time for the seller's performance, a delayed delivery of the deed (or other conveyancing instrument) cannot breach the seller's covenant to convey if the buyer *accepts* the late tender. Nonetheless, the buyer is entitled to pursue a remedy under Civ.C. § 3300 for damages resulting from the delay. [*Christensen v. Slawter* (1959) 173 CA2d 325, 332-335, 343 P2d 341, 344-347—damages from delay properly recoverable where contract contemplated definite time schedule and specifically declared time of the essence; *see also* ¶ *4:535 ff.* re "time of the essence" clauses]

(3) [11:198] **Defective title:** A buyer may accept defective title to the property and pursue a Civ.C. § 3300 damages remedy. Alternatively, the buyer may bring an action to enforce the covenants implied from a grant deed under Civ.C. § 1113 (e.g., implied representation that grantor has not conveyed the property or any right or interest therein to any other person; *see* ¶ *4:341*); or sue for specific performance and seek a reduction in the contract price equivalent to the cost of clearing the defective title (*see* ¶ *11:253*).

[11:198.1 - 11:198.4] ***Reserved.***

(4) [11:198.5] **Failure to negotiate:** Where a seller breaches an agreement to negotiate (*see* ¶ *4:275.8*), the prospective buyer may only recover reliance damages in the form of out-of-pocket costs incurred in conducting negotiations; lost profits are not recoverable (*see* ¶ *11:196.3*). [*Copeland v. Baskin Robbins U.S.A.* (2002) 96 CA4th 1251, 1263, 117 CR2d 875, 885]

(5) [11:198.6] **Failure to convey easement:** Where a seller breaches an agreement to convey its interest in an easement, Civ.C. § 3300 provides the proper legal measure of damages. [See *SCI Calif. Funeral Services, Inc. v. Five Bridges Found.* (2012) 203 CA4th 549, 568, 572-573, 137 CR3d 693, 709, 713 (also finding damages awardable under Civ.C. § 3355 predicated on easement's unique value to buyer and seller's knowledge of same prior to breach)—ornamental signage easement had measurable value based on its ability to be sold or traded to servient estate's owner in exchange for water rights, acreage, etc.]

h. [11:199] **Third party damages liability:** Third persons who are not parties to the purchase agreement cannot incur contract damages liability for the seller's breach. However, the buyer may have a *tort* cause of action for damages against third parties who *induce* the seller to breach its contract. [*Duff v. Engelberg* (1965) 237 CA2d 505, 507-508, 47 CR 114, 116; compare *Applied Equip. Corp. v. Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 513-514, 28 CR2d 475, 480—no tort cause of action for inducing breach or interfering with contract lies against *party to contract*]

The third party tort damages would be recoverable in addition to the buyer's breach of contract remedy against the seller (damages for breach of contract or specific performance along with incidental relief). This would not yield the buyer a "double recovery" because the measure of damages is not the same in the third party action as it is in the action against the seller. [See *Duff v. Engelberg*, supra, 237 CA2d at 506-509, 47 CR at 115-117]

[11:200 - 11:209] ***Reserved.***

2. [11:210] **Buyer's Right to Specific Performance:** For a seller's breach of its obligation to convey, the buyer may seek the equitable remedy of specific performance. (This is an *alternative* to a breach of contract damages remedy; while the buyer may pursue both remedies at the pleading stage, both remedies cannot be awarded because doing so would amount to a "double recovery." *See* ¶ *11:185*.)

a. [11:211] **Basic requirements:** The same general conditions to a seller's specific performance remedy (¶ *11:152*) are also applicable to a buyer. Thus, all of the following requirements must be satisfied in a buyer's suit to compel the seller to perform under a real property purchase agreement:

• a *money damages award* will *not adequately compensate the buyer* for the seller's breach;

• the *seller will receive adequate consideration;*

• the *contract is just and reasonable* and would *not subject the seller to undue hardship;*

• the *contract terms* are sufficiently *certain and enforceable* such that a court can determine with reasonable precision the act required to be performed by each party;

• the performance ordered by the court will be *substantially similar* to the performance required by the contract;

• the contract is not illegal or the result of fraud, unfair practices or mistake;

• the buyer has *performed or tendered performance* under the contract; *and*

• the performance required does not demand multiple acts by the parties over an extended period of time or other complicated performance that would make the court's supervision of its order impractical or impossible. [See generally, Civ.C. §§ 3384-3395; *Blackburn v. Charnley* (2004) 117 CA4th 758, 766, 11 CR3d 885, 891; *Henderson v. Fisher* (1965) 236 CA2d 468, 473, 46 CR 173, 177]

(1) [11:212] **Mutuality of remedy not required:** The fact that one party's obligations under the contract would not be specifically enforceable is not a bar to that party's right to seek specific performance against the other so long as (a) specific performance would otherwise be an appropriate remedy under the requirements set forth at ¶ 11:211, and (b) the counterperformance (by the party seeking specific performance) has been "substantially performed" or its concurrent or future performance is assured or, if the court deems necessary, can be secured to the court's satisfaction. [Civ.C. § 3386; *Bleecher v. Conte* (1981) 29 C3d 345, 353, 213 CR 852, 856; *Converse v. Fong* (1984) 159 CA3d 86, 91-92, 205 CR 242, 246]

Therefore, a buyer may be entitled to specific performance even though the seller's remedy for the buyer's breach is limited by the contract to liquidated damages. [*Bleecher v. Conte*, supra, 29 C3d at 353, 213 CR at 856]

(2) [11:213] **Buyer's execution of contract not required:** A buyer's action for specific performance is not barred simply because the buyer did not sign the purchase agreement … *so long as* the *seller* executed the contract and the buyer has performed or tendered performance in accordance with the contract. [Civ.C. § 3388]

(3) [11:214] **Effect of liquidated damages provision:** Generally, a party may seek specific performance even though the contract contains a liquidated damages provision for its breach. [Civ.C. § 3389] But specific performance probably would not be available to a buyer if the contract expressly makes the liquidated damages amount the aggrieved buyer's *sole* remedy (*see generally, ¶ 11:6*).

(4) [11:215] **Compare—waiver of remedy:** Whether or not the purchase agreement purports to liquidate a buyer's damages for the seller's breach, buyers sometimes specifically agree to *waive* their right to seek specific performance (*see ¶ 4:506 ff.*). In that event, of course, although the case might otherwise be amenable to specific performance, the buyer will be held to its waiver.

[11:216 - 11:219] ***Reserved.***

b. [11:220] **Damages presumed inadequate:** The law *presumes* that every parcel of land is "unique" and, therefore, that a seller's breach of contract to transfer real property *cannot be adequately compensated in money damages*. [Civ.C. § 3387; see also *Real Estate Analytics, LLC v. Vallas* (2008) 160 CA4th 463, 472-473, 72 CR3d 835, 841 (acknowledging generally presumption re inadequacy of damages remedy)—for breach of real estate purchase contract, "courts routinely grant a plaintiff's request for specific performance"; *Henderson v. Fisher* (1965) 236 CA3d 468, 473, 46 CR 173, 177—party seeking specific performance need not establish inadequacy of legal remedy and may rely upon presumption; *Wilkison v. Wiederkehr* (2002) 101 CA4th 822, 830, 837, 124 CR2d 631, 637, 642 (quasi-specific performance action arising from breach of agreement to bequeath real property)]

(1) [11:220.1] **Residential vs. commercial property:** With respect to a *single family residence* that the buyer *intends to occupy*, the "uniqueness" (inadequacy of damages remedy) presumption is *conclusive.* [Civ.C. § 3387; see *Lennar Homes of Calif., Inc. v. Stephens* (2014) 232 CA4th 673, 689, 181 CR3d 638, 652—real property traditionally is recognized as unique, particularly in context of single family dwellings; *Real Estate Analytics, LLC v. Vallas* (2008) 160 CA4th 463, 473, 72 CR3d 835, 841 & fn. 2—monetary damages can *never* be satisfactory compensation for buyers who intend to live in single-family homes]

In all other cases, however (i.e., *commercial or investment* transactions), the presumption is a *rebuttable* one affecting the burden of proof—i.e., the burden is shifted to the breaching party to prove the adequacy of a damages remedy. "[B]y establishing a rebuttable presumption with respect to other property, the Legislature left open the possibility that damages can be an adequate remedy for a breach of a real estate contract." [See *Real Estate Analytics, LLC v. Vallas*, supra, 160 CA4th at 474, 72 CR3d at 842 (noting Legislature intended damages remedy in commercial real estate context to be exception rather than rule); compare *Reese v. Wong* (2001) 93 CA4th 51, 59, 112 CR2d 669, 675, fn. 5—uniqueness presumption re commercial property often is inappropriate since loss of commercial investment opportunity normally can be offset by pecuniary award (dicta)]

(2) [11:220.2] **Compare—damages remedy lost by neglect:** A damages remedy is not rendered "inadequate" so as to permit the buyer's suit for specific performance simply because the buyer *lost* the opportunity to bring a damages action by "sleeping on their rights" or otherwise through neglect. [See *Wilkison v. Wiederkehr* (2002) 101 CA4th 822, 834-835, 124 CR2d 631, 640-641—plaintiff who, by failure to file timely creditor's claim in decedent's probate estate, lost right to recover damages for breach of agreement to convey real property could not alternatively seek quasi-specific performance]

c. [11:221] **Adequacy of consideration to seller; "just and reasonable" contract:** Courts will not compel a seller to specifically perform under a contract unless the seller receives adequate compensation for its performance and the contract is otherwise "just and reasonable" as to the seller. [Civ.C. § 3391(1) & (2); *Handy v. Gordon* (1967) 65 C2d 578, 581-582, 55 CR 769, 771-772; *Gilbert v. Mercer* (1960) 179 CA2d 29, 30-31, 3 CR 456, 457]

(1) [11:222] **Market value price not required:** The consideration received by the seller must be fair and reasonable under the circumstances. However, there is no requirement that the seller receive fair market value for its property. [Civ.C. § 3391(1) & (2) (requiring only "adequate" consideration and that contract be "just and reasonable" to seller); see *Greif v. Sanin* (2022) 74 CA5th 412, 443-444, 289 CR3d 484, 508-509; *Meyer v. Benko* (1976) 55 CA3d 937, 945, 127 CR 846, 849-850; *Lundgren v. Lundgren* (1966) 245 CA2d 582, 589, 54 CR 30, 34-35]

(2) [11:223] **Determined as of time contract entered into:** Whether the consideration under the contract is fair and reasonable is determined in reference to the circumstances as they existed *at the time the parties entered into the contract*, without regard to subsequent events. [*Petersen v. Hartell* (1985) 40 C3d 102, 110, 219 CR 170, 175; *Hastings v. Matlock* (1985) 171 CA3d 826, 839-840, 217 CR 856, 865]

(a) [11:224] **Increased value immaterial:** Thus, an increase in value of the property between the date of the seller's breach and the date of trial is immaterial; that factor does not itself render the contractual consideration "inadequate." [*Hastings v. Matlock* (1985) 171 CA3d 826, 840, 217 CR 856, 865]

(b) [11:225] **Compare—substantial discrepancy between value and consideration:** On the other hand, in the event of a gross discrepancy between the consideration and the property's fair market value, a court may determine the contract is not "just and reasonable" as to the seller and thus deny the buyer specific performance. (Therefore, buyers who are able to negotiate a "terrific deal" may find their contract is not amenable to specific performance.) [See *Gilbert v. Mercer* (1960) 179 CA2d 29, 30, 3 CR 456, 457; *Baran v. Goldberg* (1948) 86 CA2d 506, 509-510, 194 P2d 765, 767-768; see also *Donovan v. RRL Corp.* (2001) 26 C4th 261, 291-292, 109 CR2d 807, 832—"gross disparity" in values exchanged may be sufficient ground for denying specific performance based on unconscionability]

(c) [11:226] **Relevant factors:** Courts may examine a multitude of factors (in addition to the fair market value of the property) in determining whether, in light of all the circumstances, the contract is fair and reasonable to the seller—including timing issues; the need for the sale by each of the parties; the parties' relationship; the object to be obtained through the contract; and whether a party's consent was obtained by way of misrepresentation, concealment, mistake or surprise. [Civ.C. § 3391(3) & (4); *Henderson v. Fisher* (1965) 236 CA2d 468, 474, 46 CR 173, 178; see also *Greif v. Sanin* (2022) 74 CA5th 412, 446, 289 CR3d 484, 510-511—although purchase price for undeveloped land was less than expert estimates of fair market value, price was negotiated in good faith and reasonable given need for significant infrastructure development not considered by experts]

d. [11:227] **Certainty of terms:** Specific performance may be denied where the terms of the contract do not clearly set forth the acts to be performed by the party against whom the remedy is sought. [Civ.C. § 3390(e); *Patel v. Liebermensch* (2008) 45 C4th 344, 349, 86 CR3d 366, 369—specific performance cannot be granted if contractual terms are "not certain enough for the court to know what to enforce"]

(1) [11:228] **Clarification of ambiguous terms by extrinsic evidence:** However, uncertainty or ambiguity in the contract's express terms is not necessarily fatal to enforcement by specific performance or otherwise: To the extent possible, and unless barred by the parol evidence rule, courts will attempt to carry out the parties' intentions by considering extrinsic evidence to clarify and render the material terms of the contract sufficiently definite for enforcement. [*Hennefer v. Butcher* (1986) 182 CA3d 492, 500-502, 227 CR 318, 322-323—extrinsic evidence re time and manner of payment rendered contract's material provisions sufficiently definite for specific performance; *Blackburn v. Charnley* (2004) 117 CA4th 758, 766-767, 11 CR3d 885, 891-892—extrinsic evidence rendered property description sufficiently definite for specific performance]

(a) [11:229] **Reliance on custom and reason:** For example, courts may rely on local custom to clarify incidental matters such as opening an escrow, furnishing deeds, procuring title insurance policies, prorating taxes, etc. [*Patel v. Liebermensch* (2008) 45 C4th 344, 349, 86 CR3d 366, 370; *Hutton v. Gliksberg* (1982) 128 CA3d 240, 245, 180 CR 141, 143; *Burrow v. Timmsen* (1963) 223 CA2d 283, 35 CR 668, 672]

Even the time and manner of payment may be supplied by reference to custom and reason: "It is settled that if a contract for the sale of real property specifies no time of payment, a reasonable time is allowed. The manner of payment is also a term that may be supplied by implication …" [*Patel v. Liebermensch*, supra, 45 C4th at 346, 86 CR3d at 368—straightforward real estate option contract fully enforceable despite fact manner and time of payment left open]

(2) [11:230] **Fatally uncertain terms:** Uncertainty in contract terms sufficient to *defeat* an action for specific performance has been found in the following situations:

• [11:231] The failure to designate a purchase price. [*Harder v. Lang Realty Co.* (1923) 61 CA 394, 214 P 1017, 1019; but see *Carver v. Teitsworth* (1991) 1 CA4th 845, 852-853, 2 CR2d 446, 450—contract subject to specific performance though price not expressed where price may be objectively determined pursuant to contract terms (here, a pricing formula)]

• [11:232] The form of a security device. [*Mueller v. Chandler* (1963) 217 CA2d 521, 523-524, 31 CR 646, 647]

• [11:233] The interest rate and amortization schedule. [*Bruggeman v. Sokol* (1954) 122 CA2d 876, 881-883, 265 P2d 575, 578-579]

• [11:234] The terms of a release clause. [*Lawrence v. Shutt* (1969) 269 CA2d 749, 763, 75 CR 533, 541]

• [11:235] The terms of a subordination provision. [*Spellman v. Dixon* (1967) 256 CA2d 1, 3-4, 63 CR 668, 670]

[11:236 - 11:239] ***Reserved.***

e. [11:240] **Buyer's ability to perform:** A buyer seeking specific enforcement must have performed or tendered performance of all conditions precedent and concurrent, and prove that it is ready and able to perform its contractual obligations in the event a specific performance decree is issued. [Civ.C. §§ 1439, 3386(b) & 3392; *Gaggero v. Yura* (2003) 108 CA4th 884, 890, 134 CR2d 313, 318 (citing cases)—past and present ability to perform purchase agreement is requirement for specific performance]

The buyer must show that it was ready, willing and able to perform *both* at the time the contract was entered into *and* during pendency of the specific performance action. [*Ninety Nine Investments, Ltd. v. Overseas Courier Service (Singapore) Private, Ltd.* (2003) 113 CA4th 1118, 1126, 6 CR3d 891, 897]

(1) [11:241] **Sufficient financing:** Fundamentally, a buyer seeking specific performance must prove it has financial resources sufficient to pay the purchase price. [See *Stanchfield v. Hamer Toyota, Inc.* (1995) 37 CA4th 1495, 1505-1506, 44 CR2d 565, 570 (buyer's action seeking specific performance of stock purchase agreement)—trial court correctly denied specific performance where evidence suggested buyer had neither personal assets nor ability to obtain commercial financing necessary to conclude purchase transaction; see also *Gaggero v. Yura* (2003) 108 CA4th 884, 891-893, 134 CR2d 313, 318-320 (summary judgment for seller reversed)—triable issues of fact existed regarding buyer's financial ability to purchase property]

(a) [11:242] **Loan commitment:** Actual funding of the buyer's loan is not required. An institutional lender's *loan commitment* may constitute part of the tender of the purchase price in evaluating the buyer's ability to perform. [*Hutton v. Gliksberg* (1982) 128 CA3d 240, 247, 180 CR 141, 144-145; *Stratton v. Tejani* (1982) 139 CA3d 204, 212, 187 CR 231, 236]

1) [11:243] **Legally binding funding obligation?** Several cases indicate a buyer must show its lender was *legally bound* to advance the funds and had the financial ability to do so. [See *C. Robert Nattress & Assocs. v. CIDCO* (1986) 184 CA3d 55, 65, 229 CR 33, 38; *Fogarty v. Saathoff* (1982) 128 CA3d 780, 787, 180 CR 484, 488 (but no evidence buyer had obtained even preliminary loan approval at time performance came due); *Am-Cal Invest. Co. v. Sharlyn Estates, Inc.* (1967) 255 CA2d 526, 539-540, 63 CR 518, 527 (but, in any event, buyer's lender lacked capacity to fund loan in amount needed by buyer)]

However, this is not an "iron-clad" rule; rather, the proof needed to show the buyer's ability to pay depends on all the surrounding circumstances. [*Henry v. Sharma* (1984) 154 CA3d 665, 672, 201 CR 478, 482 (distinguishing above authorities); see *WYDA Assocs. v. Merner* (1996) 42 CA4th 1702, 1716, 50 CR2d 323, 331 (accord)—"A buyer is not necessarily unable to obtain a loan merely because he does not have a legally enforceable loan contract"; and *Behniwal v. Mix* (2005) 133 CA4th 1027, 1044-1045, 35 CR3d 320, 333-334—buyers found to be ready, willing, and able to perform where they had preapproved loan and had arranged with relative to help with deposit]

• [11:243.1] For example, if a seller commits an *anticipatory breach* before the buyer obtains a written loan commitment, proof of an oral, nonbinding loan commitment or of other financial resources for the buyer's financing needs may be sufficient. [*Henry v. Sharma* (1984) 154 CA3d 665, 672, 201 CR 478, 482]

[11:243.2 - 11:243.4] ***Reserved.***

2) [11:243.5] **Effect of escalating "equity cushion":** In an "up market," the "equity cushion" on a property (extent to which fair market value exceeds amount of the secured loan) that lenders typically look for grows daily. In turn, it may be much easier for buyers to obtain financing and satisfy the ability-to-perform requirement because the equity represents "a kind of extra downpayment." [*Behniwal v. Mix* (2005) 133 CA4th 1027, 1045, 35 CR3d 320, 334]

(b) [11:244] **Nonbinding third party agreement:** Sometimes, a buyer intends to resell (or "flip") the property to a third party after the buyer closes with the seller. A *binding* agreement with a secondary buyer might be sufficient to demonstrate the buyer's financial ability to close. However, if the projected resale has not been committed to a binding contract, the buyer probably will not be able to demonstrate that it possesses the ability to perform under the first contract. [*C. Robert Nattress & Assocs. v. CIDCO* (1986) 184 CA3d 55, 65, 229 CR 33, 38]

(2) [11:245] **Partial performance:** The buyer's failure to fully perform its obligations under the purchase agreement is not fatal to a specific performance remedy against the seller when the partial nonperformance either is entirely immaterial or the seller can be fully compensated by other means. [Civ.C. § 3392; *Converse v. Fong* (1984) 159 CA3d 86, 93, 205 CR 242, 247]

[11:245.1 - 11:245.4] ***Reserved.***

(3) [11:245.5] **Excused nonperformance—seller's failure to cooperate:** Where the seller's *cooperation* is necessary for the buyer's successful performance of its contractual obligations, "a promise [by the seller] to *give that cooperation*, and *not to do anything which prevents* realization of the fruits of [the buyer's] performance, will often be implied" (the implied covenant of good faith and fair dealing). [*Ninety Nine Investments, Ltd. v. Overseas Courier Service (Singapore) Private, Ltd.* (2003) 113 CA4th 1118, 1131, 6 CR3d 891, 900-901 (emphasis in original)]

If the seller breaches that implied covenant by failure to cooperate, thereby preventing the buyer's performance under the agreement, the buyer's performance is *excused* and the buyer is entitled to specific performance by the seller. [*Ninety Nine Investments, Ltd. v. Overseas Courier Service (Singapore) Private, Ltd.*, supra, 113 CA4th at 1135-1136, 6 CR3d at 904 (seller failed to timely comply with escrow obligations)]

f. [11:246] **Effect of seller's inability to perform:** Generally, a buyer will not be able to compel specific performance of the purchase agreement when the seller is *lawfully unable* to perform (Civ.C. § 3390(c)) or the seller's performance is otherwise *impossible* (see Rest.2d Contracts § 368). [See *Crittenden v. Hansen* (1943) 59 CA2d 56, 58-59, 138 P2d 37, 38—court cannot specifically enforce purchase agreement by ordering conveyance of title where seller has already conveyed title to BFP]

(1) [11:247] **Seller's ability tested as of trial date:** The fact the seller is not able to perform at the time required by the contract will not defeat a buyer's specific performance remedy if the seller *can perform at the time of trial*. [*Stevens Group Fund IV v. Sobrato Develop. Co.* (1991) 1 CA4th 886, 897, 2 CR2d 460, 466—seller's inability to convey clear title at time performance due under contract because note secured by deed of trust was not prepayable, was not proper ground

for denying buyer specific performance where note was due and capable of being paid thereafter and seller could convey clear title at time of trial]

(a) [11:248] **Seller lacking title:** The seller is not necessarily unable to perform simply because it does not have title when the buyer files a specific performance suit. Assuming the circumstances permit, the court can *order the seller to obtain title* in order to effect the conveyance to the buyer. [*Walgren v. Dolan* (1990) 226 CA3d 572, 576-578, 276 CR 554, 556-557—buyer can compel specific performance of purchase agreement executed with trust beneficiary (equitable titleholder) where beneficiary has power under terms of trust to require trustee to convey legal title; see also *Greif v. Sanin* (2022) 74 CA5th 412, 447-448, 289 CR3d 484, 511-512—buyer entitled to specific performance where, although seller transferred *legal title* to limited liability company (LLC), seller retained sole authority to dispose of property and thus had *equitable title* (also noting seller failed to record LLC operating agreement until after signing sales contract, depriving buyer of notice title had been transferred); *Miller v. Dyer* (1942) 20 C2d 526, 528-529, 127 P2d 901, 903—buyer of property in another pending escrow entitled to specific performance because seller had power, by closing escrow, to acquire title]

On the other hand, if the seller is unable to obtain the title required by the contract, a specific performance decree ordinarily will not be granted (*but see ¶ 11:249 ff.*). [*Weisberg v. Ashcraft* (1961) 194 CA2d 225, 232, 14 CR 817, 821]

(2) [11:249] **Substantially similar performance:** A specific performance decree need not necessarily compel the identical performance promised in the contract. Notwithstanding that the seller's performance has become difficult or "impossible," the court may compel a *substantially similar* performance in the buyer's favor that will best effectuate the purposes for which the contract was made. [Rest.2d Contracts § 359(2)& comm. c, d; see *Rogers v. Davis* (1994) 28 CA4th 1215, 1221-1222, 34 CR2d 716, 720]

(a) [11:250] **Transfer to BFP rendering conveyance of title impossible:** The seller's intervening transfer of the property to a BFP renders performance of its obligation to convey title to the buyer "impossible" (specific performance of the seller's duty to convey cannot be enforced against a BFP; see Civ.C. § 3395). Nonetheless, this scenario does not preclude the court from ordering some other form of specific performance in the buyer's favor … such as an order compelling the seller to remit to the buyer the *sale proceeds* (less the amount the buyer still owes under the purchase agreement). [*Rogers v. Davis* (1994) 28 CA4th 1215, 1224, 34 CR2d 716, 722—though foreclosure sale to BFP made seller's conveyance of title to buyers impossible, court properly granted buyers specific performance through award of foreclosure proceeds remaining after payment to trust deed beneficiaries (less balance buyers owed under purchase agreement)]

Viewed another way, the buyer's ability and willingness to complete its obligations under the contract warrants a finding that the buyer is the "equitable owner" of the property, with a right to the seller's proceeds from the third party sale under the doctrine of "equitable conversion." [See *Rogers v. Davis*, supra, 28 CA4th at 1223, 34 CR2d at 721]

1) [11:251] **Compare—transferees with knowledge of buyer's contractual interest:** On the other hand, *identical* performance (the conveyance of title) *can* be ordered by a specific performance decree against subsequent (intervening) third party purchasers who had *knowledge* of the previous buyer's claimed interest before they purchased the property. Here, the buyer should join such third persons as additional parties defendant in the specific performance action. [See Civ.C. § 3395]

➪ [11:252] ***PRACTICE POINTER:*** For this reason, it behooves buyers who want the particular property (rather than a "substantially similar" performance or legal damages for the buyer's breach) to immediately *record a lis pendens* upon commencement of the action. By so doing, the buyer's claim becomes "of record," thereby ensuring no subsequent buyer or encumbrancer can claim ignorance of the first buyer's interest. *See ¶ 11:300 ff.*

(b) [11:253] **Defective title:** Notwithstanding a cloud on the seller's title, the buyer may accept defective title and receive an abatement in the contract price. [*Johnson v. Lehtonen* (1957) 151 CA2d 579, 581, 312 P2d 35, 37; *Milkes v. Smith* (1949) 91 CA2d 79, 82, 204 P2d 419, 420]

However, prudence suggests that the buyer *join* in its specific performance action any party who possesses (or claims) an interest in or lien on the property that can be discharged through payment of the contract price. [See *Greenstone v. Claretian Theological Seminary* (1958) 158 CA2d 493, 494, 322 P2d 482]

[11:254 - 11:259] ***Reserved.***

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g. [11:260] **Court supervision as factor:** Ordinarily, courts will not grant specific performance of a contract that will require continuous judicial supervision. [*Moklofsky v. Moklofsky* (1947) 79 CA2d 259, 262-263, 179 P2d 628, 630-631; *see* ¶ *11:163* re seller's specific performance action]

Nonetheless, courts have inherent equitable power to make their judgments effective by supervising the details of specific performance decrees. [*Peak-Las Positas Partners v. Bollag* (2009) 172 CA4th 101, 112-113, 90 CR3d 775, 786—court extended escrow until 60 days after judgment became final; see also *Barnes v. Chamberlain* (1983) 147 CA3d 762, 768-769, 195 CR 417, 421—court extended deadline for buyer to deposit purchase money under specific performance decree]

h. [11:261] **Waiver of conditions precedent:** A party seeking specific performance must waive all conditions precedent created solely for its benefit in the contract. However, the buyer is entitled to a reduction in the purchase price to compensate it for the seller's failure to satisfy the condition(s) so waived. [*Milkes v. Smith* (1949) 91 CA2d 79, 82-83, 204 P2d 419, 421]

i. Additional parties

(1) [11:262] **Intervening transferees:** As indicated, the buyer's specific performance action may lie against *third parties* where the seller transferred the property to others who took their interest *with knowledge* of the buyer's claimed interest (Civ.C. § 3395, ¶ *11:251*).

(2) [11:263] **Third parties under contract with seller:** Similarly, the buyer should join in its action for specific performance any party who has entered into a different contract with the seller to purchase the same property, or who holds title under an obligation to convey it to the seller. [*Miller v. Dyer* (1942) 20 C2d 526, 530-531, 127 P2d 901, 903]

(3) [11:264] **Third party lienholders:** A buyer seeking clear title should also join any party claiming a lien on the property that can be satisfied by payment of the contract price (*see* ¶ *11:253*).

(4) [11:265] **Co-owners:** Where the property is co-owned, all owners who executed (or ratified) the contract as seller should be joined in the specific performance action.

On the other hand, co-owners who *neither executed nor ratified* the contract are *not bound* by its terms. In such a case, the buyer may seek specific performance only as to the interest held by the owner(s) who did execute or ratify the agreement. [*Ellis v. Mihelis* (1963) 60 C2d 206, 218-219, 32 CR 415, 422]

(a) [11:266] **Community property complications:** Co-ownership issues may be particularly problematic where the subject of the contract is *community property*. Here, the contract is *voidable* by a spouse or registered domestic partner (Fam.C. § 297.5) who did not *join in its execution*. [Fam.C. § 1102; *see* ¶ *11:33*]

The fact the seller is obligated by the contract to obtain their spouse's consent will not help a buyer seeking a full conveyance of the entire community interest …because the seller's obligation to obtain the spouse's consent (or that of "any other third person") is *not itself specifically enforceable*. [Civ.C. § 3390(d)]

Moreover, over the nonconsenting spouse's objection, the buyer may not even enforce the contract as to the *signing* spouse's interest in the property … because, absent dissolution of the community by either spouse's death or a judgment of marriage dissolution, the nonconsenting spouse is entitled to avoid the contract *in its entirety*. [*Droeger v. Friedman, Sloan & Ross* (1991) 54 C3d 26, 46-47, 283 CR 584, 597; see also *Andrade Develop. Co. v. Martin* (1982) 138 CA3d 330, 334-337, 187 CR 863, 866-868 (decided under predecessor statute)—Fam.C. § 1102(a) may be raised in defense to contracting transferee's suit for specific performance or damages]

[11:267 - 11:269] ***Reserved.***

j. [11:270] **Equitable defenses:** Specific performance is an *equitable* remedy and thus is subject to various equitable defenses, such as *impossibility of performance* and *laches.* [See *Property Controllers, Inc. v. Shewfelt* (1966) 245 CA2d 755, 762-763, 54 CR 218, 222-223 (laches defense to lessee's action for specific performance of written lease); see also *Steiner v. Thexton* (2010) 48 C4th 411, 106 CR3d 252, fn. 14—because specific performance remedy is equitable in nature, courts may consider whether ordering it is warranted or if other relief may suffice; *and* ¶ *11:246 ff.* re impossibility of seller's performance]

k. [11:271] **No right to jury trial:** Because specific performance is an equitable remedy (not involving an action "at law"), it is *not jury triable*. [*Connell v. Bowes* (1942) 19 C2d 870, 871, 123 P2d 456, 456-457; *Nwosu v. Uba* (2004) 122 CA4th 1229, 1240, 19 CR3d 416, 425-426]

Cross-refer: For a comprehensive treatment of actions that are jury triable, see Wegner, Fairbank, Wegner, Wegner & Chernow, *Cal. Prac. Guide: Civil Trials & Evidence* (TRG), Ch. 2.

(1) [11:271.1] **Notwithstanding dispute over existence of contract:** An action for specific performance is not jury triable even though it "implicates legal issues regarding contract formation." The "gist" of the action still depends on the application of equitable doctrines; "[t]he fact that in an action for specific performance of an agreement the court must determine the existence of the agreement does not in itself transform the action into one at law." [*Walton v. Walton* (1995) 31 CA4th 277, 287-288, 36 CR2d 901, 905 (internal quotes omitted)]

(2) [11:272] **Impact where complaint seeks legal damages in the alternative:** As discussed earlier, a buyer can request alternate remedies for equitable relief (specific performance) or legal damages (Civ.C. § 3306 or § 3300 damages for breach of contract) at the pleading stage, but may *not be awarded* both remedies (*see ¶ 11:185*). The buyer would, of course, be entitled to a jury trial on the legal damages claim (an action "at law"); but, in practice, most courts will try the *specific performance* action first … because if plaintiff prevails therein, this will require dismissal of the legal damages action (to prevent a "double recovery") and thus obviate the necessity for a jury trial altogether. [*Raedeke v. Gibraltar Sav. & Loan Ass'n* (1974) 10 C3d 665, 671, 111 CR 693, 696; see *Nwosu v. Uba* (2004) 122 CA4th 1229, 1242, 19 CR3d 416, 426-427—ordering trial of equitable claims before trial of remaining legal claim "preferred procedure"; and *Walton v. Walton* (1995) 31 CA4th 277, 292-293, 36 CR2d 901, 908-909—"where mutually exclusive remedies are pled, there need not be a trial on both the legal and the equitable remedy. Resolution of one renders the other moot"]

(3) [11:273] **Compare—incidental "damages" pursuant to specific performance decree:** A specific performance decree may award plaintiff incidental *compensation* in order to fully vindicate plaintiff's contractual rights. But that is *not* a "legal damages" award for breach of contract which would trigger the right to jury trial. Rather, the incidental compensation essentially effects an equitable *accounting* between the parties and thus remains an *equitable* remedy. [See *Rogers v. Davis* (1994) 28 CA4th 1215, 1221, 34 CR2d 716, 720; *and further discussion at ¶ 11:278 ff.*]

[11:274] ***Reserved.***

l. [11:275] **Specific enforcement decree:** A specific performance decree in the buyer's favor does the following:

• It directs the *seller* to *execute and deliver a deed* to the buyer (or other substantially equivalent performance, *see ¶ 11:249*) and to perform all other necessary conditions of the contract within a specified period of time;

• It directs the *buyer* to perform all of the *buyer's obligations* under the contract (including tendering the contract price to the seller); and

• It *orders an accounting* between the parties in equity (*¶ 11:278 ff.*). [*Rogers v. Davis* (1994) 28 CA4th 1215, 1221, 34 CR2d 716, 720]

(1) [11:276] **Buyer as equitable owner:** Following issuance of a specific performance decree, the prevailing buyer becomes *equitable owner* of the property, while the seller retains legal title as security for the buyer's payment of the contract price. [*Elliott v. McCombs* (1941) 17 C2d 23, 31, 109 P2d 329, 334]

In effect, the buyer is regarded as having equitable rights of ownership. For example, if the seller wrongfully conveys the property to a third party BFP, the buyer would be entitled to the *sale proceeds* on a theory of "equitable conversion": "It no longer being possible to convey the … property, the fund which represents the part conveyed belongs to the [buyer], as purchaser." [See *Rogers v. Davis* (1994) 28 CA4th 1215, 1223, 34 CR2d 716, 721 (internal quotes omitted)]

(2) [11:277] **Court clerk as "elisor" to effect conveyance:** If the seller fails to convey the property to the buyer as directed by the decree (after the buyer's proper tender of the purchase price), the court clerk may be appointed to effect the conveyance on the defaulting seller's behalf. [*Dennis v. Overholtzer* (1961) 191 CA2d 791, 797-798, 13 CR 110, 114; see also *Blueberry Properties, LLC v. Chow* (2014) 230 CA4th 1017, 1021, 179 CR3d 145, 147—by appointing clerk as elisor to execute escrow documents on seller's behalf, court properly exercised its CCP § 128(a)(4) power to enforce its judgment; *Rayan v. Dykeman* (1990) 224 CA3d 1629, 1635, 274 CR 672, 675-676, fn. 2—courts typically appoint elisors to sign deeds and other documents on behalf of recalcitrant parties]

(3) [11:278] **Incidental "damages" (equitable accounting):** An order compelling specific performance cannot also award the prevailing plaintiff legal damages for breach of contract (otherwise, plaintiff would receive a "double recovery"—both the performance called for by the contract and a monetary award compensating for the failure of performance). However, because a specific performance decree is not issued at the time performance was required under the contract, an *accounting*

occurs for the period between the date the contract was to be performed and the date of the decree in order to *adjust the equities* between the parties due to the seller's delayed performance. [*Ellis v. Mihelis* (1963) 60 C2d 206, 219-220, 32 CR 415, 423; *BD Inns v. Pooley* (1990) 218 CA3d 289, 298-299, 266 CR 815, 820; see *Kassir v. Zahabi* (2008) 164 CA4th 1352, 1357, 80 CR3d 1, 4—it is "well established" court has power to award compensation *incidental* to specific performance decree when necessary to relate performance back to contract date; compare *Greif v. Sanin* (2022) 74 CA5th 412, 449-452, 289 CR3d 484, 513-515 (distinguishing *Ellis*)—buyer entitled to specific performance *and* conversion damages in form of interest on purchase funds kept in escrow for almost 2 years due to seller's failure to return funds after repudiating purchase agreement]

(a) [11:279] ***Not "legal damages" for breach of contract:*** Though often loosely referred to as "damages," this accounting is *not* an assessment of "damages." Rather, it is additional compensation awarded *in equity* to fully vindicate plaintiff's contractual rights. [*Rogers v. Davis* (1994) 28 CA4th 1215, 1220-1221, 34 CR2d 716, 720]

"The complainant affirms the contract and asks that it be performed. Since the time for performance has passed, the court relates that performance back to that date, by treating the parties as if the change in ownership had taken place at that time." [*BD Inns v. Pooley* (1990) 218 CA3d 289, 298, 266 CR 815, 820; *Behniwal v. Mix* (2007) 147 CA4th 621, 629, 54 CR3d 427, 433; *Hutton v. Gliksberg* (1982) 128 CA3d 240, 248, 180 CR 141, 145]

Indeed, whereas legal damages for breach of contract are recoverable only to the extent they are a reasonably foreseeable or natural consequence of the breach (*¶ 11:196.1*), compensation as an incident to specific performance is not limited by contract concepts of foreseeability. [*Bravo v. Buelow* (1985) 168 CA3d 208, 215, 214 CR 65, 71]

(b) [11:280] **Accounting process—general rules:** The accounting seeks to put the buyer in the position the buyer would have been in had the conveyance occurred at the time called for by the contract. [See *Kassir v. Zahabi* (2008) 164 CA4th 1352, 1358, 80 CR3d 1, 4—seller and buyer each entitled to receive full performance of contract when specific performance granted]

Thus, the following general rules apply:

• The buyer is entitled to the *rents and profits* the buyer would have earned from the property as of the time the contract should have been performed; and

• The seller is entitled to an *offset* for (i) operating expenses incurred by the seller; and (ii) interest on the purchase money the seller would have received had the contract been timely performed. [*Ellis v. Mihelis* (1963) 60 C2d 206, 220-221, 32 CR 415, 423-424; *Stratton v. Tejani* (1982) 139 CA3d 204, 212, 187 CR 231, 236; see also *Kassir v. Zahabi*, supra, 164 CA4th at 1355, 80 CR3d at 2—no offset for future interest where property is overencumbered and seller would receive nothing under purchase agreement at close of escrow; *Greif v. Sanin* (2022) 74 CA5th 412, 451, 289 CR3d 484, 514—although buyer entitled to interest on purchase funds kept in escrow for almost 2 years due to seller's failure to return same after repudiating purchase agreement, seller not entitled to property tax offset where seller continued to assert title and retained possession of property with all ownership benefits]

1) [11:280.1] **Limitations:** The general rules set forth at ¶ 11:280 are subject to the following limitations:

— Buyers are not entitled to the profits or reasonable rental values of property *and* the value derived from the use of any retained purchase funds. Indeed, buyers must reduce their credits for rents and profits by sums equivalent to the retained purchase funds (*¶ 11:281*);

— Sellers may not receive credit for the lost use of any portion of purchase funds set aside by buyers *with notice* to sellers; *and*

— Sellers' awards for the lost use of purchase moneys cannot exceed the rents/profits awarded to buyers (otherwise, breaching sellers would profit from their wrongs). [*Stratton v. Tejani* (1982) 139 CA3d 204, 213, 187 CR 231, 236-237; *Kassir v. Zahabi* (2008) 164 CA4th 1352, 1358, 80 CR3d 1, 5]

2) [11:281] **Rents/profits:** Where the transaction involved *income-producing* property, the buyer is entitled to receive an amount equal to the rents and profits generated from the property calculated as of the date the conveyance should have occurred under the contract until the date of the specific performance decree. [*Ellis v. Mihelis* (1963) 60 C2d

206, 219-220, 32 CR 415, 423; *Stratton v. Tejani* (1982) 139 CA3d 204, 212, 187 CR 231, 236; *Hutton v. Gliksberg* (1982) 128 CA3d 240, 248, 180 CR 141, 145]

Similarly, if the contract involved *residential* property, the accounting process credits the buyer with the property's *fair rental value* as of the date the conveyance should have occurred to compensate the buyer for lost use of the property. [*Meyer v. Benko* (1976) 55 CA3d 937, 946, 127 CR 846, 850; see also *Kassir v. Zahabi*, supra—buyers' credits are reduced by sums equivalent to value of buyers' use of any retained purchase funds]

3) [11:282] **Other expenses incurred by buyer:** The accounting process allows the buyer an offset against the contract price for any other expenses caused by the seller's delayed performance—for example:

- increased development/construction costs;

- increased financing costs (including costs the buyer may incur as a result of rising interest rates); and

- any other losses the buyer may have suffered that the seller had been made aware of. [See *Hennefer v. Butcher* (1986) 182 CA3d 492, 505, 227 CR 318, 325; *Bravo v. Buelow* (1985) 168 CA3d 208, 212-216, 214 CR 65, 69-71; *Stratton v. Tejani* (1982) 139 CA3d 204, 214-215, 187 CR 231, 237]

a) [11:282.1] **No offset for buyer's attorney fees incurred to obtain specific performance:** However, an offset against the contractual purchase price may *not* include attorney fees incurred by the buyer to obtain the specific performance judgment. The attorney fees are not a true "incident" to the judgment, and to allow otherwise would play "absolute havoc with the law of liens and lien priorities" (e.g., the buyer's fees would in effect be given precedence over government liens for unpaid property taxes and prelitigation trust deeds). [*Behniwal v. Mix* (2007) 147 CA4th 621, 630-631, 54 CR3d 427, 434-435]

4) [11:283] **Limitation on seller's interest offset where funds in escrow:** The seller's right to an offset for interest accrues only on that portion of the purchase price that was not paid at the time called for by the contract. Thus, *no interest* for the seller's benefit accrues on funds toward the purchase price that the buyer already placed in escrow. [*Ellis v. Mihelis* (1963) 60 C2d 206, 221, 32 CR 415, 424; see also *Kassir v. Zahabi* (2008) 164 CA4th 1352, 1358, 80 CR3d 1, 5—sellers entitled to reasonable value of their use of entire purchase price less total of option price and cash deposited in escrow]

[11:284 - 11:299] ***Reserved.***

3. [11:300] **Lis Pendens as Interim Protection:** A *lis pendens* is not a "remedy" but, rather, a document that, if properly *recorded*, gives *constructive notice* to the "world" of a pending lawsuit affecting designated real property and thereby *preserves priority of claims* concerning the property.

Specifically, pursuant to CCP § 405 et seq., a "notice of pendency of action" (commonly referred to as a "lis pendens") may be recorded by any party to pending litigation who has a "real property claim" that is the subject of the action. [CCP § 405.20; see *De Martini v. Sup.Ct. (Gupta)* (2024) 98 CA5th 1269, 1274, 317 CR3d 441, 445, *discussed at* ¶ 11:708, 11:725, 11:735]

In turn, all subsequent purchasers or encumbrances are deemed to have *constructive notice* of the pending action and, therefore, take their interest in the designated property *subject to* the rights of the party claimant. The party claimant's rights and interest relate back to the date of recording of the lis pendens. [CCP §§ 405.24, 1908(a)(2)]

➪ [11:301] ***PRACTICE POINTER:*** Buyers interested in pursuing a specific performance action (because they want the particular property rather than compensation in money damages for the seller's breach) should *routinely record a lis pendens* at the outset of the litigation. Doing so will ensure that the seller cannot render specific performance "impossible" by subsequently conveying the property to a BFP (*see ¶ 11:250*).

Cross-refer: Lis pendens is discussed in detail at *¶ 11:600 ff.*

[11:302 - 11:332] ***Reserved.***

4. [11:333] **Other Buyer Remedies:** Breach of contract damages and specific performance are, of course, not the exclusive remedies available to buyers aggrieved in a real property purchase and sale transaction. Like sellers, under appropriate facts, they may be able to pursue an action for reformation, rescission or, perhaps, a damages suit for fraud. These and other miscellaneous remedies are discussed in the remaining sections of this Chapter (*¶ 11:350 ff.*).

[11:334 - 11:349] ***Reserved.***

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Chapter 11. Remedies in Purchase and Sale Transactions

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1. [11:350] **General Considerations:** The commission of fraud in a purchase and sale transaction may take two forms: fraud in the *inception or execution* of the purchase and sale agreement ("promisor is deceived as to the nature of his act, and actually does not know what he is signing, or does not intend to enter into a contract at all"); or fraud in the *inducement* of the contract ("promisor knows what he is signing, but his consent is *induced* by fraud"). [*Rosenthal v. Great Western Fin'l Secur. Corp.* (1996) 14 C4th 394, 415, 58 CR2d 875, 887 (emphasis in original; internal quotes omitted); see also *Village Northridge Homeowners*

Ass'n v. State Farm Fire & Cas. Co. (2011) 50 C4th 913, 921, 114 CR3d 280, 285—fraud in inception/execution renders contract void, whereas fraud in inducement renders contract merely voidable (*discussed further at ¶ 11:473.1*)]

The defrauded party (buyer or seller) may either disaffirm the contract and seek relief based on *rescission* or *affirm* the contract and sue for *damages* (¶ 11:351 ff.). Although these are inconsistent remedies, both may be sought at the pleading stage provided the underlying factual allegations are consistent (¶ 11:11 ff.).

The sections at ¶ 11:351 ff. address the defrauded party's *damages* remedy (i.e., an action that affirms the contract but seeks damages for the fraud). The remedy of *rescission* on the ground of fraud is separately addressed at *¶ 11:460 ff.*

a. [11:351] **Defrauded buyer's choice of remedies:** A defrauded buyer may elect either to affirm the contract and sue for damages under Civ.C. § 3343 (below) or rescind the contract (restoring the benefits received thereunder) and seek relief based thereon pursuant to Civ.C. § 1692 (¶ 11:505 ff.). [*Kaluzok v. Brisson* (1946) 27 C2d 760, 763, 167 P2d 481, 482; *Persson v. Smart Inventions, Inc.* (2005) 125 CA4th 1141, 1153, 23 CR3d 335, 344; see also *Ram's Gate Winery, LLC v. Roche* (2015) 235 CA4th 1071, 1087, 185 CR3d 935, 947—“We see no reason why” defrauded buyers cannot also allege action for breach of warranty in such circumstances]

A buyer who brings a damages action can retain title to the property and also be awarded monetary relief equal to the difference between the contract price and the actual value of the property received (plus any consequential damages; Civ.C. § 3343). Conversely, a buyer who rescinds the contract cannot retain title, but can recover the contract price (plus consequential damages) less the amount of rent deemed to be paid by the buyer to the seller for the period the buyer had possession of the property (*¶ 11:505 ff.*).

(1) [11:352] **Election of remedies not required at pleading stage:** The defrauded buyer need not make its election of remedies at the pleading stage. Absent a waiver of either remedy, the complaint may seek both in the alternative; however, the judgment cannot award plaintiff both remedies (i.e., an election of remedies will be required prior to judgment). [*Ram's Gate Winery, LLC v. Roche* (2015) 235 CA4th 1071, 1087, 185 CR3d 935, 947]

For example, a defrauded buyer will not be bound by its notice of rescission to the seller (thereby precluding a damages remedy) unless the offer to rescind was *accepted* by the seller (or the buyer otherwise waives its right to recover damages as evidenced by its conduct following discovery of the fraud). [*Walters v. Marler* (1978) 83 CA3d 1, 15-16, 147 CR 655, 664 (disapproved on other grounds by *Gray v. Don Miller & Assocs., Inc.* (1984) 35 C3d 498, 507, 198 CR 551, 556) —buyer's notice of rescission not accepted and thus not an effective pretrial election of remedies; see also *People ex rel. Dept. of Transp. v. Grocers Wholesale Co.* (1989) 214 CA3d 498, 512-513, 262 CR 689, 698—claim for damages based on fraud waived where party to executory contract enters into “new arrangement” with knowledge of the fraud and accepts substantial concessions not required by original contract]

(2) [11:353] **Damages remedy after consummation of transaction despite knowledge of fraud:** An affirmance of the contract despite knowledge of the perpetration of a fraud does not waive the defrauded party's damages remedy. Thus, the aggrieved party may elect to consummate the transaction, notwithstanding knowledge of the fraud, and then sue for damages pursuant to Civ.C. § 3343. [*Jue v. Smiser* (1994) 23 CA4th 312, 315-317, 28 CR2d 242, 244; *City of Vista v. Robert Thomas Securities, Inc.* (2000) 84 CA4th 882, 889, 101 CR2d 237, 241]

(a) [11:353.1] **Compare—knowledge of fraud at *inception of transaction:*** Plaintiff's reliance on the alleged misrepresentation *at the time the contract is entered into* is an essential element of a fraud cause of action (*¶ 11:354*); such reliance cannot be established where plaintiff is aware of the true facts (i.e., has knowledge of the misrepresentation) *before executing the contract*. Thus, a party cannot elect to enter into a contract despite knowledge of the other party's apparent fraud and then pursue a damages remedy based on the fraud. [See *Smith v. Brown* (1943) 59 CA2d 836, 838, 140 P2d 86, 86-87; *Carroll v. Dungey* (1963) 223 CA2d 247, 254, 35 CR 681, 686]

On the other hand, “constructive knowledge”—on the theory plaintiff *could have discovered* the falsity of defendant's representations by reasonable investigation of the facts—will *not* defeat a fraud claim (*see ¶ 11:354.3*).

Nor need plaintiff establish *continuing* reliance on a misrepresentation until the contract is fully executed in order to maintain a damages action. Thus, where a party first learns of the apparent deceit after entering into the contract, the party's continued performance of the agreement does not constitute a waiver of a damages remedy. [*Jue v. Smiser* (1994) 23 CA4th 312, 317, 28 CR2d 242, 244-245; *City of Vista v. Robert Thomas Securities, Inc.* (2000) 84 CA4th 882, 889, 101 CR2d 237, 241]

b. [11:354] **Elements of fraud cause of action:** A plaintiff seeking a remedy based upon fraud must allege and prove all of the following basic elements:

- Defendant's false representation or concealment of a "material" fact (see Rest.2d Torts § 538(2)(a); *Engalla v. Permanente Med. Group, Inc.* (1997) 15 C4th 951, 977, 64 CR2d 843, 859—misrepresentation deemed "material" if "a reasonable [person] would attach importance to its existence or nonexistence in determining his choice of action in the transaction"; see also *Hoffman v. 162 North Wolfe LLC* (2014) 228 CA4th 1178, 1186, 175 CR3d 820, 827—failure to disclose material fact is not actionable fraud unless there is *some* relationship between parties that gives rise to disclosure duty (rejecting P's fraudulent concealment of prescriptive easement claim because D, an adjacent neighbor, had no relationship with P and thus no duty to disclose));

- Defendant made the representation with knowledge of its falsity or without sufficient knowledge of the subject to warrant a representation;

- The representation was made with the intent to induce plaintiff (or a class to which plaintiff belonged) to act upon it (see *Blickman Turkus, LP v. MF Downtown Sunnyvale, LLC* (2008) 162 CA4th 858, 869, 76 CR3d 325, 333—fraud by false representations means intent to induce "reliance"; fraud by concealment involves intent to induce "conduct");

- Plaintiff entered into the contract in "justifiable reliance" upon the representation (see *Hoffman v. 162 North Wolfe LLC*, supra, 228 CA4th at 1185-1186, 1194-1198, 175 CR3d at 826, 833-836—P precluded from claiming justifiable reliance on D's vague promise, made eight months earlier, "to take care of" trespassing vehicles);

- As a result of reliance upon the false representation, plaintiff has suffered damages (*Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1239, 44 CR2d 352, 359; see *Manderville v. PCG & S Group, Inc.* (2007) 146 CA4th 1486, 1498, 55 CR3d 59, 68; and *Auerbach v. Great Western Bank* (1999) 74 CA4th 1172, 1184, 88 CR2d 718, 727—"Deception without resulting loss is not actionable fraud" (¶ *11:357.1*)).

  (1) [11:354a] **Compare—representations of opinion:** Representations of opinion (e.g., matters involving a property's value) ordinarily are *not* actionable representations of fact. "It is hornbook law that an actionable misrepresentation must be made about past or existing facts; statements regarding future events are merely deemed opinions." [*Graham v. Bank of America, N.A.* (2014) 226 CA4th 594, 606-607, 172 CR3d 218, 228-229 (borrower's action against lender for fraud dismissed)—statements in appraisal indicating, among other things, that FMV of borrower's home was "ever-increasing" and loan was "good" for borrower were not facts, but rather statements of opinion or predictions of future events made for lender's benefit, and thus not actionable; see also *Cansino v. Bank of America* (2014) 224 CA4th 1462, 1469, 169 CR3d 619, 626 (fact pattern similar to *Graham*)—appraisal's future appreciation representations were mere opinions, not actionable misrepresentations]

  (2) [11:354.1] **Particularized pleading required:** A fraud cause of action must be pleaded *with particularity;* i.e., *every element* of the cause of action must be alleged *factually and specifically* in full. [*Committee on Children's Television, Inc. v. General Foods Corp.* (1983) 35 C3d 197, 216, 197 CR 783, 795 (superseded by statute on other grounds as stated in *Branick v. Downey Savings & Loan Ass'n* (2006) 39 C4th 235, 242, 46 CR3d 66, 70); see also *West v. JPMorgan Chase Bank, N.A.* (2013) 214 CA4th 780, 793, 154 CR3d 285, 295—twofold purpose is to give defendant notice of sufficiently definite charges so defendant can meet them and to permit court to weed out meritless claims; *Stansfield v. Starkey* (1990) 220 CA3d 59, 73, 269 CR 337, 345—complaint must plead facts showing "how, when, where, to whom, and by what means the representations were tendered"; *Nagy v. Nagy* (1989) 210 CA3d 1262, 1268-1269, 258 CR 787, 790—fraud complaint deficient if it neither shows cause and effect relationship between alleged fraud and damages sought nor alleges definite amount of damages suffered]

  Cross-refer: For a detailed discussion of the pleading requirements, see Weil & Brown et al., *Cal. Prac. Guide: Civ. Pro. Before Trial* (TRG), Ch. 6.

  (3) [11:354.2] **"Justifiable reliance" element:** For purposes of a fraud claim, "justifiable reliance" exists when the misrepresentation or nondisclosure immediately caused plaintiff to alter their legal relations, and without such misrepresentation or nondisclosure plaintiff would not, in all reasonable probability, have entered into the contract or transaction. [*Manderville v. PCG & S Group, Inc.* (2007) 146 CA4th 1486, 1498, 55 CR3d 59, 68-69; see also *Hoffman*

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v. 162 North Wolfe LLC (2014) 228 CA4th 1178, 1194-1198, 175 CR3d 820, 833-836—P's particular knowledge and experience as real estate broker considered in determining whether he justifiably relied on D's alleged misrepresentation/ nondisclosure; *West v. JPMorgan Chase Bank, N.A.* (2013) 214 CA4th 780, 794, 154 CR3d 285, 296—reasonableness is judged by reference to plaintiff's knowledge and experience]

(a) [11:354.3] **Justifiable reliance not defeated by failure to investigate truth of representations:** Plaintiff cannot claim to have justifiably relied on a *known* misrepresentation (*¶ 11:353.1*). On the other hand, a fraud claim is not defeated simply by the fact plaintiff had the *means and opportunity* to investigate the truth or falsity of defendant's representations at the time the contract was entered into.

"Whenever a positive representation of fact is made, the party receiving it is, in general, entitled to rely and act upon it, and is not bound to verify it by an independent investigation." [*Teague v. Hall* (1916) 171 C 668, 670-671, 154 P 851, 852; see *Manderville v. PCG & S Group, Inc.* (2007) 146 CA4th 1486, 1499, 1502-1503, 55 CR3d 59, 69, 72—even though seller intentionally misrepresented property could be subdivided, buyer's negligence in investigating condition of property for subdivision prior to consummating transaction no defense; *but see also ¶ 11:354.4*]

(b) [11:354.4] **Impact of exculpatory clause:** A party to a contract is statutorily barred from contracting away liability for fraud (Civ.C. § 1668). Thus, exculpatory clauses in purchase and sale agreements—e.g., "as is" clauses (*¶ 4:352 ff.*) or "integration" provisions (*¶ 4:527 ff.*)—do *not* preclude as a matter of law a showing of justifiable reliance. [*Manderville v. PCG & S Group, Inc.* (2007) 146 CA4th 1486, 1499-1502, 55 CR3d 59, 69-71; see *Thrifty Payless, Inc. v. Americana at Brand, LLC* (2013) 218 CA4th 1230, 1239-1242, 160 CR3d 718, 725-728 (applying "fraud exception" to parol evidence rule)—integration clause in commercial lease did not insulate lessor from liability for misrepresenting common expenses (*¶ 11:355.10*); *McClain v. Octagon Plaza, LLC* (2008) 159 CA4th 784, 794, 71 CR3d 885, 893—exculpatory provision in commercial lease re leased unit's "statement of size" and use in calculating rent, as well as disclaimer asserting plaintiff had adequate opportunity to examine unit, did not insulate defendant from liability for fraud or prevent plaintiff from demonstrating justifiable reliance on defendant's representations]

On the other hand, an "as is" clause or "integration" provision puts the buyer on notice to investigate further and is a *factor* to consider in determining whether the buyer justifiably relied on the seller's representations in entering into the transaction. [See *Hinesley v. Oakshade Town Ctr.* (2005) 135 CA4th 289, 300-303, 37 CR3d 364, 372-374—provision in shopping center lease that lessor made no representations re status of other prospective tenants in the center rebutted plaintiff tenant's justifiable reliance on alleged representations by lessor regarding presence of 3 desirable "anchor" tenants (especially since plaintiff took no action to question, clarify or confirm the contractual status of those 3 tenants); compare *Thrifty Payless, Inc. v. Americana at Brand, LLC,* supra, 218 CA4th at 1242, 160 CR3d at 728 (distinguishing *Hinesley*)—lessee justifiably relied on commercial lessor agents' grossly inaccurate estimates regarding unfinished shopping center's anticipated common expenses where lessor's agents had all or most information regarding same and lessee was not in position to discover for itself close approximation of ultimate costs]

1) [11:354.5] **Negligent misrepresentation claims:** The rule is the same with respect to claims for *negligent misrepresentation:* An exculpatory clause does not as a matter of law bar the cause of action. [See *SI 59 LLC v. Variel Varner Ventures, LLC* (2018) 29 CA5th 146, 154, 239 CR3d 788, 794; *McClain v. Octagon Plaza, LLC* (2008) 159 CA4th 784, 794, 71 CR3d 885, 893—Civ.C. § 1668 encompasses both intentional and negligent misrepresentation; *Blankenheim v. E.F. Hutton & Co., Inc.* (1990) 217 CA3d 1463, 1472-1473, 266 CR 593, 599—"case law has long held negligent misrepresentation is included within the definition of fraud"]

[11:355] ***Reserved.***

(4) [11:355.1] **Seller's fraud liability to remote purchasers ("indirect deception doctrine"):** Lack of privity between the parties (plaintiff buyer and defendant seller) will not necessarily defeat a buyer's fraud cause of action. A *predecessor* seller may be liable to subsequent purchasers for fraudulent misrepresentation or concealment in the sale if the seller *intended or had reason to expect* its fraud would be *transmitted to* and *relied and acted upon* by third party (subsequent) purchasers (so-called "indirect deception doctrine," described in Rest.2d Torts § 533). [*Shapiro v. Sutherland* (1998) 64 CA4th 1534, 1548-1549, 76 CR2d 101, 109-110; *Geernaert v. Mitchell* (1995) 31 CA4th 601, 605-609, 37 CR2d 483, 486-488—homeowners stated fraud cause of action against 2 prior owners based on misrepresentations and concealment regarding structural and foundation problems even though defendants made no misrepresentations directly to plaintiffs; see

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also *Leko v. Cornerstone Bldg. Inspection Service* (2001) 86 CA4th 1109, 1121, 103 CR2d 858, 867-868—home inspectors retained only by previous prospective purchaser liable to *subsequent* purchasers for misrepresentations made in inspection report (*discussed further at ¶ 4:350.5*)]

(a) [11:355.2] **"Reason to expect":** Whether a prior seller of real property had "reason to expect" transmission to the plaintiff buyer depends upon (i) the extent of the seller's knowledge of resale to a particular person or class of persons, and (ii) the likelihood the particular misrepresentation or concealment would be passed on to them. "A seller's liability under this standard becomes more problematic and difficult to establish with each intervening resale and with each passing year between the occurrence of the original fraud and the lawsuit." [*Geernaert v. Mitchell* (1995) 31 CA4th 601, 608, 37 CR2d 483, 487-488—remote purchaser's complaint must state ultimate facts showing defendant intended or had reason to expect reliance by plaintiff or class of persons of which plaintiff is a member]

1) [11:355.2a] **Example:** When Sellers accepted a transfer of employment out of state, they entered into a home purchase agreement with Prudential, a relocation management service with whom Employer had contracted to assist relocating employees unable to effect a timely sale of their homes. Prudential paid Sellers the agreed-upon price and Sellers gave Prudential a grant deed that left blank the grantee's name. Sellers also executed a Civ.C. § 1102.6 disclosure form that (among other things) stated they were not aware of neighborhood noise problems. Allegedly, this statement was false; but Prudential did not know of or have reason to suspect Sellers' deception.

Several months later, Prudential sold the property to Buyer and completed Sellers' grant deed identifying Buyer as grantee. Shortly after moving into the home, Buyer discovered loud disturbing noises and commotion from the next-door neighbors but could not resolve the problem. Buyer ultimately filed suit against Sellers for rescission and damages based on Sellers' alleged fraudulent misrepresentation and material nondisclosure regarding the noise.

Though the parties were not in direct privity, Buyer stated a fraud cause of action against Sellers. Sellers "knew or had to know that Prudential was simply guaranteeing the sale of their home *to someone* at an agreed price … [Sellers] signed a *blank* grant deed and clearly authorized Prudential to fill in the name of the grantee … In short, [Sellers] had to know and realize that Prudential intended to sell the property as quickly as possible; and since Prudential had no knowledge of the property or any of its problems, other than that disclosed by [Sellers], then they also had *every reason to expect* that their written statutory disclosure statement would be delivered to the purchaser when he or she ultimately was located. These circumstances are clearly sufficient to satisfy the principles of the indirect deception doctrine." [*Shapiro v. Sutherland* (1998) 64 CA4th 1534, 1550, 76 CR2d 101, 111 (emphasis in original); *see also ¶ 4:361 ff.*]

(b) [11:355.3] **Evidentiary burden:** Even though able to satisfy the pleading hurdle and state a cause of action, remote purchasers may face a particularly difficult evidentiary burden at trial. In effect, to prevail against prior sellers on a theory of "indirect fraud," plaintiffs must convince the trier of fact that each defendant not only defrauded their direct purchaser but also intended or had reason to expect that the fraud would be transmitted to plaintiffs. [*Geernaert v. Mitchell* (1995) 31 CA4th 601, 608-609, 37 CR2d 483, 488]

[11:355.4 - 11:355.9] *Reserved.*

c. [11:355.10] **Admissibility of parol evidence—"fraud exception":** Extrinsic evidence of fraudulent representations is admissible as an exception to the parol evidence rule to show that a contract was fraudulently induced. This exception also applies to evidence of so-called *promissory fraud:* i.e., the parol evidence rule does not bar evidence of a *fraudulent promise* contradicting the parties' written agreement. [*Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Ass'n* (2013) 55 C4th 1169, 1172, 151 CR3d 93, 94-95 (overruling prior contrary authority)—"it was never intended that the parol evidence rule should be used as a shield to prevent the proof of fraud" (internal quotes omitted); *Thrifty Payless, Inc. v. Americana at Brand, LLC* (2013) 218 CA4th 1230, 1239-1242, 160 CR3d 718, 725-728—notwithstanding lease's integration clause, extrinsic evidence admissible to establish fraud based on lessor's agents' grossly inaccurate estimates re lessee's probable pro rata share of property taxes, insurance and common area maintenance expenses; *see further discussion at ¶ 11:23.2 ff.*]

d. [11:356] **Measure of damages as between buyer and seller:** Civ.C. § 1709 provides generally that a party who is willfully defrauded is entitled to recover "any damages which he thereby suffers"; and Civ.C. § 3333 sets forth the general measure of compensatory damages in a tort action ("amount which will compensate for all the detriment proximately caused thereby, whether it could have been anticipated or not"). However, both statutes are *displaced* by the more specific damages provisions

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of *Civ.C. § 3343* when the fraud occurs between *buyer and seller in a real property purchase, sale or exchange transaction*. [See Civ.C. § 3333— general measure of compensatory damages "*except where otherwise expressly provided* by this code …" (emphasis added); *Alliance Mortg. Co. v. Rothwell* (1995) 10 C4th 1226, 1240-1241, 44 CR2d 352, 360-361; see also *Stout v. Turney* (1978) 22 C3d 718, 725-726, 150 CR 637, 641 (tracing legislative history behind current Civ.C. § 3343)]

Civ.C. § 3343 authorizes general and special damages as follows:

(1) [11:357] **General damages—"out-of-pocket" measure:** A party (buyer or seller) defrauded in the purchase, sale or exchange of property is entitled to recover the difference between the actual value of the consideration given and the value of the consideration received. [Civ.C. § 3343(a); *Alliance Mortg. Co. v. Rothwell* (1995) 10 C4th 1226, 1240, 44 CR2d 352, 360; *Fragale v. Faulkner* (2003) 110 CA4th 229, 236, 1 CR3d 616, 621; *Saunders v. Taylor* (1996) 42 CA4th 1538, 1542, 50 CR2d 395, 397]

This is the traditional "out-of-pocket" measure of recovery in a fraud action. [See *Stout v. Turney* (1978) 22 C3d 718, 725, 150 CR 637, 641]

(a) [11:357.1] **Element of cause of action:** An essential element of a fraud cause of action is that plaintiff has been *damaged* as a result of defendant's misrepresentation or concealment of a material fact (*¶ 11:354*). [*Alliance Mortg. Co. v. Rothwell* (1995) 10 C4th 1226, 1240, 44 CR2d 352, 360—"unless the plaintiff merely seeks to rescind the contract, it must suffer actual monetary loss to recover on a fraud claim"; *Auerbach v. Great Western Bank* (1999) 74 CA4th 1172, 1184, 88 CR2d 718, 727; see also *Childers v. Edwards* (1996) 48 CA4th 1544, 1550-1551, 56 CR2d 328, 332—since proof of damages is essential element of fraud cause of action, plaintiff who proves liability but fails to prove damages cannot be "prevailing party" entitled to CCP § 1021 attorney fees (*¶ 11:394.2*)]

Recognizing that Civ.C. § 3343(a) (¶ 11:356 ff.) defines the "general test" by which the existence of a defrauded buyer's or seller's damage is determined in real property sale transactions, courts conclude that a buyer cannot establish a fraud cause of action against its seller absent evidence that the price the buyer paid for the property was greater than the actual value of the property. Thus, a buyer who offers no evidence of what the property's market value would have been had the true facts been known *fails to show* damages (as defined and measured by Civ.C. § 3343) and thus *fails to establish an essential element* of the fraud cause of action. [*Saunders v. Taylor* (1996) 42 CA4th 1538, 1543, 50 CR2d 395, 398; *Fragale v. Faulkner* (2003) 110 CA4th 229, 237, 1 CR3d 616, 622; see also *Auerbach v. Great Western Bank*, supra, 74 CA4th at 1185, 88 CR2d at 727]

1) [11:357.2] **Example:** Buyers sued Sellers for fraud based on Sellers' real estate transfer disclosure statement indicating no known room additions, structural modifications or other alterations that were performed without building permits or in violation of building codes; in fact, it turned out that the family room had been converted from a patio without a building permit and did not comply with applicable building codes. Contractors consulted by Buyers estimated it would cost $25,000 to bring the improvements into compliance. However, Buyers presented no evidence of what the value of the property would have been at the time it was purchased had the lack of permits and structural defects been fully disclosed. Having failed to establish Civ.C. § 3343 "general damages," Buyers did not make out a fraud cause of action and a judgment of nonsuit was properly entered against them. [*Saunders v. Taylor* (1996) 42 CA4th 1538, 1545, 50 CR2d 395, 399]

2) [11:357.3] **Comment:** On its facts, the result in *Saunders* is probably correct. However, viewed as a general proposition, the *Saunders* rule that evidence of Civ.C. § 3343 general (out-of-pocket) damages is an essential element of a buyer's or seller's fraud cause of action is troubling. Civ.C. § 3343(a) also entitles a defrauded buyer or seller to recover *consequential damages* (*¶ 11:359*); and well-established precedent (including Cal. Supreme Court authority) recognizes that plaintiff need *not* show out-of-pocket loss in order to be entitled to consequential damages for fraud under Civ.C. § 3343 (*see ¶ 11:360*).

Thus, the more accurate rule probably should be that a buyer or seller suing for fraud must offer evidence of damages *of the type prescribed by Civ.C. § 3343*—i.e., *either* general "out-of-pocket" damages *and/or* consequential damages recognized by the statute (loss of profits, etc.). (Apparently, in *Saunders*, supra, the plaintiff buyers showed neither general nor consequential damages.) Nonetheless, later cases continue to endorse the *Saunders* rule without further analysis. [See *Auerbach v. Great Western Bank* (1999) 74 CA4th 1172, 1185, 88 CR2d 718, 727]

3) [11:357.4] **Compare—action for rescission based on fraud:** Proof of damages is *not* an essential part of the prima facie case where plaintiff seeks only to *rescind* the contract based upon fraud. "A defrauded party has the right to

rescind a contract, even without a showing of pecuniary damages, on establishing that fraudulent contractual promises inducing reliance have been breached." [*Engalla v. Permanente Med. Group, Inc.* (1997) 15 C4th 951, 979, 64 CR2d 843, 861; *see* ¶ *11:474.5*]

(b) [11:358] **Date of calculation:** The defrauded party's general damages are computed as of the date of the transaction (date of completed purchase and sale). Thus, e.g., a buyer's recovery in a fraud action (difference in value between the price paid and the value of the property on the date of the transaction) will not be reduced by the fact a later resale yields a profit. [*Burkett v. J.A. Thompson & Son* (1957) 150 CA2d 523, 527, 310 P2d 56, 58—defrauded buyer "was entitled to recover the 'out-of-pocket loss,' or the difference between the price [she] paid and the actual value at the time she made the purchase"]

(2) [11:359] **Special (consequential) damages:** The party defrauded in a purchase and sale transaction is also entitled to recover "any additional damage arising from the particular transaction, including …" (Civ.C. § 3343(a)):

• Amounts actually and reasonably expended in reliance upon the fraud (Civ.C. § 3343(a)(1), ¶ *11:380*);

• An amount that will compensate the defrauded party for loss of use and enjoyment of the property to the extent such loss was proximately caused by the fraud (Civ.C. § 3343(a)(2), ¶ *11:381*);

• Where the defrauded party has been induced by reason of the fraud to *sell*, an amount that will compensate them for profits or other gains which might reasonably have been earned by use of the property had the defrauded seller retained it (Civ.C. § 3343(a)(3), ¶ *11:382*);

• Where the defrauded party has been induced by reason of the fraud to *purchase*, an amount that will compensate them for any loss of profits or other gains that were reasonably anticipated and would have been earned from the defrauded buyer's use or sale of the property had it possessed the characteristics fraudulently attributed to it (but subject to specified limitations; *see* ¶ *11:383 ff.*) (Civ.C. § 3343(a)(4)).

(a) [11:360] **General out-of-pocket loss not required:** The defrauded party may recover consequential damages under Civ.C. § 3343(a)(1)-(4) (¶ 11:359) even though the party has neither alleged nor proved general out-of-pocket damages (amount by which the consideration paid exceeded the value of the property). "The only effect of [plaintiff's] failure to show traditional 'out-of-pocket' loss is the necessity that a nullity be added to the amount shown to have been sustained as consequential damages." [*Stout v. Turney* (1978) 22 C3d 718, 729-730, 150 CR 637, 644; see *Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1241, 44 CR2d 352, 360, fn. 5; *Las Palmas Assocs. v. Las Palmas Center Assocs.* (1991) 235 CA3d 1220, 1254, 1 CR2d 301, 321]

On the other hand, a plaintiff who shows *neither* out-of-pocket *nor* consequential damages allowed by Civ.C. § 3343 has failed to establish an essential element of the fraud cause of action. *See* ¶ *11:357.1 ff.*

[11:360.1 - 11:360.4] ***Reserved.***

(3) [11:360.5] **Attorney fees as damages ("tort of another" fees):** In a very narrow set of circumstances, the defrauded plaintiff may also be entitled to recover *attorney fees as damages*.

Under the "third party tortfeasor" or "tort of another" rule, attorney fees incurred through instituting or defending an action against a third party as a *direct result of the tort of another* are a recoverable item of damages. [*Prentice v. North American Title Guar. Corp.* (1963) 59 C2d 618, 620-621, 30 CR 821, 823; Rest.2d Torts § 914; see *Shapiro v. Sutherland* (1998) 64 CA4th 1534, 1551, 76 CR2d 101, 111—buyer's attorney fees incurred in rescinding contract of purchase and sale based on third party (remote) seller's fraud recoverable as damages in fraud action against remote seller; *Mai v. HKT Cal, Inc.* (2021) 66 CA5th 504, 512, 520-525, 281 CR3d 255, 260, 265-269 & fn. 2 (distinguishing attorney fees awarded as costs from attorney fees awarded as compensatory damages under "tort of another" doctrine and discussing types of evidence admissible to sustain attorney-fees-as-damages award)]

(4) [11:361] **No general "benefit of the bargain" damages:** By enacting Civ.C. § 3343, the Legislature adopted the "out-of-pocket" rule as the *exclusive* measure of a defrauded buyer's or seller's general damages in a real property purchase, sale or exchange transaction; a broader "benefit of the bargain" measure of recovery that would give the defrauded party the difference between the value of the property as represented and the actual value thereof is *statutorily rejected*. Injury to

plaintiff's "expectancy interest" is compensable under Civ.C. § 3343 only in the form of reasonably anticipated lost profits or gains (Civ.C. § 3343(a)(3) & (4)). [Civ.C. § 3343(b)(1); *Stout v. Turney* (1978) 22 C3d 718, 726, 150 CR 637, 642; *Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1240-1241, 44 CR2d 352, 360; *Fragale v. Faulkner* (2003) 110 CA4th 229, 236, 1 CR3d 616, 621]

(a) [11:361.1] **Same result under Civ.C. § 1102.13 statutory cause of action (fraudulent real estate transfer disclosure statement):** As discussed in *Ch. 4*, sellers of residential property must provide their buyers with a statutory "real estate transfer disclosure statement" (Civ.C. § 1102 et seq.; *see ¶ 4:354 ff.*). Noncompliance does not affect the validity of a property transfer; but a seller (or seller's agent) who willfully or negligently fails to comply is liable for the buyer's consequential "actual damages." [Civ.C. § 1102.13; see *Realmuto v. Gagnard* (2003) 110 CA4th 193, 202, 1 CR3d 569, 576— § 1102.13 damages remedy applies only if buyer has gone through with the transaction despite seller's failure to comply with statutory disclosure requirements]

The reference to "actual damages" in § 1102.13 means compensatory damages; and when a buyer's § 1102.13 action is based on alleged *fraud* in a real property purchase transaction, "actual damages" means damages *as measured exclusively by the Civ.C. § 3343(a) out-of-pocket loss rule* (*not* broader "benefit of the bargain" damages). [*Saunders v. Taylor* (1996) 42 CA4th 1538, 1543-1545, 50 CR2d 395, 398-399]

(b) [11:361.2] **Fiduciary fraud exception:** Civ.C. § 3343 does not apply when plaintiff has been defrauded by a *fiduciary*. *See ¶ 11:365 ff.*

(5) [11:362] **Causation limitation:** The measure of recovery for fraud allows the defrauded party to recoup its out-of-pocket losses and expenditures and, in an appropriate case, lost profits, only to the extent those damages were *proximately caused* by the defendant's fraud. Thus, e.g., a buyer may not recover the full difference between the contract price and the value of the property (general damages) to the extent the difference in value was not a result of the seller's fraud. [*Gray v. Don Miller & Assocs., Inc.* (1984) 35 C3d 498, 504, 198 CR 551, 554; see *Las Palmas Assocs. v. Las Palmas Center Assocs.* (1991) 235 CA3d 1220, 1252-1254, 1 CR2d 301, 319-320—"damage award for fraud will be reversed where the injury is not related to the misrepresentation"]

Likewise, out-of-pocket expenditures that would have been incurred even if the property had been in the condition as represented are not made in reliance upon the fraudulent misrepresentations and thus are not recoverable damages. [*Gagne v. Bertran* (1954) 43 C2d 481, 491-492, 275 P2d 15, 22-23; *Fragale v. Faulkner* (2003) 110 CA4th 229, 241, 1 CR3d 616, 625, fn. 11; see *Walters v. Marler* (1978) 83 CA3d 1, 26-27, 147 CR 655, 671 (disapproved on other grounds by *Gray v. Don Miller & Assocs., Inc.* (1984) 35 C3d 498, 507, 198 CR 551, 556)—buyer's landscaping, property tax, title insurance, property insurance, interest on loan, and maintenance and repair costs not recoverable because not incurred as a result of seller's fraud]

[11:363 - 11:364] ***Reserved.***

e. [11:365] **Compare—fraud by fiduciary:** A "constructive fraud" arises upon breach of a duty by one in a *fiduciary relationship* who, without actual fraudulent intent, misleads another to that person's prejudice (e.g., a *broker* misrepresents or fails to disclose material facts affecting a transaction). These claims may be based on written or oral misrepresentations. [Civ.C. § 1573; *Warren v. Merrill* (2006) 143 CA4th 96, 109, 49 CR3d 122, 131; see also *Tindell v. Murphy* (2018) 22 CA5th 1239, 1249-1250, 232 CR3d 448, 456 (noting constructive fraud, like fraud, must be pled with specificity), *Michel v. Palos Verdes Network Group, Inc.* (2007) 156 CA4th 756, 762, 67 CR3d 797, 802—fiduciary's failure to share material information with principal amounts to constructive fraud, a "term of art" obviating actual fraudulent intent; *and ¶ 11:473*]

Civ.C. § 3343 (¶ 11:356 ff.) fixes the measure of damages between *buyer and seller* in a fraudulent property purchase, sale or exchange transaction. However, in the case of *constructive or fiduciary fraud*, the more general measure of damages provided by Civ.C. §§ 1709 and 3333 applies. [*Alliance Mortg. Co. v. Rothwell* (1995) 10 C4th 1226, 1241, 44 CR2d 352, 361; *Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.* (2009) 171 CA4th 1356, 1383, 124 CR3d 271, 306 (low-income housing owners' fraud action against non-profit real estate sellers/fiduciaries for failure to disclose affordable housing deed restrictions); *Strebel v. Brenlar Investments, Inc.* (2006) 135 CA4th 740, 747, 37 CR3d 699, 704 (buyer's fraud action against dual agent and broker who misrepresented status of tax liens recorded against subject property)]

As stated, Civ.C. § 1709 allows a defrauded party to recover all damages it incurs as a result of the deceit, while Civ.C. § 3333 is the general tort measure of recovery (¶ *11:356*). [*Fragale v. Faulkner* (2003) 110 CA4th 229, 236, 1 CR3d 616, 622]

(1) [11:365.1] **Not dependent on pleading breach of fiduciary duty cause of action:** So long as the evidence demonstrates that the fraud was committed by a fiduciary, the broader measure of damages applies even if plaintiff did not specifically plead a cause of action for breach of fiduciary duty, instead alleging only intentional misrepresentation. [*Fragale v. Faulkner* (2003) 110 CA4th 229, 239, 1 CR3d 616, 624, fn. 9]

(2) [11:366] **Benefit of the bargain or out-of-pocket measure?** Whereas Civ.C. § 3343 expressly rejects the "benefit of the bargain" measure of recovery in a fraud action between buyer and seller (¶ *11:361*), the appropriate measure of damages is not statutorily fixed in third party fiduciary fraud cases; and courts have split on the subject (see *Strebel v. Brenlar Investments, Inc.* (2006) 135 CA4th 740, 748, 37 CR3d 699, 705 (discussing cases)):

(a) [11:367] **View adopting benefit of the bargain approach:** Several cases adopt the broader benefit of the bargain measure of damages applicable in breach of contract actions under Civ.C. § 3300. [*Moore v. Teed* (2020) 48 CA5th 280, 289-291, 261 CR3d 642, 653-655 (collecting cases); see also *Fragale v. Faulkner* (2003) 110 CA4th 229, 237-238, 1 CR3d 616, 623; *Salahutdin v. Valley of Calif., Inc.* (1994) 24 CA4th 555, 566-568, 29 CR2d 463, 469-470, and cases cited therein]

"[W]here … the defrauding party stands in a fiduciary relationship to the victim of fraud, the damages must be measured pursuant to the broad provisions of sections 3333 and 1709 regulating compensation for torts in general … The cases amplify that the measure of damages provided by the foregoing sections is substantially the same as that for breach of contract prescribed by section 3300; i.e., it tends to give the injured party the benefit of his bargain and insofar as possible to place him in the same position he would have been had the promisor performed the contract." [*Pepitone v. Russo* (1976) 64 CA3d 685, 689, 134 CR 709, 711 (original emphasis and internal cites omitted); see also *Moore v. Teed*, supra, 48 CA5th at 291, 261 CR3d at 655—"Applying this broader measure of damages ensures that a faithless fiduciary is held to account for the full amount of the loss of which his breach of faith is a cause"; *Fragale v. Faulkner*, supra, 110 CA4th at 237, 1 CR3d at 622 (same)]

1) [11:368] **How applied:** The benefit of the bargain standard considers the *loss sustained* by the defrauded party rather than the value with which they parted. Thus, courts look solely to the *fair market value* of the property lost (i.e., the difference between the actual value of what plaintiff received and what they expected to receive) by reason of the fiduciary's fraud and the consequential expenditures plaintiff incurred as a result of the fraud. [See *Pepitone v. Russo* (1976) 64 CA3d 685, 689-690, 134 CR 709, 711 (¶ 11:368.1)]

a) Examples

• [11:368.1] **Damages for undisclosed encumbrance:** A buyer who successfully sued her real estate agents for fraud and breach of fiduciary duty was entitled to "benefit of the bargain" damages. The agents arranged an exchange of properties on the buyer's behalf but failed to disclose that a second trust deed on the property the buyer was receiving had an acceleration clause that resulted in her losing the property in foreclosure. The buyer's damages equaled the difference between the purchase price and encumbrances, plus additional expenses of $500 incurred in an effort to refinance and prevent the foreclosure. [*Pepitone v. Russo* (1976) 64 CA3d 685, 689-690, 134 CR 709, 711]

• [11:368.2] **Damages for unfinished renovations:** A real estate agent who fraudulently induced a buyer to purchase and remodel a "fixer-upper house" by misrepresenting that the agent was a licensed contractor and could deliver high-end improvements, was liable to the buyer for "benefit of the bargain" damages. An installed foundation proved defective and promised renovations were far more costly than what the agent represented. Thus, the buyer was entitled to damages in an amount equal to the difference between the actual cost he would have incurred to complete the promised work and the amount the real estate agent promised to complete the work. [See *Moore v. Teed* (2020) 48 CA5th 280, 283, 293-294, 261 CR3d 642, 648, 656-657]

[11:368.3 - 11:368.7] ***Reserved.***

2) [11:368.8] **Date of measure:** Unlike out-of-pocket damages, which are usually calculated at the time of the transaction (¶ *11:358*), benefit of the bargain damages may appropriately be measured as of the *date of discovery of the*

fraud. “Applying the difference as of the date of the transaction would defeat the goal of compensation for the entire loss where … discovery of the fiduciary's … fraud did not occur until years after purchase of the property.” [*Salahutdin v. Valley of Calif., Inc.* (1994) 24 CA4th 555, 568, 29 CR2d 463, 470-471]

(b) [11:369] **View adopting out-of-pocket approach:** Other courts, relying on Civ.C. § 3343, limit the defrauded party's recoverable damages to out-of-pocket losses (the difference between the actual value of what plaintiff received and the actual value with which plaintiff parted, plus consequential losses). [*Overgaard v. Johnson* (1977) 68 CA3d 821, 827-828, 137 CR 412, 416-417 (seller's negligence action against real estate salesperson and broker); *Hensley v. McSweeney* (2001) 90 CA4th 1081, 1086, 109 CR2d 489, 492 (purchaser's fraud action against escrow agent)]

“Civil Code section 3333 does *not* set forth any benefit of the bargain rule. That section simply sets out the measure of damages long recognized in torts, namely, to compensate a plaintiff for a loss sustained rather than give him the benefit of any contract bargain.” [*Overgaard v. Johnson*, supra, 68 CA3d at 823-824, 137 CR at 413 (emphasis in original); see also *Gagne v. Bertran* (1954) 43 C2d 481, 490-491, 275 P2d 15, 22—pursuant to Civ.C. §§ 1709 and 3333, “the damages, whether for deceit or negligence, must be measured by the actual losses suffered because of the misrepresentation”]

[11:369.1 - 11:369.4] *Reserved.*

(c) [11:369.5] **Additional view adopting general tort damage approach where actionable fraud not related to property value:** Yet another view recognizes that, in cases where the actionable fraud has nothing to do with the value of the subject property, *neither* of the approaches set forth at ¶ 11:367 ff. “is particularly helpful or appropriate.” In such cases, courts should adopt the measure of damages that most appropriately compensates the injured party for all the loss sustained (the general tort damages approach; ¶ *11:356*). [*Strebel v. Brenlar Investments, Inc.* (2006) 135 CA4th 740, 748-749, 37 CR3d 699, 705-706]

1) [11:369.6] **Date of calculation:** Unlike out-of-pocket and benefit of the bargain damages (¶ *11:358, 11:368.8*), damages in these cases are not calculated as of a particular date. But this is not to say the damages are computed over an unlimited period of time. Rather, the calculation date will be the point in time when the chain of causation between the fraud and the damages suffered (*see* ¶ *11:362*) is broken. [*Strebel v. Brenlar Investments, Inc.* (2006) 135 CA4th 740, 749-754, 37 CR3d 699, 706-710 & fn. 14 (lost appreciation damages; *see* ¶ *11:369.7*)]

2) Application

• [11:369.7] Relying on Sellers' agent's representations that tax liens recorded against Sellers' property would be removed by the close of escrow, Buyer sold his existing home before escrow closed. Sellers were unable to get the liens removed and canceled the sale. Buyer's subsequent attempts for almost four years to find a suitable replacement property were unsuccessful because of a rapidly appreciating housing market.

In his fiduciary fraud action against the agent, Buyer was entitled to recover damages for the lost appreciation on and loss of use of his home between the date of its sale and trial as reasonable compensation for his inability to purchase an acceptable replacement property concurrently with the sale of his home. Buyer's recovery was not barred by his investment of the proceeds from the sale of his home in an interest-bearing account or his decision to purchase a replacement home in a different city. [*Strebel v. Brenlar Investments, Inc.* (2006) 135 CA4th 740, 748-754, 37 CR3d 699, 705-710]

(d) [11:370] **Distinction based on fiduciary *negligent vs. intentional* misrepresentation?** The appropriate measure of damages for fiduciary fraud may depend on whether the action proceeds on a theory of *negligent* or, instead, *intentional* misrepresentation.

• [11:370.1] According to the Cal. Supreme Court, plaintiffs are *always* limited to *out-of-pocket* damages under Civ.C. § 3333 for a fiduciary's *negligent* misrepresentation. [See *Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1249-1250, 44 CR2d 352, 367 (criticizing *Salahutdin v. Valley of Calif., Inc.* (1994) 24 CA4th 555, 566-568, 29 CR2d 463, 469-470, for adopting benefit of the bargain measure in case apparently involving fiduciary negligent misrepresentation); see also *Fragale v. Faulkner* (2003) 110 CA4th 229, 237, 1 CR3d 616, 622 (citing *Alliance Mortgage*)—“a plaintiff is entitled only to its out-of-pocket losses suffered because of a fiduciary's negligent misrepresentation”]

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• [11:370.2] On the other hand, while the Court has *commented* that the measure of damages under Civ.C. § 3333 *might be greater* (benefit of the bargain damages) for a fiduciary's *intentional* misrepresentation, it has never expressly so held. [See *Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1250, 44 CR2d 352, 367—"we need not address that issue here"]

[11:371 - 11:374] ***Reserved.***

(3) [11:375] **Effect of fiduciary's fraudulent acquisition of property:** When a fiduciary acquires the subject property by fraud, various *equitable* remedies, in addition to or in lieu of monetary damages, are "available and appropriate." These remedies may include cancellation of the property-transfer document (¶ *11:545 ff.*), reconveyance, or quieting title (¶ *11:526 ff.*). [See *Warren v. Merrill* (2006) 143 CA4th 96, 114, 49 CR3d 122, 135]

Pursuant to the quiet title remedy, the holder of legal title to the property (the broker) becomes the constructive trustee of the property (having committed "constructive fraud," ¶ *11:365*) for the benefit of the equitable title holder (the seller). [*Warren v. Merrill*, supra, 143 CA4th at 114, 49 CR3d at 135]

[11:376 - 11:379] ***Reserved.***

2. Specific Items Recoverable as Out-of-Pocket Consequential Damages

a. [11:380] **Reliance damages:** The defrauded party's recoverable "reliance damages" (Civ.C. § 3343(a)(1)) generally are the amounts spent in reliance on the false representations or in efforts to mitigate damages therefrom, *provided* plaintiff shows a *causal connection* between the alleged fraud and the damages incurred. [*Walters v. Marler* (1978) 83 CA3d 1, 26-27, 147 CR 655, 671 (disapproved on other grounds by *Gray v. Don Miller & Assocs., Inc.* (1984) 35 C3d 498, 507, 198 CR 551, 556)]

For example, a defrauded buyer's reliance damages may include:

• moving costs;

• sums advanced in attempting to subdivide the property;

• escrow fees;

• fees for building permits;

• telephone hookup charges;

• expenses for fences and yard cleaning;

• amounts spent for improvements necessitated by a concealed defective condition;

• expenses incurred while negotiating the contract;

• lost opportunities;

• harm to reputation; and

• other expenses that were reasonable under the circumstances to the extent they were proximately caused by the seller's fraud. [See *Vestar Develop. II, LLC v. General Dynamics Corp.* (9th Cir. 2001) 249 F3d 958, 962 (applying Calif. law); *Hardy v. Carmichael* (1962) 207 CA2d 218, 228, 24 CR 475, 481; *Perkins v. Ketchum* (1962) 211 CA2d 245, 252-253, 27 CR 278, 282; *Garrett v. Perry* (1959) 53 C2d 178, 186, 346 P2d 758, 763]

b. [11:381] **Loss of use and enjoyment:** Damages for loss of use and enjoyment of the property are recoverable to the extent proximately caused by the fraud. [Civ.C. § 3343(a)(2); *Stout v. Turney* (1978) 22 C3d 718, 729, 150 CR 637, 643—defrauded

purchaser properly awarded damages for losses sustained as a result of having to buy and hold additional property; *Channell v. Anthony* (1976) 58 CA3d 290, 315-316, 129 CR 704, 720-721]

Loss of use damages are usually measured by the fair market rental value of the property during the period the defrauded party did not have possession, or the cost incurred by the defrauded party to rent a substitute property for the same use and purposes. [*Channell v. Anthony*, supra, 58 CA3d at 315-316, 129 CR at 720-721; *Williams v. Graham* (1948) 83 CA2d 649, 653, 189 P2d 324, 326]

c. Lost profits

(1) [11:382] **Defrauded seller's profits:** One who is fraudulently induced to *sell* a property may recover an amount equal to the profits and other gains the seller might have realized from the property had the sale not occurred. [Civ.C. § 3343(a)(3)]

(2) [11:383] **Defrauded buyer's profits:** A defrauded *buyer* is entitled to damages for reasonably anticipated profits or other gains the property would have yielded from use or a subsequent sale had the property been in the condition as represented … *but only to the extent that:*

- the buyer acquired the property for the purpose of using or reselling it for profit;

- the buyer reasonably relied on the fraud in entering into the contract and in anticipating profits from a subsequent use or sale of the property; *and*

- any loss of profits suffered by the buyer was proximately caused by the seller's fraud and the buyer's reliance thereon. [Civ.C. § 3343(a)(4); *Las Palmas Assocs. v. Las Palmas Center Assocs.* (1991) 235 CA3d 1220, 1254, 1 CR2d 301, 321; *Hartman v. Shell Oil Co.* (1977) 68 CA3d 240, 247, 137 CR 244, 248]

(a) [11:384] **Compare—where title not conveyed:** A buyer's lost profits are recoverable under Civ.C. § 3343(a)(4) only where the property was actually *acquired* for use or resale. Lost profits are not a recoverable item of damages in a buyer's fraud action where title to the subject property was never conveyed to the buyer. [*Simon v. San Paolo U.S. Holding Co., Inc.* (2005) 35 C4th 1159, 1175-1176, 29 CR3d 379, 389-390 (fraudulent promise to negotiate exclusively, *¶ 4:276 ff.*)—attempted buyer's lost profits not recoverable under promissory fraud cause of action "because *the fraud did not cause them*" (emphasis in original); *Gray v. Don Miller & Assocs., Inc.* (1984) 35 C3d 498, 504, 198 CR 551, 554 (broker's fraudulent representations that offer to purchase had been accepted); *Kenly v. Ukegawa* (1993) 16 CA4th 49, 54-55, 19 CR2d 771, 774-775 (fraudulent promise to sell)]

d. [11:385] **No emotional distress damages:** Emotional distress is *not* a recoverable item of damages for fraud in a purchase and sale transaction. [*Kruse v. Bank of America* (1988) 202 CA3d 38, 67, 248 CR 217, 234; *Gravillis v. Coldwell Banker Residential Brokerage Co.* (2006) 143 CA4th 761, 776-777, 49 CR3d 531, 541]

[11:386 - 11:389] *Reserved.*

3. [11:390] **Punitive Damages:** Punitive damages may be awardable in an action for fraud upon proof by clear and convincing evidence that defendant has been guilty of "oppression, fraud or malice." [Civ.C. § 3294(a) & (c); see *Warren v. Merrill* (2006) 143 CA4th 96, 116, 49 CR3d 122, 136-137; *Hartman v. Shell Oil Co.* (1977) 68 CA3d 240, 248-250, 137 CR 244, 249-251]

a. [11:390.1] **Not negligent misrepresentation:** "Oppression", "fraud" or "malice" warranting punitive damages essentially is *intentional* misconduct (see Civ.C. § 3294(c)(1), (2) & (3)). Consequently, punitive damages potentially are recoverable in fraud actions involving intentional, but *not negligent*, misrepresentation. [*Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1241, 44 CR2d 352, 361; *PM Group, Inc. v. Stewart* (2007) 154 CA4th 55, 69, 64 CR3d 227, 239]

b. [11:391] **Clear and convincing evidence burden of proof:** Plaintiff's success in proving an intentional misrepresentation (or concealment) does not ipso facto establish a right to punitive damages on the ground of fraud. Whereas the fraud cause of action need be proved only by a normal preponderance of the evidence, defendant's "fraud" (or oppression or malice, as defined by Civ.C. § 3294(c)) for *punitive damages purposes* must be established by *clear and convincing evidence*. [Civ.C. § 3294(a)]

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Cross-refer: For a detailed treatment of punitive damages, see Haning, Flahavan, Cheng & Wright, *Cal. Prac. Guide: Personal Injury* (TRG), Ch. 3.

4. [11:392] **Attorney Fees:** There is one narrow set of circumstances where attorney fees might be recoverable as damages (*see ¶ 11:360.5* re "third party tortfeasor" rule). Otherwise, attorney fees are not a recoverable element of damages (under Civ.C. § 3333 or § 3343) in a fraud action; nor is there any statutory authority for an attorney fees as costs award in an action for fraud. [See *Gray v. Don Miller & Assocs., Inc.* (1984) 35 C3d 498, 507, 198 CR 551, 556]

Thus, the prevailing party's right to recover attorney fees ordinarily will derive (if at all) only from the underlying contract.

a. [11:393] **Civ.C. § 1717 fees not recoverable:** A fraud cause of action sounds in *tort;* and the Civ.C. § 1717 reciprocal prevailing party attorney fee provisions apply only in actions "on the *contract*" or to enforce the *contract (see ¶ 4:514.1 ff., 11:137 ff.*). Therefore, Civ.C. § 1717 attorney fees are *not* recoverable by parties prevailing in a fraud action, notwithstanding that the underlying purchase and sale contract contains an attorney fee clause. [*Stout v. Turney* (1978) 22 C3d 718, 730, 150 CR 637, 644; see *Childers v. Edwards* (1996) 48 CA4th 1544, 1548, 56 CR2d 328, 330-331—"Tort-based misrepresentation is not within section 1717 's domain"; *Exxess Electronixx v. Heger Realty Corp.* (1998) 64 CA4th 698, 708, 75 CR2d 376, 383—constructive fraud and breach of fiduciary duty claims "sound in tort" and thus are outside ambit of § 1717]

b. [11:394] **Compare—CCP § 1021 fees under broadly worded ("arising under") fee recovery provision:** However, if the contractual provision is phrased broadly enough, attorney fees may be awardable in a fraud (or other *tort*) action under the general authority of CCP § 1021 (except as otherwise provided by statute, attorney compensation "is left to the agreement … of the parties"). [*Santisas v. Goodin* (1998) 17 C4th 599, 608, 71 CR2d 830, 836—real estate purchase agreement provided for prevailing party fee recovery in actions "arising out of the execution of the agreement or the sale"; *Exxess Electronixx v. Heger Realty Corp.* (1998) 64 CA4th 698, 708, 75 CR2d 376, 383; *see also ¶ 11:137.1 ff.*]

Thus, a broadly-worded fee clause not limited to contract actions—e.g., prevailing party shall be entitled to reasonable attorney fees and costs "in any action *arising out of this agreement*" or "in any lawsuit or legal proceeding *to which this agreement gives rise*"—provides a basis for the prevailing party's fee recovery in any suit arising from the parties' contractual relationship … whether contract *or tort* causes of action. [*Santisas v. Goodin*, supra, 17 C4th at 608, 71 CR2d at 836; *Xuereb v. Marcus & Millichap, Inc.* (1992) 3 CA4th 1338, 1342-1343, 5 CR2d 154, 157-158; see also *Khan v. Shim* (2016) 7 CA5th 49, 55, 59-62, 212 CR3d 292, 297, 300-303—contractual fee provision covering "*any litigation* or arbitration ... between the parties *concerning* [agreement's] *terms, interpretation or enforcement or the rights of any party in relation thereto*" deemed broad enough to cover seller's fees for successful defense of buyer's tort claims (emphasis in original); compare *Exxess Electronixx v. Heger Realty Corp.*, supra, 64 CA4th at 713, 75 CR2d at 386—lease providing for prevailing party fee recovery in action to "enforce the terms hereof or declare rights hereunder" *not* broad enough to cover constructive fraud and breach of fiduciary duty (*tort*) claims; *and see examples at ¶ 4:518.1 ff.*]

(1) [11:394.1] **"Prevailing party" determination, generally:** Where attorney fees are recoverable under a contract provision pursuant to CCP § 1021, courts will examine the *contract* to determine whether it defines "prevailing party" and, if so, which party meets that definition. [*Santisas v. Goodin* (1998) 17 C4th 599, 621-622, 71 CR2d 830, 845; *Exxess Electronixx v. Heger Realty Corp.* (1998) 64 CA4th 698, 708, 75 CR2d 376, 383]

Absent a contractual definition, the CCP § 1032(a)(4) rules identifying the "prevailing party" for cost recovery purposes (¶ 11:394.2 ff.) apply to attorney fees recovery pursuant to CCP § 1021 (CCP § 1033.5(a)(10)(A)). [See *Childers v. Edwards* (1996) 48 CA4th 1544, 1549, 56 CR2d 328, 331—prevailing party determination in fraud case may depend on application of CCP §§ 1021, 1032 and 1033.5; see also *Khan v. Shim* (2016) 7 CA5th 49, 59, 212 CR3d 292, 299-300—rather than overriding Civ.C. § 1717 (¶ 11:393), CCP § 1032 works in tandem with it by providing fees for non-contract claims where agreement "is broadly phrased enough to cover those claims"]

(a) [11:394.2] **Nondiscretionary determination:** The categories of parties who *automatically* have "prevailing party" status under CCP § 1032(a)(4) (and thus for purposes of a CCP § 1021 attorney fees recovery) include the party with a "net monetary recovery," a defendant who obtains a dismissal, a defendant in a case where neither plaintiff nor defendant obtains any relief, and a defendant against whom no relief is obtained. [CCP § 1032(a)(4); *Goodman v. Lozano* (2010) 47 C4th 1327, 1333, 104 CR3d 219, 223; see also *Khan v. Shim* (2016) 7 CA5th 49, 57, 212 CR3d 292, 298 (noting § 1032(a)(4)'s "prevailing party" definition may include defendant in whose favor *voluntary pretrial* dismissal is entered); *Zintel Holdings, LLC v. McLean* (2012) 209 CA4th 431, 441, 147 CR3d 157, 165—party who fits any of § 1032(a)

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(4)'s "prevailing" definitions is entitled to recover costs as matter of right; *Childers v. Edwards* (1996) 48 CA4th 1544, 1551, 56 CR2d 328, 332—where plaintiff prevailed only on liability portion of fraud claim, but failed to prove damages, defendant was "prevailing party" entitled to § 1021 attorney fees]

1) [11:394.3] **"Net monetary recovery":** The party with the "net monetary recovery" means the party who gains money by legal process "free from all deductions." [*Goodman v. Lozano* (2010) 47 C4th 1327, 1334, 104 CR3d 219, 224; see also *Andrade v. Western Riverside Council of Governments* (2024) 99 CA5th 1020, 1029-1030, 318 CR3d 396, 403-404 (distinguishing between CCP § 1032 fees available to party who received net monetary recovery (i.e., "prevailing party") and party who recovered greater relief in contract action (i.e., party "prevailing on the contract," ¶ 11:137); *Maynard v. BTI Group, Inc.* (2013) 216 CA4th 984, 994, 157 CR3d 148, 155—business owner deemed prevailing party since she obtained net recovery, "albeit under a negligence rather than a breach of contract cause of action" (¶ 11:137.1); *Vons Cos., Inc. v. Lyle Parks, Jr., Inc.* (2009) 177 CA4th 823, 825-831, 99 CR3d 562, 563-568—plaintiff who prevailed on claims assigned to it by original plaintiff in settlement of other claims obtained "net monetary recovery" of $35,556, entitling plaintiff to recover "reasonably necessary" costs incurred in connection with said claims]

a) [11:394.4] **Voluntary dismissal in exchange for monetary settlement:** A plaintiff who voluntarily dismisses an action after entering into a monetary settlement is a prevailing party for purposes of CCP § 1032(a)(4): "When a defendant pays money to a plaintiff in order to settle a case, the plaintiff obtains a net monetary recovery, and a dismissal pursuant to such a settlement is not a dismissal in the defendant's favor." [*deSaulles v. Community Hosp. of Monterey Peninsula* (2016) 62 C4th 1140, 1144, 1158, 202 CR3d 429, 431, 432 (internal quotes and brackets omitted)—although monetary settlements resemble private contracts, they also result in judgments that conclusively resolve parties' issues and therefore fit definition of "monetary recovery"—i.e., "to gain by legal process"]

b) [11:394.5] **Compare—damages awards offset by prior settlement with other parties:** A plaintiff whose damages award is offset to zero by a prior settlement with codefendants (see CCP § 877) does *not categorically* qualify as a prevailing party as a matter of law (i.e., "the party with a net monetary recovery"). Unless a party fits into one of the other CCP § 1032(a)(4) prevailing party categories (¶ 11:394.2), courts have *discretion* in determining "prevailing party" status (¶ 11:394.6). [See *Goodman v. Lozano* (2010) 47 C4th 1327, 1338, 104 CR3d 219, 228, fn. 4 (disapproving prior contrary authority)—plaintiff who settled with one co-tortfeasor and went to trial against another but obtained no additional recovery because damages awarded were less than settlement setoff amount was not "prevailing party" as matter of law]

(b) [11:394.6] **Discretionary determination:** When a party recovers *nonmonetary* relief, and in situations *other than* those described in ¶ 11:394.2, the court has *discretion* to determine the "prevailing party" and to allow, deny or apportion costs between the parties. [CCP § 1032(a)(4); *Goodman v. Lozano* (2010) 47 C4th 1327, 1338, 104 CR3d 219, 228, fn. 4; *see also ¶ 11:139.3 ff.* (similar rule for Civ.C. § 1717 contractual prevailing party fee recovery)]

1) [11:394.7] **Factors considered, generally:** Some of the significant factors considered by the court in exercising its discretion are the *necessity* for the claimed fees*, fairness,* and whether the parties *achieved their principal litigation objectives.* [See *Villa De Las Palmas Homeowner's Ass'n v. Terifaj* (2004) 33 C4th 73, 94, 14 CR3d 67, 81; *Slavin v. Fink* (1994) 25 CA4th 722, 725, 30 CR2d 750, 751; and *Fennessy v. DeLeuw-Cather Corp.* (1990) 218 CA3d 1192, 1194-1195, 267 CR 772, 773-774; *see also ¶ 11:139.16 ff.*]

2) [11:394.8] **"Unity of defense" cases:** Under CCP § 1032(a)(4) (¶ 11:394.2), in general, a defendant against whom no relief is obtained automatically qualifies as a "prevailing party" even if plaintiff recovers against another defendant. However, there is an exception: Where one of multiple, jointly represented defendants presenting a "unified defense" prevails, the court has discretion to award or deny fees to that party (the so-called "unity of defense exception"). [*Textron Fin'l Corp. v. National Union Fire Ins. Co. of Pittsburgh* (2004) 118 CA4th 1061, 1075, 13 CR3d 586, 597 (disapproved on other grounds by *Zhang v. Sup.Ct. (California Capital Ins. Co.)* (2013) 57 C4th 364, 382, 159 CR3d 672, 688); *Slavin v. Fink* (1994) 25 CA4th 722, 725-726, 30 CR2d 750, 752—exception applied where losing defendant was property owner and winning defendant was her agent; but see *Zintel Holdings, LLC v. McLean* (2012) 209 CA4th 431, 443, 147 CR3d 157, 167 (casting doubt on continued viability of exception given 1986 revision of

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cost recovery statutes)—court has "broad discretion" to *apportion* fees to extent defendant's shared counsel engaged in litigation activity on behalf of codefendant for whom fees were not recoverable]

Cross-refer: For a discussion of prevailing party attorney fee awards in *breach of contract* actions, *see ¶ 11:136 ff.*

5. [11:395] **Interest:** Prejudgment interest is potentially awardable as an item of damages in a fraud (or other tort) action under Civ.C. § 3287(a) or § 3288, *discussed at* ¶ 11:396 ff., 11:401 ff. In either case, the purpose of the interest award is to compensate plaintiff for the accrual of wealth that could have been produced during the period of the loss; it is a component of compensatory damages, awarded in order to make the defrauded plaintiff "whole." [*Cassinos v. Union Oil Co. of Calif.* (1993) 14 CA4th 1770, 1790, 18 CR2d 574, 586; *Wisper Corp. N.V. v. California Commerce Bank* (1996) 49 CA4th 948, 958, 57 CR2d 141, 147; *Newby v. Vroman* (1992) 11 CA4th 283, 289, 14 CR2d 44, 48]

a. [11:395.1] **Interest rate:** No statute specifies the rate of prejudgment interest for a fraud claim. Therefore, the constitutional rate of 7% per annum applies to that portion of plaintiff's damages awarded for fraud. [Cal.Const. Art. XV, § 1; *Michelson v. Hamada* (1994) 29 CA4th 1566, 1585, 36 CR2d 343, 352-353]

b. [11:396] **Absolute right to interest where damages readily ascertainable (Civ.C. § 3287(a)):** Plaintiffs prevailing in a tort action have an absolute right to prejudgment interest where the recoverable damages are "certain or capable of being made certain by calculation"—i.e., where *defendant* actually *knows* the amount owed or can compute that amount from reasonably available information. [*Cassinos v. Union Oil Co. of Calif.* (1993) 14 CA4th 1770, 1789, 18 CR2d 574, 585; see *Wisper Corp. N.V. v. California Commerce Bank* (1996) 49 CA4th 948, 960, 57 CR2d 141, 148; *Williams v. Graham* (1948) 83 CA2d 649, 653, 189 P2d 324, 326 (Civ.C. § 3287 interest awarded in fraud action)]

Defendant's denial of liability does not make damages uncertain for purposes of Civ.C. § 3287(a). [*Wisper Corp. N.V. v. California Commerce Bank*, supra, 49 CA4th at 958, 57 CR2d at 146; see also *Collins v. City of Los Angeles* (2012) 205 CA4th 140, 151, 139 CR3d 880, 889—legal dispute concerning defendant's liability did not render damages uncertain]

(1) [11:397] **Certainty of damages by reference to market values:** Where plaintiff's damages may be determined by reference to reasonably ascertainable market values, the damages are "capable of being made certain by calculation" within the meaning of Civ.C. § 3287(a). Civ.C. § 3287 interest is awardable in such a case even though proof is required to determine the market value of the property on a designated date. [*Cassinos v. Union Oil Co. of Calif.* (1993) 14 CA4th 1770, 1789, 18 CR2d 574, 585; *Wisper Corp. N.V. v. California Commerce Bank* (1996) 49 CA4th 948, 958, 57 CR2d 141, 147; see *Howe v. City Title Ins. Co.* (1967) 255 CA2d 85, 88, 63 CR 119, 122]

However, where the market value measure of plaintiff's damages is not readily ascertainable by the defendant, plaintiff must provide defendant with the pertinent documentation before claiming damages are sufficiently certain to trigger the right to prejudgment interest. [*Levy-Zentner Co. v. Southern Pac. Transp. Co.* (1977) 74 CA3d 762, 798, 142 CR 1, 25]

(2) [11:398] **Damages not "certain" if dependent upon proof:** In most tort actions, the exact amount of damages to which plaintiff is entitled is contested and therefore uncertain until it has been determined by the trier of fact upon the presentation of evidence. Civ.C. § 3287(a) "does not authorize prejudgment interest where the amount of damage, as opposed to the determination of liability, depends upon a judicial determination based upon conflicting evidence and is not ascertainable from truthful data supplied by the claimant to his debtor." [*Wisper Corp. N.V. v. California Commerce Bank* (1996) 49 CA4th 948, 960, 57 CR2d 141, 148 (internal quotes omitted); see also *Collins v. City of Los Angeles* (2012) 205 CA4th 140, 151, 139 CR3d 880, 889—damages are uncertain if amount depends on disputed facts *or* if available factual information is insufficient to determine amount]

Thus, Civ.C. § 3287(a) prejudgment interest is *disallowed* where the amount of damages can only be resolved by verdict or judgment (plaintiff's claim in that event is in the nature of an *unliquidated* and *uncertain* demand). [*Coughlin v. Blair* (1953) 41 C2d 587, 604, 262 P2d 305, 315; see *Wisper Corp. N.V. v. California Commerce Bank* (1996) 49 CA4th 948, 960, 57 CR2d 141, 148]

(3) [11:399] **Certainty as affected by discrepancy between damages demanded and amount of ultimate judgment:** Civ.C. § 3287(a) looks to the certainty of damages suffered by plaintiff, rather than to defendant's ultimate liability. [*Wisper Corp. N.V. v. California Commerce Bank* (1996) 49 CA4th 948, 958, 57 CR2d 141, 147]

However, the "certainty" issue may be affected by the relationship between the amount of plaintiff's damages demand and the amount of the ultimate judgment. The greater the disparity between the amount sought at the pleading stage and the damages judgment, the less likely § 3287(a) prejudgment interest is appropriate. [*Wisper Corp. N.V. v. California*

Commerce Bank (1996) 49 CA4th 948, 961, 57 CR2d 141, 148; but see *Collins v. City of Los Angeles* (2012) 205 CA4th 140, 152, 139 CR3d 880, 890 (class action complaint against city re emergency response cost billings)—large discrepancy between amount initially demanded and ultimately awarded did not indicate damages were uncertain (discrepancy resulted from resolution of legal disputes regarding city's liability rather than factual disputes arising from conflicting evidence or lack of factual information to readily calculate damages)]

• [11:399.1] Even when plaintiff puts defendant on notice of the damages and supporting data from which the damages can be ascertained, where there is a *large discrepancy* between the amount demanded in the complaint and the amount of the eventual judgment, "that fact militates against a finding of the certainty mandated by [Civ.C. § 3287(a)]." [*Wisper Corp. N.V. v. California Commerce Bank* (1996) 49 CA4th 948, 961, 57 CR2d 141, 148 (brackets in original; internal quotes omitted); see *Polster, Inc. v. Swing* (1985) 164 CA3d 427, 435, 210 CR 567, 572—more than $48,000 discrepancy between amount of demand and amount found due after trial rendered § 3287(a) inapplicable in landlord's tort action against tenant for conversion arising from return of premises in damaged condition]

• [11:399.2] *Conversely*, where there is *no significant disparity* between the amount claimed in the complaint and the amount awarded by final judgment, "this factor generally tends to show that damages were certain or capable of calculation." [*Wisper Corp. N.V. v. California Commerce Bank* (1996) 49 CA4th 948, 961, 57 CR2d 141, 148]

(4) [11:400] **Accrual of § 3287(a) interest:** Prejudgment interest under Civ.C. § 3287(a) ordinarily commences to accrue from the date of the loss. However, where the amount of the loss is not readily ascertainable until some future time, the interest accrues at the point defendant is actually put on notice of the means of calculating plaintiff's damages (e.g., date of filing of the complaint). [*Cassinos v. Union Oil Co. of Calif.* (1993) 14 CA4th 1770, 1789-1790, 18 CR2d 574, 585-586; *Stein v. Southern Calif. Edison Co.* (1992) 7 CA4th 565, 572-573, 8 CR2d 907, 911-912; *Levy-Zentner Co. v. Southern Pac. Transp. Co.* (1977) 74 CA3d 762, 801, 142 CR 1, 26—in action for damage to real property by fire, Civ.C. § 3287 interest accrued from date plaintiff supplied defendants with expert appraisals from which loss in market value could be ascertained]

c. [11:401] **Discretionary right to interest in other cases (Civ.C. § 3288):** In other tort actions, where plaintiff's damages are not liquidated or reasonably ascertainable by defendant, prejudgment interest is awardable (if at all) *only* in the *discretion of the trier of fact* (jury or judge). [Civ.C. § 3288—"in an action for the breach of an obligation not arising from contract, and in every case of oppression, fraud, or malice"; *Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1241, 44 CR2d 352, 361; see *Bullis v. Security Pac. Nat'l Bank* (1978) 21 C3d 801, 814-815, 148 CR 22, 29-30—§ 3288 interest does not require proof of both breach of noncontractual obligation and oppression, fraud or malice; and *Michelson v. Hamada* (1994) 29 CA4th 1566, 1586-1589, 36 CR2d 343, 353-355]

Section 3288 provides independent authority for awarding prejudgment interest; it is therefore immaterial that plaintiff's damages are not readily ascertainable by defendant (*Newby v. Vroman* (1992) 11 CA4th 283, 286-287, 14 CR2d 44, 46), although, in an appropriate case, interest may be awardable under *both* Civ.C. §§ 3287(a) and 3288 (see *Cassinos v. Union Oil Co. of Calif.* (1993) 14 CA4th 1770, 1790, 18 CR2d 574, 586—trespass action).

(1) [11:402] **Not a matter of right:** Since Civ.C. § 3288 interest is *discretionary* with the trier of fact (¶ 11:401), no particular fact pattern will warrant the award as a matter of right. Indeed, on appeal, reviewing courts afford great deference to the trier of fact's determination on the issue. [See, e.g., *Nordahl v. Franzalia* (1975) 48 CA3d 657, 665-667, 121 CR 794, 799-800—§ 3288 interest properly awarded in real estate fraud action; *Conger v. White* (1945) 69 CA2d 28, 40, 158 P2d 415, 422—jury had discretion to award § 3288 interest in purchaser's fraud suit against seller; compare *Pepitone v. Russo* (1976) 64 CA3d 685, 690-691, 134 CR 709, 712—no abuse of discretion in denying § 3288 interest in buyer's fraud action against real estate agent]

(2) [11:403] **Accrual of § 3288 interest:** Section 3288 prejudgment interest is calculated (at the rate of 7% per annum, ¶ *11:395.1*) on the *entire judgment* from the *date of the tortious act* proximately causing plaintiff's damages and continues to accrue until the judgment is satisfied in full. Thus, in a fraud action, the interest is awarded on plaintiff's loss "from the time the plaintiff parted with the money or property on the basis of the defendant's fraud." [*Alliance Mortgage Co. v. Rothwell* (1995) 10 C4th 1226, 1241, 44 CR2d 352, 361, quoting *Nordahl v. Department of Real Estate* (1975) 48 CA3d 657, 665, 121 CR 794, 799; see *Michelson v. Hamada* (1994) 29 CA4th 1566, 1588-1589, 36 CR2d 343, 354-355—midpoint accrual date where damage continues regularly through time of trial]

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(*Compare:* Prejudgment interest awarded in a *contract action*, where the damages are *unliquidated*, can run no earlier than the *date the action was filed*. Civ.C. § 3287(b); *see* ¶ *11:134.4, 11:193.6*.)

[11:404 - 11:409] ***Reserved.***

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Chapter 11. Remedies in Purchase and Sale Transactions

F. Reformation

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4. [11:453] Evidence and Disposition

1. [11:410] **Nature and Purpose of Reformation:** Generally, a party who agrees to a contract is bound by its provisions and cannot complain of unfamiliarity with its terms. [*Madden v. Kaiser Found. Hosps.* (1976) 17 C3d 699, 710, 131 CR 882, 889] Nevertheless, an action for "reformation" is the appropriate remedy where the contract does not accurately reflect the parties' mutual agreement; the complaint asks the court to revise (reform) the contract to make it consistent with the parties' true intentions. [Civ.C. §§ 3399-3402; see *Thrifty Payless, Inc. v. Americana at Brand, LLC* (2013) 218 CA4th 1230, 1243, 160 CR3d 718, 729 (¶ *11:440 ff.*)]

An action seeking reformation is often joined with an action for specific performance; i.e., where, through fraud or mistake, the material terms of the contract are not sufficiently "certain" to permit specific performance, the contract may be amenable to reformation to clarify the missing terms, whereupon it may then be specifically enforced. [Civ.C. § 3402]

a. [11:411] **Not a remedy to create or "rewrite" contract:** Reformation is *not* a remedy to extricate either party from a "bad deal." Upon a showing of sufficient grounds (¶ *11:425 ff.*), the court may revise the contract to conform it to the parties' original intent; but courts do *not* have the power to *create a new contract* where there is no evidence the parties reached a mutual understanding on the essential terms. [*Hess v. Ford Motor Co.* (2002) 27 C4th 516, 524, 117 CR2d 220, 226-227; *Shupe v. Nelson* (1967) 254 CA2d 693, 700, 62 CR 352, 357; and see *Jensen v. Quality Loan Service Corp.* (ED CA 2010) 702 F.Supp.2d 1183, 1197 (applying Calif. law)—court of equity may revise written instrument only insofar as revisions conform to parties' "real agreement"]

b. [11:412] **Preexisting contract essential:** Similarly, the reformation remedy does not empower a court to create an agreement for the parties out of whole cloth where they never came to a meeting of the minds. Basic to a cause of action for reformation is a showing of a "definite intention or agreement on which the minds of the parties had met [which] pre-existed [and conflicted] with the instrument in question." Absent proof the parties came to an agreement on all essential terms, there is no standard to which the contract can be reformed. [*Bailard v. Marden* (1951) 36 C2d 703, 708, 227 P2d 10, 13; *Hess v. Ford Motor Co.* (2002) 27 C4th 516, 524, 117 CR2d 220, 227—court may reform writing only "to conform with the mutual understanding of the parties at the time they entered into it, if such an understanding exists"; see *Appalachian Ins. Co. v. McDonnell Douglas Corp.* (1989) 214 CA3d 1, 21, 262 CR 716, 727—no reformation on ground of mutual mistake where proffered evidence does not establish existence of "a definite preexisting intention or agreement to which the written contract should be reformed"]

c. [11:413] **Written contracts only:** The purpose of reformation is to correct a *written* contract that does not accurately and properly reflect the parties' mutual agreement. The remedy is thus not available to revise or render enforceable a purely *oral agreement*. [*Shupe v. Nelson* (1967) 254 CA2d 693, 699-700, 62 CR 352, 357; *American Home Ins. Co. v. Travelers Indem. Co.* (1981) 122 CA3d 951, 963, 175 CR 826, 832; compare *Calhoun v. Downs* (1931) 211 C 766, 768, 297 P 548, 549—reformation will lie to supply missing terms essential to bring *written* agreement into compliance with statute of frauds]

d. [11:414] **Multiple documents:** Where reformation may properly be granted as to the principal contract, the court may also reform all *related documents* in order to conform them to the contract that is the subject of the action. [*Shupe v. Nelson* (1967) 254 CA2d 693, 701, 62 CR 352, 358—"court of equity has the power to administer complete justice by correcting all subsequent mistakes that grew out of the first"]

e. [11:415] **BFP limitation:** Notwithstanding appropriate grounds, reformation cannot be granted to the extent it would prejudice rights acquired by third parties, in good faith and for value (BFPs). Thus, neither buyer nor seller may obtain a reformation of the purchase and sale agreement that would impinge on the rights of a third party, unless the third party took its interest with actual or constructive notice of the grounds on which the reformation is sought. [Civ.C. § 3399; compare *Lin v. Coronado* (2014) 232 CA4th 696, 705, 181 CR3d 674, 681—although *void* deeds "conceivably" may be reformed to reflect party's interest even as against BFPs, "reformation" of trustee's deed to include omitted co-grantee denied where omission was immaterial, deed was not void and co-grantee never questioned BFP's status at trial level (*discussed further at* ¶ *4:37*); *Hess v. Ford Motor Co.* (2002) 27 C4th 516, 524, 528, 117 CR2d 220, 226, 230—"reformation" of release to omit language releasing third party proper where third party had acquired no rights for value to its prejudice]

2. [11:416] **Parties to Reformation Action:** Reformation may be sought by any "party aggrieved" by the contract's failure to express the contracting parties' true intention. [Civ.C. § 3399—"on the application of a party aggrieved"]

a. [11:417] **Between contracting parties:** Clearly, a reformation action may be brought by any party to a contract against any other party to the contract. [Civ.C. § 3399]

b. [11:418] **By or against third parties:** A party to the contract may seek reformation *against* a third party whose interest in the property arises out of the contract. [Civ.C. § 3399; see *Hess v. Ford Motor Co.* (2002) 27 C4th 516, 525, 117 CR2d 220, 227—release reformed against third party to omit language releasing third party from settlement]

Reformation will also lie *in favor of a third party* who has suffered prejudice or monetary loss arising out of a mistake in a contract between other parties. [Civ.C. § 3399; *Shupe v. Nelson* (1967) 254 CA2d 693, 698, 62 CR 352, 356—deeds reformed in favor of third party to include reservation of easement; *Calhoun v. Downs* (1931) 211 C 766, 768, 297 P 548, 550—purchase agreement reformed at behest of third party beneficiary broker to include broker's name and amount of commission]

c. [11:419] **Lack of consideration limitation:** An "aggrieved" party within the meaning of Civ.C. § 3399 means one whose *pecuniary interest* is affected by the ground for reformation. Thus, a grantee who *tendered no consideration* for the transaction may not seek reformation; because the grantee has not parted with anything of value, the donee is not an "aggrieved party." [*Enos v. Stewart* (1902) 138 C 112, 115, 70 P 1005, 1006]

On the other hand, a *grantor* of gifted property may bring a reformation action even when the unilateral mistake on which the action is based was not known or induced by the grantee/donee. [*Tyler v. Larson* (1951) 106 CA2d 317, 319-320, 235 P2d 39, 41]

[11:420 - 11:424] *Reserved.*

3. [11:425] **Grounds for Reformation:** Generally, reformation lies when, through the parties' fraud or mistake, or one party's unilateral mistake which the other party at the time knew or suspected, the written contract does not truly express the parties' mutual intent. [Civ.C. § 3399; *Jones v. First American Title Ins. Co.* (2003) 107 CA4th 381, 389, 131 CR2d 859, 864—essential purpose of reformation is to reflect parties' intent]

However, because the remedy of reformation is *equitable* in nature, it is not restricted to the exact situations specified in Civ.C. § 3399. [*Jones v. First American Title Ins. Co.*, supra, 107 CA4th at 388, 131 CR2d at 864; *Schools Excess Liability Fund v. Westchester Fire Ins. Co.* (2004) 117 CA4th 1275, 1284, 12 CR3d 626, 632, fn. 12]

a. [11:426] **Mistake:** A mistake of fact is ground for reformation if (1) the mistake occurred when the contract was executed, (2) the mistake concerned a term that was essential to the contract, and (3) correction of the mistake is material to the parties' rights. [*Cottle v. Gibbon* (1962) 200 CA2d 1, 8, 19 CR 82, 86; but see also *Jones v. First American Title Ins. Co.* (2003) 107 CA4th 381, 389, 131 CR2d 859, 864—mistake is an "ingredient of reformation … not its essence"]

(1) [11:427] **Revision must be consistent with parties' original intent:** Some contracts reflect the parties' true intent based on a mistaken assumption of fact. However, reformation will *not* lie to form a new contract that is inconsistent with the parties' original agreement even if the original contract was based on a mistaken assumption of fact. [*Appalachian Ins. Co. v. McDonnell Douglas Corp.* (1989) 214 CA3d 1, 20, 262 CR 716, 726; *American Home Ins. Co. v. Travelers Indem. Co.* (1981) 122 CA3d 951, 963, 175 CR 826, 832; *see ¶ 11:411 ff.*]

(2) Unilateral mistake

(a) [11:428] **Other party's knowledge or suspicion required:** Reformation may be granted on the basis of one party's *unilateral* mistake only if that mistake was *known to or suspected by* the other party to the contract at the time the contract was entered into. [Civ.C. § 3399; *Lemoge Elec. v. County of San Mateo* (1956) 46 C2d 659, 663-664, 297 P2d 638, 641; *Cedars-Sinai Med. Ctr. v. Shewry* (2006) 137 CA4th 964, 985, 41 CR3d 48, 64]

A contract cannot be reformed on the basis of unilateral mistake where the other party neither knew of nor suspected the error at the time the contract was entered into. [Civ.C. § 3399; see *La Mancha Develop. Corp. v. Sheegog* (1978) 78 CA3d 9, 14-15, 144 CR 59, 62]

1) [11:429] **Imputed knowledge:** However, in an appropriate case, a party's knowledge of the other party's unilateral mistake may be *imputed* from the knowledge of its authorized *agent*. [*Stare v. Tate* (1971) 21 CA3d 432, 438, 98 CR 264, 267-268—knowledge imputed through party's attorney; but see also *Ward v. Yorba* (1899) 123 C 447, 450, 56

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P 58, 59-60—attorney's knowledge *not* imputed; *La Mancha Develop. Corp. v. Sheegog* (1978) 78 CA3d 9, 14-15, 144 CR 59, 62—escrow agent's knowledge *not* imputed]

(b) [11:430] **Negligent mistake:** A mistake attributable to a party's negligence might be ground for reformation *unless* it constitutes "neglect of a legal duty." [See Civ.C. § 1577—excluding from definition of "mistake of fact" any mistake resulting from neglect of legal duty; see also *Mercury Ins. Co. v. Pearson* (2008) 169 CA4th 1064, 1074, 87 CR3d 310, 318]

However, "ordinary negligence" does *not* constitute the "neglect of a legal duty" ("gross negligence"). [*Donovan v. RRL Corp.* (2001) 26 C4th 261, 283, 109 CR2d 807, 825; see also *Harris v. Rudin, Richman & Appel* (2002) 95 CA4th 1332, 1341-1342, 116 CR2d 552, 559; compare *Appalachian Ins. Co. v. McDonnell Douglas Corp.* (1989) 214 CA3d 1, 19, 262 CR 716, 726—"Since reformation is an equitable remedy, it may be denied if the mistake was the result of the want of that degree of care and diligence which would be exercised by persons of reasonable prudence under the same circumstances" (internal quotes omitted)]

1) [11:430.1] **Question of fact:** Whether a unilateral mistake is a result of "gross" rather than ordinary negligence is a fact question to be decided on the basis of the mistaken party's sophistication and the circumstances existing when the contract was entered into. [See *Architects & Contractors Estimating Service, Inc. v. Smith* (1985) 164 CA3d 1001, 1008, 211 CR 45, 48-49 (mistake of fact arising from ordinary negligence vitiated consent to contract)]

2) [11:431] **Negligent failure to read contract:** Courts are generally reluctant to grant reformation in favor of a party whose unilateral mistake resulted solely from carelessness or negligence in failing to familiarize themself with the contents of the written agreement prior to its execution. [See *Roller v. California Pac. Title Ins. Co.* (1949) 92 CA2d 149, 154, 206 P2d 694, 697-698; *Miller v. Lantz* (1937) 9 C2d 544, 548, 71 P2d 585, 587—reformation denied to party who failed to explain why he was precluded from reading or fully comprehending meaning of contract; see also *Marin Storage & Trucking, Inc. v. Benco Contracting & Engineering, Inc.* (2001) 89 CA4th 1042, 1049, 107 CR2d 645, 651—"A party cannot avoid the terms of a contract on the ground that [they] failed to read it before signing"]

On the other hand, where reformation is sought on the basis of a fraudulent misrepresentation as to the contents of the contract, plaintiff's failure to read the contract will not preclude relief so long as the reliance on the misrepresentation was justified. [*Security-First Nat'l Bank of Los Angeles v. Earp* (1942) 19 C2d 774, 779, 122 P2d 900, 901-902; see also *Van Meter v. Bent Const. Co.* (1956) 46 C2d 588, 593-595, 297 P2d 644, 647-648]

3) [11:432] **Violation of statutory duty:** The negligent violation of a statutory duty of care does not itself constitute "neglect of a legal duty" that would preclude equitable relief for a unilateral mistake. Absent evidence of "bad faith" or intentional misconduct, the violation is at most ordinary negligence. [*Donovan v. RRL Corp.* (2001) 26 C4th 261, 285-286, 109 CR2d 807, 826-827]

4) [11:433] **Breach of duty of good faith and fair dealing:** On the other hand, "neglect of a legal duty" amounting to breach of the duty of good faith and fair dealing *bars* relief from mistake. [*Donovan v. RRL Corp.* (2001) 26 C4th 261, 284, 109 CR2d 807, 826, fn. 9—auto dealer's failure to catch typographical and proofreading errors resulting in advertisement's grossly understated sales price was "good faith" mistake and thus did not preclude equitable relief]

[11:434 - 11:439] ***Reserved.***

(3) [11:440] **Mutual mistake:** Reformation also may be granted on the basis of the parties' *mutual mistake* resulting in the contract's failure to express their mutual understanding. [Civ.C. § 3399; see *Thrifty Payless, Inc. v. Americana at Brand, LLC* (2013) 218 CA4th 1230, 1243-1244, 160 CR3d 718, 729—shopping center lease subject to reformation where neither party knew common expense estimates made by lessor's agents before execution were grossly inaccurate]

(a) [11:440.1] **Parol evidence admissible:** Parol evidence is properly considered in determining whether a mutual mistake occurred—even if the parties intended the written instrument to be a complete statement of their agreement. "Extrinsic evidence is necessary because the court must divine the true intentions of the contracting parties and determine whether the written agreement accurately represents those intentions." [*Hess v. Ford Motor Co.* (2002) 27 C4th 516, 525-526, 117 CR2d 220, 227-228; see also *Thrifty Payless, Inc. v. Americana at Brand, LLC* (2013) 218 CA4th 1230, 1243-1244, 160 CR3d 718, 729—extrinsic evidence admissible to show shopping center lease did not reflect parties' "true intentions"]

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(b) [11:441] **Third party mistake:** Reformation may lie to correct a mutual mistake caused by a third party acting on a party's behalf in the transaction—e.g., a surveyor, title company or real estate broker. [*Jones v. First American Title Ins. Co.* (2003) 107 CA4th 381, 389, 131 CR2d 859, 864—trust deed beneficiary neglected to record substitution of trustee; *California Pac. Title Co., Sacramento Div. v. Moore* (1964) 229 CA2d 114, 117, 40 CR 61, 62-63—title company's description in deed included too much property; *Martinelli v. Gabriel* (1951) 103 CA2d 818, 823-824, 230 P2d 444, 447—deed reformed to correct surveyor's error in defining boundary line]

Indeed, reformation is properly granted for mutual mistake even though the aggrieved party's *lawyer* made the mistake. [*Hess v. Ford Motor Co.* (2002) 27 C4th 516, 529, 117 CR2d 220, 230; see *Renshaw v. Happy Valley Water Co.* (1952) 114 CA2d 521, 524-525, 250 P2d 612, 614; *Mills v. Schulba* (1950) 95 CA2d 559, 562, 213 P2d 408, 411—attorney acting as both parties' agent omitted description from deed]

(c) [11:442] **Mistaken legal effect:** The fact the contract contains the words the parties intended to use does not bar reformation on the ground of mutual mistake. Reformation will lie to correct the parties' mutual mistake regarding the contract's *legal effect*. [See Civ.C. § 3401, ¶ *11:453;* and *Stafford v. California Canning Peach Growers* (1938) 11 C2d 212, 217-220, 78 P2d 1150, 1152-1154 (reformation predicated on mutual mistake of law)]

“There may be no mistake as to the words used or to be used, and at the same time there may have been a mutual mistake as to some other matter of fact affecting the meaning or application of the words, and by reason thereof the contract may not truly express the real intention of both parties …” [*Appalachian Ins. Co. v. McDonnell Douglas Corp.* (1989) 214 CA3d 1, 19, 262 CR 716, 726]

(d) [11:442.1] **Ordinary negligence no bar to relief:** As in the case of unilateral mistake (¶ *11:430*), ordinary negligence does not bar equitable relief for a mutual mistake “because there is an element of carelessness in nearly every case of mistake …” [*Hess v. Ford Motor Co.* (2002) 27 C4th 516, 529, 117 CR2d 220, 230 (internal quotes and citation omitted)]

1) [11:442.2] **Compare—“gross negligence”:** On the other hand, “gross negligence” or “preposterous or irrational” conduct will preclude reformation based on mutual mistake. [*Hess v. Ford Motor Co.* (2002) 27 C4th 516, 529, 117 CR2d 220, 230]

[11:442.3 - 11:442.4] ***Reserved.***

(e) [11:442.5] **Raising mutual mistake as defense:** Mutual mistake may be raised as a defense to an action seeking to enforce a contract. The aggrieved party does not have to ask for “reformation” per se but may simply allege and prove mutual mistake in order to avoid enforcement of the erroneous terms. [*Hess v. Ford Motor Co.* (2002) 27 C4th 516, 525, 117 CR2d 220, 227]

(4) [11:443] **Explanation of mistake required:** Generally, courts will require evidence explaining how the mistake occurred—e.g., a scrivener's oversight or error; or a credible reason why the party failed to carefully review the language used before executing the contract. [*Appalachian Ins. Co. v. McDonnell Douglas Corp.* (1989) 214 CA3d 1, 21, 262 CR 716, 727]

(a) [11:444] **Heavier burden where reformation sought by drafting party:** A written contract may be reformed to correct a mistake even though the party seeking that remedy was the one who drafted the contract. But when the language in the contract is attributable to the party seeking reformation, the burden of offering an excuse as to why the mistake occurred is particularly heavy. [*Roller v. California Pac. Title Ins. Co.* (1949) 92 CA2d 149, 154, 206 P2d 694, 698; *Appalachian Ins. Co. v. McDonnell Douglas Corp.* (1989) 214 CA3d 1, 21, 262 CR 716, 727]

➪ [11:445] ***PRACTICE POINTER:*** For this reason, it is generally beneficial to include a recital in the purchase agreement stating the contract shall be deemed to have been *jointly drafted* by the parties. Such a provision might ease the burden of proof in a reformation action. (*See generally* ¶ *4:549*, regarding rule of construction against drafter.)

[11:446 - 11:449] ***Reserved.***

b. [11:450] **Fraud:** The type of “fraud” warranting reformation of a contract ordinarily occurs where one party fraudulently misrepresents to the other the *meaning* of the contract or that the *contents* of the written contract conform with the parties' intended agreement. [*National Auto. & Cas. Ins. Co. v. Industrial Acc. Comm'n* (1949) 34 C2d 20, 22-25, 206 P2d 841, 843-844 (disapproved on other grounds by *Conservatorship of O.B.* (2020) 9 C5th 989, 1010, 266 CR3d 329, 344-345); *Lane*

v. Davis (1959) 172 CA2d 302, 307-308, 342 P2d 267, 270; see also *California Trust Co. v. Cohn* (1932) 214 C 619, 626-627, 7 P2d 297, 300—reformation properly granted where failure to read contract is induced by fraud]

(1) [11:451] **Compare—fraudulent inducement:** By contrast, reformation generally is not granted to remedy *fraudulent inducement to enter into a contract*. Rather, the deceived party's remedy in such cases is to disaffirm the contract and sue for rescission (*¶ 11:460 ff.*) or to affirm the contract and sue for damages (*¶ 11:350 ff.*).

(2) [11:452] **Reformation to prevent fraud:** Because reformation is an equitable remedy, courts may exercise their equitable power to grant reformation in order to *prevent a fraud* or injustice even though there was no fraudulent misrepresentation as to the contents or meaning of the contract. [See *MacFarlane v. Peters* (1980) 103 CA3d 627, 631-633, 163 CR 655, 656-657—although a party's acts may be legal, "where they are done with a fraudulent or oppressive intent, equity will intervene" (where purchaser at tax assessment sale acquired small parcel of tract, albeit legally, with intent to prevent use of remainder of tract and thereby force owner of balance of tract to negotiate on his terms, court properly exercised equitable power to reform treasurer's deed so as to restore lots to salable and usable state)]

[11:452.1 - 11:452.9] *Reserved.*

c. [11:452.10] **Compare—illegality not ground for reformation:** Courts do not have the power to reform an agreement to make it legal. Contracts are reformed to cure a mistake or fraud—"not for the purpose of saving an illegal contract." [*Kolani v. Gluska* (1998) 64 CA4th 402, 407-408, 75 CR2d 257, 260 (illegal noncompete agreement)]

4. [11:453] **Evidence and Disposition:** Whether there is a sufficient basis for reformation (mistake or fraud as a result of which the contract does not express the parties' true intent) is a question of fact. Notwithstanding the statute of frauds and the parol evidence rule, oral testimony and extrinsic evidence are admissible to explain the intended contents of the contract (*¶ 11:440.1*). [*Hess v. Ford Motor Co.* (2002) 27 C4th 516, 525-526, 117 CR2d 220, 227-228; *Cummins v. Levy* (1953) 116 CA2d 610, 255 P2d 29—party cannot assert written agreement does not represent parties' intent and simultaneously object to extrinsic evidence explaining intent]

In revising the contract, the court "may inquire what the instrument was intended to mean [and] what were intended to be its legal consequences." The party seeking relief bears the burden of proving the parties' true intent by *clear and convincing evidence*. [Civ.C. § 3401; *Shupe v. Nelson* (1967) 254 CA2d 693, 700, 62 CR 352, 357]

[11:454 - 11:459] *Reserved.*

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Chapter 11. Remedies in Purchase and Sale Transactions

G. Rescission

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1. [11:460] **Nature and Purpose of Rescission:** Rescission is a remedy that *disaffirms* the contract (Civ.C. § 1688 et seq.). The remedy assumes the contract was properly formed, but effectively *extinguishes* the contract ab initio as though it never came into existence; and its terms cease to be enforceable. [Civ.C. § 1688; *NMSBPCSLDHB v. County of Fresno* (2007) 152 CA4th 954, 959-960, 61 CR3d 425, 428-429; see also *Schauer v. Mandarin Gems of Calif., Inc.* (2005) 125 CA4th 949, 960, 23 CR3d 233, 241; *Viterbi v. Wasserman* (2011) 191 CA4th 927, 935, 123 CR3d 231, 236—contract between parties is prerequisite for any rescission claim]

As will be discussed, a contract can be rescinded by the parties' mutual agreement or unilaterally by a party upon proper grounds (*see ¶ 11:469 ff.*). An "action for rescission" is actually a suit to *enforce* the rescission by seeking appropriate relief (i.e., a return to the status quo) based upon rescission (*¶ 11:505 ff.*). [See generally, *Runyan v. Pacific Air Indus., Inc.* (1970) 2 C3d 304, 312-314, 85 CR 138, 144-145; see also *Viterbi v. Wasserman*, supra, 191 CA4th at 935, 123 CR3d at 236—rescission requires each party to restore to the other everything of value received under contract; *Sharabianlou v. Karp* (2010) 181 CA4th 1133, 1144-1145, 105 CR3d 300, 310—suit for rescission (i.e., to disaffirm contract's existence) seeks to extinguish contract, terminate further liability and restore parties to their former positions by requiring them to return whatever consideration they received]

a. [11:461] **Election as between inconsistent remedies:** Grounds for rescission also may support other contract remedies; but, because rescission is predicated on a disaffirmance of the contract, it is inconsistent with a damages suit for breach of contract or fraud, a reformation suit, or a specific performance suit, all of which effectively *affirm* the contract. [*Akin v. Certain Underwriters at Lloyd's London* (2006) 140 CA4th 291, 296-298, 44 CR3d 284, 287-288; *Sharabianlou v. Karp*

(2010) 181 CA4th 1133, 1144, 105 CR3d 300, 310—statute permitting relief based on rescission does not authorize claims based on affirmance of contract]

Nonetheless, absent a waiver, a plaintiff may plead and pursue alternative remedies (assuming they are based on consistent facts) and is not finally put to an election of remedies until the case has proceeded through trial and all evidence has been presented. [See Civ.C. § 1692; *Williams v. Marshall* (1951) 37 C2d 445, 455-457, 235 P2d 372, 379—complaint may seek rescissionary relief based on fraud or alternatively damages for breach of contract in event relief based on rescission is not granted; *and discussion at* ¶ *11:11 ff., 11:351 ff.*]

b. [11:462] **Compare—lack of contract formation:** A finding that there *never was a meeting of the minds* on the essential terms—i.e., that the parties *lacked contractual intent*—means that *no contract was formed*. If money has changed hands, or one party has taken possession, there may be an equitable remedy. But there is *no* remedy of rescission, "[s]ince a contract cannot be rescinded if it has never been formed." [*Hedging Concepts, Inc. v. First Alliance Mortgage Co.* (1996) 41 CA4th 1410, 1417-1418, 49 CR2d 191, 196]

c. [11:463] **Unavailable to third party beneficiaries:** Only the parties to a contract may rescind it. Pursuant to the relevant statutes (see Civ.C. §§ 1559, 1689) and "common sense," rescission is not available to third party beneficiaries (*see* ¶ *4:525*). [*Schauer v. Mandarin Gems of Calif., Inc.* (2005) 125 CA4th 949, 959-960, 23 CR3d 233, 240-241]

[11:464] ***Reserved.***

2. [11:465] **Grounds for Rescission:** A contract always may be rescinded upon mutual consent of the parties thereto. But rescission at only one party's behest requires proper notice (¶ *11:490*) on statutory grounds and, if necessary to adjust the equities, a court action to enforce the rescission. [Civ.C. §§ 1689, 1691, 1692; see also *Estate of Wong* (2012) 207 CA4th 366, 383, 143 CR3d 342, 354—courts do not rescind contracts but, rather, only afford relief based on a "party effected" rescission as governed by statute]

a. [11:466] **Rescission by consent:** Rescission of a contract may be effected by mutual consent of all parties to the contract. [Civ.C. § 1689(a); *Estate of Wong* (2012) 207 CA4th 366, 383, 143 CR3d 342, 354; *Grill v. Hunt* (1992) 6 CA4th 73, 78-79, 7 CR2d 768, 771-772]

(1) [11:467] **Written, oral or implied:** The parties' consent need not be in writing, even if the contract to be rescinded was required by the statute of frauds to be in writing. A consensual rescission may occur by the parties' *oral* agreement; or it can be *implied* from their unequivocal conduct that is inconsistent with continued existence of the contract. [*Martin v. Butter* (1949) 93 CA2d 562, 565-566, 209 P2d 636, 638; *Bush v. Vernon* (1955) 135 CA2d 33, 36-37, 286 P2d 903, 906; see *Unger v. Isaacs* (1954) 123 CA2d 533, 535, 266 P2d 869, 870—sale agreement impliedly rescinded by subsequent execution of inconsistent exchange agreement]

[11:468] ***Reserved.***

b. [11:469] **Unilateral rescission on basis of mistake, duress, fraud or undue influence:** A contract is subject to unilateral rescission by a party whose consent to the contract (or the consent of another party jointly contracting with the rescinding party) was:

• given by *mistake*; *or*

• obtained through *duress*, *fraud or undue influence* exercised by or with the connivance of the party against whom rescission is sought or any other party to the contract jointly interested with the party against whom rescission is sought. [Civ.C. § 1689(b)(1); *Donovan v. RRL Corp.* (2001) 26 C4th 261, 278, 109 CR2d 807, 821; see *Wong v. Stoler* (2015) 237 CA4th 1375, 1388-1389, 188 CR3d 674, 683-684—despite difficulty of unwinding "years-old" real estate transaction and alleged prejudice to sellers, error not to effectuate rescission and provide buyers with complete relief where sellers engaged in clear misrepresentation regarding property's sewer system and buyers satisfied all procedural requirements; *Sharabianlou v. Karp* (2010) 181 CA4th 1133, 1145, 105 CR3d 300, 310—rescission is appropriate remedy where parties are mutually mistaken as to property's condition; *Schiavon v. Arnaudo Brothers* (2000) 84 CA4th 374, 380, 100 CR2d 801, 805—deed obtained by use of undue influence may be rescinded]

Therefore, the wrongful acts of third persons who are not parties to the contract may support an action for rescission if the party against whom the rescission is sought had knowledge of the wrongdoing before parting with consideration for the contract. [*Leeper v. Beltrami* (1959) 53 C2d 195, 206, 1 CR 12, 20; see also *Jones v. Adams Fin'l Services* (1999) 71 CA4th 831, 836, 84 CR2d 151, 154-155—Lender participated in fraud where Lender was present when false statements were made to Borrower and Lender not only did nothing to correct false statements but actually helped Borrower sign loan documents; compare *Chan v. Lund* (2010) 188 CA4th 1159, 1173-1179, 116 CR3d 122, 133-139—any duress, undue influence or fraud purportedly applied to plaintiff by his attorney by, among other things, threatening to withdraw if plaintiff did not settle, was legally insufficient for purposes of rescinding settlement agreement (attorney was not a party to settlement or "jointly interested" with any contracting party, and defendants did not "connive" with him in allegedly exerting pressure on plaintiff)]

Under the court's broad equitable power, rescission also may lie against a contracting party who was *entirely innocent* of any wrongdoing but simply a "conduit" through whom a *third party's* fraud was perpetrated. *See* *¶ 11:474.1 ff.*

(1) [11:470] **Not affected by conflicting contractual provisions:** The parties may contract to provide for either's unilateral right of rescission. Conversely, however, a contractual prohibition against rescission does not defeat the statutory right of rescission for fraud, mistake or failure of consideration. [Civ.C. § 1690; see *Santa Clara Properties Co. v. R.L.C., Inc.* (1963) 217 CA2d 840, 852-857, 32 CR 333, 340-344]

(a) [11:470.1] **Compare—statutory preemption of remedy for tax-defaulted property purchasers:** Rescission and other common law contract remedies are *not available* to buyers of tax-defaulted real property at public auction (Rev. & Tax.C. § 3691 et seq.; see *¶ 4:351.1 ff.*). The buyer's exclusive remedies are prescribed by statute: a *refund* of purchase money paid and *only* where the court determines the tax deed is void (Rev. & Tax.C. § 3729) or the property "should not have been sold" (Rev. & Tax.C. § 3731). [See *Ribeiro v. County of El Dorado* (2011) 195 CA4th 354, 356-357, 125 CR3d 577, 578-579—investor who mistakenly bought real estate from public entity at tax sale without knowing bond arrearage amount was limited to statutory remedies and not entitled to rescind; *L&B Real Estate v. Housing Auth. of County of Los Angeles* (2007) 149 CA4th 950, 959, 57 CR3d 298, 304—§ 3729 refund sole remedy available to purchaser of public property mistakenly conveyed for nonpayment of taxes (tax deed was void because public property is exempt from taxation); *Van Petten v. County of San Diego* (1995) 38 CA4th 43, 50-51, 44 CR2d 816, 821—buyer who purchased in reliance on grossly overinflated assessed value had neither a rescission nor breach of contract remedy]

1) [11:470.1a] **Contra authority:** One earlier case holds otherwise—i.e., the contractual remedy of rescission is available in connection with the purchase of tax-defaulted property because the Revenue & Taxation Code does not state its remedies are exclusive. [See *Schultz v. County of Contra Costa* (1984) 157 CA3d 242, 247, 203 CR 760, 763]

Schultz, supra, however, has been criticized and probably was not decided correctly; *see* *¶ 4:351.1a*.

2) [11:470.2] **Statute of limitations:** An action challenging the validity or regularity of any tax sale proceeding must be commenced within one year after the sale. [Rev. & Tax.C. § 3725; *Quelimane Co., Inc. v. Stewart Title Guar. Co.* (1998) 19 C4th 26, 40, 77 CR2d 709, 716; but see *Mayer v. L&B Real Estate* (2008) 43 C4th 1231, 1233-1234, 78 CR3d 62, 63—limitations period did not commence until property owners in "undisturbed possession" received *actual notice* that portion of property was sold more than one year earlier (owners had no reason to suspect portion was erroneously assessed separately and that tax bills in connection therewith were sent to previous owner); *and* *¶ 11:531.6 ff.*]

Likewise, a *defense* based on the alleged invalidity or irregularity of a tax sale proceeding is maintainable only in a proceeding commenced within one year after execution of the tax deed. [Rev. & Tax.C. § 3726; *Quelimane Co., Inc. v. Stewart Title Guar. Co.*, supra, 19 C4th at 40, 77 CR2d at 716]

a) [11:470.3] **Exception—jurisdictionally defective tax deed:** The limitations period for raising the invalidity of a tax deed does *not apply* when the claimed invalidity is a *jurisdictional defect* in the tax sale proceeding (e.g., the property was exempt from taxation). A jurisdictionally defective tax deed is *void*. [*L&B Real Estate v. Housing Auth. of County of Los Angeles* (2007) 149 CA4th 950, 959, 57 CR3d 298, 304; *see also* *¶ 4:37.7*]

(2) [11:471] **Consent mistakenly given:** Rescission may be granted in favor of a party whose consent to the contract was given under a material "mistake of fact" or "mistake of law." [Civ.C. § 1576; *Harris v. Rudin, Richman & Appel* (2002) 95

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CA4th 1332, 1339, 116 CR2d 552, 557; *Hedging Concepts, Inc. v. First Alliance Mortgage Co.* (1996) 41 CA4th 1410, 1421, 49 CR2d 191, 198]

(a) [11:471.1] **Mistake of fact:** A party gives consent under a "mistake of fact" when, not because of the party's "neglect of a legal duty" (*see ¶ 11:430*), the party (i) is ignorant of or has forgotten a past or present fact material to the contract, or (ii) believes in the present existence of something material to the contract, that does not exist, or in the past existence of something that never existed. [Civ.C. § 1577; *Donovan v. RRL Corp.* (2001) 26 C4th 261, 278, 109 CR2d 807, 821; *Grenall v. United of Omaha Life Ins. Co.* (2008) 165 CA4th 188, 193, 80 CR3d 609, 612 & fn. 4; see also *Paramount Petroleum Corp. v. Sup.Ct.* (*Building Materials Corp. of America*) (2014) 227 CA4th 226, 245, 173 CR3d 518, 534—Civ.C. § 1577 refers to mistakes as to present or past facts, *not* mistakes regarding *future* events]

In effect, this type of mistake relates to an erroneous belief about an *objective* existing or nonexisting fact material to the contract. [*Hedging Concepts, Inc. v. First Alliance Mortgage Co.* (1996) 41 CA4th 1410, 1421, 49 CR2d 191, 198; see *Crocker-Anglo Nat'l Bank v. Kuchman* (1964) 224 CA2d 490, 496, 36 CR 806, 809—mistake of fact occurs "when a person understands the facts to be other than they are"; *Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 409, 98 CR2d 176, 181—purchaser sufficiently alleged rescission cause of action against seller for failing to disclose details of construction defect litigation; compare *Paramount Petroleum Corp. v. Sup.Ct. (Building Materials Corp. of America)*, supra, 227 CA4th at 246, 173 CR3d at 535—asphalt supplier's mistake in believing price of particular oil used as benchmark would continue to track price of oil actually used by shingle manufacturer constituted error in judgment rather than mistake of fact]

1) [11:471.2] **Rescission based on unilateral mistake of fact—unconscionability requirement:** Rescission for a unilateral mistake of fact is authorized where "the effect of the mistake is such that enforcement of the contract would be *unconscionable*." In such cases, it need not be shown that the opposing (nonrescinding) party caused or even knew of the mistake (*but see ¶ 11:471.15*). [*Donovan v. RRL Corp.* (2002) 26 C4th 261, 281-282, 109 CR2d 807, 823-824 (emphasis added) (adopting rule as Calif. law and rejecting contrary cases); see Rest.2d Contracts § 153(a)]

a) [11:471.3] **Substantive unconscionability generally determinative:** In determining whether rescission is warranted for a unilateral mistake of fact, *substantive* rather than procedural unconscionability is often the determinative factor, "because the oppression and surprise ordinarily results from the mistake—not from inequality in bargaining power" (*see ¶ 11:36.1*). [*Donovan v. RRL Corp.* (2001) 26 C4th 261, 292, 109 CR2d 807, 832—even though defendant's unilateral mistake did not result from unequal bargaining power (procedural unconscionability), enforcing contract would yield overly harsh and one-sided result (substantive unconscionability), thereby entitling defendant to rescission]

[11:471.4] ***Reserved.***

2) [11:471.5] **Limitation—no rescission in favor of party who bears risk of mistake:** Rescission is unavailable to a contracting party who bears the risk of the mistake at issue.

A party bears the risk of a mistake when (i) the contract allocates the risk to the party; or (ii) the party is aware when the contract is made that the party has only limited knowledge regarding facts to which the mistake relates but treats that limited knowledge as sufficient; or (iii) it is reasonable under the circumstances to allocate the risk to the party. [*Donovan v. RRL Corp.* (2001) 26 C4th 261, 283, 109 CR2d 807, 825; Rest.2d Contracts § 154; see also *Grenall v. United of Omaha Life Ins. Co.* (2008) 165 CA4th 188, 192-193, 80 CR3d 609, 612-613—rescission unavailable where reasonable to allocate risk of mistake "as matter of law" to decedent annuitant who was unaware she had terminal cancer at time of contract (noting decedent had limited knowledge of her health but treated that knowledge as sufficient)]

• [11:471.6] For instance, a beneficiary is deemed to assume the risk of an inadequate price at a foreclosure sale. "Unless beneficiaries assume the risk of such errors, a low opening bid at a foreclosure sale will invariably trigger suspicion about the sale's finality, deterring buyers and impairing the efficacy of foreclosure sales." [*6 Angels, Inc. v. Stuart-Wright Mortg., Inc.* (2001) 85 CA4th 1279, 1287-1288, 102 CR2d 711, 716-717—loan servicer who conveyed wrong amount to be bid by trustee at foreclosure sale ($10,000 instead of $100,000) could not set aside sale to third party]

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• [11:471.7] Similarly, it is "reasonable and equitable" to allocate the risk of a mistake to a party who assumed the risk of the mistake as an "element of the bargain." [*Stermer v. Board of Dental Examiners* (2002) 95 CA4th 128, 134, 115 CR2d 294, 298]

a) [11:471.8] **Allocation of risk of mistake required for "neglect of legal duty":** The risk of a mistake of fact *must* be allocated to a party where the mistake results from that party's "neglect of a legal duty" (*see* ¶ *11:430*). [*Donovan v. RRL Corp.* (2001) 26 C4th 261, 283, 109 CR2d 807, 825]

[11:471.9 - 11:471.14] ***Reserved.***

3) [11:471.15] **Rescission where unilateral mistake of fact *unknown to nonrescinding party:*** As noted, rescission on the basis of a unilateral mistake of fact is not barred by the fact the other party was unaware of the mistake (¶ *11:471.2*). However, where the nonrescinding party had no reason to know of and did not cause the other party's unilateral mistake of fact, the following must be established to obtain rescission:

• the mistake concerns a basic assumption upon which the contract was made;

• the mistake has a material effect on the agreed exchange of performances under the contract that is adverse to the rescinding party;

• the rescinding party does not bear the risk of the mistake (¶ *11:471.5*); *and*

• the effect of the mistake is such that enforcement of the contract would be unconscionable (¶ *11:471.2*). [*Donovan v. RRL Corp.* (2001) 26 C4th 261, 282, 109 CR2d 807, 824—defendant established all requirements for rescission based on unilateral mistake of law where plaintiff attempted to purchase used car from defendant auto dealer at advertised price significantly lower than intended sale price due to newspaper's typographical and proofreading errors; compare *Grenall v. United of Omaha Life Ins. Co.* (2008) 165 CA4th 188, 193, 80 CR3d 609, 612-613—rescission barred where defendant did not cause or have reason to know of mistake and rescinding party bore risk as matter of law (¶ *11:471.5*)]

[11:471.16 - 11:471.19] ***Reserved.***

(b) [11:471.20] **Mistake of law:** A mistake of law occurs when a party to the contract knows the facts as they actually are but has a mistaken belief as to the *legal consequences of those facts.* [*Hedging Concepts, Inc. v. First Alliance Mortgage Co.* (1996) 41 CA4th 1410, 1421, 49 CR2d 191, 198, fn. 9]

A mistake of law exists only when (i) all parties think they know and understand the law but all are mistaken in the same way, or (ii) one side misunderstands the law at the time of contracting and the other side knows the correct law but does not rectify the other party's misunderstanding. [Civ.C. § 1578; *Harris v. Rudin, Richman & Appel* (2002) 95 CA4th 1332, 1339, 116 CR2d 552, 557—defendants entitled to trial on rescission defense where *both* sides unaware of amendment to relevant law affecting basis of agreement when made; *Hedging Concepts, Inc. v. First Alliance Mortgage Co.*, supra, 41 CA4th at 1421, 49 CR2d at 198—no mutual mistake of law because parties understood contract in *different* ways, and no cognizable unilateral mistake because no evidence either party knew the other misunderstood the deal and yet failed to rectify the matter; and *Donovan v. RRL Corp.* (2001) 26 C4th 261, 279, 109 CR2d 807, 822—rescinding party's lack of knowledge regarding typographical error in advertised sale price of car not mistake of law]

1) [11:471.21] **Subjective misunderstanding of contract not enough:** The fact that one of the parties subjectively misunderstood their contractual duties or other contractual terms, or that both parties had differing subjective understandings of the contract from its inception, does not warrant rescission based on mistake of law. [*Hedging Concepts, Inc. v. First Alliance Mortgage Co.* (1996) 41 CA4th 1410, 1421, 49 CR2d 191, 198-199—rescission based on mistaken undisclosed subjective interpretation would conflict with objective theory of enforceable contracts]

2) [11:471.22] **"Neglect of legal duty" no bar to relief:** Unlike cases where a party's "neglect of a legal duty" precludes rescission or reformation based on a mistake of fact (¶ *11:430*), "freedom from negligence" is *not a prerequisite to* rescission based on a mistake of law. This is because Civ.C. § 1578 makes no reference to

"negligence." [*Harris v. Rudin, Richman & Appel* (2002) 95 CA4th 1332, 1341, 116 CR2d 552, 559—attorneys' purported negligence in failing to track proposed amendment to statute going to heart of malpractice action and subsequent settlement not relevant where attorneys sought rescission of settlement based on mistake of law]

(3) [11:472] **Consent obtained through duress or undue influence:** Courts consider a variety of factors in determining whether the rescinding party's consent was procured through duress or undue influence, including:

• the adequacy of the consideration involved;

• whether the rescinding party acted with a free mind;

• whether the contract was negotiated at arm's length; and

• whether the parties to the contract were in a confidential relationship. [*Mills v. Kopf* (1963) 216 CA2d 780, 786, 31 CR 80, 84 (no undue influence); *Kloehn v. Prendiville* (1957) 154 CA2d 156, 161, 316 P2d 17, 22 (undue influence established)]

(4) [11:473] **Consent obtained through fraud:** The type of "fraud" sufficient to support a unilateral rescission may be either an "actual fraud" (misrepresentation with intent to deceive) or a "constructive fraud" (misleading conduct without fraudulent intent to the prejudice of the other party). A presumption of constructive fraud may arise where there is inadequate consideration for the rescinding party's performance and especially where the parties are in a confidential relationship. [See Civ.C. § 1572 (defining "actual fraud"), Civ.C. § 1573 (defining "constructive fraud"); *Kloehn v. Prendiville* (1957) 154 CA2d 156, 161, 316 P2d 17, 22; *Younis v. Hart* (1943) 59 CA2d 99, 138 P2d 323, 325-326 (rescission based on seller's fraudulent misrepresentation as to area of tract)]

(a) [11:473.1] **Distinguishing fraud in the inception/execution from fraud in the inducement:** If fraud goes to the execution or inception of a contract so that parties do not know what they are signing, the contract lacks mutual assent and is void. Thus, the contract may be disregarded without the necessity of rescission. [*Village Northridge Homeowners Ass'n v. State Farm Fire & Cas. Co.* (2011) 50 C4th 913, 921, 114 CR3d 280, 285]

In the usual case, however, where parties know what they are signing but their consent is induced by fraud, mutual assent is present and a contract is formed that, by reason of the fraud, is voidable. Under these circumstances, a party seeking to void the contract must rescind. [*Village Northridge Homeowners Ass'n v. State Farm Fire & Cas. Co.*, supra]

(b) [11:474] **Innocent misrepresentation:** Even an innocent misrepresentation, made in good faith and with a reasonable belief in its truth, may provide a basis for rescission if it related to a material fact upon which the rescinding party relied in consenting to the contract. [*Wood v. Kalbaugh* (1974) 39 CA3d 926, 930, 114 CR 673, 676; see *Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 410, 98 CR2d 176, 182 (defining "material" as fact that would measurably affect property value)]

Although neither a specifically-enumerated ground for rescission nor the equivalent of "fraud," innocent misrepresentation supports rescission as a type of "mistake" (*¶ 11:471 ff.*). [*Crocker-Anglo Nat'l Bank v. Kuchman* (1964) 224 CA2d 490, 495-497, 36 CR 806, 809-810; see also *Thrifty Payless, Inc. v. Americana at Brand, LLC* (2013) 218 CA4th 1230, 1243-1244, 160 CR3d 718, 729—while no tort liability exists for "innocent misrepresentation," a shopping center lease was subject to rescission where neither party knew common expense estimates made by lessor's agents before execution were grossly inaccurate]

1) [11:474.1] **Rescission against innocent "conduit":** Being in the nature of an equitable remedy, rescission may lie in an appropriate case against a contracting party who was simply the *conduit* through whom a *third party's* fraud was perpetrated upon the plaintiff. Although entirely innocent of any wrongdoing, the "conduit" is a "necessary party" to the action "because, in its absence, complete relief in the form of rescission cannot be accorded to plaintiff …" [*Shapiro v. Sutherland* (1998) 64 CA4th 1534, 1551-1552, 76 CR2d 101, 112]

• [11:474.2] This was the case in *Shapiro*, supra, where Buyer purchased a home from an intermediary relocation assistance service to whom Sellers (who had accepted an out-of-state job transfer) sold their home *knowing* it would immediately be resold to another. Sellers had represented to the relocation service that there were no noise problems in the neighborhood (when in fact there were serious noise disturbances from the next-door neighbors) and the relocation service innocently passed this representation onto Buyer.

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Buyer's right of rescission could not lie against Sellers, who had perpetrated the fraud, because Buyer's contract of purchase and sale was with the relocation service to whom Buyer had paid the purchase price and thus from whom Buyer had to seek return of that consideration. “Although there was no evidence that [relocation service] made any misrepresentations to plaintiff, nonetheless, because of the nature of this particular transaction by which the property was transferred, [relocation service] must remain a party to the action because, in its absence, complete relief in the form of rescission cannot be accorded to plaintiff in the event plaintiff can prove a case for rescission.” [*Shapiro v. Sutherland* (1998) 64 CA4th 1534, 1551-1552, 76 CR2d 101, 112—relocation service a “necessary party to the action to the extent that plaintiff seeks the equitable remedy of rescission of the contract of sale”]

2) [11:474.3] **Compare—opinions re property value *not actionable:*** Opinions concerning how the legal or practical ramifications of disclosed facts might adversely impact the value of property are not actionable “facts.” [*Assilzadeh v. California Fed'l Bank, FSB* (2000) 82 CA4th 399, 411-412, 98 CR2d 176, 183-184; see *Neu-Visions Sports, Inc. v. Soren/McAdam/Bartells* (2000) 86 CA4th 303, 310, 103 CR2d 159, 163—“value is quintessentially a matter of opinion, not a statement of fact”]

[11:474.4] *Reserved.*

(c) [11:474.5] **Damages not part of prima facie case:** Whereas proof of damages is an essential prerequisite to a fraud cause of action seeking damages (¶ *11:357.1*), a defrauded party has the right to *rescind* a contract even without a showing of pecuniary damages. “The rule derives from the basic principle that a contracting party has a right to what it contracted for, and so has the right to rescind where he obtain[ed] something substantially different from that which he [is] led to expect.” [*Engalla v. Permanente Med. Group, Inc.* (1997) 15 C4th 951, 979, 64 CR2d 843, 861 (brackets in original; internal quotes omitted)]

(d) [11:475] **Partial rescission based on fraud:** Since the goal of rescission is to restore the parties to the precontract status quo, courts ordinarily will not grant relief based upon rescission where the rescinding party is unable to restore substantially all of the consideration the party received under the contract—i.e., unless the contract is divisible because supported by severable consideration, it cannot be “partially rescinded.” [*Simmons v. California Institute of Technology* (1949) 34 C2d 264, 275, 209 P2d 581, 587-588—partial rescission not permitted because “retention of only the benefits of the transaction amounts to unjust enrichment and binds the parties to a contract which they did not contemplate”; *Persson v. Smart Inventions, Inc.* (2005) 125 CA4th 1141, 1154, 23 CR3d 335, 344-345; *and see* ¶ *11:500 ff.*]

However, this rule may be relaxed in cases of fraud. Here, even though the contract is not severable and the innocent party cannot restore the identical consideration, courts may grant a partial rescission that nonetheless produces an equitable result. [See *Farina v. Bevilacqua* (1961) 192 CA2d 681, 684-685, 13 CR 791, 793]

• [11:476] Buyers acquired a 20-foot strip bordering Seller's land on the representation they wanted to dedicate the strip to County for use as a road. In fact, Buyers conveyed only an 18-foot strip to County and retained the balance, which separated Seller's land from the road, for the purpose of cutting off Seller's access. Though Buyer's irrevocable conveyance to County precluded their restoration to Seller of the entire 20-foot parcel, partial rescission restoring the two-foot parcel to Seller and returning a pro rata share of the purchase price to Buyers was properly granted. [*Farina v. Bevilacqua* (1961) 192 CA2d 681, 684-685, 13 CR 791, 793]

“Where a defendant has been guilty of fraud, courts of equity are not so much concerned with decreeing that defendant receive back the identical property with which he parted … as they are in declaring that his nefarious practices shall result in no damage to the plaintiff.” [*Farina v. Bevilacqua*, supra, 192 CA2d at 685, 13 CR at 793 (internal quotes omitted)]

c. [11:477] **Unilateral rescission on basis of failure of consideration:** A unilateral rescission can be based on a failure of consideration in three situations (Civ.C. § 1689(b)(2), (3) & (4)):

• Where the consideration for the rescinding party's obligation *fails*, in *whole or in part*, through the *fault of the other party* to the contract (Civ.C. § 1689(b)(2));

• Where the consideration for the rescinding party's obligation becomes entirely *void from any cause* (Civ.C. § 1689(b)(3)); or

• Where the consideration for the rescinding party's obligation *fails* in a *material respect* from *any cause before it is rendered* (Civ.C. § 1689(b)(4)). [See, e.g., *Sun Garden Packing Co. v. Narducci* (1959) 170 CA2d 763, 769, 339 P2d 562, 565-566]

[11:478 - 11:479] ***Reserved.***

d. Other grounds for unilateral rescission

(1) [11:480] **Illegality:** A contract is subject to unilateral rescission if it is unlawful "for causes which do not appear in its terms and conditions" and "the parties are not equally at fault." [Civ.C. § 1689(b)(5); see *Yuba Cypress Housing Partners, Ltd. v. Smith* (2002) 98 CA4th 1077, 1081, 120 CR2d 273, 276—plaintiff rescinded real estate contract with defendant developer on ground of illegality after discovering defendant violated Subdivided Lands Act; see also *Lund v. Cooper* (1958) 159 CA2d 349, 351-352, 324 P2d 62, 64-65—purchase agreement calling for sellers to complete construction of incomplete dwelling on property was rescindable by buyer on ground of illegality because sellers were not licensed contractors as required by law]

(2) [11:481] **Public interest:** A party may also rescind a contract where its enforcement would be prejudicial to the public interest. [Civ.C. § 1689(b)(6)—"[i]f the public interest will be prejudiced by permitting the contract to stand"]

(3) [11:482] **Statutory grounds applicable to particular contracts:** Civ.C. § 1689 incorporates by reference several other statutes providing a basis for rescission in particular contractual relationships, and also includes a "catch-all" provision recognizing a party's right to rescind under "any other statute providing for rescission." [See Civ.C. § 1689(b)(7)] Some of these other statutes specifically grant buyers the right to rescind a real property purchase contract:

• [11:482.1] Gov.C. § 66499.32 allows a buyer to rescind a real property contract that is in violation of the Subdivision Map Act at any time within one year after discovery of the violation. [See *Le Gault v. Erickson* (1999) 70 CA4th 369, 375, 82 CR2d 692, 696—only *buyer*, not junior lienholder, has option to void purchase contract; compare *Black Hills Investments, Inc. v. Albertson's, Inc.* (2007) 146 CA4th 883, 894-895, 53 CR3d 263, 271-272—contracts for purchase of 2 commercial real property parcels *not* voidable because parcels had not been subdivided when contracts executed; *Sixells, LLC v. Cannery Business Park* (2008) 170 CA4th 648, 653-654, 88 CR3d 235, 239-240—contract allowing sale of 4 undivided acres absent approval and filing of final map not voidable because contract violated Subdivision Map Act, rendering it void "at its inception"]

[11:483 - 11:489] ***Reserved.***

3. [11:490] **Prompt Notice Required to Effect Unilateral Rescission:** A party intending to effect a unilateral rescission must *give notice* to the other party *promptly upon discovering the facts* entitling the party to rescind (provided the aggrieved party is "free from duress, menace, undue influence or disability" and is aware of the right to rescind at that time). [Civ.C. § 1691(a); *Village Northridge Homeowners Ass'n v. State Farm Fire & Cas. Co.* (2011) 50 C4th 913, 921, 114 CR3d 280, 285; *Citicorp Real Estate, Inc. v. Smith* (9th Cir. 1998) 155 F3d 1097, 1103 & fn. 3 (applying Calif. law); see also *Harris v. Rudin, Richman & Appel* (2002) 95 CA4th 1332, 1340, 116 CR2d 552, 558—equities on side of defendants seeking rescission of settlement agreement who gave notice of rescission few days after discovering basis therefor]

a. [11:491] **Effect:** The notice itself *effects* the unilateral rescission. Thereafter, the rescinding party is entitled to bring an action to *obtain relief* based upon the rescission (or, viewed another way, an action to *enforce* the rescission). [See *Runyan v. Pacific Air Indus., Inc.* (1970) 2 C3d 304, 312-314, 85 CR 138, 144-145]

b. [11:492] **Service of pleading as notice:** Although technically a prerequisite to filing suit based upon rescission, if the notice has not otherwise been given, plaintiff's *service of a pleading seeking rescission* (i.e., a complaint) "shall be deemed to be" the requisite notice. [Civ.C. § 1691; *Wong v. Stoler* (2015) 237 CA4th 1375, 1385-1386, 188 CR3d 674, 681]

c. [11:493] **Waiver of relief by delay:** Despite the statutory requirement that notice of rescission be given "promptly" (¶ 11:490), delay in providing timely notice will amount to a waiver of the right to relief based on rescission *only* if the delay has *substantially prejudiced* the other party. [Civ.C. § 1693; *Williams v. Marshall* (1951) 37 C2d 445, 455, 235 P2d 372, 378-379; see also *DM Residential Fund II, LLC v. First Tennessee Bank Nat'l Ass'n* (9th Cir. 2015) 813 F3d 876, 877 (applying Calif. law)—purchaser's two-year delay in pursuing action against vendor deprived it of equitable remedy of rescission (¶ 11:495.4)]

(1) [11:494] **Question of laches:** In effect, this amounts to a laches defense: "[R]easonable diligence or promptness on the part of the party seeking rescission is [not] … a prerequisite for the remedy. The … requirement is essentially one of freedom from laches. Its application depends on whether, under the particular facts, the delay has in any way prejudiced the defendant." [*Wilke v. Coinway, Inc.* (1967) 257 CA2d 126, 140, 64 CR 845, 854]

(2) [11:495] **Justified delay:** In any event, no waiver will be found where the delay is justified under the facts—e.g., pursuit of settlement negotiations after discovery of one party's fraud, or reliance on the other party's promise to make the aggrieved party "whole." [See *Williams v. Marshall* (1951) 37 C2d 445, 455-456, 235 P2d 372, 378-379; *Potter v. Contra Costa Realty Co.* (1934) 220 C 31, 33-34, 29 P2d 189, 190; *Wilson v. Rigali & Veselich* (1934) 138 CA 760, 765-766, 33 P2d 455, 458]

(3) Application

- [11:495.1] Plaintiff's five-month delay in giving notice of rescission of settlement documents substantially prejudiced defendant law firm and thus barred plaintiff from seeking rescission. [*Saret-Cook v. Gilbert, Kelly, Crowley & Jennett* (1999) 74 CA4th 1211, 1227, 88 CR2d 732, 744]
- [11:495.2] Mortgagor's nearly two-year delay in amending its misrepresentation claim to include the additional remedy of rescission substantially prejudiced the mortgagee, thus waiving mortgagor's right to seek rescission. [*Citicorp Real Estate, Inc. v. Smith* (9th Cir. 1998) 155 F3d 1097, 1103 & fn. 4]
- [11:495.3] Buyers waived their right to seek rescissionary relief by making payments on the purchase price of a beach lot for over two years after learning of the seller's misrepresentation and before giving notice of rescission. [*McCray v. Title Ins. & Trust Co.* (1936) 12 CA2d 537, 538-542, 55 P2d 1234, 1235-1237]
- [11:495.4] Plaintiff's two-year delay in pursuing rescission after purchasing a foreclosed residential property that, among other things, lacked a utilities easement resulted in summary judgment in the seller's favor. "Instead of investigating and pursuing its claims, [plaintiff] took actions inconsistent with unwinding the contract, including encumbering the property, building improvements, and attempting to sell it. By taking those actions and waiting two years before suing [defendant], [plaintiff] affirmed the transaction, and its right to rescind it is gone." [*DM Residential Fund II, LLC v. First Tennessee Bank Nat'l Ass'n* (9th Cir. 2015) 813 F3d 876, 878 (internal quotes omitted)]

d. [11:496] **Waiver of relief by inconsistent conduct:** A party may waive the right to rescind by words or actions indicating an affirmance of the contract after learning of the facts entitling the party to rescind. [*Union Pac. R.R. Co. v. Zimmer* (1948) 87 CA2d 524, 532, 197 P2d 363, 368; see *Beason v. Griff* (1954) 127 CA2d 382, 391, 274 P2d 47, 53—waiver by signing escrow instructions and depositing deed of trust after learning of fraud]

A waiver commonly occurs by *accepting the benefits* of the contract after knowledge of the facts warranting rescission. [*Palmquist v. Palmquist* (1963) 212 CA2d 322, 331, 27 CR 744, 750] A party wishing to rescind "cannot play fast and loose. He cannot conduct himself so as to derive all possible benefit from the transaction and then claim the right to rescind … Waiver of a right to rescind will be presumed against a party who, having full knowledge of the circumstances which would warrant him in rescinding, nevertheless accepts and retains benefits accruing to him under the contract." [*Neet v. Holmes* (1944) 25 C2d 447, 457-458, 154 P2d 854, 859; see *Saret-Cook v. Gilbert, Kelly, Crowley & Jennett* (1999) 74 CA4th 1211, 1226, 88 CR2d 732, 743]

(1) [11:497] **No waiver if induced by fraud:** However, there is no such waiver if the acts indicating affirmance of the contract were induced by the other party's fraud. [*Channell v. Anthony* (1976) 58 CA3d 290, 304-305, 129 CR 704, 713]

(2) [11:498] **No waiver by accepting contractual benefits after rejection of rescission:** Continued acceptance of the benefits of the contract after giving notice of rescission does not waive the right to relief based upon rescission if the other party has rejected the notice of rescission. In such event, the rescinding party may continue to accept the benefits until the action for rescissionary relief is concluded. [*Soderling v. Tomlin* (1959) 170 CA2d 169, 173, 338 P2d 946, 948-949]

(3) [11:499] **No waiver by seeking breach of contract damages in the alternative:** Nor does a party waive the right to rescind by bringing an action based upon rescission *or* damages for breach of contract *in the alternative*. Though the remedies are inconsistent (rescission disaffirms the contract, while a damages suit affirms it), the aggrieved party is not put to a final election of remedies until after a trial upon presentation of the evidence. [See Civ.C. § 1692—"claim for damages is not inconsistent with a claim for relief based upon rescission"; *and* ¶ *11:461*]

On the other hand, a party may be deemed to have waived its right of rescission by bringing an action *exclusively* for damages or specific performance (i.e., waiver by conduct *unequivocally affirming* the contract). [*Price v. McConnell* (1960) 184 CA2d 660, 665-666, 7 CR 695, 698]

[11:499.1 - 11:499.4] ***Reserved.***

e. [11:499.5] **Revocation of notice:** A notice of rescission remains revocable up until the time that the rescinding (innocent) party receives restitution of the benefits (consideration) parted with. [*Mackenzie v. Voelker* (1954) 123 CA2d 538, 541, 266 P2d 867, 869; see also *Denevi v. LGCC* (2004) 121 CA4th 1211, 1221, 18 CR3d 276, 283]

f. [11:499.6] **Loans secured by consumer dwellings; federal truth in lending laws (TILA):** Homeowners have an *unconditional* right to rescind their home loans upon *three days' notice,* after which they may rescind only if the lender fails to satisfy TILA's disclosure requirements. This conditional right expires *three years* after the transaction is consummated or the property is sold, whichever comes first. [15 USC § 1635(a), (f); *Jesinoski v. Countrywide Home Loans, Inc.* (2015) 574 US 259, 261-262, 135 S.Ct. 790, 792; see also *U.S. Bank Nat'l Ass'n v. Naifeh* (2016) 1 CA5th 767, 780, 205 CR3d 120, 132—timely rescission notice automatically voids lender's security interest unless lender contests notice; *and further discussion at ¶ 6:99.1 ff.*]

4. [11:500] **Restoration of Benefits Received as Condition to Unilateral Rescission:** In addition to giving prompt notice of rescission, the party seeking rescissionary relief must "promptly," upon discovering the facts entitling them to rescind, *restore* to the other party "everything of value" received under the contract or *offer to restore* the benefits received "upon condition that the other party do likewise" … *unless* the other party "is unable or positively refuses to do so." [Civ.C. § 1691(b); see also *Village Northridge Homeowners Ass'n v. State Farm Fire & Cas. Co.* (2011) 50 C4th 913, 921, 114 CR3d 280, 285; *Viterbi v. Wasserman* (2011) 191 CA4th 927, 935, 123 CR3d 231, 236; *Little v. Pullman* (2013) 219 CA4th 558, 566-567, 162 CR3d 74, 81—no rescission effected where, instead of returning or offering to return benefits received ($42,500), investor merely made available for pick-up undelivered check made payable to third party money market entity and that stated it constituted "payment in full to effect the rescission"]

This restoration of benefits accomplishes the ultimate purpose of rescission—i.e., to return the parties to their precontract status quo positions. Thus, in a real property purchase and sale transaction, a rescission normally requires the buyer to return the property (title) to the seller and the seller to return the funds received from the buyer. [*Tampico v. Wood* (1963) 222 CA2d 211, 216-217, 34 CR 885, 888; and see *Sharabianlou v. Karp* (2010) 181 CA4th 1133, 1147, 105 CR3d 300, 312—statutory requirements are fully satisfied if property can be returned in substantially same condition as when received; *NMSBPCSLDHB v. County of Fresno* (2007) 152 CA4th 954, 959-960, 61 CR3d 425, 429—very definition of rescission is "to restore the parties to their former position"]

a. [11:501] **Service of pleading as offer to restore:** A formal offer to restore the contractual benefits received is not required. Plaintiff's *service of a pleading seeking rescissionary relief* (i.e., a complaint) "shall be deemed" to be the requisite offer. [Civ.C. § 1691]

b. Exceptions

(1) [11:502] **Restoration impossible:** Full or "in-kind" restoration of the benefits received is not a prerequisite to an effective rescission where, through no fault of the rescinding party, restoration would be impossible and the court can otherwise adjust the equities between the parties. [See *Farina v. Bevilacqua* (1961) 192 CA2d 681, 684-685, 13 CR 791, 793 (*discussed at ¶ 11:476*)]

(2) [11:503] **No value received:** Nor, of course, is an offer or restoration of benefits required where the rescinding party received no benefits under the contract. [*Realty Co. of America, Inc. v. Burton* (1958) 160 CA2d 178, 195, 325 P2d 171, 181-182]

(3) [11:503.1] **Other inequity:** And generally, courts may decide that an offer to restore the benefits received is not required where it otherwise would be "inequitable" (e.g., plaintiff has an offsetting counterclaim). [See *Onofrio v. Rice* (1997) 55 CA4th 413, 424, 64 CR2d 74, 80 (rescission of foreclosure sale)]

c. [11:504] **Waiver of relief by delay:** As with the notice of rescission, a delay in restoring benefits received under the contract or in tendering such restoration does *not waive* the right to relief based upon rescission *unless* the delay *substantially*

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prejudices the other party (again, the issue is essentially one of laches; *¶ 11:494*). However, the court may condition its judgment awarding relief on plaintiff's tender of restoration. [Civ.C. § 1693; see *Village Northridge Homeowners Ass'n v. State Farm Fire & Cas. Co.* (2011) 50 C4th 913, 928-929, 114 CR3d 280, 291 & fn. 6 (disapproving prior case law to extent it ignores § 1693 's express grant of authority to court to exercise discretion in delaying restoration until judgment)]

5. [11:505] **Relief Based Upon Rescission—Restitution, Consequential Damages, Etc.:** In an action based upon rescission, courts may order whatever relief is necessary to adjust the equities between the parties and ensure restoration to the precontract status quo. [Civ.C. § 1692; *Runyan v. Pacific Air Indus., Inc.* (1970) 2 C3d 304, 316, 85 CR 138, 147; see also *Wong v. Stoler* (2015) 237 CA4th 1375, 1386, 188 CR3d 674, 681—if court finds contract was rescinded, aggrieved party must be awarded *complete relief* (¶ 11:469); *Sharabianlou v. Karp* (2010) 181 CA4th 1133, 1144, 105 CR3d 300, 309—despite fact status quo cannot be exactly reproduced, rescission is intended to restore parties as nearly as possible to their former positions and bring about substantial justice by adjusting equities between them; *Shapiro v. Sutherland* (1998) 64 CA4th 1534, 1553, 76 CR2d 101, 113—"trial court has full authority under … section 1692 and … principles of equity to fashion a full and fair remedy in its judgment which takes into account and equitably addresses the respective rights and interests of *all* of the participants in [transaction giving rise to rescission remedy]" (emphasis in original)]

Unilateral rescission, however, does *not by itself* entitle a party to relief; it simply disaffirms the underlying contract. "In other words, although a party need not seek relief upon rescission if he does not want any … if he does want relief, … he must bring an action to obtain it or assert the rescission by way of defense or cross-complaint." [See *Little v. Pullman* (2013) 219 CA4th 558, 568-570, 162 CR3d 74, 82-84 (concluding motion to compel arbitration may qualify as Civ.C. § 1692 "action" for relief based upon rescission)—if to determine whether arbitration agreement exists it is necessary to determine whether rescission of that or any other agreement is justified, trial court may make both determinations in context of motion to compel arbitration]

a. [11:506] **Adjustment of equities in either party's favor:** The goal is to reach an equitable result by returning the parties to the position they were in before the contract was entered into and avoiding unjust enrichment. Therefore, such additional relief may operate in favor of either or both parties. [*Runyan v. Pacific Air Indus., Inc.* (1970) 2 C3d 304, 316, 85 CR 138, 147; *Akin v. Certain Underwriters at Lloyd's London* (2006) 140 CA4th 291, 298, 44 CR3d 284, 288; see also *Estate of Wong* (2012) 207 CA4th 366, 382-383, 143 CR3d 342, 354—rescission restores parties to their former positions by requiring each to return whatever they received as consideration under contract *or* its value if specific restoration not possible]

For example, the court may order a restitution of benefits conferred by the rescinding party and also award the rescinding party consequential damages incurred as a result of entering into the contract (so long as the award does *not include a double or inconsistent recovery*). The court may also award compensation or other equitable relief to the nonrescinding party (e.g., an offset for the value of the rescinding party's use of the property). [Civ.C. § 1692; see *Runyan v. Pacific Air Indus., Inc.*, supra, 2 C3d at 315-318, 85 CR at 146; *NMSBPCSLDHB v. County of Fresno* (2007) 152 CA4th 954, 963, 61 CR3d 425, 431—rescinding party may seek any form of relief warranted under circumstances, whether legal or equitable]

➪ [11:507] ***PRACTICE POINTER:*** In cases of *fraud* or other tortious conduct by a seller, the restitution and "consequential damages" awardable to the aggrieved buyer who elects to rescind are not the equivalent of "legal damages" that would be awardable had the buyer instead elected to affirm the contract and sue for damages. An action for relief based upon rescission simply allows the court to adjust the equities between the parties (in the nature of an accounting); depending on the facts, the equities might require the aggrieved buyer to reimburse the wrongdoing seller.

Assume, for example, the buyer had possession of the property for some period of time before the rescission. Notwithstanding the seller's fraud, if the buyer's out-of-pocket expenses (e.g., downpayment, upkeep costs, escrow and title fees, etc.) are *less than* the reasonable rental value for that period, the ultimate outcome of the buyer's rescission suit is likely to be a judgment requiring the *buyer* to reimburse the seller (amount by which rental value during buyer's occupancy exceeds buyer's expenses). In this scenario, it would make sense for the buyer to *waive* its right to rescind and instead bring a *damages suit* against the seller for fraud (*see ¶ 11:356 ff.* re recoverable damages in fraud action).

(1) [11:507.1] **Limitation—no enlargement of contract benefits:** The authority to "adjust the equities" does not empower the court to provide either party with *greater relief* than the party would have realized had the contract been affirmed. A court cannot, in the name of "adjusting the equities," *rewrite* the terms of the parties' contract. [*Hedging Concepts, Inc. v. First Alliance Mortgage Co.* (1996) 41 CA4th 1410, 1422-1423, 49 CR2d 191, 199—Civ.C. § 1692 relief could not include award of compensation subject to contractual contingency that never occurred]

b. [11:507.2] **Damages, generally:** The damages available in rescission cases depend in part on the reasons for which the contract was rescinded. For example, damages obtainable in actions for rescission based on the *nonrescinding party's fault* (e.g., cases involving fraud or misrepresentation) are more expansive than those not involving fault (e.g., illegality or mistake), and may include consequential damages (¶ *11:508*) and even punitive damages (¶ *11:510*). [See *Runyan v. Pacific Air Indus., Inc.* (1970) 2 C3d 304, 317, 85 CR 138, 147-148 & fn. 16; *Sharabianlou v. Karp* (2010) 181 CA4th 1133, 1146-1148, 105 CR3d 300, 311-312]

In cases involving the rescission of a real property purchase agreement, California courts have held that the seller must, at a minimum, refund all payments received in connection with the sale. And if the buyer has taken possession of the property, the buyer must restore possession to the seller. [See *Wong v. Stoler* (2015) 237 CA4th 1375, 1386, 188 CR3d 674, 681; *Sharabianlou v. Karp*, supra, 181 CA4th at 1145-1146, 105 CR3d at 310-311—recovery of consideration exchanged is part of restitution]

c. [11:508] **Consequential damages:** Consequential damages in the rescinding party's favor may include all out-of-pocket expenses incurred in reliance on the contract—including, e.g., real estate commissions, escrow fees, title charges, interest on specific sums paid to the other party, the value (or cost) of any improvements made to the property, payments made by a rescinding buyer on a mortgage imposed by the seller, and attorney fees (if authorized by the rescinded contract). [*Sharabianlou v. Karp* (2010) 181 CA4th 1133, 1146, 105 CR3d 300, 311; see also *Wong v. Stoler* (2015) 237 CA4th 1375, 1390, 188 CR3d 674, 684-685—consequential damages may be offset by property's reasonable rental value while rescinding parties are in possession of it; *Hastings v. Matlock* (1985) 171 CA3d 826, 841, 217 CR 856, 866-867—Civ.C. § 1717 attorney fees recoverable in action to enforce rescission of contract containing attorney fee clause so long as contract does not limit fee recovery to any particular form of action involving the contract]

(1) [11:508.1] **Not "benefit of bargain" damages:** The "consequential damages" contemplated by Civ.C. § 1692 are those that would *restore the parties to their original positions* (the purpose of rescission) and thus do not include breach of contract "benefit of bargain" damages. [*Akin v. Certain Underwriters at Lloyd's London* (2006) 140 CA4th 291, 298, 44 CR3d 284, 288; see also *Sharabianlou v. Karp* (2010) 181 CA4th 1133, 1146-1148, 105 CR3d 300, 311-312—damages award based on difference between rescinded contract's sale price and amount actually received from later sale of property (i.e., "benefit of bargain" damages) exceeded amount allowable under Civ.C. § 1692]

d. [11:509] **Interest:** A rescinding buyer is entitled to prejudgment interest on contract payments made to the seller (net of liquidated offsets awarded to the seller), running from the date of notice of the rescission. The interest is awardable under Civ.C. § 3287(a), providing for prejudgment interest as a matter of right on damages that are certain or capable of ascertainment. [*Lund v. Cooper* (1958) 159 CA2d 349, 352, 324 P2d 62, 65—money due buyers at time of rescission was capable of ascertainment by deducting from downpayment rent received during period buyers had possession; see also *Hayt v. Bentel* (1913) 164 C 680, 685-686, 130 P 432, 434—interest runs only from date of notice of rescission (rather than earlier date buyer made payments to seller) because until rescission, no money due from defendant]

On the other hand, prejudgment interest on the rescinding party's *unliquidated* consequential damages is awardable only in the trier of fact's *discretion* (Civ.C. §§ 3287(b), 3288). Otherwise, interest runs only from the *date of the judgment* (postjudgment interest), as on money judgments generally. [CCP §§ 685.010, 685.020; see *Younis v. Hart* (1943) 59 CA2d 99, 138 P2d 323, 327]

e. [11:510] **Punitive damages:** Civ.C. § 1692 expressly states that in an action to enforce a rescission, the aggrieved party "shall be awarded *complete relief*"; and it also states that a "claim for damages is *not inconsistent* with a claim for relief based upon rescission." [Civ.C. § 1692 (emphasis added)] Thus, where the rescission is based upon fraud, and provided plaintiff (rescinding party) satisfies the applicable statutory standards (Civ.C. § 3294), the court apparently has discretion to award the rescinding party punitive damages. [See *Mahon v. Berg* (1968) 267 CA2d 588, 589-590, 73 CR 356, 357-358]

f. [11:511] **Compare—counter-relief if contract not effectively rescinded:** In the event the court determines the contract was not effectively rescinded, it may grant the other party whatever relief the party may be entitled to under the circumstances. [Civ.C. § 1692]

Thus, e.g., a party who elects to rescind based on the other party's nonperformance (i.e., an alleged failure of consideration, Civ.C. § 1989(b)(1)) may in fact be liable for breach of contract damages if the court determines the other party's performance under the contract was not yet due or was not otherwise in default (i.e., there was not a failure of consideration

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warranting a unilateral rescission). [Cf. *Freedman v. Rector, Wardens & Vestrymen of St. Mathias Parish* (1951) 37 C2d 16, 18-19, 230 P2d 629, 630-631]

g. [11:512] **Jury trial right dependent on nature of relief requested:** Whether an action seeking relief based upon rescission is triable by jury depends on whether the "gist of the action" is legal or equitable. A rescission action is an action in equity and thus *not* jury triable when the recovery sought consists entirely of something *other than money paid as consideration* by plaintiff (e.g., land). [*NMSBPCSLDHB v. County of Fresno* (2007) 152 CA4th 954, 956, 61 CR3d 425, 426]

On the other hand, a rescinding plaintiff who seeks to recover money paid as consideration for the contract has a right to jury trial notwithstanding that the complaint also seeks incidental ancillary relief of an equitable nature. [See *NMSBPCSLDHB v. County of Fresno*, supra, 152 CA4th at 963-965, 61 CR3d at 432-433 (collecting cases)]

• [11:513] Plaintiff sued for rescission of a contract to sell defendant a parcel of unimproved land. The action sought monetary damages for *profits* plaintiff allegedly would have made by keeping the land, constructing an office building on it, renting out the building for 30 years, and then selling the building and land. Plaintiff did *not* seek a return of the land (the consideration paid by plaintiff) and made no effort to return the money it received for conveying the land to defendant (*see ¶ 11:500*). Thus, the relief sought was equitable and did not entitle plaintiff to a jury trial. [*NMSBPCSLDHB v. County of Fresno* (2007) 152 CA4th 954, 963-965, 61 CR3d 425, 432-433—not a jury triable "legal action" simply because plaintiff seeks a monetary recovery in place of the nonmonetary consideration paid]

[11:514 - 11:524] ***Reserved.***

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Cal. Prac. Guide Real Prop. Trans. Ch. 11-H

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Chapter 11. Remedies in Purchase and Sale Transactions

H. Other Remedies

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[11:525] The remaining sections of this Chapter overview several additional remedies available to buyers and sellers to redress the myriad of disputes that may arise in a real property purchase and sale transaction. Although they may not directly impact a buyer's or seller's rights under a purchase contract, recourse to these remedies may be necessary to effectuate the intended result of the transaction.

(*Compare:* This Practice Guide does not address the full panoply of remedies bearing on interests and rights of possession in real property generally—e.g., actions for trespass, ejectment, unlawful detainer, slander of title, partition, etc. Those actions are somewhat attenuated from issues customarily arising out of a purchase and sale transaction. For a comprehensive treatment of unlawful detainers, however, see Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Chs. 7, 8 & 9.)

1. Quiet Title Action

a. [11:526] **Nature and purpose of remedy:** A "quiet title" action (CCP § 760.010 et seq.) is maintained to establish or "quiet" title to or an interest in real property as between adverse claimants. [CCP § 760.020(a); *Deutsche Bank Nat'l Trust Co. v. McGurk* (2012) 206 CA4th 201, 210, 141 CR3d 603, 610]

The action is an appropriate remedy to establish any kind of legal or equitable rights, title, estate, lien or interest in real property as against any adverse claim or cloud on title. [CCP §§ 760.010(a) & 760.020(a); see also *Chao Fu, Inc. v. Chen* (2012) 206 CA4th 48, 58, 141 CR3d 381, 389—description of parties' legal interests in real property "is all that can be expected" of quiet title judgments]

"A quiet title action seeks to declare the rights of the parties in realty … The object of the action is to finally settle and determine, as between the parties, all conflicting claims to the property in controversy, and to decree to each such interest or estate therein as he may be entitled to." [*Western Aggregates, Inc. v. County of Yuba* (2002) 101 CA4th 278, 305, 130 CR2d 436, 456 (internal quotes omitted); *Jensen v. Quality Loan Service Corp.* (ED CA 2010) 702 F.Supp.2d 1183, 1198 (applying Calif. law); see also *Caira v. Offner* (2005) 126 CA4th 12, 24, 24 CR3d 233, 242—quiet title action "akin" to declaratory relief action]

(1) [11:527] **Other remedies not precluded:** A quiet title action is cumulative to and not exclusive of other appropriate remedies (e.g., an action to remove a cloud on title by cancellation, ¶ 11:528 ff.); it may be pursued in connection with any other remedy, form or right of action or proceeding for establishing or quieting title to property. [CCP § 760.030(a); *Jensen v. Quality Loan Service Corp.* (ED CA 2010) 702 F.Supp.2d 1183, 1198; *Yeung v. Soos* (2004) 119 CA4th 576, 580, 14 CR3d 502, 504, fn. 2; *see also* ¶ *11:375*]

However, the court may require that the quiet title statutory provisions (¶ *11:533.1 ff.*) be utilized in pursuing any such other remedies or actions. [CCP § 760.030(b); *Yeung v. Soos*, supra, 119 CA4th at 580, 14 CR3d at 504, fn. 2]

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(2) [11:528] **Compare—action to remove cloud on title:** An action to quiet title may accomplish the same objective as an action to remove a cloud on title by establishing plaintiff's interest as against adverse claimants. However, the two actions have distinct focuses and procedural requirements:

• [11:529] A *quiet title action* (CCP § 760.010 et seq.) ordinarily is aimed at a *person* asserting an adverse claim to property (see CCP § 762.010—"plaintiff shall name as defendants … the persons having adverse claims" to plaintiff's title). The action is framed simply by alleging plaintiff's ownership interest and entitlement to possession and that defendant claims an interest (any right, title, estate, lien or other interest) adverse to plaintiff without right (see CCP § 761.020 re essential allegations of complaint). [*Wolfe v. Lipsy* (1985) 163 CA3d 633, 638, 209 CR 801, 804 (disapproved on other grounds by *Droeger v. Friedman, Sloan & Ross* (1991) 54 C3d 26, 35-36, 283 CR 584, 589-590)]

• [11:530] An action to *remove a cloud on title* (Civ.C. § 3412 et seq.) is aimed at a particular *instrument* or item of evidence. The cause of action cannot be pleaded generally (simply by alleging defendant claims an adverse interest) but, rather, must allege specific facts showing the actual invalidity of the apparently valid instrument or item of evidence clouding title. [*Wolfe v. Lipsy* (1985) 163 CA3d 633, 638, 209 CR 801, 804 (disapproved on other grounds by *Droeger v. Friedman, Sloan & Ross* (1991) 54 C3d 26, 35-36, 283 CR 584, 589-590); *Robin v. Crowell* (2020) 55 CA5th 727, 740-741, 270 CR3d 25, 32-34—suit filed against second trust deed holder, who was mistakenly omitted from prior judicial foreclosure action, was not quiet title action based on mistake (action was one to remove cloud from title since plaintiffs did not seek property rights determination as "existed at … time the action was filed," but instead sought "a judgment changing the parties' interests in the property … by eliminating defendant's existing lien," *discussed further at* ¶ 11:548.1a); *Reiner v. Danial* (1989) 211 CA3d 682, 689, 259 CR 570, 573; *and discussion of "cancellation" remedy at* ¶ *11:545 ff.*]

b. [11:531] **Standing generally limited to holder of legal title:** In general, a holder of only *equitable* title to property cannot state a quiet title cause of action against the holder of *legal* title. [*Warren v. Merrill* (2006) 143 CA4th 96, 113, 49 CR3d 122, 135; see also *Chao Fu, Inc. v. Chen* (2012) 206 CA4th 48, 58, 141 CR3d 381, 389—absent an interest in property, one has no standing to ask court to quiet title (applying same rationale to actions to cancel trust deeds and other instruments purporting to transfer title); *Thompson v. Ioane* (2017) 11 CA5th 1180, 1193-1198, 218 CR3d 501, 511-515—where judicially noticeable facts showed defendant's interest depended on void judgment, she had no actual interest in subject property and therefore could not state cross-claim to quiet title (applying same rationale to defendant's causes of action for declaratory relief and cancellation of various recorded documents, including true owner's grant deed; also, summary judgment in favor of plaintiff's quiet title and declaratory relief causes of action reversed because triable issue of fact existed regarding his chain of title)]

However, one who acquires legal title through *fraud* has only "bare legal title," and is considered "constructive trustee" of the property for the benefit of the defrauded equitable title holder. Under these circumstances, the equitable title holder may pursue a quiet title action against the "legal" title holder. [*Warren v. Merrill*, supra, 143 CA4th at 113-114, 49 CR3d at 135; *see also* ¶ *11:375*]

(1) [11:531.1] **Bona fide purchasers distinguished:** A bona fide purchaser (BFP) may bring a quiet title action to determine that they obtained property free and clear of any adverse interest in the property. [See *Vasquez v. LBS Fin'l Credit Union* (2020) 52 CA5th 97, 107-108, 113-115, 265 CR3d 78, 86, 90-92—BFP owned property free and clear of judgment liens against seller due to lienholder incorrectly using seller's middle name as first name on recorded abstracts of judgment]

[11:531.2 - 11:531.4] ***Reserved.***

c. [11:531.5] **Statute of limitations:** The statute of limitations on a quiet title action is determined with reference to the underlying theory of relief. [*Muktarian v. Barmby* (1965) 63 C2d 558, 560, 47 CR 483, 485; see also *Alfaro v. Community Housing Improvement System & Planning Ass'n, Inc.* (2009) 171 CA4th 1356, 1395, 124 CR3d 271, 306—nature of right sued upon determines applicable statute of limitations, not form of action or relief demanded]

"Generally, the most likely time limits for a quiet title action are the five-year limitations period for adverse possession, the four-year limitations period for the cancellation of an instrument, or the three-year limitations period for claims based on fraud and mistake." [*Salazar v. Thomas* (2015) 236 CA4th 467, 476-477, 186 CR3d 689, 695 (fns. omitted); see *Walters v. Boosinger* (2016) 2 CA5th 421, 424, 428-433, 205 CR3d 895, 897, 900-904 & fn. 16—quiet title claim premised on void ab initio grant deed subject to "a statute of limitation" (e.g., CCP § 338(d) three-year limitations period for fraud or CCP § 343 four-year "catch-all" limitations period); see also *Crestmar Owners Ass'n v. Stapakis* (2007) 157 CA4th 1223, 1227,

69 CR3d 231, 233—cause of action based on CC&Rs (a writing) is subject to CCP § 337 four-year limitations period; *Ankoanda v. Walker-Smith* (1996) 44 CA4th 610, 615, 52 CR2d 39, 42—CCP § 338(d) three-year limitations period for quiet title action based on fraud or mistake commenced running when plaintiff discovered her cousin never intended to reconvey subject property as plaintiff allegedly was led to believe]

(1) [11:531.6] **Tolling while plaintiff in possession:** The statute of limitations is *tolled* for the period plaintiff is *in possession* of the subject property regardless of whether plaintiff knows during that period there is a *potential* adverse claimant. [*Muktarian v. Barmby* (1965) 63 C2d 558, 560-561, 47 CR 483, 485—"no statute of limitations runs against a plaintiff seeking to quiet title while he is in possession of the property"; *Kumar v. Ramsey* (2021) 71 CA5th 1110, 1122, 286 CR3d 876, 887; see also *Mayer v. L&B Real Estate* (2008) 43 C4th 1231, 1237, 78 CR3d 62, 66—general rule that statute does not run against one in possession does not apply if owner has adequate notice title was transferred for nonpayment of taxes (*¶ 11:470.2 & 11:531.9*)]

The reason for the rule is that many times one in possession does not know of dormant adverse claims by those not in possession. Moreover, there is no reason to put plaintiff "to the expense and inconvenience of litigation" until the adverse claim is pursued. [*Muktarian v. Barmby*, supra, 63 C2d at 560, 47 CR at 485; see also *Reuter v. Macal* (2020) 57 CA5th 571, 578, 271 CR3d 557, 561-562—statute of limitations tolled while plaintiff and defendant shared possession of condominium because defendant did not assert adverse claim of title against plaintiff (¶ 11:531.10); *Crestmar Owners Ass'n v. Stapakis* (2007) 157 CA4th 1223, 1228, 69 CR3d 231, 234— statute of limitations does not begin running until someone presses adverse claim against person holding property]

(a) [11:531.7] **Undisturbed possession required:** In order to toll the statute of limitations, plaintiff must have undisturbed possession of the property. [See *Mayer v. L&B Real Estate* (2008) 43 C4th 1231, 1237, 78 CR3d 62, 66]

• [11:531.8] A mistake in a deed purported to convey more land to plaintiffs than was intended. But the deed holder never took possession of the land at issue, which remained in plaintiffs' "actual" possession. The statute of limitations for plaintiffs' quiet title action, filed many years later, was tolled during the time plaintiffs were in "actual possession" of the land. [*Smith v. Matthews* (1889) 81 C 120, 121, 22 P 409]

• [11:531.9] The statute of limitations for a quiet title action following an allegedly invalid property tax sale was tolled while the landowners were in *undisturbed possession*. The statute could not begin running until the owners had *actual notice or reason to suspect* they were delinquent in paying their property taxes (i.e., when their possession was in fact "disturbed"). [*Mayer v. L&B Real Estate* (2008) 43 C4th 1231, 1233-1234, 78 CR3d 62, 63]

• [11:531.9a] It was error to impose CCP § 128.7 sanctions against plaintiff real property purchaser, who made a plausible, nonfrivolous claim that the four-year statute of limitations (CCP § 343) did not bar his 2017 quiet title action. When he took unconditional title and possession in 2008, he knew from recorded agreements that a prior owner claimed to retain "land coverage rights" to sell to third parties. However, from that time until the prior owner *actually transferred* the purported rights to a third party in 2016, the recorded documents constituted only an inchoate threat to plaintiff's superior title that did not disturb his possession. Although the parties' attorneys and the regional planning agency corresponded about the dispute between 2009 and 2013, plaintiff reasonably asserted that he did not perceive any threats to his coverage rights or title during that time. [*Kumar v. Ramsey* (2021) 71 CA5th 1110, 1123-1125, 286 CR3d 876, 888-890]

• [11:531.10] The statute of limitations did not run while plaintiff and defendant continued to live together in condominium after ending their romantic relationship. Although plaintiff executed a grant deed conveying a joint interest in his condominium to defendant and "voluntarily shared" possession with her, the statute of limitations was tolled because plaintiff remained in possession of the condominium and defendant never asserted an adverse claim of title against him. [*Reuter v. Macal* (2020) 57 CA5th 571, 573-574, 578-580, 271 CR3d 557, 558-559, 561-563]

• [11:531.11] Delivery of default notices issued under a forged and therefore void deed of trust was insufficient to commence the statute of limitations on an action to quiet title to commercial property: "On this issue of first impression, we conclude that the notices of default under a void deed of trust provided notice of a cloud on the plaintiff's title, but did not dispute or disturb the plaintiffs' possession of the property. Consequently, the statute of limitations does not bar their quiet title action." [*Salazar v. Thomas* (2015) 236 CA4th 467, 471, 479, 186 CR3d 689, 691, 697—plaintiffs remained "seised and possessed" of subject property through either their own occupancy or their tenants' occupancy]

• [11:531.12] A notice of trustee's sale posted on plaintiffs' residence did not disturb their possession sufficiently to trigger the statute of limitations on an action to quiet title to the property. This was so because (i) the sale was not definite at that point, and (ii) plaintiffs took immediate action to prevent the sale by transmitting the notice to their title insurer. Thereafter, the title insurer took charge of the matter and advised plaintiffs it was going to conduct an investigation. Moreover, the trustee's sale was indefinitely postponed, the title insurer sent plaintiffs periodic updates indicating the investigation was ongoing, plaintiffs resided on the property undisturbed for nearly four years, and during those four years plaintiffs reasonably relied on their title insurer to handle the matter. In short, once the issue was "in the hands" of plaintiffs' insurer, it was determined plaintiffs "should not be expected to independently sue to protect their title." [*Huang v. Wells Fargo Bank, N.A.* (2020) 48 CA5th 431, 439-440, 261 CR3d 798, 803-804 (finding notice did not call into question validity of plaintiffs' control/possession, only that their ownership required them to pay default amount)]

(b) [11:531.13] **Split authority—"exclusive and undisputed" possession requirement:** California courts disagree as to whether possession must be "exclusive and undisputed" to toll the statute of limitations. [See *Ankoanda v. Walker-Smith* (1996) 44 CA4th 610, 616, 52 CR2d 39, 43 (interpreting and extending *Muktarian* tolling principle)—"The 'possession' required to toll the statute of limitations must be 'exclusive and undisputed'"; compare *Reuter v. Macal* (2020) 57 CA5th 571, 579-580, 271 CR3d 557, 563 (rejecting *Ankoanda's* conclusion that *Muktarian* tolling is limited to "owners whose possession is 'exclusive and undisputed'"); see also *Crestmar Owners Ass'n v. Stapakis* (2007) 157 CA4th 1223, 1228-1230, 69 CR3d 231, 234-236 (concluding statute of limitations tolled where plaintiff "had exclusive and undisputed possession" of parking spots for approximately 25 years prior to filing suit, but finding *Ankoanda* "inapt" and its "refinement of *Muktarian*" inapplicable)]

(2) [11:531.14] **Claims based on fraud or mistake:** As noted above, a three-year statute of limitations applies to causes of action based on fraud or mistake (¶ 11:531.5). Moreover, causes of action based on fraud or mistake do not accrue until discovery (CCP § 338(d)). Thus, the three-year statute of limitations period does not begin to run until the aggrieved party "could have discovered" the mistake by exercising reasonable diligence. [*Robin v. Crowell* (2020) 55 CA5th 727, 739-740, 270 CR3d 25, 32 (internal quotes omitted); see also *Vera v. REL-BC, LLC* (2021) 66 CA5th 57, 69, 281 CR3d 54-55—inspection reports gave buyer reason to suspect sellers' misrepresentations and investigate potential defects (actual knowledge is unnecessary to trigger discovery rule)]

(3) [11:531.15] **Possible laches defense?** According to dicta in a 1965 California Supreme Court decision, even if the statute of limitations is tolled by plaintiff's continued possession, a quiet title action may be barred under the doctrine of *laches* if plaintiff's delay in bringing suit *prejudiced* the adverse claimant (defendant). [*Muktarian v. Barmby* (1965) 63 C2d 558, 561, 47 CR 483, 485; but see *Connolly v. Trabue* (2012) 204 CA4th 1154, 1167, 139 CR3d 537, 547 (declining to follow *Muktarian*)—because quiet title action is *now* considered one in law, *not* equity, laches doctrine does *not* apply, especially concerning actions to establish prescriptive easement rights]

d. [11:531.16] **Necessary/indispensable parties:** As previously noted (¶ 11:529), a plaintiff bringing a quiet title action must name as defendants all "persons having adverse claims" to the property that are of record, known to the plaintiff, or reasonably apparent from an inspection of the property (CCP §§ 762.010, 762.060(b)). Indeed, a quiet title judgment may not be entered without joining all parties who have an interest in the property. [See *Ranch at the Falls LLC v. O'Neal* (2019) 38 CA5th 155, 173, 178-180, 250 CR3d 585, 598, 602-603—individual homeowners deemed necessary/indispensable parties to quiet title action seeking access easement over private streets in gated subdivision (¶ 4:102.11)]

e. [11:532] **Jurisdiction and venue:** Actions under CCP § 760.010 et seq. must be commenced in the superior court of the county where the subject real property, or any part thereof, is located. [CCP §§ 760.040(a), 760.050(a)]

Commencement of the action vests the superior court with "complete jurisdiction" over the parties and the subject property for purposes of rendering an appropriate quiet title judgment. The court also has jurisdiction to grant "such equitable relief as may be proper under the circumstances of the case." [CCP § 760.040(b) & (c); see also *Vanderkous v. Conley* (2010) 188 CA4th 111, 119, 115 CR3d 249, 251—court's equity jurisdiction in quiet title action extends to "all issues necessary to do complete justice"]

f. [11:532.1] **Pleading requirements:** A complaint for quiet title must be verified and include all of the following:

— the subject property's description (i.e., both its legal description and street address or common designation, if any);

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— plaintiff's title as to which a determination is sought and the basis of the title;

— the adverse claims to plaintiff's title against which a determination is sought;

— the date as of which the determination is sought (if other than the date the complaint is filed, a statement of reasons why that date is sought); and

— a prayer for the determination of plaintiff's title against the adverse claims. [CCP § 761.020; see *Orcilla v. Big Sur, Inc.* (2016) 244 CA4th 982, 1010-1011, 198 CR3d 715, 738 (applying traditional rule that judgment rendered by court of competent jurisdiction is conclusive as to any issues necessarily determined therein)—quiet title suit based on irregularities in trustee's sale barred by prior unlawful detainer judgment; *West v. JPMorgan Chase Bank, N.A.* (2013) 214 CA4th 780, 802, 154 CR3d 285, 303—quiet title action premised on lenders' failure to strictly comply with statutory nonjudicial foreclosure procedures insufficiently pled because none of the defendant-lenders had adverse claims to title; *Jensen v. Quality Loan Service Corp.* (ED CA 2010) 702 F.Supp.2d 1183, 1198 (applying Calif. law)—California statutory quiet title action insufficiently pled where complaint failed to allege plaintiff's title, basis of title and adverse claims to title; compare *In re Cedano* (9th Cir. BAP 2012) 470 BR 522, 534 (applying Calif. law)—although sufficiently pled, statutory quiet title action premised on lender's alleged wrongful foreclosure through its nominee (MERS) properly dismissed (mortgage recording services, as beneficial nominees for original trust deed lenders, have authority to initiate nonjudicial foreclosure sales; ¶ 6:524a)]

In addition, plaintiff must allege payment of any debt owed on the property. [*Shimpones v. Stickney* (1934) 219 C 637, 649, 28 P2d 673, 678—mortgagor cannot quiet title against mortgagee "without paying the debt secured"; compare *Sciarratta v. U.S. Bank Nat'l Ass'n* (2016) 247 CA4th 552, 568, 202 CR3d 219, 232 (action for quiet title and cancellation of instruments)—tender unnecessary where foreclosure sale void; *Fonteno v. Wells Fargo Bank, N.A.* (2014) 228 CA4th 1358, 1360, 176 CR3d 676, 679 (quiet title action for equitable cancellation of trustee's deed)—tender unnecessary where trustee's sale void or voidable (*discussed further at ¶ 6:535.15i*)]

(1) [11:532.2] **Establishing defendant's right to equitable relief:** The defendant in a quiet title action need not file a cross-complaint seeking affirmative relief to recover compensation for any equitable interest defendant may have in the subject property. The general prayer in defendant's answer requesting "such other and further relief as the court may deem just and proper" is sufficient to provide a basis for awarding compensatory damages. In fact, within the context of a quiet title action, seeking affirmative relief by filing an answer instead of a cross-complaint is merely a "distinction without a difference." [See *Vanderkous v. Conley* (2010) 188 CA4th 111, 119, 115 CR3d 249, 256—defendant's answer vested court with equitable power to do "complete justice" by ordering plaintiff to compensate defendant in exchange for her quitclaiming her partial interest in subject property]

g. [11:533] **Mandatory lis pendens:** A quiet title action is one of the few proceedings in which a *lis pendens is mandatory:* Immediately upon commencement of the action, plaintiff "shall file" a notice of pendency of the action (CCP § 405 et seq.) in the county recorder's office for each county in which any real property described in the complaint is located. [CCP § 761.010(b); *Carr v. Rosien* (2015) 238 CA4th 845, 850, 190 CR3d 245, 248; see also *Deutsche Bank Nat'l Trust Co. v. McGurk* (2012) 206 CA4th 201, 210, 141 CR3d 603, 610 & fn. 11—although lis pendens statutes speak in terms of date of "filing" rather than "recording," they "clearly" mean date of recordation with recorder's office, *not* filing in court]

Cross-refer: The lis pendens procedure is discussed at *¶ 11:600 ff.*

h. [11:533.1] **Not jury triable:** A quiet title action has historically been characterized as *equitable* in nature (not an "action at law") and thus not triable by jury. [See CCP § 764.010—"The *court* shall examine into and determine the plaintiff's title against the claims of all the defendants …" (emphasis added); and *Caira v. Offner* (2005) 126 CA4th 12, 25-29, 24 CR3d 233, 242-245 (action to determine stock ownership); but see also *Connolly v. Trabue* (2012) 204 CA4th 1154, 1167, 139 CR3d 537, 547 (not dealing with jury trial right)—"clearly a quiet title action is now considered to be one in law, not equity"]

(1) [11:533.2] **"Possession exception":** However, the label given a lawsuit is not dispositive of the right to jury trial. Where the "gist" of a quiet title action is the *recovery of* possession (i.e., in the nature of ejectment), it is *legal* in nature and thus jury triable. [*Caira v. Offner* (2005) 126 CA4th 12, 27-28, 24 CR3d 233, 244-245; see also *Connolly v. Trabue*

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(2012) 204 CA4th 1154, 1167, 139 CR3d 537, 547—action to determine existence of prescriptive easement is one in law, *not* equity (*discussed further at ¶ 11:531.15*)]

[11:533.3] ***Reserved.***

i. [11:533.4] **Burden of proof:** In a quiet title action, plaintiff must *prove plaintiff's own title* to prevail. It is not enough simply to present evidence challenging defendant's title. [*Preciado v. Wilde* (2006) 139 CA4th 321, 326, 42 CR3d 792, 796; see also *XPO Logistics Freight, Inc. v. Hayward Property, LLC* (2022) 79 CA5th 1166, 1180, 295 CR3d 371, 381-382 (boundary dispute)—although plaintiff sufficiently proved *defendants had no valid claim* to disputed area, plaintiff could not sufficiently prove *its own title* to support judgment quieting title in plaintiff's favor]

(1) [11:533.5] **Prove-ups/judgments in default cases:** Courts disagree whether default judgments are permissible in quiet title actions. According to one line of cases, the statutory prohibition (CCP § 764.010) on quiet title default judgments is *absolute*, precluding not only traditional default prove-ups but also imposing a complete ban on any judgments by default. In other words, plaintiffs not only must prove their cases in *evidentiary hearings* with live witnesses and any other admissible evidence but, unlike ordinary default prove-ups in which the defendants have no right to participate, courts must *in all cases* hear such evidence as may be offered by any defaulting defendant. [See *Paterra v. Hansen* (2021) 64 CA5th 507, _, 279 CR3d 77, 96 (citing text)—CCP § 764.010 "imposes an absolute ban on a judgment by default in a quiet title action, and an 'open-court' evidentiary hearing is required"; *Nickell v. Matlock* (2012) 206 CA4th 934, 941-942, 947, 142 CR3d 362, 366-367, 371—if defaulting defendant "shows up" before judgment is entered, court must hear any evidence defendant offers; *Harbour Vista, LLC v. HSBC Mortg. Services Inc.* (2011) 201 CA4th 1496, 1501-1504, 134 CR3d 424, 428-430, 433-434—court renders judgment "in accordance with the evidence and the law" if it holds properly noticed evidentiary hearing and no defendant shows up]

Dicta in another case, however, maintains that the quiet title statutes merely subject plaintiffs in default cases to a *higher evidentiary standard* at the prove-up hearing than applicable in general civil actions. Thus, while still requiring a *full evidentiary hearing*, this authority permits courts to enter quiet title default judgments. [See *Yeung v. Soos* (2004) 119 CA4th 576, 580-581, 14 CR3d 502, 505 (finding statutory prohibition re quiet title default judgments an apparent "misnomer")]

(a) [11:533.6] **Comment:** The *Nickell* and *Harbour Vista* decisions probably are correct (¶ 11:533.5). *Yeung* did not address whether defaulting defendants may participate in evidentiary hearings under CCP § 764.010; it only decided that full evidentiary hearings are required (i.e., plaintiffs must produce competent evidence of title by way of live testimony and authenticated real property records). Moreover, the "higher prove-up burden" advocated in *Yeung* has been criticized as "erroneous" dicta. [See *Paterra v. Hansen* (2021) 64 CA5th 507, _, 279 CR3d 77, 96 (citing text and finding "the reasoning in *Harbour Vista* and *Nickell* persuasive"); *Nickell v. Matlock* (2012) 206 CA4th 934, 947, 142 CR3d 362, 371—"We agree with *Harbour Vista* that the dicta in *Yeung* is erroneous"]

j. [11:534] **Conclusive effect of judgment:** Generally, judgment in a quiet title action operates *in rem*, binding all persons (known or unknown) claiming an interest in the property. [CCP § 764.030; *Nickell v. Matlock* (2012) 206 CA4th 934, 944, 142 CR3d 362, 369 (citing text); compare *XPO Logistics Freight, Inc. v. Hayward Property, LLC* (2022) 79 CA5th 1166, 1179, 295 CR3d 371, 381 (boundary dispute)—plaintiff not entitled to in rem judgment quieting title in plaintiff as against world because it failed to follow CCP § 763.010 et seq. service-by-publication requirements for in rem jurisdiction]

(1) [11:535] **Parties bound:** The judgment is binding and conclusive on all *persons who were parties to the action*. [CCP § 764.030(a)]

(a) [11:535.1] **Res judicata:** Res judicata (or claim preclusion) applies to judgments in quiet title actions. Accordingly, parties to a quiet title action, or parties in privity with them (e.g., successors-in-interest), cannot bring a subsequent quiet title action based on the same cause of action or issue. [*SPLR, L.L.C. v. San Diego Unified Port Dist.* (2020) 49 CA5th 284, 315-316, 262 CR3d 782, 806-807—res judicata barred plaintiffs from bringing quiet title and inverse condemnation action against port district re bayside boundaries of plaintiffs' properties and public tidelands because plaintiffs and port district were successors-in-interest to parties' decades-old judgment that permanently fixed boundaries]

(2) [11:536] **Nonparties bound:** The judgment also is binding and conclusive on *nonparties* claiming an interest in the property that was *not of record* at the time plaintiff's lis pendens was filed or, if no lis pendens was filed, at the time the quiet title judgment was recorded. [CCP § 764.030(b); *Deutsche Bank Nat'l Trust Co. v. McGurk* (2012) 206 CA4th 201,

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214, 141 CR3d 603, 612; see also *Nickell v. Matlock* (2012) 206 CA4th 934, 942, 142 CR3d 362, 367—once quiet title judgment becomes final on any grounds, it is good against "all the world as of the time of the judgment"; *Harbour Vista, LLC v. HSBC Mortg. Services Inc.* (2011) 201 CA4th 1496, 1506, 134 CR3d 424, 432 (same)]

(a) [11:537] **Compare—nonparties with prior claims of record:** On the other hand, the judgment is *not* binding on nonparties who recorded their adverse claims before plaintiff's lis pendens was recorded; or, if plaintiff did not record a lis pendens, who recorded their adverse claims before the quiet title judgment was recorded. [CCP § 764.045; see also *Deutsche Bank Nat'l Trust Co. v. McGurk* (2012) 206 CA4th 201, 212, 141 CR3d 603, 611—judgment not binding on assignee of trust deed holder who was voluntarily dismissed from quiet title action and whose interest was "of record" prior to filing of lis pendens (voluntary dismissal transformed trust deed holder into nonparty)]

(b) [11:538] **Exception—plaintiff aware of nonparty adverse claims:** Without regard to priority of recordation, the quiet title judgment is *not* binding on nonparties whose adverse claims were either *actually known* to plaintiff or *would have been reasonably apparent from an inspection of the property at the time plaintiff's lis pendens was recorded* (or, if no lis pendens was recorded, at the time the quiet title judgment was entered). [CCP § 764.045(b); *Deutsche Bank Nat'l Trust Co. v. Pyle* (2017) 13 CA5th 513, 524, 220 CR3d 691, 700; see also *Deutsche Bank Nat'l Trust Co. v. McGurk*, supra—judgment not binding on assignee of trust deed holder who was voluntarily dismissed from quiet title action and whose interest was actually known to plaintiff prior to filing of lis pendens (voluntary dismissal transformed trust deed holder into nonparty)]

1) [11:539] **Limitation—BFP protection:** Notwithstanding the general rule set forth at ¶ 11:538, intervening BFPs are fully protected against nonparty claims: "Nothing in this subdivision [CCP § 764.045(b)] shall be construed to impair the rights of a bona fide purchaser or encumbrancer for value dealing with the plaintiff or the plaintiff's successors in interest." [CCP § 764.045(b); see also CCP § 764.060 (¶ 11:539.1); compare *Deutsche Bank Nat'l Trust Co. v. Pyle* (2017) 13 CA5th 513, 525-526, 220 CR3d 691, 697-698, 701 (declining to apply § 764.060 to *non-quiet title* judgment because such judgments lack statutory protections governing quiet title actions)—subsequent purchaser did not qualify as BFP where property owner's suit against bank for wrongful foreclosure and cancellation of trustee's deed ultimately resulted in void default judgment, leaving trustee's deed in chain of title and purchaser with record notice thereof]

(c) [11:539.1] **Third parties who relied on quiet title judgment:** If a quiet title judgment is subsequently invalidated, a third party who relied on the judgment will retain their property rights if they (i) qualify as a purchaser or encumbrancer for value and (ii) lacked both actual and constructive knowledge of any defects or irregularities in the prior quiet title judgment or proceedings. [CCP § 764.060; *Tsasu LLC v. U.S. Bank Trust, N.A.* (2021) 62 CA5th 704, 718, 722-724, 277 CR3d 76, 84, 87-89—invalidation and expungement of prior quiet title judgment effective as to third party because third party had constructive knowledge of defect or irregularity based on recorded documents; see also *Ridec LLC v. Hinkle* (2023) 92 CA5th 1182, _, _, 310 CR3d 298, 302-303, 310-311 (citing *Tsasu* with approval)—although quiet title judgment initially entered in borrower's favor was later set aside for fraud, lender's trust deed remained valid because lender had no knowledge re judgment's defects]

(d) [11:540] **Exception—nonparty government claims:** A quiet title judgment is *not* binding on (i) the *State*, unless individually joined in the action; or (ii) the *federal government*, unless individually joined in the action and federal law authorizes the judgment to be binding as to its interests. [CCP § 764.070(a) & (b)]

k. [11:541] **Suit against United States—waiver of sovereign immunity under Quiet Title Act:** The Quiet Title Act (QTA) waives the federal government's immunity in actions to quiet title to real property in which the United States claims an interest, other than a security interest or water rights. (The QTA's waiver of sovereign immunity does not apply to title disputes involving restricted Indian land or land held in trust for an Indian tribe.) [28 USC § 2409a; see also *Mills v. United States* (9th Cir. 2014) 742 F3d 400, 405—QTA is exclusive means by which adverse claimants can challenge United States' title to real property; *State of Alaska v. Babbitt* (9th Cir. 1999) 182 F3d 672, 675 (same)]

(1) [11:542] **Action must challenge federal government's title:** A suit that actually challenges the federal government's title, however denominated, falls within the scope of the QTA. For example, disputes over rights of access, easement rights (including declarations as to an easement's scope), rights-of-way and claims involving fee simple interests fall squarely within the purview of the QTA. [See *Robinson v. United States* (9th Cir. 2009) 586 F3d 683, 686-688; *Mills v. United States* (9th Cir. 2014) 742 F3d 400, 405—finding QTA's sovereign immunity waiver inapplicable where U.S. did not actually

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"dispute" existence of plaintiff's right-of-way; see also *Skranak v. Castenada* (9th Cir. 2005) 425 F3d 1213, 1218 (dispute over plaintiff's right to easement over national forest); *Michel v. United States* (9th Cir. 1995) 65 F3d 130, 131-133 (dispute regarding scope of easement over national wildlife refuge)]

By contrast, a suit that does *not* challenge title but instead concerns the *use* of land as to which title is not disputed can sound in tort or contract and therefore *not* come within the QTA's scope. [See *Robinson v. United States*, supra, 586 F3d at 688—QTA did not apply to tort action that related to easement but did not dispute its terms; see also *Mills v. United States*, supra, 742 F3d at 405, fn. 6—QTA is nonexclusive remedy for claims not involving adverse title disputes with government such as those founded upon administrative wrongdoing]

(2) [11:542.1] **12-year time limit for bringing claim:** Under the QTA, any real property quiet title action (except an action brought by a State) is barred unless it is commenced within 12 years of the date upon which it accrued (i.e., the date plaintiff or their predecessor in interest knew or should have known of the United States' claim). [28 USC § 2409a(g)]

The 12-year time limit for bringing a claim against the United States is a *nonjurisdictional* claims-processing rule. [See *Wilkins v. United States* (2023) 598 US _, _, _, 143 S.Ct. 870, 874-875, 881 (resolving split among appellate courts)]

l.. [11:543] **Tribal sovereign immunity:** Absent waiver or congressional abrogation, tribal sovereign immunity bars a quiet title action against an Indian tribe. [*Self v. Cher-Ae Heights Indian Community of Trinidad Rancheria* (2021) 60 CA5th 209, 212, 215-216, 274 CR3d 255, 256, 259—tribal sovereign immunity barred quiet title action to establish public easement for coastal access on property owned by Indian tribe (common law "immovable property exception" to state and federal sovereign immunity in property disputes did not extend to Indian tribes)]

[11:544] ***Reserved.***

2. [11:545] **Clearing Cloud on Title by Action to Cancel Instrument:** Cancellation, pursuant to Civ.C. § 3412 et seq., is the appropriate remedy to clear a cloud on title that is evidenced by an allegedly invalid written instrument (e.g., a contract, deed or lease). Plaintiff may commence an action to cancel a written instrument that, as to plaintiff, is void or voidable, when there is a "reasonable apprehension" that if left outstanding the instrument will cause plaintiff serious injury. [Civ.C. § 3412; *Robertson v. Sup.Ct. (Brooks)* (2001) 90 CA4th 1319, 1324, 109 CR2d 650, 653; see also *U.S. Bank Nat'l Ass'n v. Naifeh* (2016) 1 CA5th 767, 774, 205 CR3d 120, 128—substantial evidence supported conclusion that title holder to real property obtained through foreclosure would suffer pecuniary loss and prejudicial change of position absent cancellation of numerous recorded documents deemed void/voidable due to fraud; *Saterbak v. JPMorgan Chase Bank, N.A.* (2016) 245 CA4th 808, 818-819, 199 CR3d 790, 798-799—no error in dismissing Civ.C. § 3412 action to cancel trust deed assignment where plaintiff failed to allege instrument was void/voidable as *against her* and if left outstanding would cause her "serious injury"]

Unlike rescission, which is a "retroactive termination" of a contract (¶ 11:460), cancellation is a "prospective termination." [See *NMSBPCSLDHB v. County of Fresno* (2007) 152 CA4th 954, 959, 61 CR3d 425, 429]

As discussed, cancellation is distinct from quiet title but, in an appropriate case, both remedies may be joined and pursued in a single proceeding (¶ 11:527 ff.).

a. [11:546] **Grounds for cancellation:** A court-ordered cancellation is authorized only if the document in issue is *void or voidable*. [Civ.C. § 3412]

Accordingly, the § 3412 remedy may be used to cancel a document:

- Executed by a person lacking legal capacity (*see ¶ 11:31*);

- Procured by fraud or undue influence (see *Schiavon v. Arnaudo Brothers* (2000) 84 CA4th 374, 378, 100 CR2d 801, 804—action to cancel deed of trust on ground of fraudulent procurement; *Jones v. Adams Fin'l Services* (1999) 71 CA4th 831, 836, 84 CR2d 151, 154 (same)); or

- Otherwise legally invalid (see *Ward v. Sup.Ct. (Beverlywood Homes Ass'n)* (1997) 55 CA4th 60, 67, 63 CR2d 731, 735—motion to cancel homeowner association's recorded notice of noncompliance with CC&Rs brought pursuant to Civ.C. § 3412 on ground it was not recordable document).

(1) [11:547] **Exception—document void on its face:** A cancellation action is premised on the fact the void or voidable instrument will cause plaintiff serious injury unless it is canceled (Civ.C. § 3412). If the invalidity is *apparent on the face*

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of the document (or upon the face of another instrument that is necessary to the use of the void document in evidence), it is not deemed capable of causing injury within the meaning of Civ.C. § 3412 and therefore is *not subject to court-ordered cancellation*. [Civ.C. § 3413]

b. Procedural considerations

(1) [11:548] **Must be specifically alleged:** An action for cancellation cannot be pleaded generally. Plaintiff must *specifically allege* the *facts* demonstrating the invalidity of the instrument under attack. [*Wolfe v. Lipsy* (1985) 163 CA3d 633, 638, 209 CR 801, 804-805 (disapproved on other grounds by *Droeger v. Friedman, Sloan & Ross* (1991) 54 C3d 26, 35-36, 283 CR 584, 589-590); see *Kroeker v. Hurlbert* (1940) 38 CA2d 261, 101 P2d 101, 102 (distinguishing quiet title action)]

(2) [11:548.1] **Statute of limitations:** Generally, actions relating to the possession of or title to real property must be commenced within five years after the claimant's (or the claimant's predecessor in interest's) possession of the property terminates … unless the chain of title includes a person who was either a minor or “insane,” in which case a tolling period applies (see CCP §§ 318, 319, 328). An action to cancel a quitclaim deed under Civ.C. § 3412 is covered by these statutes. [*Robertson v. Sup.Ct. (Brooks)* (2001) 90 CA4th 1319, 1327-1329, 109 CR2d 650, 656-658; see also *Martin v. Van Bergen* (2012) 209 CA4th 84, 91-92, 146 CR3d 667, 671 (noting failure to properly plead statute of limitations waives defense)—CCP § 318 five-year limitations period applicable to boundary dispute; *Nielsen v. Gibson* (2009) 178 CA4th 318, 325-326, 100 CR3d 335, 340—CCP § 328 creates tolling period, not to exceed 20 years, for “insane” landowners who fail to initiate trespass/ejectment actions or otherwise defend title during adverse claimant's five-year continuous possession]

(a) [11:548.1a] **Statute of limitations for actions to remove trust deed liens:** An action by the holder of a senior deed of trust to remove a junior trust deed lien is governed by the statutes of limitations that apply to foreclosure actions. Foreclosure statutes of limitations begin to run upon the secured obligation's maturity—i.e., when the underlying obligation comes due, but is unpaid. [*Robin v. Crowell* (2020) 55 CA5th 727, 741, 744-745, 270 CR3d 25, 33-34, 36—senior trust deed holder's action against junior trust deed holder who was mistakenly omitted from prior judicial foreclosure action time-barred because it was filed more than 8 years after underlying promissory note's maturity (leaving undecided whether CCP § 337's 4-year or Comm'l C. § 3118's 6-year limitations period applied because both statutory periods had expired)]

Cross-refer: For a detailed discussion of deeds of trust and real property foreclosure actions, *see Ch. 6*.

(3) [11:548.2] **No right to jury trial:** An action to cancel an instrument is purely equitable in nature, and thus not jury triable. [*Santa Ana Mortg. & Invest. Co. v. Kinslow* (1938) 30 CA2d 107, 109, 85 P2d 899, 901; see also *Corrigan v. Stiltz* (1965) 233 CA2d 381, 387, 43 CR 548, 552]

c. [11:549] **Partial cancellation:** Where the invalid document is severable (i.e., evidences different rights or obligations), the court has discretion to order it canceled *in part*, allowing the balance to remain in effect. [Civ.C. § 3414]

3. Purchaser's or Seller's Equitable Lien

a. [11:550] **Purchaser's lien:** If there is a “failure of consideration” from the seller, the buyer of real property who has paid any portion of the contract price has a “special lien” upon the property “for such amount paid as he may be entitled to recover back.” [Civ.C. § 3050] In effect, Civ.C. § 3050 gives the buyer an equitable interest in the property as security for the reimbursement of any consideration paid, including any downpayment and consequential expenditures for improvements, taxes and insurance. [*McCall v. Sup.Ct.* (1934) 1 C2d 527, 534-535, 36 P2d 642, 646; *Soderling v. Tomlin* (1959) 170 CA2d 169, 174, 338 P2d 946, 949]

A court may enforce a purchaser's lien (e.g., by foreclosure sale) against subsequent purchasers or encumbrancers *unless* they are BFPs (purchaser or encumbrancer in good faith and for value). [Civ.C. § 3048]

b. [11:551] **Vendor's lien:** A seller of real property technically has a “vendor's lien” on the property to the extent of any *unsecured* portion of the contract price that remains unpaid. The vendor's lien remains in existence for so long as the contract price remains unpaid, regardless of who has possession of the property. [Civ.C. § 3046]

Sellers holding a vendor's lien have an equitable interest in the property (to the extent of the lien) and an equitable right to foreclose on the lien upon the buyer's failure to pay the full amount of the contract price. A court may enforce a vendor's lien

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against any party *except* a purchaser or encumbrancer in good faith and for value (BFPs). [Civ.C. § 3048] However, because notice of a vendor's lien is not deemed to affect title to the property, its recordation does not impart constructive notice to parties who do not have actual knowledge of the lien. [*Brown v. Johnson* (1979) 98 CA3d 844, 851, 159 CR 675, 679]

• [11:552] **Comment:** Civ.C. § 3046 is a little understood statute. According to *Brown*, supra, a vendor's lien "is of no operative force or effect until established by a decree of court and may be asserted only by a suit in equity …" [*Brown v. Johnson* (1979) 98 CA3d 844, 851, 159 CR 675, 679]

Fundamentally, therefore, enforcement of a vendor's lien will simply result in a judgment for money damages. But the same result would obtain if, rather than seeking to enforce its vendor's lien, the seller simply sued for breach of contract damages; the money judgment in the breach of contract suit could then be converted into a lien by recording an abstract of judgment (CCP § 674). Consequently, a vendor's lien seems to be of no greater benefit to a seller than the right to obtain a money judgment—a right which the seller would have in any event upon its buyer's breach of contract.

[11:553 - 11:554] ***Reserved.***

4. [11:555] **Declaratory Relief:** A declaratory relief action is an appropriate remedy where a controversy arises relating to the parties' respective legal rights and duties under the purchase agreement (or under any deed or other instrument). Such a suit seeks a judicial declaration of the parties' rights and obligations in reference to the contract. [CCP § 1060] Declaratory relief may be based upon an oral contract or on disputed questions of fact. [*Moklofsky v. Moklofsky* (1947) 79 CA2d 259, 263, 179 P2d 628, 631]

An action for declaratory relief may be brought by itself or may be joined with requests for other relief; but the court is empowered to make a binding determination of the parties' rights and duties under dispute whether or not other relief has been requested or could have been sought at the time. Thus, declaratory relief may be granted before a breach of contract occurs and it will have the effect of a final judgment. [CCP § 1060]

A court may refuse to grant declaratory relief in any case where a declaration is "not necessary or proper at the time under all circumstances" (as where the court determines there is not in fact an "actual controversy"). [CCP § 1061; see *Artus v. Gramercy Towers Condominium Ass'n* (2018) 19 CA5th 923, 930-935, 228 CR3d 496, 501-505 (noting declaratory relief is equitable remedy and need not be awarded if unwarranted)—declaratory relief properly denied where condo owner's claim that HOA violated governing law in connection with one board member election did not present "actual controversy"]

5. [11:556] **Third Party Remedies—Standing Hurdle:** Other persons, not parties to a real property purchase and sale contract, may be aggrieved in the event the transaction is not consummated (e.g., prospective buyer's lender advances funds to buyer, taking trust deed on the property to be purchased; or broker's commission is defeated by either party's breach). However, third persons have *no remedy* for the breach of a contract to which they are not parties unless they are expressly made *intended beneficiaries* of the contract.

Under normal third party beneficiary law, a contract may not be enforced (through a damages suit, specific performance or otherwise) by a third person who will only incidentally benefit from performance of the agreement. [*Sheppard v. Banner Food Products, Inc.* (1947) 78 CA2d 808, 812, 178 P2d 455, 457—buyer's lender had no standing to seek specific performance of purchase and sale contract (since contract was not made specifically for lender's benefit, lender's remedy was against buyer for money damages); see also *Super 7 Motel Assocs. v. Wang* (1993) 16 CA4th 541, 546-547, 20 CR2d 193, 197-198—broker not third party beneficiary of purchase agreement and thus lacked standing to invoke contract's attorney fee clause]

a. [11:557] **Compare—third party included within ambit of contractual provision:** The result is otherwise where the contract specifically includes a third party within the ambit of one of its benefit provisions.

For example, where the purchase and sale agreement includes a party's broker within the ambit of an attorney fee recovery provision, the broker is a *party* to the contract for that purpose (rather than an intended third party beneficiary). [*Pacific Preferred Properties, Inc. v. Moss* (1999) 71 CA4th 1456, 1463, 84 CR2d 500, 504-505 (tripartite contract provision for attorney fees award formed between buyer, seller and broker); *see* ¶ *11:139.28*]

[11:558 - 11:599] ***Reserved.***

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California Practice Guide: Real Property Transactions | September 2024 Update
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Chapter 11. Remedies in Purchase and Sale Transactions

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1. [11:600] **Nature of Lis Pendens:** Proper recordation of a lis pendens (CCP § 405 et seq.) during litigation gives *constructive notice* to the "world" of the pendency of an action affecting title to or possession of the described real property. [*Kirkeby v. Sup.Ct. (Fascenelli)* (2004) 33 C4th 642, 647, 15 CR3d 805, 808; *Park 100 Investment Group II v. Ryan* (2009) 180 CA4th 795, 807, 103 CR3d 218, 226; see also *Cyr v. McGovran* (2012) 206 CA4th 645, 652, 142 CR3d 34, 40—lis pendens provides constructive notice such that any judgment later obtained relates back to filing of lis pendens (¶ *11:683*)]

Until the litigation is concluded or the lis pendens expunged (removed), title to the property is clouded, preventing transfer of the real estate to bona fide purchasers and effectively preserving the priority of claims to and against the property. [*Malcolm v. Sup.Ct. (Green)* (1981) 29 C3d 518, 523, 174 CR 694, 696, fn. 2; *J & A Mash & Barrel, LLC v. Sup.Ct. (Tower Theater Properties)* (2022) 74 CA5th 1, 15, 289 CR3d 110, 122; *Castro v. Sup.Ct. (Calif. Savings)* (2004) 116 CA4th 1010, 1015, 10 CR3d 865, 867, fn. 6; see also *Cyr v. McGovran*, supra, 206 CA4th at 652, 142 CR3d at 40—any party acquiring interest in property after action filed and lis pendens recorded is bound by judgment]

a. Other procedures compared

(1) [11:601] **Attachment:** A lis pendens is similar in effect to an attachment lien on the property. Unlike an attachment, however, *no prior court order* is required to create a lis pendens lien. Plaintiffs represented by counsel can do so unilaterally by complying with the procedures discussed at ¶ 11:660 ff.

(2) [11:602] **Preliminary injunction:** A lis pendens may also have the same effect as a preliminary injunction forbidding transfer of the property. But an injunction, unlike a lis pendens, is directed at a party, absolutely forbids transfer and is backed by the sanction of contempt. [See *Orange County v. Hongkong & Shanghai Banking Corp. Ltd.* (9th Cir. 1995) 52 F3d 821, 825-826]

[11:603 - 11:604] ***Reserved.***

b. Advantages vs. disadvantages of lis pendens

(1) [11:605] **Advantages:** There are significant tactical advantages to a proper lis pendens:

(a) [11:606] **Preserves priority of claim:** A properly served, recorded, indexed and filed lis pendens preserves priority of claims concerning real property (*see* ¶ *11:683 ff.*).

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(b) [11:607] **Leverage:** A lis pendens strengthens plaintiff's hand because it usually renders defendant's property unmarketable and unsuitable as security for a loan. Potential purchasers or lenders are rarely willing to assume the risk of pending litigation. This often puts defendant under pressure to settle regardless of the merits of plaintiff's claim. [See *Kirkeby v. Sup.Ct. (Fascenelli)* (2004) 33 C4th 642, 651, 15 CR3d 805, 811; and *Gale v. Sup.Ct. (Gale)* (2004) 122 CA4th 1388, 1394-1395, 19 CR3d 554, 558-559—lis pendens has potential "to pour sand into the smooth gears of a real estate transaction"]

(c) [11:608] **Recording may be privileged:** Recording a lis pendens is treated as a "publication" in a judicial proceeding and may be protected by the statutory "litigation privilege" (Civ.C. § 47(b)) *if* "it *identifies an action* previously filed with a court of competent jurisdiction which affects the title or right of possession of real property, as *authorized or required by law*" (i.e., the lis pendens statutes, CCP § 405 et seq.). [Civ.C. § 47(b)(4) (emphasis added); see also *La Jolla Group II v. Bruce* (2012) 211 CA4th 461, 473, 149 CR3d 716, 725]

1) Application

• [11:608.1] The litigation privilege applied to the recording of a lis pendens in connection with a quiet title action, where the lis pendens expressly identified the quiet title complaint. [*La Jolla Group II v. Bruce* (2012) 211 CA4th 461, 472-474, 149 CR3d 716, 724-725]

• [11:608.2] The privilege attached to a lis pendens recorded in connection with an action to foreclose on a mechanic's lien because the underlying action described in the lis pendens affected title to real property. [*Alpha & Omega Develop., LP v. Whillock Contracting, Inc.* (2011) 200 CA4th 656, 665, 132 CR3d 781, 786]

• [11:608.3] The privilege attached to a lis pendens recorded in connection with an easement dispute because the underlying action identified in the lis pendens was a real property claim. [*Park 100 Investment Group II v. Ryan* (2009) 180 CA4th 795, 813, 103 CR3d 218, 230 (citing text)]

• [11:608.4] *Compare:* The privilege did *not* attach to a lis pendens filed in connection with collection and bankruptcy actions because there was no underlying real property claim. [*Palmer v. Zaklama* (2003) 109 CA4th 1367, 1380, 1 CR3d 116, 125 (citing text)]

2) [11:608.5] **Slander of title claims precluded:** Where the Civ.C. § 47(b) privilege applies, plaintiffs cannot be sued for slander of title based on *recording* the lis pendens … even if they acted with actual malice. [*Albertson v. Raboff* (1956) 46 C2d 375, 378-382, 295 P2d 405, 408-410; *Palmer v. Zaklama* (2003) 109 CA4th 1367, 1379, 1 CR3d 116, 125; see also *La Jolla Group II v. Bruce* (2012) 211 CA4th 461, 474-488, 149 CR3d 716, 725-728 (declining to follow contrary dictum in *Palmer*)—where privilege applies, plaintiffs cannot be sued for slander of title even if underlying action lacks "evidentiary merit"; *Alpha & Omega Develop., LP v. Whillock Contracting, Inc.* (2011) 200 CA4th 656, 666-667, 132 CR3d 781, 788-789 (same)]

3) [11:608.6] **Compare:** The Civ.C. § 47(b) privilege is no defense to a suit for malicious prosecution. [*Silberg v. Anderson* (1990) 50 C3d 205, 215-216, 266 CR 638, 644]

By the same token, without regard to the § 47(b) privilege, recording a lis pendens cannot be the basis for an abuse of process or intentional interference with prospective economic advantage cause of action. [See *Palmer v. Zaklama* (2003) 109 CA4th 1367, 1379-1381, 1 CR3d 116, 125-126 (collecting cases)]

[11:609] ***Reserved.***

(2) [11:610] **Disadvantages:** There are also potential disadvantages to recording a lis pendens:

(a) [11:611] **Bond may be required to maintain:** No bond is required to record a lis pendens. However, plaintiff may be required to post a substantial bond as a condition of maintaining the lis pendens. [CCP § 405.34; *see* ¶ *11:715 ff.*]

(b) [11:612] **Effect of expungement or withdrawal:** If a lis pendens is expunged or withdrawn, the property may then be freely conveyed to a nonparty "irrespective of whether that person possessed actual knowledge of the action …" [CCP § 405.61]

This facilitates sale or transfer to persons who have *actual knowledge* of plaintiff's claim and therefore could not claim to be BFPs. Defendant may thus end up with more freedom to convey or encumber the property than if a lis pendens had never been recorded. (*See further discussion at* ¶ *11:694 ff., 11:728 ff.*)

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(c) [11:613] **Attorney fees and costs:** If the lis pendens is expunged, the lis pendens claimant "shall" be ordered to pay the other party's attorney fees and costs in connection with the expungement proceeding. [CCP § 405.38; *see* ¶ *11:727*]

(d) [11:614] **Enhanced liability for breach of contract:** Recording a lis pendens may expose the buyer to greater damages for breach of contract if the buyer loses the lawsuit: e.g., for diminished property value, operating costs, and lost interest on expected sale proceeds while the seller's title was unmarketable due to the lis pendens. [*Askari v. R & R Land Co.* (1986) 179 CA3d 1101, 1108-1112, 225 CR 285, 289-293]

(e) [11:615] **Potential tort liability:** Even where the litigation privilege applies (¶ *11:608*), only the *recordation* is privileged. There is no bar to an action for malicious prosecution of the *underlying lawsuit*; and evidence that a lis pendens was recorded may be admissible in such action on the issues of "malice" and damages. [*Albertson v. Raboff* (1956) 46 C2d 375, 382-383, 295 P2d 405, 410-411]

An alternative course for plaintiff is to give actual notice to parties potentially interested in the property instead of seeking the protection afforded by a lis pendens. But giving actual notice may backfire: i.e., in a later malicious prosecution or slander of title action, proof that plaintiff gave actual notice instead of utilizing the lis pendens process arguably may be evidence of malice or increased damage.

[11:616 - 11:623] ***Reserved.***

2. [11:624] **Actions in Which Lis Pendens Authorized:** A lis pendens may be recorded in connection with a pending civil action in either state or federal court. [CCP § 405.5; and see *Manhattan Loft, LLC v. Mercury Liquors, Inc.* (2009) 173 CA4th 1040, 1056, 93 CR3d 457, 468—term "action" does not include arbitration proceedings for purposes of recording lis pendens]

a. [11:625] **Actions in which lis pendens *required:*** There are a few actions in which recordation of a lis pendens is *required* by statute:

- *Quiet title* actions. [CCP § 761.010]
- Actions for *partition*. [CCP § 872.250]
- *Eminent domain* proceedings. [CCP §§ 1250.130, 1250.150]
- Claim to escheated property. [CCP §§ 1355, 1410]
- Action to declare building uninhabitable. [CCP § 405.7]
- *Forfeiture* proceedings. [Fin.C. § 5321(b); Health & Saf.C. § 11488.4; Pen.C. § 186.4]

(1) [11:626] **Other remedies:** However, a lis pendens is not the exclusive remedy in these cases. Plaintiff may also seek an injunction, attachment or other provisional remedy. [CCP § 405.8]

[11:627] ***Reserved.***

b. [11:628] **Permitted in other actions affecting title, possession or easement:** Recordation of a lis pendens is permitted in any action by a "claimant" who has a "real property claim." [CCP § 405.1; *Kirkeby v. Sup.Ct. (Fascenelli)* (2004) 33 C4th 642, 647, 15 CR3d 805, 808; see also *Park 100 Investment Group II v. Ryan* (2009) 180 CA4th 795, 808, 103 CR3d 218, 226—purpose of § 405.1 is to "clarify" that party who records lis pendens must be same party who asserts CCP § 405.4 real property claim]

A "real property claim" is any cause of action that, *if meritorious*, would affect:

- title to, or the right to possession of, specific real property; or
- the use of an easement identified in the pleading (other than an easement obtained pursuant to statute by any regulated public utility). [CCP § 405.4; *Park 100 Investment Group II v. Ryan*, supra]

(1) [11:628.1] **Title of claim not dispositive:** The lis pendens statutes offer no definition of a claim that affects "title to, or the right to possession of, specific real property," leaving the matter for judicial development.

In deciding whether a cause of action is a "real property claim" for purposes of CCP § 405.1, courts must look to the specific nature of the claim within the context of the entire complaint; the title of the claim is not dispositive. [See *Lewis v. Sup.Ct. (Folksam Gen. Mut. Ins. Soc.)* (1994) 30 CA4th 1850, 1865, 37 CR2d 63, 73]

(2) [11:629] **Application:** The following are actions that may "affect title or possession" of real property for lis pendens purposes:

(a) [11:630] **Specific performance:** A buyer suing for specific performance of a real property purchase and sale agreement clearly has a "real property claim" within the meaning of the statute (if meritorious, the action would affect both *title* and *possession* concerning the subject property). This "is a classic example of an action in which a lis pendens is both appropriate and necessary." [*BGJ Assocs., LLC v. Sup.Ct. (M2B2, LLC)* (1999) 75 CA4th 952, 967, 89 CR2d 693, 702-703; see also *Dyer v. Martinez* (2007) 147 CA4th 1240, 1242-1243, 54 CR3d 907, 908]

(b) [11:631] **Rescission:** A lis pendens is properly recorded in an action to rescind a real property sale contract. [*Wilkins v. Oken* (1958) 157 CA2d 603, 606, 321 P2d 876, 878]

(c) [11:632] **Declaratory relief:** An action for declaratory relief as to rights in real property is a "real property claim." [*Mason v. Sup.Ct. (Bond)* (1985) 163 CA3d 989, 994, 999, 210 CR 63, 66, 69 (superseded by statute on other grounds as stated in *Mix v. Sup.Ct. (Behniwal)* (2004) 124 CA4th 987, 994, 21 CR3d 826, 822, fn. 6) (declaratory relief suit involving whether ambiguous provision in deed created condition subsequent or simply a covenant); *Ziello v. Sup.Ct. (First Fed'l Bank of Calif.)* (1995) 36 CA4th 321, 325, 42 CR2d 251, 253 (borrower's declaratory relief suit against secured lender involving whether lender, by refusing to release earthquake insurance proceeds to borrower, violated "security first rule," thus forfeiting its lien on secured real property; *see* *¶ 11:708*)]

(d) [11:633] **Easements:** A lis pendens is properly recorded in suits to enforce or determine easement rights in real property. [CCP § 405.4(b); *Park 100 Investment Group II v. Ryan* (2009) 180 CA4th 795, 809-812, 103 CR3d 218, 227-230—lis pendens on dominant tenement; *Woodcourt II Ltd. v. McDonald Co.* (1981) 119 CA3d 245, 247-248, 173 CR 836, 837—lis pendens on servient tenement]

(e) [11:634] **Leaseholds:** A lis pendens may be recorded in an action to enforce or determine ownership of a leasehold interest in real property. [See *Bailey v. Outdoor Media Group* (2007) 155 CA4th 778, 781, 66 CR3d 322, 325 (civil action for, among other things, wrongful occupation of real property leasehold); *Parker v. Sup.Ct. (Dwight)* (1970) 9 CA3d 397, 399-400, 88 CR 352, 353-354 (marriage dissolution action involving real property leasehold)]

(f) [11:635] **Setting aside fraudulent conveyance:** A suit seeking to set aside a conveyance of real property on the ground it was made in fraud of creditors may result in the voiding of a transfer of title and, therefore, constitutes a "real property claim" for purposes of lis pendens law. [*Kirkeby v. Sup.Ct. (Fascenelli)* (2004) 33 C4th 642, 648-649, 15 CR3d 805, 809-810; *Hunting World, Inc. v. Sup.Ct. (Bogar)* (1994) 22 CA4th 67, 72-73, 26 CR2d 923, 926]

1) [11:636] **Uniform Voidable Transactions Act (UVTA):** The UVTA (Civ.C. § 3439 et seq.) provides a variety of tools for unsecured creditors who seek payment from debtors attempting to evade collection—e.g., a court may void a transfer of assets, attach assets, or employ equitable remedies like injunctive relief or receivership. [*Nagel v. Westen* (2021) 59 CA5th 740, 747-748, 274 CR3d 21, 25-26 (citing Civ.C. § 3439.07)]

The UVTA can even be applied to unwind real property transfers that were intended to prevent a creditor from reaching the debtor's assets, including third-party transfers and transmitting property sale proceeds out of state. [See *Nagel v. Westen*, supra, 59 CA5th at 743-745, 748-750, 274 CR3d at 22-23, 26-27 (finding for plaintiff in a "matter of first impression")—plaintiff stated UVTA claim against defendants who allegedly used proceeds from California real property sale to buy and improve Texas property after it became apparent defendants would lose arbitration action against plaintiff]

(g) [11:637] **Marriage dissolution property proceedings:** A lis pendens may be recorded in marriage dissolution proceedings in which ownership of specific real property is at issue. [*Kane v. Huntley Fin'l* (1983) 146 CA3d 1092, 1096, 194 CR 880, 882—wife's failure to record lis pendens allowed husband to encumber home held in both names but which was her separate property; *Mabie v. Hyatt* (1998) 61 CA4th 581, 589, 71 CR2d 657, 661, fn. 5 (same)]

Cross-refer: For further discussion of lis pendens in marriage dissolution actions, see Hogoboom & King, *Cal. Prac. Guide: Family Law* (TRG), Ch. 3.

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(h) [11:638] **Mechanic's lien foreclosure:** A lis pendens is expressly authorized by statute in suits to foreclose mechanics' liens. [Civ.C. § 8461; *Howard S. Wright Const. Co. v. Sup.Ct. (BBIC Investors, LLC)* (2003) 106 CA4th 314, 318, 130 CR2d 641, 645, fn. 1 (citing former Civ.C. § 3146)]

(3) [11:639] ***Not money damages action:*** An action for money *only*, even if it *relates* in some way to specific real property, is not a "real property claim" and thus will not support a lis pendens. The following are illustrative:

• [11:640] Several limited partners sued general partners for *breach of fiduciary duty* in transferring partnership real property. Plaintiffs' interest was in the partnership, not the property; thus, their suit did not affect "title or possession" of the property for lis pendens purposes. [*North Coast Business Park v. Sup.Ct. (Jones)* (1984) 158 CA3d 858, 860, 205 CR 81, 82]

• [11:641] Former shareholders of corporation that owned real property sued to *rescind the sale of their shares*. The action did *not* "concern title or possession" to real property because even if plaintiffs won the lawsuit, the corporation would still have title to the property. [*Pacific Lumber Co. v. Sup.Ct. (Martel)* (1990) 226 CA3d 371, 375-376, 276 CR 425, 427-428 (different result if minority shareholder brought *derivative action* to *rescind sale of property* because such action would benefit *corporation* and not shareholders as individuals)]

• [11:642] To satisfy a debt, Defendant promised to convey property to plaintiff *if certain contingencies* occurred. They never occurred. Plaintiff's claimed "investment" in the property was merely a debt and its suit to compel repayment could not support a lis pendens. [*Deane v. Sup.Ct. (Fischer)* (1985) 164 CA3d 292, 296, 210 CR 406, 408]

• [11:643] Borrower's suit for a declaration that she had the exclusive right to earthquake insurance proceeds as against Lender (named as loss payee on the insurance policy) did not involve real property; it was strictly a matter of contract. Therefore, Lender's motion to expunge Borrower's lis pendens was properly granted. [*Ziello v. Sup.Ct. (First Fed'l Bank of Calif.)* (1995) 36 CA4th 321, 331-332, 42 CR2d 251, 257; *see* ¶ *11:708*]

[11:644 - 11:645] ***Reserved.***

(4) [11:646] **Constructive trust; equitable lien:** The weight of authority holds a lis pendens may *not* be recorded in a creditor's action to impose a constructive trust or equitable lien on real property *solely* as a means of *enforcing a debt*. Indeed, the creditor's suit claims *no present interest* in the property, and only entitlement to a remedy that, if granted, *would* "affect title." Thus, a lis pendens cannot be used as a shortcut method of attachment for unsecured creditors or to provide plaintiffs with additional leverage for negotiating purposes. [See *Urez Corp. v. Sup.Ct. (Keefer)* (1987) 190 CA3d 1141, 1149, 235 CR 837, 843; *Campbell v. Sup.Ct. (La Barrie)* (2005) 132 CA4th 904, 916-918, 34 CR3d 68, 76-78; see also *Cal-Western Reconveyance Corp. v. Reed* (2007) 152 CA4th 1308, 1318, 62 CR3d 244, 251—lis pendens notice does not make person who recorded it a secured creditor]

(a) [11:647] **Complaint alleging causes of action for money damages and constructive trust to obtain real property title:** At least two appellate courts have reached differing conclusions where the plaintiffs' complaints asserted causes of action for monetary damages and to impose constructive trusts in order to obtain title to property. [See *BGJ Assocs., LLC v. Sup.Ct. (M2B2, LLC)* (1999) 75 CA4th 952, 970-972, 89 CR2d 693, 705-706—no CCP § 405.31 "real property claim" stated where plaintiff sought monetary damages and constructive trust based on allegations that plaintiff's joint venture partners breached their fiduciary duty by wrongfully acquiring certain real property the joint venture intended to purchase; compare *Shoker v. Sup.Ct. (Phangureh)* (2022) 81 CA5th 271, 282-283, 296 CR3d 746, 749-751 (disagreeing with *BGJ Assocs.*)—claim seeking damages, constructive trust, and conveyance of real property based on defendant's alleged fraudulent acquisition of plaintiffs' property in breach of defendant's fiduciary duties stated "real property claim" (finding said claim, if meritorious, would affect title to real property within CCP § 405.4's meaning)]

Comment: Although *BGJ Assocs.* and *Shoker* came to different conclusions, both opinions recognized the case-by-case nature of their analyses. [See *Shoker v. Sup.Ct. (Phangureh),* supra, 81 CA5th at 283, 296 CR3d at 751—"[b]ecause constructive trusts arise in a wide variety of factual circumstances, courts should decide these cases on a case-by-case basis"; *BGJ Assocs., LLC v. Sup.Ct. (M2B2, LLC)*, supra, 75 CA4th at 971-972, 89 CR2d at 706]

c. [11:648] **Compare—out-of-state litigation:** Out-of-state litigation is not a matter within the ambit of California's lis pendens statutes. Thus, notice of an out-of-state action may not be recorded against California property. [See *Formula Inc. v. Sup.Ct. (iStar Fin'l, Inc.)* (2008) 168 CA4th 1455, 1457, 86 CR3d 341, 343—notice of lis pendens based on Florida action should not have been recorded against California property and was subject to expungement (¶ *11:714.1*)]

[11:649 - 11:650] ***Reserved.***

d. [11:651] **Civil penalties, reasonable attorney fees and costs for false claims:** No person may knowingly file or record, or direct another to file or record, a false notice of lis pendens against another person or entity with the intent to harass that person or entity, or for the purpose of influencing or hindering a public officer or employee in discharging their official duties. [See CCP § 765.010]

Any person who knowingly files or records, or directs another to file and record, a lis pendens in violation of CCP § 765.010 (above) is liable for a civil penalty of up to $5,000. That person also may be ordered to pay reasonable attorney fees and costs to the petitioning (injured) party. [See CCP §§ 765.030 & 765.040]

[11:652 - 11:659] ***Reserved.***

3. Creation of Lis Pendens Lien—Filing, Service and Recording Requirements

a. [11:660] **Form and content of lis pendens:** The notice of pendency of action (lis pendens) must contain:

- *Names of the parties* (*see ¶ 11:670 ff.*) (CCP § 405.20);
- *Description of the property affected* (*see ¶ 11:666 ff.*) (CCP § 405.20); and
- *Signature of plaintiff's attorney* (or court approval where plaintiff is in pro per; *see ¶ 11:684*) (CCP § 405.21).

FORM: Notice of Pendency of Action (Lis Pendens), *see Form 11:A*.

(1) [11:661] **Real names of parties:** Subsequent purchasers and lenders are charged with constructive notice of pendency of the action *only* "against parties *not fictitiously named*." [CCP § 405.24 (emphasis added); *Ross v. Title Guar. & Trust Co.* (1934) 136 CA 393, 402, 29 P2d 236, 240]

(a) [11:662] **Fictitious parties:** When the names of some parties are unknown, it is customary to designate them in the complaint and lis pendens as "Doe" defendants. But this does *not* give effective notice to purchasers or lenders dealing with persons identified in the complaint only by the fictitious name "Doe" and who acquired their interest independent of the chain of title involving a named defendant. [CCP § 405.24]

➪ [11:663] ***PRACTICE POINTER:*** After the real names of "Doe" defendants are ascertained, be sure to amend the complaint and record a *new lis pendens* setting forth the real names. Moreover, the newly-named parties must be served *immediately* with a copy of the revised lis pendens. [CCP § 405.22; *see ¶ 11:674*]

(b) [11:664] **Effect of misspelling:** If the names of parties are misspelled, the recorder will index them as misspelled. In turn, a title search will not reveal the lis pendens against the real parties. The lis pendens may then be inadequate to give constructive notice and hence ineffective. (Proper indexing can be assured by purchasing a litigation guaranty from a title company; *see ¶ 3:40*.)

(c) [11:665] **Statutory exceptions:** In certain types of actions, it is *not* necessary to set forth the real names of all parties in order to give effective notice (e.g., CCP §§ 764.030, 874.210—actions to quiet title and for partition). In such actions, even successors of "Doe" defendants may take their interests subject to the outcome of the litigation.

(2) [11:666] **Property description:** The lis pendens document must contain "a description of the property." [CCP § 405.20]

➪ [11:667] ***PRACTICE POINTER:*** Be sure to provide both the legal description and street address whenever available.

(3) [11:668] **Format:** There are no statutory format requirements. However, CCP § 405.22 requires that a copy of the lis pendens be filed with the court. Therefore, lis pendens are customarily drafted in the form of a standard court pleading (CRC 2.100); *see Form 11:A*.

Cross-refer: Pleading rules and format are explained in detail in Weil & Brown et al., *Cal. Prac. Guide: Civ. Pro. Before Trial* (TRG), Ch. 6.

(4) [11:669] **Signature:** To be recordable, a lis pendens must be signed by plaintiff's attorney. If plaintiff is in pro per, it must be both signed by plaintiff *and* approved by a judge of the court in which the action is pending. [CCP § 405.21 (exception for lis pendens filed by public agency in eminent domain actions)]

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b. Mailing and service requirements

(1) [11:670] **Prior to recordation:** *Before recordation*, copies of the lis pendens must be mailed, by *registered or certified mail*, return receipt requested, to:

• *adverse parties* at "*all* known addresses"; and

• *all owners of record* shown in the "latest county assessment roll." [CCP § 405.22; see also *J & A Mash & Barrel, LLC v. Sup.Ct. (Tower Theater Properties)* (2022) 74 CA5th 1, 26, 289 CR3d 110, 130 (noting claimant must mail notice to address on assessor's role but need not ensure address's *validity*)—notice mailed to individual partner at partnership/ record owner's address on assessment roll was adequate notice to partnership; *Carr v. Rosien* (2015) 238 CA4th 845, 848, 856-857, 190 CR3d 245, 246—regardless of address' validity, failure to mail notice to record owner's address as shown on assessor's roll rendered lis pendens void]

If the address of any such party is unknown, a declaration to this effect is required, which excuses service on that party. [CCP § 405.22; see also *Carr v. Rosien,* supra, 238 CA4th at 853, 190 CR3d at 250—if owner's address is not listed in assessment roll because unknown to assessor, "then—and only then" may claimant satisfy its obligation to mail lis pendens by submitting declaration stating owner has no known address (dicta); *and ¶ 6:671 ff.*]

(a) [11:671] **"All known addresses":** The term "known addresses" probably means *knowable* addresses, in the sense that one who makes reasonable inquiry can ascertain them.

If a person has *both* a business address and a residence address (and both are discoverable through reasonable inquiry), copies must be mailed with return receipt requested to *each address*. Mailing to one address alone renders the service defective.

➪ [11:672] ***PRACTICE POINTER:*** In view of the invalidity provisions of CCP § 405.23 (*¶ 11:682*), be *scrupulously careful* to mail copies of the lis pendens to adverse parties at *all* addresses that might later be deemed to be a "known" address—e.g., business and residential addresses.

(2) [11:673] **Adverse parties joined later:** Adverse parties brought into the action after the initial filing must be served with a copy of the lis pendens *immediately*. [CCP § 405.22; *Rey Sanchez Investments v. Sup.Ct. (Pch Enterprises, Inc.)* (2016) 244 CA4th 259, 261, 197 CR3d 575, 578]

• [11:674] **Comment:** With regard to newly-joined adverse parties, the statute specifies "service" (a different and broader term than mailing) and requires service "immediately." This appears to require serving a copy of the lis pendens at the same time, and by the same method, as service of the complaint or cross-complaint on the new party.

c. Recording procedures

(1) [11:675] **Who may record:** Any party who asserts a "real property claim" may record a lis pendens. [CCP § 405.20; *Park 100 Investment Group II v. Ryan* (2009) 180 CA4th 795, 808, 103 CR3d 218, 226—party who records lis pendens must be same party who asserts real property claim]

Thus, it may be recorded by either a plaintiff or cross-complainant. [See *Fremont Indem. Co. v. Du Alba* (1986) 187 CA3d 474, 478, 231 CR 683, 685—cross-complainant may not rely on plaintiff's lis pendens where cross-complaint seeks affirmative relief and contains new cause of action]

(2) [11:676] **When to record:** A lis pendens may be recorded at the time of filing the complaint or cross-complaint, or at any time thereafter (provided a copy of the lis pendens has first been mailed to interested parties; *see ¶ 11:685 ff.*).

(3) [11:677] **Where to record:** The lis pendens is recorded in the office of the county recorder of the county (or counties) where the property is situated. [CCP § 405.20]

(4) [11:678] **Proof of service recorded with lis pendens:** A proof of service (mailing) as set forth in CCP § 1013a must be *recorded with the lis pendens.* [CCP § 405.23]

(a) [11:679] **Unknown addresses:** If there is "no known address" for service on an adverse party or owner (¶ 11:670 ff.), a declaration to that effect must be recorded in lieu of proof of service. [CCP § 405.23]

d. [11:680] **Filing requirements:** A copy of the lis pendens must be filed with the court in which the pending action is being litigated. [CCP § 405.22]

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➪ [11:681] ***PRACTICE POINTER:*** Although not statutorily required, it is also good practice to file a copy of the proof of service of the lis pendens.

e. [11:682] **Effect of noncompliance:** The service (mailing) and filing requirements set forth in CCP §§ 405.22 and 405.23 are *necessary prerequisites* for "perfecting" a lis pendens. A lis pendens "shall be void and invalid" as to any adverse party or record owner with regard to whom these statutory requirements have not been met. [CCP § 405.23; see also *Rey Sanchez Investments v. Sup.Ct. (Pch Enterprises, Inc.)* (2016) 244 CA4th 259, 263-264, 197 CR3d 575, 578—lis pendens recorded by prospective purchasers void as to alleged prior transferee and prospective sellers due to invalid service; *Carr v. Rosien* (2015) 238 CA4th 845, 848, 190 CR3d 245, 252—lis pendens void as to one owner also void as to that owner's transferees]

f. [11:683] **Effect of compliance; constructive notice to transferees:** Once a proper lis pendens is recorded and properly indexed, "a purchaser, encumbrancer, or other transferee of the real property described in the notice *shall be deemed to have constructive notice* of the pendency of the noticed action as it relates to the real property … against parties not fictitiously named." [CCP § 405.24 (emphasis added); *Bishop Creek Lodge v. Scira* (1996) 46 CA4th 1721, 1733-1734, 54 CR2d 745, 751-752; see also *Bailey v. Outdoor Media Group* (2007) 155 CA4th 778, 793-794, 66 CR3d 322, 334—transferee of sublessee's purported leasehold interest "deemed to have constructive knowledge" of pending litigation between sublessee and sublessor (properly recorded lis pendens vitiated transferee's claim of wrongful occupancy due to mistake of fact re sublease's validity)]

Thus, there *cannot* be a "bona fide purchaser without notice." Any transferee takes "subject to" plaintiff's claims to the property; and if plaintiff wins, "[t]he rights and interests of the claimant in the property … *relate* back to the date of the recording of the notice." [CCP § 405.24 (emphasis added); *Cyr v. McGovran* (2012) 206 CA4th 645, 652, 142 CR3d 34, 40; *Slintak v. Buckeye Retirement Co., LLC, Ltd.* (2006) 139 CA4th 575, 586-587, 43 CR3d 131, 139; see also *Mira Overseas Consulting Ltd. v. Muse Family Enterprises, Ltd.* (2015) 237 CA4th 378, 381, 385-386, 187 CR3d 858, 860, 864—judgment granting investors' fraudulent transfer claim against construction company, as well as monetary damages, related back to date investors recorded lis pendens]

(1) [11:684] **Notice not effective until document properly indexed:** A lis pendens, however, like any recorded document, does not impart constructive notice until it is *properly indexed* so that it can be located by a diligent title search. [See Gov.C. §§ 27230-27265; *First Bank v. East West Bank* (2011) 199 CA4th 1309, 1320, 132 CR3d 267, 276—indexing "essential" for imparting constructive notice to defeat claims of bona fide subsequent buyers; *Dyer v. Martinez* (2007) 147 CA4th 1240, 1243-1246, 54 CR3d 907, 909-911 (collecting cases)—term "recording" in CCP § 405.24 means "recorded as prescribed by law," and Gov.C. § 27250 requires indexing of all recorded lis pendens; *Lewis v. Sup.Ct. (Folksam Gen. Mut. Ins. Soc.)* (1994) 30 CA4th 1850, 1866, 37 CR2d 63, 74—indexing is "operative event" for purposes of imparting constructive notice]

➪ [11:685] ***PRACTICE POINTERS:*** To avoid malpractice claims, verify the recorder's office *promptly and accurately* indexed a recorded lis pendens; and, to the extent possible, provide actual notice of the lis pendens to any prospective buyers and escrow and title companies.

Also, a litigation guarantee obtained from a title insurer (*¶ 3:40*) will protect against the effects of improper indexing by the recorder.

[11:686 - 11:689] ***Reserved.***

4. [11:690] **Withdrawal of Lis Pendens:** A lis pendens may be withdrawn by recording a notice of withdrawal in the office of the county recorder in which the lis pendens was recorded. [CCP § 405.50]

a. [11:691] **Who may record withdrawal notice:** Either the party who recorded the lis pendens or that party's *successor in interest* may record a notice of withdrawal. [CCP § 405.50]

b. [11:692] **Form:** The only statutory requirement as to form is that the notice of withdrawal must be acknowledged in accordance with Civ.C. § 1180 et seq. [CCP § 405.50]

c. [11:693] **Effect of withdrawal notice:** Upon recordation of the notice of withdrawal, the lis pendens no longer affords "constructive or actual notice" of the lawsuit involving the property. [CCP § 405.60]

(1) [11:694] **Actual knowledge irrelevant:** Moreover, nonparty purchasers take free and clear of any claims involved in the lawsuit, even if they had actual knowledge thereof. [CCP § 405.61—no person *other than* a named party to the lawsuit

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"shall be deemed to have actual knowledge of the action or any of the matters contained, claimed, or alleged therein … irrespective of whether that person possessed actual knowledge"]

(a) [11:695] **Purpose:** The Legislature has expressed its intent that this provision "shall provide for the absolute and complete free transferability of real property after the expungement or withdrawal" of a lis pendens. [CCP § 405.61; *see further discussion at ¶ 11:729 ff.*]

"Accordingly … withdrawal of a lis pendens conclusively insulates a purchaser prior to judgment from the claims of the plaintiff in the underlying action." [*Bishop Creek Lodge v. Scira* (1996) 46 CA4th 1721, 1735, 54 CR2d 745, 752]

(2) [11:696] **Compare—no basis for fraud action:** CCP § 405.61 does *not* permit purchasers who *have* actual knowledge of the relevant facts to claim, after withdrawal of a lis pendens, that they were deceived. "[T]he Legislature intended to protect purchasers [from constructive notice of adverse claims] but not to give them, as a bonus, a fraud cause of action that would not otherwise exist." [*Bishop Creek Lodge v. Scira* (1996) 46 CA4th 1721, 1735, 54 CR2d 745, 752-753]

The result is that the withdrawal of a lis pendens is *irrelevant* to a fraud action. [*Bishop Creek Lodge v. Scira*, supra, 46 CA4th at 1734, 54 CR2d at 752]

[11:697 - 11:704] ***Reserved.***

5. [11:705] **Expungement of Lis Pendens:** The "cloud" on title arising from a lis pendens continues so long as the litigation is pending and even after judgment (*Slintak v. Buckeye Retirement Co., LLC, Ltd.* (2006) 139 CA4th 575, 586-587, 43 CR3d 131, 139), thereby creating a potential injustice to the property owner. The Legislature has therefore authorized procedures by which a lis pendens may be removed ("expunged"). [See *Shah v. McMahon* (2007) 148 CA4th 526, 529, 55 CR3d 792, 795; *Amalgamated Bank v. Sup.Ct. (Corinthian Homes)* (2007) 149 CA4th 1003, 1011-1012, 57 CR3d 686, 690-691 (discussing "evolution" of expungement statutes)]

a. [11:706] **Grounds:** A lis pendens may be ordered removed from record title (expunged) for any of the following reasons:

(1) [11:707] **Improper lis pendens:** A lis pendens *must* be ordered expunged if:

- The pleading on which it is based does not contain a "real property claim" (CCP § 405.31; *Kirkeby v. Sup.Ct. (Fascenelli)* (2004) 33 C4th 642, 647, 15 CR3d 805, 808; ¶ *11:628 ff., 11:707.2*); *or*

- The party who recorded the lis pendens cannot establish the "probable validity" of the real property claim by a preponderance of the evidence (CCP § 405.32; *Castro v. Sup.Ct. (Calif. Savings)* (2004) 116 CA4th 1010, 1017, 10 CR3d 865, 869-870; ¶ *11:708 ff.*).

(a) [11:707.1] **Burden and standard of proof—in general:** Unlike most other motions in civil actions, the burden is on the party *opposing* the expungement motion (i.e., the plaintiff claimant) to defeat the underlying bases for the motion by establishing the existence of a real property claim, or the probable validity of the underlying real property claim, by a preponderance of the evidence. [CCP §§ 405.30, 405.32; *Kirkeby v. Sup.Ct. (Fascenelli)* (2004) 33 C4th 642, 647, 15 CR3d 805, 808 (motion based on lack of real property claim); *Shoker v. Sup.Ct. (Phangureh)* (2022) 81 CA5th 271, 277, 296 CR3d 743, 746 (same); *J & A Mash & Barrel, LLC v. Sup.Ct. (Tower Theater Properties)* (2022) 74 CA5th 1, 32-33, 289 CR3d 110, 136 (motion based on underlying claim's lack of probable validity); *Howard S. Wright Const. Co. v. Sup.Ct. (BBIC Investors, LLC)* (2003) 106 CA4th 314, 319, 130 CR2d 641, 646 (same)]

(b) [11:707.2] **Expungement where pleading fails to identify *specific real property:*** A pleading does not contain a "real property claim," and thus will not support a lis pendens, unless it identifies *specific* real property that is the subject of the action (CCP § 405.4). [*Gale v. Sup.Ct. (Gale)* (2004) 122 CA4th 1388, 1396, 19 CR3d 554, 559-560; see also *Park 100 Investment Group II v. Ryan* (2009) 180 CA4th 795, 808, 103 CR3d 218, 227—court must engage in "demurrer-like analysis" in determining whether pleading states real property claim]

While a legal description by reference to a recorded map or metes and bounds is not essential, the pleading, at a minimum, should contain a description sufficient to allow a search of public records to identify the subject property. [*Gale v. Sup.Ct. (Gale)*, supra, 122 CA4th at 1397, 19 CR3d at 560, fn. 6 (dictum)—husband's motion to expunge wife's lis pendens in dissolution action granted where wife's pleading only stated that there were community assets "as may be discovered at a later date" (insufficient description)]

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(c) [11:708] **Expungement based on failure to establish "probable validity" of underlying claim:** "Probable validity" of the claim for purposes of avoiding expungement under CCP § 405.32 means that it is *more likely than not* that the party who asserted the real property claim will obtain a judgment on the claim in that party's favor. [CCP § 405.3; *J & A Mash & Barrel, LLC v. Sup.Ct. (Tower Theater Properties)* (2022) 74 CA5th 1, 32-33, 289 CR3d 110, 136, *discussed at ¶ 8:212b*; *Howard S. Wright Const. Co. v. Sup.Ct. (BBIC Investors, LLC)* (2003) 106 CA4th 314, 319, 130 CR2d 641, 646, fn. 5; see also *De Martini v. Sup.Ct. (Gupta)* (2024) 98 CA5th 1269, 1278-1280, 317 CR3d 441, 448-449—error to apply prima facie standard in determining whether commercial property purchaser established claim's probable validity (concluding recording party must show by *preponderance of evidence* action is "probably valid")]

As such, a § 405.32 expungement motion effectively requires the court to conduct a "mini-trial" on the merits of the real property claim. The plaintiff claimant (in opposing expungement) must, at the very least, establish a prima facie case; if defendant (the moving party) makes an appearance, the court must then consider the relative merits of the parties' respective positions and make a determination of the probable outcome of the litigation. [See *Kirkeby v. Sup.Ct. (Fascenelli)* (2004) 33 C4th 642, 651, 15 CR3d 805, 811; *Amalgamated Bank v. Sup.Ct. (Corinthian Homes)* (2007) 149 CA4th 1003, 1011-1012, 57 CR3d 686, 691—§ 405.32 intended to disapprove of cases holding that court on expungement motion may not conduct "mini-trial" on case's merits]

1) [11:708.1] **Example:** Borrower recorded a lis pendens based on her declaratory relief action seeking a judicial declaration that she had the exclusive right to earthquake insurance proceeds and that Lender, by refusing to turn over the proceeds, violated the "security first rule" (CCP § 726) and thus forfeited its lien on Borrower's property. The only portion of the case affecting title to real property was Borrower's claim that Lender had waived its security interest in Borrower's real property.

Once the trial court concluded there was no waiver of Lender's security, the only remaining issue was which party (Borrower or Lender) was entitled to the insurance proceeds; that determination was strictly a matter of contract, not involving the real property. Therefore, Borrower did not establish the "probable validity" of her real property claim, and the lis pendens was properly expunged pursuant to CCP § 405.32. [*Ziello v. Sup.Ct. (First Fed'l Bank of Calif.)* (1995) 36 CA4th 321, 331-332, 42 CR2d 251, 257]

2) [11:709] **Judgment for defendant on merits generally mandates expungement:** Ordinarily, if plaintiff loses on the merits of the underlying claim, the trial court must grant the motion to expunge unless (in very rare circumstances) it finds it more likely than not that the appellate court will reverse the judgment. [*Amalgamated Bank v. Sup.Ct. (Corinthian Homes)* (2007) 149 CA4th 1003, 1015, 57 CR3d 686, 693-694; *Mix v. Sup.Ct. (Behniwal)* (2004) 124 CA4th 987, 989, 21 CR3d 826, 828; *but see ¶ 11:726.1* re statutory stay of expungement order]

[11:710] ***Reserved.***

(2) [11:711] **Adequate relief by posting undertaking:** Even if the lis pendens is proper (based on a "real property claim" that has "probable validity," ¶ 11:628, 11:708), the court *must* order it expunged if adequate relief may otherwise be secured to protect the claimant by the giving of an *undertaking* (bond). [CCP § 405.33; *Kirkeby v. Sup.Ct. (Fascenelli)* (2004) 33 C4th 642, 651, 15 CR3d 805, 811]

An undertaking is deemed "adequate relief" if it will indemnify the claimant against all damage resulting from removal of the lis pendens should the claimant prevail in the action. [See *Sheets v. Sup.Ct. (Devcorp)* (1978) 86 CA3d 68, 70-71, 149 CR 912, 914—undertaking deemed inadequate security given "fairly large and unique piece of commercial real estate"]

(a) [11:712] **Civ.C. § 3387 presumption inapplicable; single family residence exception:** As earlier discussed, there is a general statutory presumption that every parcel of real property is "unique" and the loss of an interest therein cannot adequately be compensated in money damages (Civ.C. § 3387, *¶ 11:220*). However, for purposes of determining whether a bond will provide "adequate" security for expungement, this presumption applies *only to a single family residence the claimant intends to occupy.* [CCP § 405.33; see also *Real Estate Analytics, LLC v. Vallas* (2008) 160 CA4th 463, 479, 72 CR3d 835, 846—§ 405.33 plainly reflects Legislature's view that "in certain cases a monetary undertaking will provide adequate protection in lieu of a lis pendens to a disappointed buyer of commercial and/or investment property"]

1) [11:712.1] **Comment:** As a practical matter, the removal of a lis pendens from commercial and/or investment property may result in a party losing the right to obtain specific performance should the party ultimately prevail at

trial—i.e., if the defendant no longer has title to the property, a specific performance remedy may not be possible. [See *Real Estate Analytics, LLC v. Vallas* (2008) 160 CA4th 463, 480, 72 CR3d 835, 847]

Nonetheless, there is nothing in the lis pendens statutes "suggesting the Legislature was intending to change the long held view that a nonbreaching real estate buyer in a commercial or investment context is entitled to specific performance, unless the seller rebuts the presumption with *evidence* showing that monetary damages are adequate to compensate the buyer." [See *Real Estate Analytics, LLC v. Vallas*, supra]

(b) [11:713] **Conditional expungement order:** A § 405.33 expungement is *conditioned* on the moving party posting the designated undertaking by a specified "return date." If the party fails to do so, the expungement motion will be *denied* "without further notice or hearing." [CCP § 405.33]

(3) [11:714] **Defects in service or filing:** Defects in statutory service and filing requirements also are grounds for expungement. [See CCP § 405.23; *McKnight v. Sup.Ct. (Faber)* (1985) 170 CA3d 291, 303, 215 CR 909, 915; but see also *Carr v. Rosien* (2015) 238 CA4th 845, 857, 190 CR3d 245, 253—"Legislature did not intend to *require* that a void lis pendens be expunged" (emphasis in original) (defective lis pendens declared void even though never expunged)]

(4) [11:714.1] **Out-of-state litigation:** Again, California's lis pendens statutes do not authorize recording a notice of litigation pending in another state (*¶ 11:648*). Any such notice is subject to expungement, "albeit not under the authority of CCP § 405.30." [See *Formula Inc. v. Sup.Ct. (iStar Fin'l, Inc.)* (2008) 168 CA4th 1455, 1457, 86 CR3d 341, 343—Florida litigation notice recorded against California property was properly expunged notwithstanding lack of any supporting statutory authority]

(5) [11:715] **Compare—undertaking for *continuance of lis pendens:*** Whether or not a motion to expunge has been filed, any person with an interest in the affected property may file a motion to *require the claimant* (party who recorded the lis pendens) to *provide an undertaking* as a *condition to maintaining* the lis pendens in the record title. [CCP § 405.34 (nonparty movants must seek leave to intervene, *¶ 11:725.1*)]

(a) [11:716] **Expungement if undertaking not timely posted:** If the motion is granted and the claimant fails to file the requisite undertaking by the specified "return date," the court *must* order the lis pendens expunged "without further notice or hearing." [CCP § 405.34]

(b) [11:717] **Recovery on undertaking:** A § 405.34 undertaking secures the moving party's damages as a result of maintenance of the lis pendens. Specifically, if the party who recorded the lis pendens does not prevail in the case, damages suffered by the other party as a result of the lis pendens clouding title throughout pendency of the action may be recovered against the undertaking (but not in excess of the undertaking). [CCP §§ 405.33, 405.34]

(6) [11:718] **Compare—voluntary withdrawal:** The party who recorded the lis pendens may voluntarily withdraw it at any time by recording an *acknowledged* "notice of withdrawal" (e.g., where the case settles or is dismissed). [CCP § 405.50; *see ¶ 11:690 ff.*]

(An acknowledgment before a notary public is required; see Civ.C. § 1181 et seq.)

[11:719 - 11:723] *Reserved.*

b. [11:724] **Motion procedure:** A *motion to expunge* is the exclusive procedure by which the court can *compel* removal of a lis pendens prior to final judgment in the action. [CCP § 405.30; *Peery v. Sup.Ct. (Beneficial Standard Properties)* (1981) 29 C3d 837, 842, 176 CR 533, 536]

FORM: Motion to Expunge Lis Pendens, *see Form 11:B*.

(1) [11:725] **Party or nonparty:** The motion to expunge (or a CCP § 405.34 motion to require the claimant to post an undertaking, *¶ 11:715*) may be filed by any party (typically, the defendant property owner) *or* a *nonparty* having an interest in the affected real property. [CCP §§ 405.30, 405.34; see *De Martini v. Sup.Ct. (Gupta)* (2024) 98 CA4th 1269, 1274-1275, 317 CR3d 441, 445—§ 405.30 is intended to prevent unwarranted clouding of party's title with inappropriate or void notice of pending litigation (concluding lis pendens may be expunged if action does not contain real property claim or claimant fails to establish claim's probable validity; ¶ 11:708)]

(a) [11:725.1] **Nonparty intervention prerequisite:** However, a nonparty movant must obtain *leave to intervene* in the action at or before the time the motion is heard. [CCP §§ 405.30, 405.34]

(2) [11:726] **Evidence/hearing:** Normally, the motion is heard on the basis of declarations filed with the moving papers and counter-declarations filed in opposition. But the court also has discretion to permit *oral testimony* at the expungement

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hearing; and may make orders it "deems just" to provide for discovery by any party affected by the motion. [CCP §§ 405.30, 405.34]

Cross-refer: For further discussion of motions to expunge lis pendens, see Weil & Brown et al., *Cal. Prac. Guide: Civ. Pro. Before Trial* (TRG), Ch. 9 Part I.

c. [11:727] **Prevailing party attorney fees/costs award:** The party prevailing on an expungement motion (or on a CCP § 405.34 motion to require an undertaking from the claimant (*see ¶ 11:715 ff.*)) *must* be awarded reasonable attorney fees and costs incurred in making or opposing the motion … *unless* the court finds the other party acted with "substantial justification" or that other circumstances make the imposition of attorney fees and costs "unjust." [CCP § 405.38; *Kirkeby v. Sup.Ct. (Fascenelli)* (2004) 33 C4th 642, 651, 15 CR3d 805, 811-812—"the possible imposition of attorney fees and sanctions should discourage abuse of the lis pendens statute"; *Castro v. Sup.Ct. (Calif. Savings)* (2004) 116 CA4th 1010, 1018, 10 CR3d 865, 870 (same)]

(1) [11:727.1] **"Practical approach" to "prevailing party" determination:** The statute does not define "prevailing party" for purposes of a CCP § 405.38 attorney fees award. Courts therefore decide the issue based on which party succeeded on a "practical level," and award § 405.38 fees to the party who "realized its litigation objectives." [*Castro v. Sup.Ct. (Calif. Savings)* (2004) 116 CA4th 1010, 1018-1019, 10 CR3d 865, 870-871—same approach used to determine prevailing party in pretrial voluntary dismissal cases (*¶ 11:139.17*)]

(a) [11:727.2] **Effect of withdrawing lis pendens during pendency of motion to expunge:** When a lis pendens is withdrawn while a motion to expunge is pending, the moving party achieves its litigation objectives by removing the cloud on title, thus freeing the property to be transferred while the underlying litigation continues; the moving party has obtained the relief that the court would have granted had it ruled on the motion. [*Castro v. Sup.Ct. (Calif. Savings)* (2004) 116 CA4th 1010, 1021, 10 CR3d 865, 873]

Nonetheless, § 405.38 attorney fees are *not* automatically awarded to the moving party. Instead, the "court has *discretion* to award fees based on a determination of which party would have prevailed on the motion, *and* whether the lis pendens claimant acted with *substantial justification in withdrawing* the lis pendens, *or* whether, in light of all the circumstances, the imposition of fees would *otherwise be unjust*." [*Castro v. Sup.Ct. (California Savings)*, supra, 116 CA4th at 1024-1025, 10 CR3d at 875-876 (emphasis added)]

(2) [11:727.3] **Reviewable only by timely writ petition:** *See ¶ 11:727.10*.

[11:727.4 - 11:727.9] ***Reserved.***

d. [11:727.10] **Writ review of expungement order; automatic stay:** An order expunging a lis pendens is not appealable; it is reviewable only by petition for writ of mandate filed and served *within 20 days* after service of written notice of the order. [CCP § 405.39; *De Martini v. Sup.Ct. (Gupta)* (2024) 98 CA5th 1269, 1272, 317 CR3d 441, 444; *Park 100 Investment Group II v. Ryan* (2009) 180 CA4th 795, 809, 103 CR3d 218, 227; *Amalgamated Bank v. Sup.Ct. (Corinthian Homes)* (2007) 149 CA4th 1003, 1016, 57 CR3d 686, 695; see also *Shah v. McMahon* (2007) 148 CA4th 526, 529, 55 CR3d 792, 794—CCP § 405.39 mandate for exclusive writ review applies to all orders made under CCP § 405.30 et seq. (expungement and related orders) and thus to orders awarding CCP § 405.38 prevailing party attorney fees on motion to expunge]

Moreover, the trial court's expungement order does *not take effect* and may *not be recorded* until the 20-day period for seeking writ review has expired; and, if a writ petition *is* timely filed, the expungement order is stayed, and may not be recorded, until final disposition of the writ proceeding. [CCP § 405.35]

(1) [11:727.11] **Standard of writ review:** The "probable validity" standard used by the trial court to determine whether a lis pendens should be expunged (*¶ 11:707*, *11:708*) is also used by the appellate court on writ review of the expungement order. Thus, the appellate court must assess whether it is more likely than not that the underlying claim will prevail at the end of the appellate process … even if this puts the court "in the somewhat awkward position of attempting to forecast our own resolution of the underlying appeal." [*Amalgamated Bank v. Sup.Ct. (Corinthian Homes)* (2007) 149 CA4th 1003, 1016-1017, 57 CR3d 686, 695]

e. [11:728] **Effect of recording expungement order:** Upon recordation of a certified copy of the expungement order, the lis pendens ceases to have any effect.

- It no longer provides actual or constructive notice of the matters stated therein or a duty of inquiry to anyone dealing with the property. [CCP § 405.60]

- Moreover, until a copy of the ultimate judgment in the action is recorded, no one other than the named parties to the action takes subject to plaintiff's claims in the lawsuit. [CCP § 405.61]
  As a result, a subsequent purchaser takes title unencumbered by the judgment ultimately rendered in the action in which the lis pendens was recorded. [*Federal Dep. Ins. Corp. v. Charlton* (1993) 17 CA4th 1066, 1069-1070, 21 CR2d 686, 689]
  "It is the intent of the Legislature that this section shall provide for the *absolute and complete free transferability* of real property after the expungement or withdrawal of a notice of pendency of action." [CCP § 405.61 (emphasis added)]
  (1) [11:729] **Actual knowledge irrelevant:** Except for named parties, the Code provides for "absolute and complete free transferability" of property after expungement of the lis pendens. *Nonparty purchasers take free and clear* of the claims involved in the lawsuit … even if they had actual knowledge thereof and would have been subject thereto had a lis pendens not been filed. [CCP § 405.61; *Knapp Develop. & Design v. Pal-Mal Properties, Ltd.* (1987) 195 CA3d 786, 790, 240 CR 920, 923 (decided under former law but same rule under present statute)]
  - [11:730] **Example:** Buyer 1 sues Vendor for specific performance and records a lis pendens. Vendor has the lis pendens expunged. Vendor may *freely* convey the subject property to Buyer 2, even though Buyer 2 knows of the underlying lawsuit and has been "waiting in the wings" to purchase the property for more money.
    (This is one of the major *disadvantages* to a lis pendens; *see ¶ 11:612*.)

  (2) [11:731] **Compare—if no lis pendens filed:** If, in the example at ¶ 11:730, Buyer 1 had never recorded the lis pendens, Buyer 2 would be subject to the judgment in the underlying action because Buyer 2 had actual knowledge of the lawsuit. [See CCP § 1908(a)(2)—judgment binding on successors in interest who have actual or constructive notice of action]
  (3) [11:732] **Not applicable to transfers to named parties:** The rule set forth at ¶ 11:728 ff. applies only to nonparties. Where the property is conveyed to a *named party* ("a nonfictitious party to the action"), the transferee takes subject to the outcome of the litigation. [CCP § 405.61]
  (4) [11:733] **No basis for claiming fraud:** CCP § 405.61 relieves purchasers of "actual knowledge" following expungement of a lis pendens only for purposes of transferability of title. It does not permit someone with knowledge of relevant facts to purchase property after a lis pendens has been expunged in order to claim fraudulent misrepresentations or nondisclosure of *matters as to which that person has actual knowledge*. *See ¶ 11:696*.
  (5) [11:734] **Effect on other liens or interests:** Expungement of a lis pendens affects only the claims asserted in the underlying lawsuit. It has no effect on liens or interests previously recorded under *other* documents or conveyances.
  (6) [11:735] **Refiling lis pendens prohibited:** After a lis pendens has been expunged, plaintiff *must* obtain leave of court before recording another lis pendens as to the affected property. (That may be appropriate, for example, where the expungement was for technical defects in service and filing (*¶ 11:714*) or where a judgment adverse to plaintiff is reversed on appeal.) [CCP § 405.36; *Park 100 Investment Group II v. Ryan* (2009) 180 CA4th 795, 809, 103 CR3d 218, 227; *McKnight v. Sup.Ct. (Faber)* (1985) 170 CA3d 291, 303, 215 CR 909, 915-916 (decided under former law); see also *De Martini v. Sup.Ct. (Gupta)* (2024) 989 CA5th 1269, 1276-1277, 317 CR3d 441, 446-447—commercial property purchaser was required to obtain court permission before filing second lis pendens in subsequent action following vendor's successful expungement of purchaser's original lis pendens in earlier related action (concluding it would "simply invite more of the abuse which the statute was intended to cure" if purchaser could record "at will" second lis pendens after first one was expunged)]

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Cal. Prac. Guide Real Prop. Trans. Form 11:A

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 11. Remedies in Purchase and Sale Transactions

Forms

[Form 11:A] Notice of Pendency of Action (Lis Pendens)

....
State Bar No. ....
....
....
Attorney for: ....

SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF _____

___________,	)	CASE NO. ___________
	)	
Plaintiff,	)	NOTICE OF PENDENCY OF ACTION (LIS PENDENS)
	)	
vs.	)	
	)	
___________,	)	
	)	
Defendant.	)	
....	)	

PLEASE TAKE NOTICE THAT above-captioned action, by plaintiff ___________ ___________ against ___________, affects title to and/or possession of real property in that plaintiff seeks specific performance of a contract to purchase the real property located in ___________ County at _____ *(street address)* _____ and described as:

[LEGAL DESCRIPTION OF PROPERTY]

DATED: _____
/s/

____
Attorney for ___________

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Cal. Prac. Guide Real Prop. Trans. Form 11:B

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 11. Remedies in Purchase and Sale Transactions

Forms

[Form 11:B] Motion to Expunge Lis Pendens

....
State Bar No. ....
....
....
Attorney for: ....

SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF _____

___________,	)	CASE NO. ___________
	)	
Plaintiff,	)	HEARING DATE/TIME: _____
	)	DEPT. NO.: ___________
vs.	)	HEARING JUDGE: _ *(if known)*
	)	
___________,	)	NOTICE OF MOTION TO
	)	EXPUNGE LIS PENDENS
	)	AND FOR ATTORNEY FEES
Defendant.	)	AND COSTS; DECLARATION OF
	)	_____; POINTS AND
	)	AUTHORITIES; PROPOSED
	)	ORDER
	)	
	)	DATE ACTION FILED: _____
	)	DATE SET FOR TRIAL: _ *(if set)*
....	)	

TO ALL INTERESTED PARTIES AND THEIR ATTORNEYS OF RECORD;

PLEASE TAKE NOTICE THAT at _____ on _____, _____, or as soon thereafter as counsel can be heard, in Dept. _____ of the above-entitled Court, located at ___________, defendant _____ will move for an order expunging that certain notice of pendency of action (lis pendens) recorded on _____, _____, in the office of the County Recorder of _____ County, in book ___, on page ___, as instrument no _____, and filed in the above-captioned action; and for a reasonable award of attorney fees and costs. The motion will be made on the ground(s) that _____ *(insert applicable ground(s) below)* ___________

(FOR MOTION TO EXPUNGE IMPROPER LIS PENDENS)

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("the complaint does not contain a cause of action which would, if meritorious, affect title or possession of specific real property or use of an easement identified in the complaint and is therefore subject to expungement under Code of Civil Procedure Section 405.31")

AND/OR

("plaintiff cannot establish the probable validity of the real property claim contained in the complaint by a preponderance of the evidence and is therefore subject to expungement under Code of Civil Procedure Section 405.32")

(FOR MOTION TO EXPUNGE—UNDERTAKING PROVIDES ADEQUATE SECURITY)

("even if the real property claim asserted by plaintiff has probable validity, adequate relief can be secured to plaintiff by the giving of an undertaking and therefore the notice of pendency of action is subject to expungement under Code of Civil Procedure Section 405.33")

(FOR MOTION TO EXPUNGE FOR DEFECTIVE SERVICE OR FILING)

("the notice of pendency of action (lis pendens) was defectively served (or filed)")

The motion will be based on this notice, the attached declarations of ___________ and points and authorities, and the complete files and records of this action.

DATED: _____
/s/

____
Attorney for ___________

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Chapter 12. Residential Co-Ownership Agreements

A. General Considerations

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[12:1] As between married persons (or registered domestic partners, see Fam.C. § 297.5), residential property is commonly co-owned as community property or joint tenants. However, there is also a growing trend among other individuals to jointly acquire residential property—e.g., nonmarital cohabitants purchasing a house in joint tenancy (or as tenants in common), neighbors buying a multiunit house or small apartment building, or friends combining to purchase a vacation home. These co-ownership arrangements present unique problems that buyers' counsel must be prepared to address in addition to the host of issues arising in connection with any real property acquisition.

This Chapter focuses on issues to be considered by parties contemplating a *residential* co-ownership arrangement. Co-ownership of income-producing or other kinds of investment real property most commonly occurs in the context of a partnership, limited liability company or corporation, which is beyond the scope of this Practice Guide. (Nevertheless, many of the issues discussed in this Chapter are germane to simple real estate partnerships which own income property.)

1. [12:2] **Lawyer's Role, Generally:** Residential property co-owners are often unsophisticated in (and, sometimes, emotionally reluctant to deal with) the business and legal practicalities of sharing ownership. Consequently, co-ownership arrangements require special counseling by the lawyer.

Significantly, co-owners frequently do not appreciate the need to formalize their ownership arrangement and do not want to create an extensive written agreement. Counsel must be prepared to advise the parties of the importance of a written co-ownership agreement—in particular, the need to agree upon an efficient method for dissolving the co-ownership relationship (¶ *12:37 ff.*); and counsel should be equipped to assist in the negotiation and drafting of the pertinent documents.

2. [12:3] **Kinds of Co-Ownership:** There are four fundamental types of co-ownership:

- Joint interests (*¶ 12:4 ff.*);
- Interests in common (*¶ 12:6 ff.*);
- Community property (*¶ 12:8 ff.*); or
- Partnership interests (*¶ 12:10 ff.*). [See Civ.C. § 682]

a. [12:4] **Joint tenancy:** The "joint interests" referred to in Civ.C. § 682 are *joint tenancy* interests between co-owners. A joint tenancy is created when two or more persons acquire property in equal shares by the same conveyance and at the same time, with identical possessory rights, pursuant to an instrument of transfer that expressly declares the co-ownership to be a joint tenancy. [See Civ.C. § 683]

(1) [12:5] **Distinguishing features:** Joint tenancies are distinguishable primarily from tenancies in common and partnership interests in that the joint tenants own *equal interests* in the property, all of which are subject to the *right of survivorship*; i.e., upon any joint tenant's death, their interest passes *by operation of law* to the surviving joint tenant(s). [*Dieden v. Schmidt* (2002) 104 CA4th 645, 650, 128 CR2d 365, 368-369; see also *Dang v. Smith* (2010) 190 CA4th 646, 660, 118 CR3d 490, 501-502—joint tenancy character of real property in which judgment debtor held interest automatically terminated when judgment debtor died, leaving secured creditor without recourse (only way to protect creditor's lien against judgment debtor's death was to "successfully execute" on property *before* debtor died)]

(Spouses and registered domestic partners also hold equal ownership interests in community property; but community property carries no right of survivorship, *unless* title is expressly taken as "community property with right of survivorship"; *see ¶ 12:9.1*.)

(2) [12:5.1] **Extinguishing right of survivorship by severance:** A joint tenancy may be *severed* (as to all joint tenants or as to any single joint tenant's interest) by agreement of the parties, by written declaration or by conveyance with or without the other joint tenants' joinder or consent. A severance *extinguishes the right of survivorship feature* and the co-owners thereafter hold the property as tenants in common. [See Civ.C. § 683.2; see also *Walters v. Boosinger* (2016) 2 CA5th 421, 434-435, 205 CR3d 895, 905-906—§ 683.2 outlines *nonexclusive* list of methods by which joint tenancy may be severed]

- [12:5.1a] The joint tenancy character of a family residence was terminated when the spouses included it in a trust executed by both even though the trust document was not recorded. [*Estate of Powell* (2000) 83 CA4th 1434, 1442-1443, 100 CR2d 501, 506]
- [12:5.2] Unrecorded deeds between two of three joint tenants granting each other joint tenancy as to their 2/3 interest severed the overall joint tenancy, creating a tenancy in common with the third former joint tenant. [*Re v. Re* (1995) 39 CA4th 91, 98-99, 46 CR2d 62, 67]
- [12:5.2a] During the pendency of a marital dissolution action, wife attempted to sever a joint tenancy with her husband and eliminate his survivorship right by recording a deed pursuant to Civ.C. § 683.2 that purportedly transferred her 50% interest in the underlying property to her son in trust. Wife died pending resolution of the dissolution action which was subsequently dismissed for lack of jurisdiction. Nonetheless, Fam.C. § 2040(b)(3)'s notice requirements (¶ 4:150b) were satisfied and the severance was completed when wife's son served wife's husband with the aforementioned deed in conjunction with a previously filed partition action. [*Raney v. Cerkueira* (2019) 36 CA5th 311, 316-317, 329-330, 248 CR3d 426, 429, 439-440 (finding statutorily-mandated recordation *and* notice requirements for severing survivorship rights may be satisfied in any order); see also Hogoboom & King, *Cal. Prac. Guide: Family Law* (TRG), Ch. 5]
- [12:5.3] *Compare:* A wife who unilaterally quitclaimed her interest in a joint tenancy residence to an irrevocable trust did not defeat her husband's right of survivorship in the residence because her quitclaim deed was not timely notarized and recorded pursuant to Civ.C. § 683.2(c). [See *Dorn v. Solomon* (1997) 57 CA4th 650, 653, 67 CR2d 311, 313 (*discussed at ¶ 4:150a*)]
- [12:5.4] Decedent's ex-girlfriend did not sever their joint tenancy in real property by way of his predeath complaint for partition and her superseded answer: "We are aware [of no authority] that holds that a court may interpret a party's complaint and another party's *superseded* answer to constitute an *instrument* that severs a joint tenancy." [*Walters v. Boosinger* (2016) 2 CA5th 421, 438, 205 CR3d 895, 908 (emphasis in original)]

Cross-refer: The creation of a joint tenancy, nature of joint tenancy ownership, and severance of joint tenancy interests are discussed in greater detail at *¶ 4:146 ff.*

b. [12:6] **Tenancies in common:** Co-ownership that is not in the form of joint tenancy title, community property or a partnership is a tenancy in common. [Civ.C. §§ 685, 686]

A tenancy in common is deemed created whenever the conveyancing instrument does not specify how title among the several co-owners is taken (except when the acquisition is by spouses during marriage or registered domestic partners during their registered domestic partnership, in which case the parties presumptively take their interests as community property; *¶ 12:8*). [Civ.C. § 686; *Wilson v. S.L. Rey, Inc.* (1993) 17 CA4th 234, 242, 21 CR2d 552, 555] Even so, parties who desire the creation of a tenancy in common often expressly designate that form of ownership in the conveyancing instrument.

(1) [12:7] **Distinguishing features:** Tenants in common own separate legal title to their undivided interests in the property; unlike joint tenants, their interests are not necessarily equal and are *not* subject to a right of survivorship. Any single co-owner may sell, transfer or encumber the undivided interest as the owner pleases, and the transferee takes title as a tenant in common with the other co-owners. [*Wilson v. S.L. Rey, Inc.* (1993) 17 CA4th 234, 242, 21 CR2d 552, 555; see also *Dang v. Smith* (2010) 190 CA4th 646, 559-660, 118 CR3d 490, 501—tenant in common's death poses no hazard to creditors since deceased tenant's interest in property passes directly to tenant's estate (rather than to surviving tenant(s)), making it available to satisfy debts]

However, like joint tenants, unless the tenants in common otherwise agree, each has equal rights to possession of the property. *See discussion at ¶ 4:143 ff.*

Tenants in common (like joint tenants) stand in a fiduciary relationship to each other, *except* where the "cotenants acquire their interests at different times through different instruments …" [*Wilson v. S.L. Rey, Inc.*, supra, 17 CA4th at 242-243, 21 CR2d at 556—there being no relationship of trust and confidence between strangers, "[i]t would be an elevation of form over substance to hold that a fiduciary relationship exists between [them] merely because they have acquired interest in the same piece of property"]

Cross-refer: Tenancies in common are discussed in greater detail at *¶ 4:140 ff.*

c. [12:8] **Community property:** A spouse's/registered domestic partner's acquisitions during the marriage or domestic partnership (whether real or personal property and no matter where situated) are presumptively community property unless traceable to a separate property source. [Civ.C. § 687; Fam.C. §§ 297.5(a), (b), (c), 760, 770, 2581—parties' acquisitions in "joint form" are presumptively community property for purposes of property division upon dissolution or legal separation; see also *In re Brace* (2020) 9 C5th 903, 935-938, 266 CR3d 298, 320-323 (finding (i) community property presumption applies not only to interspousal disputes, but also to disputes with one or more spouses and bankruptcy trustee, and (ii) titling deed as joint tenancy by itself did not transmute property into separate property); *Trenk v. Soheili* (2020) 58 CA5th 1033, 1046, 273 CR3d 184, 193—presumption "cannot be rebutted simply by the form of title in which a married couple holds property" (couple that "held title" to property as "joint tenants" not sufficient to show property "in fact was separate property")]

The source of funds does not have to be proven in order for the presumption to apply. [*Trenk v. Soheili*, supra, 58 CA5th at 1048, 273 CR3d at 194—"To the contrary: The law is clear that the presumption may be *rebutted* with proof that separate funds were used to purchase the property at issue" (emphasis in original)]

Spouses/domestic partners may, however, by written declaration between them, "transmute" their community property to separate property interests. [Fam.C. § 850 et seq.; see also Fam.C. § 750—"[s]pouses may hold property as joint tenants or tenants in common, or as community property, or as community property with a right of survivorship"; *Marriage of Wozniak* (2020) 59 CA5th 120, 134, 273 CR3d 421, 434—Fam.C. § 850 does not permit unilateral property transfers from one spouse to another and requires transferee spouse's acceptance of property interest for valid transmutation]

(1) [12:9] **Distinguishing features:** Spouses/domestic partners own "present, existing and equal interests" in their community property during continuance of their marriage/domestic partnership—i.e., each party has an equal ownership interest in the whole of the community estate. [Fam.C. § 751; see *State Board of Equalization v. Woo* (2000) 82 CA4th 481, 483, 98 CR2d 206, 208; *In re McIntyre* (9th Cir. 2000) 222 F3d 655, 658 (applying Calif. law)—spouses' "equal" interests are 50-50 interests in *whole* of community property, *not* "exclusive" interests in only half]

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Spouses/domestic partners also share equal rights of management and control over the community estate, but subject to several intraspousal fiduciary obligations. [Fam.C. §§ 721(b), 1100 et seq.]

Each party has complete rights of testamentary disposition over their community property interest. But unlike tenants in common, neither may unilaterally transfer or encumber their community property interest during the marriage/domestic partnership; indeed, such an unauthorized disposition will be voidable by the non-consenting spouse/domestic partner. [See Fam.C. § 1102; *Droeger v. Friedman, Sloan & Ross* (1991) 54 C3d 26, 36-39, 283 CR 584, 590-592]

(2) [12:9.1] **Community property with right of survivorship:** Spouses/domestic partners can also hold title as "community property with right of survivorship." This is essentially a probate avoidance device that otherwise retains the features of community property. Before either party's death, the right of survivorship may be terminated in the same manner that a joint tenancy is severed. [Civ.C. § 682.1; Fam.C. § 750] *See discussion at ¶ 4:177 ff.*

Cross-refer: Community property ownership is discussed in greater detail at ¶ *4:166 ff. and 4:201 ff.* And, for an exhaustive treatment of the subject, see Hogoboom & King, *Cal. Prac. Guide: Family Law* (TRG), Ch. 8.

d. [12:10] **Partnerships:** A partnership interest is one owned by several persons, in partnership, for partnership purposes. [Civ.C. § 684]

The rights of partners in a real estate partnership (or in any partnership that owns real property) are governed by their partnership agreement (Corps.C. § 16103) and by the Uniform Partnership Act (UPA, Corps.C. § 16100 et seq.).

(1) [12:11] **Distinguishing features:** Although many of the considerations regarding co-ownership agreements are applicable to partnerships, the rights and obligations of partners are different from the rights and obligations of other kinds of co-owners. This is fundamentally because many principles of partnership law have no application to co-owners who are not partners.

(a) [12:12] **Co-ownership for profit:** A "partnership" is defined as "an association of two or more persons to carry on as coowners a business for profit" and includes a registered limited liability partnership. [Corps.C. § 16101(a)(9); see also Corps.C. § 16202(a)—"association of two or more persons to carry on as coowners a business for profit forms a partnership, whether or not the persons intend to form a partnership"] Thus, persons who jointly own a piece of property for their personal use, and not for profit, cannot be "partners."

The UPA also specifically provides, however, that a "[j]oint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not by itself establish a partnership, even if the coowners share profits made by the use of the property." [Corps.C. § 16202(c)(1)]

(b) [12:13] **Agency relationship; power to bind copartners:** Unlike joint tenants, tenants in common or other forms of co-ownership, partners are deemed *agents* of each other. [Corps.C. § 16301] Therefore, each partner acting within the scope of partnership business binds the other partners.

Moreover, one partner's knowledge generally is imputed to the partnership (Corps.C. § 16102(f)); and each partner generally is liable for the wrongful acts of the co-partners in the course of partnership business (see Corps.C. §§ 16305, 16306, 16308). This is not necessarily the case as between joint tenants or tenants in common.

1) [12:14] **Conveyance of title to partnership real property; statement of authority as limitation:** Under the UPA, title to real property held in the partnership name generally can be conveyed by any single partner acting within the ordinary scope of partnership business. Even a conveyance that would not normally bind the partnership (e.g., because outside the normal course of partnership business or because otherwise made by a partner lacking authority) may be effective as to a bona fide purchaser for value. [See Corps.C. § 16302]

However, by *filing* a certified copy of a statement of partnership authority with the Secretary of State and *recording* the statement in the office of the county recorder where the property is located, a partnership can *limit* a partner's authority to transfer partnership real property, imparting *constructive notice* thereof to "the world" (Civ.C. § 1218) and thus preventing BFP transferee rights. [See Corps.C. §§ 16105, 16303(d)(2); ¶ *4:204 ff.*]

(2) [12:15] **Partnership agreement vs. co-ownership agreement:** Generally, co-owners should at least consider structuring their co-ownership rights under a partnership agreement (see Corps.C. § 16103) rather than by way of a "generic" co-ownership agreement. [See *Jones v. Wagner* (2001) 90 CA4th 466, 469, 108 CR2d 669, 671]

The main disadvantage of a partnership format, however, is that each partner is deemed the agent of the other partners (¶ *12:13*) and co-owners often do not want to be responsible for the actions of the other co-owners.

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Cross-refer: The incidents of co-ownership in the form of a partnership are discussed in greater detail at ¶ *4:160 ff.* *and 4:203 ff.*

[12:16 - 12:19] ***Reserved.***

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Chapter 12. Residential Co-Ownership Agreements

B. Agreements Regarding Co-Ownership Rights and Obligations

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4. [12:44] Recording Memorandum of Agreement

1. [12:20] **Necessity for Formal Agreement:** Unmarried couples or friends who pool their resources to buy residential property are often naive about co-ownership responsibilities; they are also unlikely to recognize the possibility of disputes arising between them, which could affect the management or termination of their co-ownership arrangement. A written co-ownership agreement regarding the parties' respective rights and obligations will accomplish two important objectives:

• Fundamentally, it will document the parties' agreed-upon understanding, thus ensuring a legally-*enforceable* arrangement with regard to co-ownership rights and obligations. [See *Jones v. Wagner* (2001) 90 CA4th 466, 472-473, 108 CR2d 669, 674—in action for constructive fraud and breach of partnership agreement formed to purchase residential property, plaintiffs' claims not supported by evidence since agreement was oral and did not include any terms regarding contribution by one partner for other partner]

• Just as important, the effort in creating such a document will compel the parties to *think about (and resolve) issues* they might not otherwise consider.

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2. [12:21] **"Joint Representation" Conflict of Interest Concerns:** As a threshold concern, an attorney asked to prepare a residential property co-ownership agreement must deal with the potential *conflict of interest* in representing more than one party. The most prudent approach is for each party to retain independent counsel. As a practical matter, however, that option is frequently unrealistic when the co-owners are an unmarried couple or close friends. Because of the amicable nature of their relationship, they are likely not to appreciate the risks inherent in "joint representation"; and, for convenience (to save time and money), they are likely to insist that a single attorney represent them both.

Technically, such "joint representation" is not legally or ethically prohibited. However, even when it appears both parties are aligned in interests and there are no actual conflicts between them, they must be advised of the *potential* for a future conflict of interests. Those risks must be fully disclosed to the clients in writing; and the joint representation cannot be accepted without each party's *informed written consent*. [See CRPC 1.7, and accompanying "Comment"; *and more detailed treatment of joint representation conflicts of interest at ¶ 1:81 ff.*]

3. [12:22] **Issues to Address:** The sections set forth at ¶ 12:23 ff. summarize the issues to consider when counseling residential co-owners about a co-ownership agreement and in negotiating and preparing the agreement.

FORM: Residential Co-Ownership Agreement, *see Form 12:A*.

a. [12:23] **Subdivision issues:** Multi-unit building tenants sometimes join together for the purpose of buying their building, with each party thereafter having the exclusive right to use a particular unit (see, e.g., *Tom v. City & County of San Francisco* (2004) 120 CA4th 674, 677, 16 CR3d 13, 16). Counsel should be aware that, because the building will still constitute one legally subdivided parcel, such a co-ownership arrangement could result in a violation of the Subdivision Map Act (Gov.C. § 66410 et seq.).

On the other hand, any laws that have the effect of discouraging the arrangement could be struck down as violating the parties' rights of privacy under the California Constitution (see *Tom v. City & County of San Francisco*, supra, 120 CA4th at 677-688, 16 CR3d at 16-24).

➪ [12:24] ***PRACTICE POINTER:*** Subdivision Map Act issues are extremely complex. Unless you have appropriate expertise in this area, the parties should be referred to counsel specializing in land use and subdivision matters; at a minimum, experienced counsel should be associated on the case. As in any legal matter, do *not* attempt to advise clients on issues that could compromise your duty to provide "*competent*" representation. [See CRPC 1.1, *and discussion of counsel's duty of "competence" at ¶ 1:46 ff.*]

b. [12:25] **Initial contributions and ongoing expenses:** The parties must consider how much each of them will initially contribute to acquire the property *and* how and when each will be responsible for the payment of ongoing expenses. Typically, these expenses will include such things as mortgage payments, real property taxes and assessments, insurance premiums, utilities, maintenance and repair costs (gardeners, pool maintenance, painting and general upkeep, security system, etc.); and they are also likely to include a host of unanticipated costs (furniture and furnishings, etc.).

Expenses are commonly shared between co-owners based on the percentage of their respective ownership interests. However, *how* the costs are to be divided is not nearly as problematic as *who* decides when to incur the expense and the penalties (if any) for a co-owner's failure to make their contribution toward ongoing expenses (*see ¶ 12:33 & 12:36*).

c. [12:26] **Form of title:** The parties should agree on how they wish to hold title to the property—i.e., as joint tenants or tenants in common (*¶ 12:6*).

➪ [12:27] ***PRACTICE POINTER—EVIDENTIARY EFFECT*****:** Be prepared to advise the parties about the distinguishing features of the various forms of title (e.g., consequences of the right of survivorship that attaches to joint tenancy title). The parties should also be advised of the *evidentiary effect* of a recorded title designation:

A party asserting an interest in property contrary to *record title* bears a heavy evidentiary burden: There is a statutory presumption that the owner of legal title to property is the owner of the full beneficial title; and this presumption may be rebutted only by *clear and convincing evidence.* [Ev.C. § 662—presumption is based on public policy favoring stability of titles to property]

Therefore, pursuant to Ev.C. § 662, property acquired in the name of only *one* of the parties presumptively belongs to that party in full; and any other purported co-owner bears the burden of proving the co-ownership agreement by clear and convincing evidence. [See *Tannehill v. Finch* (1986) 188 CA3d 224, 228, 232 CR 749, 751 (ownership dispute between

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nonmarital cohabitants); but see *In re Brace* (2020) 9 C5th 903, 935, 266 CR3d 298, 320—Ev.C. § 662 presumption does not apply when it conflicts with Fam.C. § 760 community property presumption (¶ 12:8); *Marriage of Haines* (1995) 33 CA4th 277, 283, 300-302, 39 CR2d 673, 677, 688-689 (disagreed with on other grounds by *In re Brace* (2020) 5 C5th 903, 916, 266 CR3d 298, 304-305)—in marital proceedings, Ev.C. § 662 presumption and its higher rebuttal standard must *yield* to presumption of undue influence emanating from Fam.C. § 721(b) (fiduciary standard of care between spouses)]

d. [12:28] **Percentage ownership:** The parties must also decide on their respective percentage ownership interests in the property.

➪ [12:29] ***PRACTICE POINTER:*** This issue is particularly important as between unmarried couples who often enter into their nonmarital cohabitation relationship on the assumption all of their acquisitions during the relationship will be owned *as if* they were spouses (or registered domestic partners). If that is really their shared intent, each party will probably assume each has a 50% undivided interest in the property, regardless of how much each contributed to the acquisition (and notwithstanding that one of them might have contributed nothing to the acquisition). Yet, without a written agreement on the issue, the matter is likely to end up in court with both parties facing rather onerous burdens of proof. (See detailed discussion of nonmarital cohabitant rights and remedies in Hogoboom & King, *Cal. Prac. Guide: Family Law* (TRG), Ch. 20.)

e. Right to transfer or encumber co-ownership interest

(1) [12:30] **Sale of co-ownership interest:** Co-ownership arrangements are invariably entered into under the assumption the parties will be dealing only with each other; typically, the parties are not strangers to each other and are willing to share rights and responsibilities because they know and trust each other. Consequently, the parties often will want to restrict the right of any individual co-owner to sell or transfer their interest so as not to risk an unwitting cotenancy with unknown third parties.

With this in mind, the co-ownership agreement should carefully deal with how and when co-owners may transfer their respective interests, if at all—e.g., only with the express consent of the other co-owners, who have a right to approve or disapprove the proposed transferee.

• [12:31] **Comment:** Bear in mind that a *joint tenancy* is severable as to any co-owner's interest by a unilateral conveyance *unless* the parties have otherwise agreed. [Civ.C. § 683.2(a) & (b)] The severance will defeat the right of survivorship feature as to the severing joint tenant's interest, and the transferee will hold their share as tenant in common. (But see Civ.C. § 683.2(c), *discussed at ¶ 4:150a.*)

Likewise, a tenant in common can transfer their interest without the co-owners' consent, unless the parties have otherwise agreed (*¶ 12:7*).

(Even so, as a practical matter, a co-ownership interest does not have much marketability; thus, a co-owner is likely to have a difficult time selling the interest.) (*See further discussion at ¶ 12:37 ff.* re termination of co-ownership relationship.)

(2) [12:32] **Mortgaging co-ownership interest:** Because each co-owner owns less than full fee title to the property, each can encumber only its *own* undivided interest (not the entire fee). Therefore, it is unlikely that any lender would accept a co-ownership interest as collateral for a loan. [See *Zieve, Brodnax & Steele, LLP v. Dhindsa* (2020) 49 CA5th 27, 32-33, 262 CR3d 567, 570—lender's lien only encumbered 75% of property because prior attempt to convey minor's 25% interest was null and void (¶ 6:535.13a)]

Nevertheless, the co-owners may still wish to prohibit any party from voluntarily encumbering an interest. Otherwise, upon a foreclosure, the remaining co-owners would share ownership with a new, unanticipated co-owner (i.e., the lender or some other party who purchases the foreclosed interest at the foreclosure sale).

In any event, a lien encumbering only a portion of real property does not divest co-owners of their right to foreclosure sale proceeds in proportion to their ownership interests (Civ.C. § 2924k; ¶ 6:535.13 ff.). [See *Zieve, Brodnax & Steele, LLP v. Dhindsa*, supra, 49 CA5th at 40-41, 262 CR3d at 576-577—lender whose junior lien encumbered only 75% of property could not divest co-owner's right to 25% of surplus sale proceeds]

f. [12:33] **Control issues:** One of the most difficult aspects of a co-ownership relationship concerns the decision-making process regarding ownership, usage and operation of the property and how those decisions will be implemented. Property

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control issues can range from the very important (e.g., who will decide when the property will be rented should the co-owners not be using it, how much rent to charge, who to rent to, etc.) to seemingly far less significant matters (e.g., how the residence will be furnished).

Even the simplest of management issues can open the door to a multitude of potential problems—for example: Who decides when the roof needs to be replaced? Who decides what contractor will be hired to replace the roof? Who will be responsible for hiring the contractor, reviewing the contractor's work and getting the contractor paid?

There are basically two ways of solving such “micro-problems”:

• [12:33.1] One approach is simply to designate one or more of the co-owners as having the appropriate decision-making authority, to be exercised in that co-owner's discretion.

• [12:33.2] Alternatively, the parties might choose not to deal with minor property management/control issues in the co-ownership agreement, preferring instead to work out any differences as they arise. If they cannot reach a consensus of decision as the issues arise, the agreement should provide for a fast, easy method to dissolve the co-ownership arrangement and dispose of the property (*see ¶ 12:37 ff.*).

g. [12:34] **Usage issues:** Unless the parties are cohabitating, the co-ownership agreement should spell out their respective usage rights. For example:

• When (if at all) does each owner have the right to exclusive use of the property?

• If the co-owners want to occupy the property at the same time, can their usage be physically divided up during the joint occupancy periods?

• Will the co-owners permit subletting or otherwise allow third persons to use the property? (For example, can a co-owner's friends use the property? Will the parties allow boarders or roommates?)

h. [12:35] **Co-owner liability; indemnifications:** Absent an agency relationship between them (e.g., a partnership), co-owners do not have inherent legal authority to bind each other. However, if they intend in any way to be bound by a co-owner's acts, their agreement should delineate the specific circumstances under which the liability of one of them with regard to the property could be imputed to all.

In any event, it is prudent to include an *indemnification provision* whereby any culpable party will be obligated to account to the other co-owners for the party's wrongful acts. This step gives the innocent co-owners some protection in the event a third party successfully pursues a suit against all co-owners on the premise they were acting as each other's agents.

i. [12:36] **Default remedies:** It might be beneficial to include a provision specifying co-owner rights against another co-owner who defaults on their obligations (e.g., failure to make a required mortgage, utility or other payment). The parties might agree to assess “late charges” for payment defaults. [See *Jones v. Wagner* (2001) 90 CA4th 466, 472-473, 108 CR2d 669, 674—partnership property lost by lender foreclosure where co-owner failed to make timely mortgage payments and no provision in partnership agreement requiring other co-owner to be responsible for such payments]

As a practical matter, however, once residential co-owners are fighting with each other, it is more likely they will want to sever their relationship. Thus, the more important issue is how the parties can unwind their co-ownership arrangement once one party is in default or they have otherwise come to a parting of the ways (*see ¶ 12:37 ff.*).

j. [12:37] **Termination of relationship/sale of property:** Too often, co-owners neglect to consider how and when they ultimately will terminate their co-ownership relationship and dispose of the property. However, this is probably the most important issue in a co-ownership agreement. Early on, the parties need to agree upon an “exit strategy” to deal with situations when they have divergent opinions about selling the property and/or their relationship is not working out.

In the absence of a co-ownership agreement, the Partition of Real Property Act (formerly known as the Uniform Partition of Heirs Property Act (UPHPA)) applies to *any* real property held in tenancy in common “where there is no agreement in a record binding all the cotenants which governs the partition of the property.” [See CCP § 874.311 et seq. (preserving partitioning party's right to sell their interest while ensuring non-partitioning co-tenants can prevent a forced sale by requiring notice, appraisals (when directed by court), and the right of first refusal)]

Comment: The Partition of Real Property Act removed the UPHPA's previous restriction that limited the subject property to “heirs property.”

➪ [12:38] ***PRACTICE POINTER:*** It is essential that the agreement incorporate a definite and efficient method for bringing finality to the relationship and ultimately disposing of the property; indeed, a well-drafted agreement will cover this issue extensively. While the parties could, of course, sue for partition of the property—i.e., a court-ordered sale (CCP § 872.010 et seq.)—litigation in the context of a residential co-ownership arrangement should always be a last resort. [See *LEG Investments v. Boxler* (2010) 183 CA4th 484, 493, 107 CR3d 519, 525—co-owners of property have absolute right to partition unless barred by valid contractual waiver, either express or *implied*]

And even if a partition suit ultimately is unavoidable, the court first must resolve each co-owner's respective interest in the subject property before it can order a sale. [*Summers v. Sup.Ct.* (*Tan*) (2018) 24 CA5th 138, 144, 234 CR3d 63, 67]

Thus, a well-drafted agreement that expressly addresses this issue can save time and assist in lowering litigation costs.

(1) [12:39] **Termination approaches:** There are several approaches to dealing with termination of the relationship (and/or the disposition of a co-owner's interest). Some of the more common methods are as follows:

(a) [12:40] **Right of first refusal:** The parties might agree that, in the event a co-owner wishes to sell an interest, the others will have a preemptive right to purchase that interest (at some agreed-upon price, at the appraised value, or at the price offered by an outside party). [See *LEG Investments v. Boxler*, supra—contract giving first refusal rights to co-owners implies an agreement not to bring partition action in lieu of sale to them]

If the other co-owner(s) do not wish to buy, either (i) the selling co-owner will be permitted to sell to an outside party; or (ii) the entire property will be sold and the co-ownership relationship terminated. Indeed, a right of first refusal merely modifies a co-owner's absolute statutory right to partition; it does *not* permanently waive the right. [See *LEG Investments v. Boxler* (2010) 183 CA4th 484, 493-497, 107 CR3d 519, 525-528—where nonselling owners declined to exercise their right to purchase within reasonable period of time after selling owner first offered to sell on terms as favorable as those offered by prospective buyer, selling owner could proceed with partition; *Schwartz v. Shapiro* (1964) 229 CA2d 238, 253, 40 CR 189, 199—selling owner required to first offer his interest to co-owner before filing partition action]

Cross-refer: Preemptive purchase rights (options, rights of first refusal, etc.) are discussed in detail in *Ch. 8*.

(b) [12:41] **Sale of property:** Another method for triggering dissolution of the co-ownership relationship is to provide that, upon the election of any co-owner (or a certain percentage of co-owners), the property will be listed for sale and sold. However, there should be some predetermined mechanism for selecting the broker and settling on a listing price. It may be necessary for the parties to agree that some type of appraisal will be conducted (even if an informal appraisal by a local real estate broker) and an offer will be accepted if it is, for example, equal to or greater than 90% of the listing price.

(c) [12:42] **Co-owner's death:** The agreement should provide some methodology for buying out a deceased co-owner's interest or, if the parties prefer, selling the property upon a co-owner's death and thereby terminating the relationship.

[12:42.1 - 12:42.4] ***Reserved.***

(2) [12:42.5] **Accounting:** Where co-owners have structured their arrangement under a partnership agreement, the agreement commonly (and should) provide for an "accounting" of partnership moneys upon termination of the partnership. [See *Jones v. Wagner* (2001) 90 CA4th 466, 469, 108 CR2d 669, 671]

k. [12:43] **Dispute resolution by arbitration/mediation:** An agreed-upon methodology for expedited resolution of co-ownership disputes is advisable. As a general rule, arbitration and/or mediation is preferable to litigation because any dispute between residential co-owners will probably involve a limited set of facts, with limited discovery and fairly simple legal issues. These sorts of cases are more appropriate for speedy and relatively inexpensive resolution than costly and time-consuming litigation. (*See* *¶ 4:485 ff.* re advantages and disadvantages of arbitration/mediation vs. litigation.)

4. [12:44] **Recording Memorandum of Agreement:** It is advisable for the parties to *record a memorandum of their co-ownership agreement* with the county recorder of the county in which the property is located (Civ.C. § 1169). This step will give third parties constructive notice of any transfer or encumbrance restrictions in the co-ownership agreement, preventing "BFP" status and thus ensuring no third party will be able to acquire an interest in the property in derogation of the co-ownership agreement. [See Civ.C. § 1218]

• ***FORM:*** Memorandum of Co-Ownership Agreement, *see Form 12:B*.

➪ [12:45] ***PRACTICE POINTER:*** The parties could, of course, record their entire co-ownership agreement; but that will make all aspects of the agreement a matter of public record. In most cases, provisions regarding rights of usage, expense and upkeep obligations, and other management and control issues, will not be significant vis-à-vis potential third party BFPs (¶ 12:44); and, in fact, the parties will want to keep those provisions confidential. For "notice" purposes, the important provisions of a co-ownership agreement are those affecting the parties' rights to transfer or encumber their respective interests. Consequently, it is usually most appropriate to record only a *memorandum* of the agreement, which sets forth the pertinent transfer restrictions but keeps most other details about the co-ownership arrangement out of the public records. [See 87 Ops.Cal.Atty.Gen. 87—recording memorandum of *lease* provides constructive notice of parties' leasehold interest in property and avoids expense of recording entire agreement and disclosure of confidential and/or proprietary information in lease]

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Chapter 12. Residential Co-Ownership Agreements

Forms

[Form 12:A] Residential Co-Ownership Agreement

The following is a basic form Co-ownership Agreement for residential property. This form will require substantial modification depending on many factors, including: the number of co-owners; whether the co-owners intend to occupy the residence (or simply rent it out as investment property); whether the co-owners will be cohabitating; and a host of other issues which must be carefully considered.

CO-OWNERSHIP AGREEMENT

This CO-OWNERSHIP AGREEMENT, (this "Agreement") is made and entered into as of the ___ day of ___________, ___, by and between ___________ ("Smith"), ___________ ("Doe") and ___________ ("Jones").

1. **Purpose.** The purpose of this Agreement is to set forth the agreement of Smith, Doe and Jones (sometimes hereinafter collectively referred to as "Co-owners" or, individually, as "Co-owner") with respect to their interest, rights and remedies with respect to that certain real property, improvements thereon and furnishings and fixtures therein located at _____Street, _____, California (more particularly described on Exhibit "A" attached hereto and incorporated herein and hereinafter referred to as the "Property"). **[If the Co-owners will be entitled to separately own specific items of furniture, the Agreement should specify the ownership thereof.]**

2. **Term of Agreement.**

2.1. The term of this Agreement shall commence on the date hereof and shall continue until the sooner of:

2.1.1. The sale of the Property by the Co-owners;

2.1.2. _____ (___) years from the date hereof;

2.1.3. The written vote by a majority in numbers of the Co-Owners to terminate this Agreement.

[The Co-Owners should consider whether they will permit termination of the Co-Ownership Agreement (and sale of the Property) upon the vote of any one of the Co-Owners.]

3. **Contributions.**

3.1. **Initial Contribution.** The initial capital contribution of each Co-owner shall be ___________ Dollars ($________), to be contributed on or before ___________, ___.

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3.2. **Additional Contributions.** Each Co-owner shall make such additional capital contributions as may be necessary to maintain, own, operate and manage the Property.

[It may be necessary to spell out the methodology for making initial and additional contributions. For example, the Co-owners might want to designate one Co-owner to collect the additional contributions from everyone and make the necessary payments. For example, the Co-owners will have ongoing obligations to pay their respective share of mortgage payments, real estate taxes, insurance, gardening and other regularly accruing expenses. It may be wise to have the Co-owners contribute an initial reserve and thereafter replenish it on an annual basis.]

3.3. **Interest.** No interest shall be paid to any Co-owner on account of any initial or additional capital contributions. No Co-owner shall withdraw any capital theretofore contributed. Should any Co-owner fail to make any contribution as required pursuant to this Agreement, such amount shall thereafter be due, together with interest thereon at the rate of ___________ percent (____%) per annum from the date such contribution was required to be made. **[In addition, the Co-owners may wish to impose a "late charge" (for example, 5%) on any contribution which is not paid by a Co-owner when required.]**

4. **Bank Accounts.** All monies contributed by the Co-owners shall be deposited in a bank account in the name of all Co-owners. Withdrawals from such account and checks upon such account may be signed by Smith, alone, if such checks are for ___________ Dollars ($________) or less, but must be signed by any two (2) Co-owners if such checks are for in excess of ___ Dollars ($________).

5. **Accounting and Management.**

5.1. Smith is designated to maintain the books and records for the Property, and such records shall be open at all reasonable times to Co-owners for examination. The cost of maintaining such books shall be an expense of all Co-owners. Within thirty (30) days after the end of each calendar year, Smith shall provide a written report of income and expenses for the Property to each Co-owner.

5.2. Smith shall supervise the day-to-day operations of the Property; provided, however, that all decisions of a substantial or material nature shall require the approval of a majority in numbers of the Co-owners. Each Co-owner shall be required to devote such time to the ownership and operation of the Property as may be reasonably required. **[The phrase "decisions of a substantial or material nature," as used above, may be considered too ambiguous by the Co-owners. If so, the Co-owners may want to list the kinds of decisions which require the approval of a majority of the Co-owners; e.g., the terms and conditions upon which the Property will be leased, etc.]**

5.3. Except as specifically provided in this Agreement, no Co-owner shall incur any debt or obligation which would affect the Property or any other Co-owner's Ownership Interest (defined below), except for emergency repairs not exceeding a cost of ___ Dollars ($________). Notwithstanding the foregoing, Smith may incur non-emergency repair, maintenance and related costs in an amount not exceeding ___________ Dollars ($________) in any one (1) calendar month. Any expense advanced by a Co-owner pursuant to this Agreement ("Advance"), shall be repaid to such Co-owner as soon as cash flow from the Property permits. Should any Co-owner violate the terms of this Paragraph 5.3, such Co-owner shall indemnify and hold each and all of the other Co-owners harmless from and against any loss, claim or liability (including but not liability to attorneys' fees) arising out of or relating to such violation of this Paragraph 5.3.

5.4. All rental income and other income or profits earned, accrued or acquired by virtue of ownership of the Property shall be profits of the Co-owners, prorata, in accordance with their respective Ownership Interest, irrespective of which Co-owner procured any given renter for, or income in respect of, the Property.

6. **Ownership Interests.**

The Co-owners shall own the Property as tenants-in-common, each holding the following respective percentage interest ("Ownership Interest"): Smith: _____ percent (____%); Doe _____ percent (____%); and Jones _____ percent (____%). The

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net profit or net loss pertaining to the Property shall be determined in accordance with generally accepted accounting principles, consistently applied.

[If the Co-owners do not have equal Ownership Interests, consider whether any approvals by the Co-owners contemplated by the Agreement should be based on a majority in percentage Ownership Interest, instead of a majority in numbers of the Co-owners. In addition, if any one Co-owner consists of two people (such as a married couple or owners who own their Ownership Interest as joint tenants or tenants-in-common among themselves), specify which of the individuals is authorized to speak on behalf of and bind the multiple joint owners.]

7. **Assignment of Ownership Interests; Transfer on Death.**

7.1. Other than as specifically provided in this Agreement, no Co-owner shall voluntarily, involuntarily or by operation of law, assign, encumber, sell or otherwise transfer or hypothecate its Ownership Interest, or any part thereof, nor enter into any agreement as a result of which any person, firm or corporation may own an interest in the Property, except upon the prior written consent of all of the other Co-owners.

7.2. In the event that the transfer of a Co-owner's Ownership Interest is permitted under this Agreement, the transferee shall be required to assume in writing all of the terms, covenants, conditions and obligations of the transferor contained in this Agreement. Any attempt to transfer by a Co-owner in violation of this Paragraph 7 shall be deemed void and shall be deemed to allow the transferee to take only the right of the transferor Co-owner to share in profits from the Property (in accordance with such Co-owner's Ownership Interest), but such transferee shall not acquire any right or legal interest in the Property nor the right to exercise any power granted to a Co-owner under this Agreement.

7.3. The death of any Co-owner ("Deceased Co-owner") shall not terminate this Agreement. In the event of the death of a Co-owner, the remaining Co-owners shall have the choice of either approving and accepting the heir (or heirs) of the Deceased Co-owner as a substitute Co-owner for such Deceased Co-owner. Either or both of the remaining Co-owners, in his/her or their sole and absolute discretion, may disapprove of such heir(s) and refuse to accept such heir(s) as a substitute Co-owner. If the remaining Co-owners do not disapprove of the heir(s), such heir(s) shall be the successor-in-interest to the Deceased Co-owners Ownership Interest and such heir(s) shall execute this Agreement. If either or both of the remaining Co-owners disapprove of the said heir(s), both remaining Co-owners shall be required to purchase the Ownership Interest of the Deceased Co-owner in accordance with this Paragraph 7.3. The remaining Co-owners shall purchase the Deceased Co-owner's Ownership Interest, prorata, in accordance with their respective Ownership Interest in the Property. Accordingly, assuming that each Co-owner owns a one-third (33.33%) Ownership Interest, upon the death of the Deceased Co-owner, the two remaining Co-owners shall each pay 50% of the Purchase Price for the Deceased Co-owner's 33.33% Ownership Interest in the Property. The method for determining the purchase price ("Purchase Price") of the Deceased Co-owner's Ownership Interest shall be calculated by multiplying the Deceased Co-owner's Ownership Interest by the value of the Property. The value of the Property for purposes of this Paragraph 7.3 shall be that which the remaining Co-owners and the representative of the Deceased Co-owner agree upon within _____ (___) days after the death of the Deceased Co-owner. However, if the Co-owners and the representative of the Deceased Co-owner cannot agree upon the value of the Property within said time period, the value of the Property shall be deemed to be that which is determined by **[at this point the Co-owners may wish to designate a local real estate brokerage firm (and an alternative firm in the event the first firm is no longer in business). However, any method of valuation is appropriate (e.g., appraisal, arbitration, etc.). Whatever method is chosen should be expedient and inexpensive.]** The remaining Co-owners shall pay the Purchase Price for the Deceased Co-owner's Ownership Interest to the Deceased Co-owner's estate by means of a promissory note in the amount of the Purchase Price, bearing interest at the rate of 10% per annum, payable in ___________ (___) equal monthly installments of principal and interest. Upon the first of the aforesaid monthly payments, the Deceased Co-owner shall execute a grant deed conveying its Ownership Interest in the Property to the other Co-owners, fifty percent (50%) each, free and clear of all liens and encumbrances except current taxes (not yet due and payable) and those liens and encumbrances to which the other Co-owners have previously consented.

[The Co-owners may also want to consider making the sale of any Co-owner's Ownership Interest subject to a right of first refusal (or right of first offer) in favor of the other Co-owners. See Chapter 8, regarding rights of first refusal/first offer and sample form right of first refusal/first offer (Form 8:D)].

8. Termination of Agreement and Distribution of Proceeds.

8.1. To the extent any income from the Property in any calendar year exceeds (i) the cost of owning, maintaining and operating the Property; and (ii) a reserve in the amount of ____________ Dollars ($_________), Smith shall distribute such excess annually to the Co-owners, prorata, in accordance with their respective Ownership Interest.

8.2. This Agreement shall terminate upon any of the events described in Paragraph 2.1, above, and, except as otherwise specifically provided in this Paragraph 8, the Co-owners shall not engage in further business with respect to the Property except as may be necessary to wind up the dissolution of the co-ownership relationship between the Co-owners. Upon the happening of any of the events described in Paragraphs 2.1.2 or 2.1.3, the Co-owners shall as soon as possible thereafter proceed to list the Property for sale and thereafter consummate a sale of the Property.

8.3. When, pursuant to this Agreement, the Property is required to be sold, the Co-owners shall attempt to agree upon the following within twenty (20) days thereafter:

(i) The real estate broker who shall list the Property for sale;

(ii) The selling price at which the Property will be listed for sale; and

(iii) The purchase price (and other terms and conditions) which the Co-owners will accept for the sale of the Property.

(iv) If the Co-owners cannot agree on any of the foregoing, the same shall be determined by ____________. **[The Co-owners may wish to select a specific real estate broker to make the various foregoing decisions; or defer the dispute to arbitration; or the Co-owners may wish to select one of the Co-owners as the final arbitrator. In any event, there must be an expedient methodology for getting the property listed and sold.]**

8.4. Upon the sale of the Property, the affairs of the Co-owners with respect to the Property shall be wound up and liquidated. The net proceeds available to the Co-owners after the sale of the Property shall be applied in the following order of priority:

(a) To the payment of debts and liabilities pertaining to the Property, including any Advances which may have been made by any Co-owner pursuant to this Agreement.

(b) To the setting up of any reserves which may be reasonable and necessary for any contingent or unforeseen liabilities or obligations of Co-owners which relate directly to the Property. Smith shall be the party who shall determine the amount of such reserves, which shall be held in the Co-ownership bank account referred to in Paragraph 4, above. However, in no event shall any reserve be held for a period in excess of _____ (_____) months after the sale of the Property.

(c) The balance of any proceeds shall be paid out and distributed among the Co-owners in accordance with their respective Ownership Interest. In the event the proceeds of the sale of the Property consist of a promissory note, each Co-owner shall be entitled to receive that portion of each installment payment, and the final payment, in accordance with their respective Ownership Interest. Smith shall be the party who shall retain the original promissory note and shall be entitled to collect and distribute payments thereon. If the maker under the promissory note shall be in default thereof, Smith is authorized to take all steps necessary to commence and consummate non-judicial foreclosure proceedings; provided, however, that Smith shall first notify the other Co-owners of his/her intention to commence foreclosure proceedings and each Co-owner shall pay such trustee's and other fees as may be necessary to consummate the foreclosure sale. If the Co-owners are the successful bidder at the foreclosure sale, the Property shall thereafter promptly be resold in accordance with the provisions of Paragraph 8.3, above.

9. Notices.

9.1. Any and all notices of demands permitted or required to be made under this Agreement shall be in writing. Such notice shall be served either personally or by certified or registered mail. If served personally, service shall be conclusively deemed made at the time of service. If served by certified or registered mail, service shall be conclusively deemed made 48 hours after the deposit thereof in the United States mail, postage prepaid, addressed to the party whom such notice or demand is to be given, as hereinafter provided.

9.2. Any notice or demand to the Co-owners shall be given at the following addresses:

If to Jones:	____________
	____________
	____________
If to Doe:	____________
	____________
	____________
If to Smith:	____________
	____________
	____________

10. Entire Agreement. This Agreement contains the entire understanding between the Co-owners and supersedes any prior understandings and agreements between them with respect to the subject matter of this Agreement. There are no representations, agreements, arrangements or understandings, oral or written, between and among the Co-owners hereto relating to the subject matter of this Agreement which are not fully expressed herein. This Agreement may only be amended upon the written agreement of a majority in numbers of the Co-owners.

11. Binding on Successors. Except as otherwise hereinabove provided, this Agreement shall be binding upon and inure to the benefit of the Co-owners hereto, their respective heirs, administrators, successors and assigns.

12. California Law. This Agreement shall be governed by and construed in accordance with the laws of the State of California.

13. Arbitration. [An expedient arbitration method is advisable. See Chapter 4 regarding advantages of arbitration and sample arbitration provision (Form 4:1).]

14. Memorandum of Agreement. The Co-owners shall execute a Memorandum of this Agreement and cause the same to be recorded in the Office of the County Recorder of County, California, as soon as possible after execution of this Agreement.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement on the date first written above.

"SMITH"

____

"DOE"

____

"JONES"

____

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Chapter 12. Residential Co-Ownership Agreements

Forms

[Form 12:B] Memorandum of Co-Ownership Agreement

Recording requested by
And When Recorded Return to:

____
____
____
____

Memorandum of Co-ownership Agreement

This Memorandum of Co-ownership Agreement (this "Memorandum") is made ___ this day of ___________, ___ by and between ___________ ("_____"), ___________ ("_____") and ___________ ("_____"), collectively referred to herein as "Co-owners" and individually referred to as "Co-owner."

1. Co-owners are the owners of all that certain real property located in the County of _____, State of California, more particularly described on Exhibit "A" attached hereto and incorporated herein (the "Property").

2. Each Co-owner holds its interest in the Property as a tenant-in-common with the other Co-owners pursuant to that certain Co-ownership Agreement dated ___________, ___, between all of the Co-owners ("Co-ownership Agreement").

3. The rights of the Co-owners with respect to the Property are subject to and governed exclusively by the said Co-ownership Agreement which is incorporated herein in its entirety by this reference. Among other things, the Co-ownership Agreement provides that no Co-owner shall sell, transfer or encumber the Property or its interest in the Property without the prior written consent of all Co-owners. Any transfer by a Co-owner in violation of the Co-ownership Agreement shall be void.

4. Any party who is interested in acquiring any interest in the Property, whether pursuant to a transfer of an ownership interest or the grant of a lien, should first contact all of the Co-owners at the following addresses to determine whether consent to such transfer or lien has been granted by the Co-owners: ________________.

IN WITNESS WHEREOF, this Memorandum has been executed this ___ day of ___________, ___.

"CO-OWNERS"

____
____

[ATTACH NOTARY ACKNOWLEDGMENTS]

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Chapter 13. Real Property Purchase and Sale Tax Concerns

Scope Note

This Chapter is intended as a summary treatment of important federal and state tax aspects of real property acquisition (*Part I, ¶ 13:1 ff.*), ownership and operation (*Part II, ¶ 13:120 ff.*) and disposition (*Part III, ¶ 13:300 ff.*).

Attorneys are cautioned that many tax issues require substantial expertise; thus, it is always advisable to consult specialized counsel when confronting unfamiliar tax matters.

As discussed in this Chapter, the Tax Cuts and Jobs Act ("2017 Tax Act") resulted in some substantial revisions to the tax treatment of real estate. The Treasury Department continues to provide guidance with respect to this legislation, which may alter or affect the 2017 Tax Act's impact on acquisition, ownership, operation and/or disposition of real estate.

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Chapter 13. Real Property Purchase and Sale Tax Concerns

Part I. Acquisition of Real Property

A. Pertinent Tax Issues

[13:1] Taxpayers acquiring real estate need to be concerned with the following tax issues, each of which is addressed in a separate section of this Chapter, commencing with the paragraphs set forth below:

• What is the *basis* of the property for income tax purposes? (*¶ 13:2 ff.*)

• Beginning on *what date* will the taxpayer be treated as the “owner” of the property? (*¶ 13:45 ff.*)

• Are any *expenses* of the acquisition *deductible* or a *credit* for income tax purposes? (*¶ 13:55 ff.*)

• How will the property be *valued* for property tax purposes? (*¶ 13:65 ff.*)

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Chapter 13. Real Property Purchase and Sale Tax Concerns

Part I. Acquisition of Real Property

B. Basis of Acquired Property

- 1. [13:2] Significance of “Basis”
  - a. [13:3] Adjusted basis
- 2. Determination of Basis
  - a. [13:4] Generally equivalent to cost
    - (1) [13:5] Includes expenses of purchase (costs “capitalized”)
      - (a) [13:5.1] Transaction costs
      - (b) [13:5.2] Title defense costs
      - (c) [13:6] Loan fees
        - 1) [13:7] Loan procurement costs
        - 2) [13:8] Interest
    - (2) [13:9] Options
    - (3) [13:10] Purchase money debt
      - (a) [13:11] Example
      - (b) [13:12] Exception—contingent liabilities or liabilities of seller
      - (c) [13:13] Exception—property worth less than amount of debt
      - (d) [13:14] Compare—improvements paid by promissory note
        - 1) [13:14a] Comment
    - (4) [13:14.1] Property subject to lease
  - b. [13:15] Special rules—basis established other than by cost
    - (1) [13:16] Transfers between spouses or incident to divorce
      - (a) [13:17] Example
      - (b) [13:17.1] Same-sex married couples included
      - (c) [13:17.2] Compare—transfers between domestic partners and cohabitants under federal law
        - 1) [13:17.3] Transfers between domestic partners under state law distinguished
    - (2) [13:18] Property acquired by gift
      - (a) [13:19] Exception—basis exceeding value (donee's “split basis”)
      - (b) [13:21] Gift tax adjustment
    - (3) [13:22] Inherited property
      - (a) [13:23] Date of death market value
      - (b) [13:23.1] Rules used to compute basis of inherited property
        - 1) [13:24] Estate tax alternate valuation date
        - 2) [13:25] Community Property
          - a) [13:25.1] Example

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b) [13:25.2] Compare—domestic partners under federal law
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(2) [13:43.2] No allocation where developer retains full ownership/control of improvement

1. [13:2] **Significance of "Basis":** For income tax purposes, it is essential to establish the "basis" of property. The basis of property becomes relevant in numerous situations—most importantly, in order to calculate *depreciation* and compute *gain or loss* upon disposition of the property.

a. [13:3] **Adjusted basis:** Once basis is computed, the Internal Revenue Code (hereafter, "IRC" or "Code") requires numerous "adjustments" to the basis. For example, basis is increased by improvements to the property and is decreased by depreciation. [IRC § 1016(a)(1), (2)]

2. Determination of Basis

a. [13:4] **Generally equivalent to cost:** As a general rule, the basis of property is its cost. [IRC § 1012] However, determining the property's cost often involves several subissues:

(1) [13:5] **Includes expenses of purchase (costs "capitalized"):** The various costs of acquiring real property must be included in its basis; i.e., costs are "capitalized" rather than deducted as expenses (*see ¶ 13:150 ff.* for general discussion of capitalization vs. deductibility; *and ¶ 13:158* re property acquired and improved for resale purposes).

(a) [13:5.1] **Transaction costs:** A taxpayer must capitalize amounts paid to *facilitate* the acquisition of real property—including legal, accounting, title, engineering, appraisal, recording and application fees; survey, inspection and moving costs; commissions; and compensation for the services of a qualified intermediary or other facilitator of an IRC § 1031 exchange (*¶ 13:338 ff.*). [Treas.Reg. § 1.263(a)-2(f)(1)-(2)]

Transfer taxes levied on the purchase also must be capitalized. [IRC § 164(a) (last sent.)]

(b) [13:5.2] **Title defense costs:** The costs incurred in defending title to property must be capitalized rather than deducted as expenses. [See Treas.Reg. § 1.212-1(k)—title defense expenses constitute part of property's cost; Treas.Reg. § 1.263(a)-2(e) (citing examples of capital expenditures); *Wellpoint, Inc. v. Commissioner* (7th Cir. 2010) 599 F3d 641, 646-648—for-profit health insurance company had to capitalize cost of defending against state's attempts to divest it of title to acquired company formerly operated on nonprofit basis]

(c) [13:6] **Loan fees:** The costs of obtaining a loan are also capitalized but are treated as a separate asset.

1) [13:7] **Loan procurement costs:** For example, loan commitment fees, appraisal fees paid to the lender, and/or fees paid to loan brokers must be capitalized. Such costs are treated as part of the cost of the loan. [See *Anover Realty Corp. v. Commissioner* (1960) 33 TC 671, 675]

If the loan was incurred to purchase property held in a trade or business or for investment, such costs can be amortized over the life of the loan. [Rev.Rul. 81-160, 1981-1 CB 312—loan commitment fees must be capitalized] If the loan is paid off prior to full amortization of these costs, the unamortized costs should be deductible as a loss. [IRC § 165]

2) [13:8] **Interest:** Prepaid interest is not deductible but must be capitalized and treated as if paid during the period to which it is applicable. [IRC § 461(g)(1)] The payment of points is treated as the payment of prepaid interest and would be deductible as interest in the year in which they are deemed to have been paid. (*See ¶ 13:165 ff.* on deductibility of interest.)

In the case of a purchase or improvement of a principal residence, points can be currently deducted as interest. [IRC § 461(g); *see ¶ 13:58*]

(2) [13:9] **Options:** Where the taxpayer bought an option to purchase property, and then exercised the option, the cost of the option is included in the cost of the property. However, if the option lapsed, the cost of the option is treated as a loss. If the property subject to the option would have been a capital asset (*¶ 13:421 ff.*), the loss on lapse of the option is a capital loss. [IRC § 1234(a)]

(3) [13:10] **Purchase money debt:** Normally, the basis of property includes not only cash outlays at the time of purchase but also the amount of any recourse or nonrecourse debt incurred to purchase the property. [*Commissioner v. Tufts* (1983) 461 US 300, 307, 103 S.Ct. 1826, 1831]

(a) [13:11] **Example:** T purchases Blackacre for $1,000, paying $100 down and borrowing $900. T's basis for Blackacre is $1,000, whether the $900 was borrowed from the seller or a third-party lender and regardless of whether the loan is recourse or nonrecourse.

(b) [13:12] **Exception—contingent liabilities or liabilities of seller:** Purchase money debt is *not* included in the basis of the property if liability to pay the debt is contingent.

Thus, if the taxpayer's liability depends on the occurrence of future events, such liability is not includible in basis at the time of purchase. However, when the contingent liability is ultimately *paid*, it must normally be capitalized and

added to the basis. [See *David R. Webb Co., Inc. v. Commissioner* (1981) 77 TC 1134, aff'd (7th Cir. 1983) 708 F2d 1254, 1256—purchasing corporation that pays selling corporation's pension liability must treat pension liability as part of purchase price of property; *Illinois Tool Works Inc. & Subsidiaries v. Commissioner* (7th Cir. 2004) 355 F3d 997, 1002-1003—purchasing corporation's payment of judgment based on patent infringement claim brought against selling corporation and assumed as contingent liability was capital expenditure treated as part of cost basis of acquired property even if judgment exceeded parties' expectations]

(c) [13:13] **Exception—property worth less than amount of debt:** Where property is subject to a nonrecourse debt and the property is worth *less* than the amount of the debt, the taxpayer may not include the entire debt in basis. However, the Code does not contain any specific provision regarding the computation of basis in this situation, and courts are presently divided on the issue. Moreover, the IRS often argues that in such situation the taxpayer really does not own the property at all and therefore seeks to deny any tax benefits. [See Cowan, "Is Any Part of a Nonrecourse Mortgage Greatly Exceeding FMV Includable in Basis?" (Nov. 1992) 77 J. of Tax. 260; Toth, "Nonrecourse Debt in Excess of Fair Market Value and Disappearing Basis: The Partnership Paradox" (1996) 50 Tax Lwyr. 37]

• [13:13.1] **Example:** Blackacre is worth about $1,000 and is subject to an existing debt of $1,200. T purchases the property subject to this debt. In T's hands, the $1,200 obligation is a nonrecourse debt. Assuming it is found that T actually owned the property for tax purposes, Blackacre's basis in T's hands is *not* $1,200. The basis might be $0 or it might be $1,000.

The apparent majority view is that when the debt is nonrecourse in nature and exceeds a reasonable estimate of fair market value, the *entire debt is disregarded in calculating basis*; thus, in this example, the basis is $0. [See *Bergstrom v. United States* (Fed.Cl. 1996) 37 Fed.Cl. 164, 168-169—zero basis (classifying result as "majority rule"); *Estate of Franklin v. Commissioner* (9th Cir. 1976) 544 F2d 1045, 1048 (zero basis); compare *Pleasant Summit Land Corp. v. Commissioner* (3rd Cir. 1988) 863 F2d 263, 278—mortgage included in basis to extent of property's value; *Regents Park Partners v. Commissioner*, TC Memo 1992-336 (same)]

(d) [13:14] **Compare—improvements paid by promissory note:** IRC § 1016 allows subsequent adjustments to basis "for expenditures, receipts, losses, or other items properly chargeable to capital account …" (IRC § 1016(a)(1)). However, one district court held that a cash basis taxpayer who pays for subsequent improvements with a *promissory note* may not increase their basis until the note is *paid off.* [See *Owen v. United States* (WD TN 1998) 34 F.Supp.2d 1071, 1079-1080]

Rationale: The "mere incurring of a liability" is *not* an "expenditure" under § 1016. [*Owen v. United States*, supra, 34 F.Supp.2d at 1079-1080]

1) [13:14a] **Comment:** The liability incurred in *Owen* (¶ 13:14) involved an *addition* to the existing building and thus should have been characterized as a *nondeductible capital expenditure* rather than a current "expense." Because a capital expenditure generally increases basis regardless of the taxpayer's method of accounting or whether the taxpayer has actually paid for it (*see ¶ 13:10*), *Owen* is not likely to be followed. [See Geier, "1999 Award For Worst Opinion In A Tax Case" (June 14, 1999) 83 Tax Notes 1642]

(4) [13:14.1] **Property subject to lease:** Purchased or inherited property may be subject to a lease that is favorable to the lessor. However, no separate basis can be allocated to the premium lease and no separate amortization is permitted. [IRC § 167(c)(2); *see ¶ 13:138.7*]

b. [13:15] **Special rules—basis established other than by cost:** Despite the general "cost" rule, ¶ 13:4 ff., there are several situations where special tax provisions control the computation of basis:

(1) [13:16] **Transfers between spouses or incident to divorce:** When property is transferred between spouses or incident to marriage dissolution, the transferor recognizes no gain or loss on the transfer and the transferee's basis for the property is the same as that of the transferor … regardless of whether the taxpayer pays for the property. [IRC § 1041(b)(2); Rev. & Tax.C. § 18031, *¶ 13:385 ff.*]

(a) [13:17] **Example:** In connection with marriage dissolution, H acquires W's community property interest in Blackacre by paying W $4,000. H and W previously had a basis of $100 for Blackacre. W has no gain on the transfer and H's basis for Blackacre remains $100. [Treas.Reg. § 1.1041-1T, A-11]

(b) [13:17.1] **Same-sex married couples included:** On June 26, 2015, the U.S. Supreme Court declared marriage a fundamental right inherent in the liberty of the person. The Court further concluded, under the Fourteenth Amendment

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Due Process and Equal Protection Clauses, same-sex couples may not be deprived of that fundamental right and that liberty. Accordingly, every state must license a marriage between two people of the same sex and recognize lawful same-sex marriages performed in other states. [*Obergefell v. Hodges* (2015) 576 US 644, 675, 680-681, 135 S.Ct. 2584, 2604-2605, 2607-2608; see also *United States v. Windsor* (2013) 570 US 744, 769-775, 133 S.Ct. 2675, 2693-2696 (striking down as unconstitutional that portion of the Defense of Marriage Act (DOMA) that prohibited federal recognition of same-sex married couples); Treas.Reg. § 301.7701-18(b)(1) (recognizing all lawfully married same-sex couples regardless of domicile)]

As a result of the foregoing, parties to any lawfully contracted same-sex marriage, regardless where it was entered into, are entitled to all the same benefits afforded heterosexual married couples (including IRC § 1041 nonrecognition).

(c) [13:17.2] **Compare—transfers between domestic partners and cohabitants under federal law:** Neither *Obergefell* nor *Windsor* (*¶ 13:17.1*) changed the law regarding domestic partners and other nonmarital cohabitants. Thus, the special IRC § 1041 nonrecognition rule (*¶ 13:16*) remains inapplicable to them under federal law. Dividing property between domestic partners following dissolution of their relationship, and between co-habitants when resolving *Marvin* claims, should continue to result in a taxable transaction to the transferor and a basis to the transferee equal to the fair market value of the property at the time of transfer.

1) [13:17.3] **Transfers between domestic partners under state law distinguished:** Registered domestic partners have the rights of spouses for *California* tax law purposes. Thus, transfers arising from dissolution of a registered domestic partnership are tax-free for *state* income tax purposes; the transferor does not recognize gain or loss and the transferee's basis remains the same. [Rev. & Tax.C. § 62(p)]

Cross-refer: For a more detailed treatment of the tax considerations affecting domestic partnerships and nonmarital cohabitants, see Hogoboom & King, *Cal. Prac. Guide: Family Law* (TRG), Ch. 20.

[13:17.4 - 13:17.5] ***Reserved.***

(2) [13:18] **Property acquired by gift:** Where the property is acquired by gift, the donee's basis is the same as the donor's adjusted basis. [IRC § 1015(a)]

(a) [13:19] **Exception—basis exceeding value (donee's "split basis"):** If the property is worth *less* at the time of the gift than the donor's basis, the donee has a "split basis." For purposes of determining *gain*, the donee's basis is the same as the donor's. But for purposes of determining *loss*, the donee's basis is the donor's basis, or the value at the date of the gift, whichever is lower. [IRC § 1015(a); Treas.Reg. § 1.1015-1(a)]

• [13:20] **Example:** F gave Blackacre to D. F's adjusted basis was $1,000. At the date of the gift, Blackacre was worth $400. D's basis for determining gain is $1,000, but her basis for determining loss is $400. If D sells Blackacre for $250, she has neither gain nor loss.

Comment: In this scenario, F should have sold Blackacre and given D the cash proceeds; this would have preserved F's $600 loss.

(b) [13:21] **Gift tax adjustment:** The donee may increase the basis of the property by a percentage of gift tax paid by the donor at the time of the transfer equivalent to the net appreciation in value of the property divided by the amount of the gift. But this adjustment may not increase the basis of the property beyond its fair market value. [IRC § 1015(d)]

• [13:21.1] **Example:** F gives D Blackacre and pays a gift tax of $100,000. F's basis for Blackacre was $200,000. At the time of the gift, Blackacre was worth $800,000. The net appreciation in the gift was $600,000. Consequently, D may add 75% ($600,000/$800,000) of $100,000 (or $75,000) to her basis. Her basis is now $175,000.

(3) [13:22] **Inherited property:** In 2010, the federal estate tax lapsed and the basis for inherited property during that year was carried over from the decedent to the person inheriting it, with a series of complicated adjustments. At the end of 2010, Congress passed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act ("2010 Tax Act") that, among other things, effectively restored the old rule—i.e., the basis of inherited property is the fair market value at the date of death for persons dying in 2011 and later years. (Special rules apply for decedents who died in 2010; *see ¶ 13:28 ff.*). In addition, the estate tax was made subject to a higher exemption ($5,000,000, with adjustments for inflation) and lower flat tax rate (35%) than existed in 2009 and earlier years. [Pub.L. 111-312]

Effective January 2, 2013, the 2010 changes were made permanent by the American Taxpayer Relief Act of 2012, and the flat tax rate was raised from 35% to 40%. [Pub.L. 112-240]

Under the 2017 Tax Act, the estate tax exemption was increased to *$10 million*, with adjustments for inflation annually. [Pub.L. 115-97]

(a) [13:23] **Date of death market value:** In the case of decedents who die on or after January 1, 2011, or who died on or before December 31, 2009, the basis of inherited property is the fair market value at the date of death. In other words, property that appreciated in value in the hands of the decedent receives a *stepped-up basis.* On the other hand, property that declined in value in the decedent's hands receives a *stepped-down basis.* [IRC § 1014(a), (b)]

(For decedents who died in 2010, *see ¶ 13:28 ff.*)

(b) [13:23.1] **Rules used to compute basis of inherited property:** The following rules apply to determine the basis of property that passes by reason of death:

1) [13:24] **Estate tax alternate valuation date:** If, for estate tax purposes, the property was valued on the alternate valuation date (six months after death), that value becomes the property's basis for income tax purposes. [IRC §§ 1014(a)(2), 2032]

Cross-refer: For a detailed discussion of the federal estate tax, see Ross & Cohen, *Cal. Prac. Guide: Probate* (TRG), Ch. 10.

2) [13:25] **Community Property:** If the property was community property of the decedent and a surviving spouse, *both halves* of the community receive a basis equal to the value at date of death (or alternate valuation date). [IRC § 1014(b)(6); see Jurinski, "Income Taxation and State Community Property Laws—Part I" (2015) 42 J. Real Est. Tax. 87; Jurinski, "Income Taxation and State Community Property Laws—Part II" (2015) 42 J. Real Est. Tax. 138]

a) [13:25.1] **Example:** H and W own Blackacre, an unimproved parcel purchased for $100 and held as community property. At the time of H's death, Blackacre is worth $1,000. H's community one-half of Blackacre was bequeathed to D. Thus, D's basis for her inherited interest is $500. W's basis for her retained interest in Blackacre is now $500.

b) [13:25.2] **Compare—domestic partners under federal law:** As noted, federal law does not treat domestic partners as "spouses" (*see ¶ 13:17.2*). Consequently, IRC § 1014(b)(6) should *not* apply to the community property of a registered domestic partnership. (See further discussion in Hogoboom & King, *Cal. Prac. Guide: Family Law* (TRG), Ch. 20.)

c) [13:25.3] **Compare—domestic partners under state law:** Registered domestic partners have the rights of spouses under California law, including community property rights (Fam.C. § 297.5). Thus, *both halves* of their community property receive a basis equal to the value at date of death of the first such domestic partner for state tax law purposes.

[13:25.4] ***Reserved.***

3) [13:25.5] **Community property with right of survivorship:** Community property may be held as "community property with right of survivorship." The property must be expressly declared to be such in the transfer instrument or title document and must be "accepted in writing on the face of the document" by a statement signed or initialed by the spouses (or registered domestic partners, Fam.C. § 297.5(a)). [Civ.C. § 682.1; *see ¶ 4:177 ff.*]

Although it shares the survivorship feature of joint tenancy property (¶ 13:26 ff.), as between *spouses* (but *not* domestic partners), community property with right of survivorship should be considered community property for tax purposes, both halves thus receiving a stepped-up basis on the death of the first spouse. However, there is some risk the IRS might challenge that treatment; until a published ruling clarifies the matter, counsel should *proceed with caution* in advising clients in this area. [See Rev.Rul. 87-98, 1987-2 CB 207—joint tenancy property declared "community property" in spouses' wills treated as community property for purposes of computing basis; Arthur Andrews, "Community Property With Right of Survivorship: Uneasy Lies the Head that Wears a Crown of Surviving Spouse for Federal Income Tax Basis Purposes" (1998) 17 Va. Tax Rev. 577]

4) [13:26] **Joint tenancy property:** When a joint tenant dies, their interest in the property passes to the surviving joint tenant by right of survivorship. The survivor's basis in the inherited part of the property depends on the amount that was includible in the decedent's estate for estate tax purposes. The survivor's basis will be the same whether or not the decedent actually paid estate tax or even filed a return. [Treas.Reg. § 1.1014(b)(2); see Harris, "Determining the Survivor's Tax Basis in Jointly Held Property" (1995) 24 Real Est. L.J. 45]

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a) [13:26.1] **Married joint tenants:** If the decedent and survivor were married (and are the only joint tenants), half the value of the property at the date of death is included in the decedent's estate. That value becomes the basis for the half of the property inherited by the surviving spouse. The same rule applies to tenancy by the entirety property (a form of ownership between spouses not recognized in California). [IRC § 2040(b)]

But property *transferred* by decedent to their surviving spouse is *not* subject to estate tax. [IRC § 2056(a)]

1/ [13:26.2] **Compare—community property:** Note the distinction from how community property is treated: As noted at ¶ 13:25, *both halves* of a married couple's community property receive a new basis upon the first spouse's death, whereas only the *decedent's half* receives a new basis in the case of joint tenancy property. Consequently, spouses enjoy a substantial tax advantage in holding appreciated property as community property rather than in joint tenancy. (Presumably, property held by spouses as "community property with right of survivorship" will be treated for tax purposes as community property, not as joint tenancy, but counsel should take account of the risk of an IRS challenge; *see ¶ 13:25.5*.)

Whether property held in joint tenancy actually is community property (e.g., because it was effectively transmuted) is governed by state law. [*Estate of Young v. Commissioner* (1998) 110 TC 297, 300—no transmutation to community property under Calif. law absent Fam.C. § 852 written declaration; see also Rev.Rul.87-98, 1987-2 CB 207—joint tenancy property transmuted to community by spouses' wills treated as community property for federal tax purposes]

b) [13:26.3] **Unmarried joint tenants:** If the decedent and survivor were not married, the amount included in the decedent's estate depends on the percentage of the total consideration for the purchase price (downpayment plus principal payments on the mortgage) and improvements contributed by the decedent.

If the decedent contributed 75% of the cost of the property plus improvements (and if the survivor contributed the remaining 25% from their own money), 75% of the property's value is included in the decedent's estate. That 75% becomes the basis for the inherited portion of the property in the survivor's hands. The survivor has a cost basis for the portion of the property not inherited from the decedent. [IRC § 2040(a)]

• [13:26.4] **Example:** A and B were not married and owned Blackacre in joint tenancy when A died. Blackacre was then worth $200,000. A and B had each contributed half of Blackacre's $20,000 purchase price. $100,000 is included in A's estate. B's basis for Blackacre is $110,000—$10,000 for B's half, $100,000 for A's half.

5) [13:27] **Income in respect of a decedent (IRD):** Certain items, referred to as "income in respect of a decedent" (or IRD), do *not* receive a new basis at death. These are items on which income was earned at the time of death but not actually recognized for tax purposes under the decedent's accounting method. [IRC § 691(a); see also Ross & Cohen, *Cal. Prac. Guide: Probate* (TRG), Ch. 10]

For example, in the case of real property, if the property was in escrow but escrow had not closed at the time of the owner's death, the property would not receive a new basis. Consequently, the gain on sale would be taxable to the decedent's estate, or to a legatee who receives the proceeds if escrow closes after probate is completed. [IRC § 691(a); see also Ross & Cohen, *Cal. Prac. Guide: Probate* (TRG), Ch. 10]

6) [13:27.1] **Property given to decedent:** If the legatee of property gave it to the decedent within one year of the decedent's death, then inherited the same property from the decedent, the legatee's basis is the same as the decedent's adjusted basis prior to death. [IRC § 1014(e)]

(c) [13:28] **Special rules for deaths in 2010:** As discussed, the federal estate tax lapsed during 2010 and the basis for inherited property that year was carried over from decedent to the person inheriting it, with a series of complicated adjustments (¶ *13:22*). However, at the end of 2010, Congress passed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act ("2010 Tax Act") which, among other things, permits the personal representative of the estate of a decedent who died in 2010 to choose between two methods for computing the basis of inherited property (¶ *13:28.1 ff.*). The election is made on IRS Form 8939.

(The 2010 Tax Act makes the fair market value at date of death the basis for property inherited from decedents who die on or after January 1, 2011, or who died on or before December 31, 2009; *see ¶ 13:23 ff.*)

1) [13:28.1] **Electing to pay estate tax at new rates:** The personal representative of the estate of a decedent who died in 2010 may choose to pay estate tax at the new rates adopted in the 2010 Tax Act. The basis of the inherited

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property will be determined in accordance with IRC § 1014(a)—i.e., the property receives a basis equal to the value at the date of decedent's death (¶ *13:23*).

a) [13:28.2] **Comment:** In the majority of cases, the estate will be worth less than the $5,000,000 exemption (¶ *13:22*); thus, no estate tax will be due and the election to use IRC § 1014 will produce a stepped-up basis.

[13:28.3] ***Reserved.***

2) [13:28.4] **Electing not to pay estate tax; carryover basis rules:** Alternatively, the personal representative of the estate of a decedent who died in 2010 can decline to pay estate tax and the basis of assets will be carried over from the decedent to the person inheriting the property. If this carryover basis option is elected, the rules are set forth in IRC § 1022 (now repealed), as discussed at ¶ *13:28.5 ff.*

a) [13:28.5] **Step-down in basis for property that has declined in value:** If the value of inherited property at the date of death is *greater* than decedent's adjusted basis, the survivor's basis will be the same as decedent's adjusted basis. On the other hand, if the value of inherited property at the date of death is *less* than decedent's adjusted basis, the survivor's basis is the value of the property at the date of decedent's death. Thus, the rules are essentially the same as for property received by gift (¶ *13:18 ff.*). [IRC § 1022(a) (now repealed and applicable only to estates of decedents who died in 2010)]

b) [13:28.6] **Tax attributes inherited:** A survivor inherits the tax attributes of the inherited property. For example, if the property was depreciable and would have been subject to recapture in decedent's hands, it also is subject to recapture if sold by an heir. [See Comm. Rep. on Pub. Law 107-16; *and* ¶ *13:417.5* re recapture]

Presumably, if the asset would have been "dealer property" (¶ *13:422 ff.*) in decedent's hands, it will remain so in the heir's hands. On the other hand, the holding period of the property also should carry over from decedent to the heir.

c) [13:28.7] **Property "acquired" from a decedent:** The carryover basis rules apply to "property acquired from a decedent." This term includes (i) property acquired by bequest, devise or inheritance; (ii) property acquired by decedent's estate from the decedent; and (iii) property acquired from a revocable trust established by the decedent (or a trust in which decedent reserved the power to alter or amend the trust). [IRC § 1022(e) (now repealed and applicable only to estates of decedents who died in 2010)]

d) [13:28.8] **Adjustments:** The basis of the inherited property is subject to complex adjustments. These adjustments apply to property "owned by the decedent" at the time of death. [IRC § 1022(d)(1) (now repealed and applicable only to estates of decedents who died in 2010)]

The first adjustment is for an "aggregate basis increase" (¶ *13:28.9*); the second is a spousal adjustment for property transferred to a spouse (¶ *13:28.10*).

1/ [13:28.9] **Aggregate basis increase:** The decedent is entitled to an "aggregate basis increase" of $1,300,000 (only $60,000 for a nonresident alien decedent). [IRC § 1022(b)(2)(B) & (3) (now repealed and applicable only to estate of decedents who died in 2010)]

However, the $1,300,000 figure (but not the $60,000 figure for nonresident alien decedents) is increased by the amount of the decedent's capital loss carryover or net operating loss carryover that, but for the decedent's death, would be carried from decedent's last taxable year to a later taxable year. It also is increased by the amount of any losses that would have been allowed under IRC § 165 if the property acquired from decedent had been sold at fair market value immediately before decedent's death. [IRC § 1022(b)(2)(C) (now repealed and applicable only to estates of decedents who died in 2010)] The latter phrase covers losses incurred in a trade or business or in any transaction entered into for profit. [IRC § 165(c)(1), (2)]

2/ [13:28.10] **Property received by surviving spouse:** In the case of "qualified spousal property," there is an *additional* basis increase of $3,000,000. [IRC § 1022(c)(2)(B) (now repealed and applicable only to estates of decedents who died in 2010)] Thus, where all of decedent's property is transferred to a spouse, the property is eligible for a basis increase of $4,300,000 (the $1,300,000 aggregate basis increase, plus $3,000,000).

"Qualified spousal property" means any interest acquired from a decedent by the decedent's surviving spouse *except for* a "terminable interest" (i.e., where the surviving spouse's ownership interest fails due to a lapse of time, event or contingency).

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However, notwithstanding the terminable interest rule (above), property qualifies for a basis step up if the surviving spouse has a "qualified terminable interest," meaning that the surviving spouse is entitled to all of the property's income for life and no person has a power to appoint any part of the property to any person other than the surviving spouse. [IRC § 1022(c)(3), (4), (5) (now repealed and applicable only to estates of decedents who died in 2010)]

e) [13:28.11] **Joint tenancy property:** In the case of property held in joint tenancy with a surviving spouse, only the decedent's half of the property is subject to a basis increase. If the property is held in joint tenancy with a person other than the surviving spouse, the portion of the property attributable to the decedent is equal to the percentage of the purchase price furnished by the decedent. [IRC § 1022(d)(1) (now repealed and applicable only to estates of decedents who died in 2010)]

f) [13:28.12] **Community property:** Both the decedent's and the survivor's one-half of the community property are eligible for a basis increase. [IRC § 1022(d)(1)(B)(iv) (now repealed and applicable only to estates of decedents who died in 2010)]

[13:28.13 - 13:28.15] ***Reserved.***

(4) Term interests

(a) [13:29] **Cost basis:** If a taxpayer purchases a term interest in property or in a trust (such as a life estate or a term of years), the basis of the term interest is its *cost*. [*Bell v. Harrison* (7th Cir. 1954) 212 F2d 253, 254]

(b) [13:30] **Special rule for inherited or donated term interests:** The basis of term interests received by gift or inheritance is determined by a "uniform basis rule" that allocates the total basis of the property (term interest plus remainder) between the holders of the various interests. [Treas.Reg. § 1.1014-5] This basis shifts between the holders of the term and remainder interests based on actuarial principles.

1) [13:31] **Basis of term interest cannot be used:** The holder of a term interest received by gift or inheritance is limited in the use to which this basis can be put:

• [13:32] The holder may not recover any portion of the basis by depreciation or amortization. [IRC § 273]

• [13:33] Similarly, the holder is not entitled to recover any portion of the basis if the holder sells the term interest, *unless the term interest and the remainder are sold in a single transaction*. [IRC § 1001(e); Treas.Reg. § 1.1001-1(f)]

(5) [13:34] **Property received in nonrecognition exchange:** In many situations, property is received as part of a prior transaction in which gain or loss was not recognized. For example, the taxpayer may own property that was received as part of a tax-free exchange of business or investment property (IRC § 1031 "like-kind" exchange).

In these situations, basis is determined by special statutory provisions, discussed in connection with nonrecognition transactions. *See ¶ 13:304 ff.*

(6) [13:35] **Partnerships and corporations:** Property contributed to corporations or partnerships often has a basis that is the same as in the hands of the transferor. [IRC §§ 362, 723]

In the case of a partnership, if the partnership has so elected, basis of property can be adjusted by reason of sales of partnership interests or because of certain partnership distributions. [IRC §§ 734, 743, 754]

(a) [13:35.1] **Exception—contributions of loss property to corporations:** For contributions of loss property to a corporation, the basis steps down to fair market value unless the parties agree instead to reduce the shareholders' basis in the stock they received. [See IRC § 362(e)(2)]

3. [13:36] **Allocation of Basis:** The property's purchase price is often allocated among several items.

a. [13:37] **Allocation between land and building:** Where land and building are acquired together, basis must be allocated between the land and building, since only the building is depreciable (*¶ 13:121 ff.*). [Treas.Reg. § 1.167(a)-5]

(1) [13:38] **Contractual allocations not conclusive:** An allocation in the purchase contract is entitled to some weight, but is not conclusive for tax purposes; however, if the contractual allocation makes a tax difference to both the seller and buyer, it is entitled to greater weight. Often, the allocation is determined by the current property tax appraisal of the property. [See *Sleiman v. Commissioner* (11th Cir. 1999) 187 F3d 1352, 1359-1361—contractual allocation disregarded where purchase and sale agreement determined to be "unreliable evidence" of relative value of land and buildings; *2554-58 Creston Corp.*

v. Commissioner (1963) 40 TC 932, 940, fn. 5—property tax valuations often too low to be reliable as furnishing correct value of real property parcel as whole, but may be probative in determining relative value of land and buildings]

(a) [13:39] **Example:** Blackacre contains a small warehouse. According to the property tax valuation, the land is worth $50,000 (or 1/3 of the total) and the building is worth $100,000 (or 2/3 of the total). T purchases the land and building for $300,000. Using the proportions in the appraisal, 1/3 ($100,000) is allocated to the land and 2/3 ($200,000) to the warehouse.

(b) [13:40] **Use of appraiser:** The purchaser may find it worthwhile to engage an appraiser to prepare a study allocating the purchase price between land and building.

(2) [13:41] **Exception—building to be demolished:** Where the purchaser intends to demolish an existing building, the entire purchase price must be allocated to the land. [Treas.Reg. § 1.165-3(a)(1)]

Moreover, in the case of any other demolition, the basis of a demolished building must be added to the basis of the land; it cannot be deducted as a loss or added to the basis of the replacement building and thus depreciated. [IRC § 280B; and see generally, Grigsby, Coe & Vandenbergh, "Section 280B: Impediment to Environmental Remediation?" (July 21, 1997) 76 Tax Notes 385]

(a) [13:41.1] **Modification of building distinguished:** For purposes of IRC § 280B, a *modification* of a building is not a "demolition" if 75% of the walls and structural framework remain in place. [Rev.Proc. 95-27, 1995-1 CB 704]

(b) [13:41.2] **Obsolescence distinguished:** Where a building becomes worthless and is abandoned before being demolished, the taxpayer is entitled to a deduction for abnormal retirement of the building. [Treas.Reg. § 1.167(a)-8(a)(4)] This deduction may reduce the building's basis to zero.

Similarly, when a building is damaged or destroyed by a *casualty* (e.g., earthquake or hurricane) and is abandoned, the taxpayer *must* reduce the basis of the building by the amount of the deduction taken for the casualty loss (see IRC § 165(b)). Then, any remaining basis is added to the basis of the land after the building is demolished.

Thus, although a post-abandonment demolition does not provide any deduction under IRC § 280B (¶ *13:41*), a taxpayer may succeed in immediately deducting the building's entire basis through the deduction for abnormal retirement or casualty loss. [See *De Cou v. Commissioner* (1994) 103 TC 80, 86-87—loss sustained prior to demolition as a result of building's abnormal retirement from taxpayer's business (caused by building's extraordinary obsolescence) not treated as having been sustained "on account of" demolition and thus not disallowed under § 280B; see also Raby & Raby, "Demolition Loss, or Something Else?" (Feb. 6, 2006) 110 Tax Notes 623]

b. [13:42] **Allocation between parcels:** If several parcels are purchased in a single transaction, the purchase price must be allocated between the parcels. As with the purchase of land and building (¶ 13:37 ff.), such allocation is determined by the respective values of the parcels.

Thus, the allocation is not based simply on the square footage of the parcels, unless the parcels are equally valuable, but must take account of their *differing values*. [See *Vaira v. Commissioner* (1969) 52 TC 986, 998 (rev'd and remanded on other grounds (3rd Cir. 1971) 444 F2d 770, 778)—"more realistic" to allocate half of basis to valuable portion of 75 acres of property condemned by state for highway use than to allocate according to acreage; and for general discussion of various allocation methods, see Williford & Sinnett, "Tax Planning for the Developer: Allocating Costs Among Land and Improvements" (2005) 103 J. of Tax. 335, 339-342]

(1) [13:42.1] **Parcels subdivided from larger property:** When property is acquired in a lump-sum purchase and then divided and sold off in parts, the cost basis for the entire property should generally be allocated between the several parts. [Treas.Reg. § 1.61-6(a); *Gladden v. Commissioner* (9th Cir. 2001) 262 F3d 851, 853]

[13:42.2 - 13:42.4] ***Reserved.***

(2) [13:42.5] **Compare—sales of appurtenant easement rights:** Taxpayers sometimes purchase land with appurtenant easements and then sell the easement rights without selling the land. Where it is "impracticable or impossible" to allocate the purchase price between the land and an appurtenant easement (i.e., the easement rights cannot be described by metes and bounds or may change in the future), the taxpayer is allowed to reduce the cost basis of the property by the amount realized from sale of the easement. [*Inaja Land Co., Ltd. v. Commissioner* (1947) 9 TC 727, 736—no portion of payment received by taxpayer from water rights sale considered income, but full amount applied to reduce property's cost basis]

(a) [13:42.6] **Example:** T purchases land beside a river for $100,000. The primary use of the land is for fishing in the river. X pollutes the river and kills the fish by T's property. X pays T $65,000 as damages for the loss of T's fishing rights.

Because T cannot prove the basis for the water rights alone, the Commissioner argues that the basis is 0, resulting in a $65,000 gain to T. On appeal, the Tax Court allows T to offset the $65,000 basis against the $65,000 in damages, so that T has no gain. Accordingly, the basis for the land is reduced to $35,000. When T later sells the remaining property rights (i.e., the land and the water but without any fish) for $46,000, T has an $11,000 gain.

(b) [13:42.7] **Later-acquired water rights:** Where a purchaser of land pays a premium based on a *realistic expectation* that water rights not legally vested at the time of purchase will attach to that land in the future, the purchaser may, upon sale of the later-acquired water rights, allocate a portion of the cost basis in the land to the later sale of the water rights in an amount equal to the premium paid. [*Gladden v. Commissioner* (9th Cir. 2001) 262 F3d 851, 855]

On the other hand, when land is purchased with *no expectation* of obtaining water rights, it is improper to allocate any of the cost of the land purchase to the sale of later-acquired water rights. [*Gladden v. Commissioner*, supra, 262 F3d at 854]

c. [13:43] **Allocation of development improvements benefiting several parcels:** The cost of a common improvement incurred by a developer may, under certain circumstances, be added to the basis of the adjacent properties benefiting from the improvement. [*Country Club Estates, Inc. v. Commissioner* (1954) 22 TC 1283, 1293—cost of land transferred to country club added to cost of lots sold where basic purpose was to bring about construction of country club for benefit of nearby lots; see generally Williford & Sinnett, supra, 103 J. of Tax. at 342-346; *and ¶ 13:158* for discussion of "uniform capitalization" rules requiring developers to capitalize rather than deduct direct and indirect costs of constructing or acquiring property for resale]

(1) [13:43.1] **Limitation—improvement intended to induce sales:** A developer may not allocate the cost of a common improvement to adjoining properties unless the intended purpose of incurring that cost is to *induce sales* of the adjoining properties. [*Norwest Corp. v. Commissioner* (1998) 111 TC 105, 133-134—taxpayer who constructed facility to benefit its own adjoining rental property not allowed to allocate cost of common improvement when it subsequently decided to sell its improved property; Rev.Rul. 68-478, 1968-2 CB 330—irrelevant that developer retains "tenuous rights, without practical value" to common improvement, such as contingent reversion]

(2) [13:43.2] **No allocation where developer retains full ownership/control of improvement:** The cost of a common improvement (such as a sewage facility) is *not* added to the basis of the benefited parcels where the developer retains "full ownership and control" of the improvement. [*Estate of Collins v. Commissioner* (1958) 31 TC 238, 256; *Norwest Corp. v. Commissioner* (1998) 111 TC 105, 133]

[13:44] ***Reserved.***

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Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 13. Real Property
Purchase and Sale Tax Concerns

Part I. Acquisition of Real Property

C. Acquisition and Disposition Dates

1. [13:45] Significance
2. [13:46] General Rule—Ownership Determined by Date Title Passes
3. [13:47] Exception—Ownership Determined by Transfer of Incidents of Ownership
    a. [13:48] Example—land sale contract
    b. [13:49] Example—delay of title passage
    c. [13:50] Example—option to purchase/sell

1. [13:45] **Significance:** It is often important to know the dates on which the taxpayer will be treated as the owner of property. For example:

• A taxpayer can deduct depreciation, interest and property taxes only during the period in which the taxpayer owns the property for tax purposes (*¶ 13:144*).

• The taxpayer's "holding period" for purposes of qualifying for long-term capital gain treatment is measured by the acquisition and disposition dates (*¶ 13:457*).

• The date on which property is disposed of determines the year in which gain or loss is recognized for tax purposes (unless the gain is deferred because a nonrecognition section applies or the installment method is used). (*See ¶ 13:304 ff.* for discussion of nonrecognition of gain or loss; *and ¶ 13:466 ff.* for discussion of the installment method.)

• Similarly, the date of disposition of property starts the clock running on the seller's need to identify a replacement property for purposes of a deferred § 1031 exchange. (*See ¶ 13:332 ff.* for discussion of deferred exchanges.)

2. [13:46] **General Rule—Ownership Determined by Date Title Passes:** As a general rule, the buyer does not acquire ownership (nor does the seller dispose of ownership) when the parties execute a contract of sale or when the buyer makes payments into escrow. Instead, the date on which *title passes* determines the date on which acquisition and disposition of real property occurs for tax purposes. [Rev.Rul. 69-93, 1969-1 CB 139]

The passage of title depends upon execution and delivery of a deed to the property. Normally, therefore, the date *escrow closes* (when the deed is delivered to the buyer) establishes the date on which ownership shifts for tax purposes (*see Ch. 4*).

3. [13:47] **Exception—Ownership Determined by Transfer of Incidents of Ownership:** Ownership of property shifts for tax purposes when there is a transfer of the benefits and burdens of ownership, *even though title has not yet passed*. Thus, the buyer is treated as the owner if the buyer is allowed to take possession and assume the benefits and burdens of ownership.

The time at which a taxpayer has assumed the benefits and burdens of ownership is a question of fact. *State law* determines the nature of *property rights*, while *federal law* determines the appropriate *tax treatment* of those rights. [*Blanche v.*

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Commissioner, TC Memo 2001-63; see generally, Copple, “What if the Seller Needs More Time?” (2007) 34 J. Real Est. Tax 69, 71-76]

a. [13:48] **Example—land sale contract:** A seller retains title to property sold under a land sale contract as security that the buyer will make the required payments. However, since the buyer has all of the burdens and benefits of ownership, the buyer is treated as the owner for tax purposes from the time the buyer is permitted to take possession of the property. [*Keith v. Commissioner* (2000) 115 TC 605, 610-616—“contract for deed” under Georgia law treated as completed sale; *Hoven v. Commissioner* (1971) 56 TC 50, 55]

b. [13:49] **Example—delay of title passage:** Similarly, a seller might seek to defer the date on which gain on sale is recognized by formally keeping the property in escrow even though all of the conditions for the sale have been satisfied and the buyer is entitled to possession. Case law indicates that ownership shifts to the buyer when all the conditions have been satisfied. [*Merrill v. Commissioner* (1963) 40 TC 66, 74-75, aff'd (9th Cir. 1964) 336 F2d 771]

c. [13:50] **Example—option to purchase/sell:** Generally, ownership of property does *not* shift when the seller grants the buyer an option to purchase or when the buyer grants the seller an option to sell. [See *Williams v. Commissioner* (7th Cir. 1993) 1 F3d 502, 505-507; Rev.Rul. 71-265, 1971-1 CB 223]

The same is true when the buyer is granted an option to purchase and takes possession of the property under a lease, *unless* the terms of the lease are such that exercise of the option is a virtual certainty. [See *Haggard v. Commissioner* (9th Cir. 1956) 241 F2d 288; *Blanche v. Commissioner*, TC Memo 2001-63—conduct of taxpayers who had contract for sale of residence with option to lease prior to closing date failed to show they had “benefits and burdens of ownership” prior to closing date; *Ryan v. Commissioner*, TC Memo 1995-579]

Moreover, where the buyer takes possession pursuant to an “irrevocable written option,” the option itself is treated as the equivalent of an immediate sale. [Rev.Rul. 75-563, 1975-2 CB 199]

[13:51 - 13:54] ***Reserved.***

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Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 13. Real Property Purchase and Sale Tax Concerns

Part I. Acquisition of Real Property

D. Deductions in Connection with Purchase of Property

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2. [13:57] "Points"
   a. [13:58] Exception—purchase or improvement of principal residence
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[13:55] Expense items incurred in connection with purchasing real property normally are *not* deductible but must be *capitalized:* i.e., they are added either to the basis of the property or to the basis of the loan. *See ¶ 13:5 ff.*

However, there are a few special rules:

1. [13:56] **Real Property Taxes:** If the purchase price of real property includes reimbursement of the seller for property taxes already paid by the seller, that portion of the taxes allocable to the period after the sale occurs are treated as imposed on the buyer and may be deductible by the buyer, subject to the $10,000 cap on the aggregate amount of state property, sales and state and local income taxes deductible on federal returns (*see ¶ 13:200.2*). They are not capitalized as part of the cost of the property. [IRC §§ 1012, 1001(b)(2), 164(b)(6), (d)]

2. [13:57] **"Points":** Normally, "points" paid to the lender are not currently deductible. They must be capitalized and deducted over the period of the loan (assuming the interest is deductible; *see* ¶ *13:8, 13:165 ff.*). [IRC § 461(g)(1)]

In most cases, the IRS permits a simple allocation of the points to each year the loan is outstanding, as opposed to the more sophisticated methods normally used to determine timing of interest deductions. [Rev.Proc. 87-15, 1987-1 CB 624; *and see ¶ 13:496 ff.* for discussion of original issue discount principles]

a. [13:58] **Exception—purchase or improvement of principal residence:** Points incurred in connection with the purchase or improvement of, and which are secured by, the taxpayer's *principal residence* can be deducted immediately … provided that payment of points is an established business practice in the area and the amount of points does not exceed that which is generally charged in the area. [IRC § 461(g)(2); Rev.Proc. 94-27, 1994-1 CB 613]

b. [13:59] **Points paid to refinance loan:** In general, points paid in connection with refinancing a loan do not qualify for immediate deduction. [Rev.Rul. 87-22, 1987-1 CB 146—if points incurred partly in connection with home improvement, partly in connection with refinance, only portion allocable to improvement is currently deductible]

However, there is case law holding that points incurred in refinancing a very short-term balloon payment purchase money loan are deductible in the year they were paid, since the refinance related so closely to purchase. [*Huntsman v. Commissioner* (8th Cir. 1990) 905 F2d 1182, 1185-1186]

• [13:59.1] ***Caveat:*** The IRS will not follow *Huntsman* outside the Eighth Circuit and the Tax Court has confined the decision to its facts. [*Kelly v. Commissioner*, TC Memo 1991-605]

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[13:60 - 13:64] ***Reserved.***

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Chapter 13. Real Property Purchase and Sale Tax Concerns

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(c) [13:98.3] Family home/farm's taxable value post-transfer

(2) Eligible real property

(a) [13:99] “Principal residence”

(b) [13:100] $1,000,000 of other real property—pre-February 16, 2021 transfers

1) [13:100.1] Joint transferors' option to cumulate $1,000,000 exclusions

2) [13:100.2] Nonexcluded principal residence transfer from grandparent to grandchild included in applying $1,000,000 limit

3) [13:100.3] Could be prorated between transferred property and building located thereon

(c) [13:100.4] Cooperative housing corporation unit or lot

(d) [13:100.5] Pro rata ownership interests in mobile home parks/floating home marinas

(3) [13:101] “Eligible” transferors and transferees

(a) [13:101a] Compare—pre-February 16, 2021 transfers

(4) [13:101b] “Transfers” covered

(a) [13:101.1] Direct transfers only; transfers to wholly owned entities distinguished

1) [13:101.2] Comment

(5) [13:102] Timely exclusion claim required

(a) [13:102.1] Compare—pre-February 16, 2021 transfers

1) [13:103] General three-year deadline

a) [13:103.1] Pre-February 16, 2021 transfers upon death

2) [13:104] Extension—special “deemed timely filing” rule

3) [13:104.1] Special provision for late claims

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(b) [13:104.5] Notice by assessor
(6) [13:104.7] Stock transfers in family corporations owning real property
(a) [13:104.8] Qualified corporation
(b) [13:104.9] Qualified property
f. Joint tenancy property
(1) [13:105] Transferor remaining joint tenant
(2) [13:106] Reappraisal upon termination
g. [13:107] Property damaged/destroyed by disaster—base-year value transfer to comparable property
(1) [13:108] “Substantial” damage or destruction
(2) [13:109] “Comparable” replacement
(3) [13:109.1] Application to homeowners who are (i) over age 55, (ii) severely and permanently disabled, or (iii) wildfire or natural disaster victims
h. [13:109.5] “Qualified contaminated property”—base-year value transfer to replacement property; or “new construction” reappraisal exclusion
(1) [13:109.6] Timely claim of exemption required
i. [13:110] Acquisition to replace condemned property
j. [13:111] Tenant acquisitions of mobilehome park
(1) [13:111.1] Compare—transfer of ownership in entity that owns mobilehome park
k. [13:111.5] Cotenancy interest transfer upon death
l. [13:111.6] Floating home marina transfers
(1) [13:111.7] Compare—transfer of ownership in entity that owns floating home marina
5. [13:112] Reporting Obligations
a. Penalties
(1) [13:114] For individuals
(2) [13:115] For legal entities
(3) [13:116] Abatement of penalties
6. [13:117] Foreclosure

1. [13:65] **Proposition 13 Reassessment:** “Proposition 13” establishes an “acquisition value” system (rather than a “current value” method) for the assessment of real property tax (i.e., a tax triggered by *property ownership*, as distinguished from an “excise tax,” which is imposed upon a particular use of property or the exercise of a privilege associated with property ownership, such as sale, transfer, rental, etc.; see *Thomas v. City of East Palo Alto* (1997) 53 CA4th 1084, 1088-1089, 62 CR2d 185, 187).

Under Prop. 13, real property is assessed at its 1975-76 full cash value (adjusted for inflation at a maximum rate of 2% per year). But if the property is purchased, newly-constructed or changes ownership after the 1975 assessment, it is *reassessed* at a new “base-year value” (i.e., *revalued* at current fair market value) as of the date of the transfer or completion of construction. [Cal.Const. Art. XIIIA, § 2(a); Rev. & Tax.C. § 110.1; *Steinhart v. County of Los Angeles* (2010) 47 C4th 1298, 1319, 104 CR3d 195, 213; *Auerbach v. Assessment Appeals Bd. No. 1 for County of Los Angeles* (2006) 39 C4th 153, 160, 45 CR3d 774, 778; see also *Nordinger v. Hahn* (1992) 505 US 1, 12-17, 112 S.Ct. 2326, 2333-2335 (upholding constitutionality of Prop. 13 against equal protection challenge)]

After a Prop. 13 reassessment, the property retains its new valuation until another change in ownership occurs (¶ 13:65.1).

a. [13:65.1] **Assessment approaches:** No property may escape assessment for real property tax purposes because of difficulty in determining its full cash value. Thus, assessors have developed three methods for determining the full cash value of real property: the sales comparison method, the cost method and the income method. “Since no one of these methods alone can be used to estimate the value of all property, the assessor, subject to requirements of fairness and uniformity, may exercise his discretion in using one or more of them.” [*Exxon Mobil Corp. v. County of Santa Barbara* (2001) 92 CA4th 1347, 1352, 112 CR2d 751, 755; see *Olen Comm'l Realty Corp. v. County of Orange* (2005) 126 CA4th 1441, 1448, 24 CR3d 609, 613 (assessor used all three valuation methods, but taxpayer only challenged application of sales comparison method); *and* ¶ *6:665 ff.* for discussion of three methods of appraising real property]

b. [13:65.2] **Correcting errors in base-year value; statute of limitations:** Errors or omissions in the base-year value *not* involving the exercise of the assessor's judgment are correctable in any assessment year in which the error or omission is

discovered. [Rev. & Tax.C. § 51.5(a); see also *William Jefferson & Co., Inc. v. Orange County Assessment Appeals Bd. No. 2* (2014) 228 CA4th 1, 10, 174 CR3d 642, 647—nonjudgmental errors subject to correction include assessor's erroneous determination that change in ownership occurred, assessor's failure to set new base-year value upon change in ownership and defects of a mechanical, mathematical or clerical nature not involving judgment as to value; *Little v. Los Angeles County Assessment Appeals Bds.* (2007) 155 CA4th 915, 925-926, 66 CR3d 401, 407-408—nonjudgmental errors include clerical error, taxpayer's fraud, concealment and misrepresentation]

However, errors or omissions in the base-year value involving the exercise of an assessor's judgment as to value are subject to a four-year limitations period. [Rev. & Tax.C. § 51.5(b); *Little v. Los Angeles County Assessment Appeals Bds.,* supra, 155 CA4th at 925, 66 CR3d at 408; see also *William Jefferson & Co., Inc. v. Orange County Assessment Appeals Bd. No. 2*, supra, 228 CA4th at 6, 10, 174 CR3d at 644, 647 (noting judgmental errors "typically" involve claim that assessor's base-year value failed to reflect property's fair market value)—lawsuit challenging base-year value assigned by assessor must be timely brought against county or city that collected tax, *not* local assessment appeals board]

c. [13:65.3] **Assessing and taxing real property when its market value declines:** Proposition 13 did not address how real property should be assessed and taxed when its market value declines due to substantial damage, destruction or other factors. To address the issue, voters passed Proposition 8, which permits a property to be reassessed and taxed based on its actual fair market value whenever that value declines to a level below the property's adjusted base-year value under Prop. 13. Thus, while there is a cap on the assessed value of property when its fair market value has appreciated, the assessed value of property remains its fair market value when that value has fallen. [Cal.Const. Art. XIIIA, § 2(b); Rev. & Tax.C. § 51(a); see also *Western States Petroleum Ass'n v. Board of Equalization* (2013) 57 C4th 401, 409-410, 416, 159 CR3d 702, 707, 712]

d. [13:65.4] **Reporting obligations:** *See ¶ 13:112 ff.*

e. [13:65.5] **Escape assessments:** A reassessment might not be completed in the same year as the triggering event. In order to capture any value that might have been untaxed during the interim period between the triggering event and the reassessment, the county assessor can levy a retroactive assessment known as an "escape assessment." [See Rev. & Tax.C. §§ 51.5(d), 531 & 532]

f. [13:65.6] **Challenging assessments; exhaustion of administrative remedies:** In order to challenge a regular (¶ 13:65) or escape assessment (¶ 13:65.5), taxpayers must exhaust their administrative remedies by following a three-step statutory process: (i) file an application for assessment reduction (i.e., an "assessment appeal") with the county board of assessors (see Rev. & Tax.C. § 1603); (ii) file an administrative refund claim (see Rev. & Tax.C. § 5096 et seq.); and (iii) file a refund action in superior court (see Rev. & Tax.C. § 5140 et seq.). [See *Steinhart v. County of Los Angeles* (2010) 47 C4th 1298, 1307-1308, 104 CR3d 195, 202-203; *LA Live Properties, LLC v. County of Los Angeles* (2021) 61 CA5th 363, 371-372, 380-381, 275 CR3d 726, 730, 737-738—trial court lacked jurisdiction to review escape assessment challenge due to taxpayer's failure to apply for assessment reduction (county's failure to provide 10-day notice of proposed escape assessment did not nullify taxpayer's failure to exhaust administrative remedies)]

2. [13:66] **"Change in Ownership" Triggering Reassessment—General Definition:** A real property "change in ownership" for property tax reassessment purposes means (a) a transfer of a present interest in the property, (b) including the beneficial use thereof, (c) the value of which is substantially equal to the value of the fee interest. [Rev. & Tax.C. § 60; *Auerbach v. Assessment Appeals Bd. No. 1 for County of Los Angeles* (2006) 39 C4th 153, 161, 45 CR3d 774, 779; see also *Dyanlyn Two v. County of Orange* (2015) 234 CA4th 800, 809, 184 CR3d 88, 94; *Ocean Avenue LLC v. County of Los Angeles* (2014) 227 CA4th 344, 353, 173 CR3d 445, 452]

(For general treatment of the change in ownership provisions, see Ehrman & Flavin, "Taxing California Property"§§ 2.11-2.28 (Clark Boardman Callaghan, 4th ed. 2009, and annual supp.); 18 CCR § 462.001 et seq.)

➪ [13:66a] ***PRACTICE POINTER—"ASSESSOR'S HANDBOOK" ONLINE***: IRC § 401 of the State Board of Equalization's Assessor's Handbook, entitled "Change in Ownership," addresses the various statutes, regulations and court cases pertaining to real property tax change of ownership rules. It is a useful tool for researching the Board's position on a variety of change in ownership issues. Section 401 is accessible online at the State Board of Equalization's website (see *www.boe.ca.gov*).

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a. [13:66.1] **"Present interest" requirement:** The intent behind the Rev. & Tax.C. § 60 "present interest" requirement is to protect contingent, inchoate or future transfers from "unintended change in ownership treatment." [*Reilly v. City & County of San Francisco* (2006) 142 CA4th 480, 492, 48 CR3d 291, 299]

b. [13:66.2] **"Beneficial use" prong:** Similarly, the "beneficial use" prong of the Rev. & Tax.C. § 60 change in ownership test is necessary to protect custodianships, guardianships, trusteeships, security interests and other fiduciary relationships from unintended change in ownership treatment. Thus, "the focus is on the person or entity that enjoys the benefits of the property, not upon the fiduciary that holds title to property for the benefit of another." [*Reilly v. City & County of San Francisco* (2006) 142 CA4th 480, 494-495, 48 CR3d 291, 301]

(1) [13:66.3] **Legal owner presumed to have "beneficial use":** The owner of legal title to property is *presumed* to be the owner of beneficial title property as well; but this presumption may be *rebutted* by clear and convincing evidence. [*Auerbach v. Assessment Appeals Bd. No. 1 for County of Los Angeles* (2006) 39 C4th 153, 163, 45 CR3d 774, 780-781]

(2) [13:66.4] **Possession of property not required:** The receipt of income generated by property qualifies as a "beneficial use" of the property; possession of the property is not required. [*Reilly v. City & County of San Francisco* (2006) 142 CA4th 480, 494-495, 48 CR3d 291, 301; see also *Phelps v. Orange County Assessment Appeals Bd. No. 1* (2010) 187 CA4th 653, 662, 114 CR3d 463, 470—beneficiary who received rental income from trust property during life had "beneficial use" sufficient to trigger reassessment once beneficiary died and his interest passed to successors; *¶ 13:75*]

(3) [13:66.5] **Inapplicable to transfers between entities:** The "beneficial use" test does *not* apply to transfers between business entities. A change in ownership results from these transactions because no fiduciary relationship (e.g., custodianship, guardianship, etc.) exists between the parties—i.e., no party holds title for the benefit of another. [See *Fashion Valley Mall, LLC v. County of San Diego* (2009) 176 CA4th 871, 881-888, 98 CR3d 327, 335-340—100% ownership change occurred when corporation transferred record title in shopping mall to limited liability company in which corporation held 50% interest (retention of economic interest in property does not equal beneficial use); *and see further discussion at ¶ 13:77 ff.*]

[13:66.6 - 13:66.9] ***Reserved.***

c. [13:66.10] **"Value equivalence" test:** Rev. & Tax.C. § 60's third prong, described as the "value equivalence" test, is intended to "find a change in ownership when the *primary economic value* of the land is transferred." [*Reilly v. City & County of San Francisco* (2006) 142 CA4th 480, 495-496, 48 CR3d 291, 301-302 (emphasis in original; internal quotes omitted)]

(1) [13:66.11] **"Primary economic value":** This is not simply a question of who possesses the "incidents of ownership" (i.e., the power to possess, sell or devise the property). For example, a transfer of the right to receive lifetime income generated by the property is considered a transfer of the property's "primary economic value" even though the income beneficiary does not have possession. [See *Phelps v. Orange County Assessment Appeals Bd. No. 1* (2010) 187 CA4th 653, 662-663, 114 CR3d 463, 470-471—beneficiary's lifetime interest in rental income generated by trust-held shopping center deemed substantially equivalent to value of fee interest for change in ownership purposes; *Reilly v. City & County of San Francisco* (2006) 142 CA4th 480, 498, 48 CR3d 291, 304—beneficiary's lifetime interest in income from trust-held real property met value equivalency prong of Rev. & Tax.C. § 60]

3. [13:67] **Special Rules of Inclusion and Exclusion:** The Revenue & Taxation Code specifically treats numerous transactions as changes in ownership or provides for exceptions to the change in ownership provisions; but these provisions are intended to be largely illustrative of the basic rule set forth in Rev. & Tax.C. § 60 (transfer of present interest substantially equivalent to value of the fee, *¶ 13:66.10 ff.*). [See *Pacific Southwest Realty Co. v. County of Los Angeles* (1991) 1 C4th 155, 166, 2 CR2d 536, 543; *Auerbach v. Assessment Appeals Bd. No. 1 for County of Los Angeles* (2006) 39 C4th 153, 161, 45 CR3d 774, 779]

a. [13:68] **Long-term leases:** Although a leasehold interest in real property generally is not an ownership interest in the property (*Auerbach v. Assessment Appeals Bd. No. 1 for County of Los Angeles* (2006) 39 C4th 153, 163, 45 CR3d 774, 780), the disposition of certain long-term leases is deemed tantamount to the transfer of a fee and thus a "change in ownership" for reassessment purposes.

The language of the lease itself is not dispositive of whether there has been a change in ownership. Rather, all of the Rev. & Tax.C. § 60 prongs (*¶ 13:66*) must be satisfied. [See *Auerbach v. Assessment Appeals Bd. No. 1 for County of Los Angeles*, supra, 39 C4th at 162, 45 CR3d at 780]

(1) [13:69] **Leases for minimum 35 years:** A change in ownership triggering reassessment occurs upon the creation, termination or transfer of a leasehold for a term of *35 years or more* (counting renewal options). [Rev. & Tax.C. § 61(c)(1)(A)-(C); 18 CCR § 462.100(a)(1)(A); *Auerbach v. Assessment Appeals Bd. No. 1 for County of Los Angeles* (2006) 39 C4th 153, 164, 45 CR3d 774, 781; see also *Dyanlyn Two v. County of Orange* (2015) 234 CA4th 800, 812, 184 CR3d 88, 96—change in ownership occurs because transaction transfers present interest, beneficial ownership and value equivalence as required by Rev. & Tax.C. § 60 (¶ *13:66*)]

(a) [13:69.1] **Compare—lease extensions:** Whether a lease extension triggers a change in ownership depends entirely on the duration of the original lease, *not* the lease's remaining term. For example, assume a lease for 35-plus years is created and the passage of time drops the lease term to under 35 years. Assume further the parties negotiate to extend the lease for another 35-plus years (so-called "over/under/over" extension). No change in ownership results. This is so because a change in ownership based upon the transfer of all three ownership elements (¶ *13:66*) already occurred when the lease was originally created. [See Assessment Bd. Advisory Opn. (2009) No. 09013291; see also *Dyanlyn Two v. County of Orange* (2015) 234 CA4th 800, 813-814, 820, 184 CR3d 88, 97-98, 102 (rejecting Assessor's determination that lease extension constituted sham transaction designed to avoid reassessment)—no change in ownership following "over/under/over" lease extension even though underlying fee interest was transferred not only to original lessee, but also to *outside* investor]

(2) [13:70] **Lessor's transfer subject to lease of less than 35 years:** A change in ownership also results from the transfer of a lessor's interest in real property subject to a lease with a remaining term (including renewal options) of *less than 35 years*. [Rev. & Tax.C. § 61(c)(1)(D); 18 CCR § 462.100(a)(2)(A); *Auerbach v. Assessment Appeals Bd. No. 1 for County of Los Angeles* (2006) 39 C4th 153, 164, 45 CR3d 774, 781; see *Equinix LLC v. County of Los Angeles* (2024) 101 CA5th 1108, 1117-1118, 320 CR3d 803, 809 (upholding constitutionality of § 61(c)(1)(D) where change in ownership was triggered because property lessor's lease term was less than 35 years, even though lessor was property's original owner); compare *Dyanlyn Two v. County of Orange* (2015) 234 CA4th 800, 816-817, 184 CR3d 88, 100 (finding 18 CCR § 462.100(a)(2)(A) "problematic" because, among other things, "it is not in sync" with case authority and fails to distinguish long-term lessees who have primary ownership from third parties who do not)]

(a) [13:70.1] **Compare—transfer subject to minimum 35-year leasehold:** A change in ownership does *not* occur by the transfer of a lessor's interest in real property subject to a remaining term (including renewal options) of *35 years or more* (i.e., ownership had already changed when the leasehold interest was created). [Rev. & Tax.C. §§ 61(c), 62(g); 18 CCR § 462.100(b)(2)(A); *Pacific Southwest Realty Co. v. County of Los Angeles* (1991) 1 C4th 155, 167, 2 CR2d 536, 544; *Auerbach v. Assessment Appeals Bd. No. 1 for County of Los Angeles* (2006) 39 C4th 153, 164-165, 45 CR3d 774, 782; see also *Dyanlyn Two v. County of Orange* (2015) 234 CA4th 800, 816, 184 CR3d 88, 99—no change in ownership occurred when underlying fee interest in property subject to 35-plus-year lease was transferred from lessor to lessee and third party investor (long-term lessee "captured" primary ownership when leasehold was created)]

(3) [13:71] **Effect of constructing building on leased property:** Commercial long-term leases often permit the lessee to construct a building on the leased land. A change in ownership of the land also may effect a change in ownership of the building … so long as the change in ownership test (¶ *13:66*) as applied to the building is satisfied. If reassessment is required, any applicable exclusion must then be prorated between the land and the building (*see* ¶ *13:100.3*). [*Auerbach v. Assessment Appeals Bd. No. 1 for County of Los Angeles* (2006) 39 C4th 153, 157, 45 CR3d 774, 775; see also *Phelps v. Orange County Assessment Appeals Bd. No. 1* (2010) 187 CA4th 653, 658-661, 114 CR3d 463, 467-469—income beneficiary had "present interest" in shopping center built by lessee on trust-held property sufficient to trigger reassessment of center and land under change in ownership test (lease provision requiring surrender of improvements when lease concluded showed that trust held fee interest, and "suggested" trust's income beneficiaries held present interest, in shopping center)]

(4) [13:72] **Sale and leaseback:** A sale of property with a long-term leaseback to the seller is a change in ownership. [*Pacific Southwest Realty Co. v. County of Los Angeles* (1991) 1 C4th 155, 162-166, 2 CR2d 536, 540-543; *Industrial Indem. Co. v. City & County of San Francisco* (1990) 218 CA3d 999, 1004-1006, 267 CR 445, 447-449; see also *Crow Winthrop Operating Partnership v. County of Orange* (1992) 10 CA4th 1848, 1857-1858, 13 CR2d 696, 702; and Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 2A]

b. [13:73] **Co-ownership:** There is a change in ownership for property tax purposes upon the creation, transfer or termination of a *joint tenancy* or *tenancy-in-common interest*, unless covered by one of the statutory exceptions (e.g., transfer to a spouse; *see ¶ 13:90 ff.*). [Rev. & Tax.C. § 61(e), (f)]

c. [13:74] **Transfers into and out of trusts:** Generally, the transfer of real property into or out of a trust constitutes a change in ownership of the property for reassessment purposes. [18 CCR § 462.160(a); *Reilly v. City & County of San Francisco* (2006) 142 CA4th 480, 488, 48 CR3d 291, 295] However, there are numerous exceptions:

(1) Exclusions

(a) [13:74.1] **Transfers to trust where trustor remains sole beneficiary:** No change in ownership occurs when property is transferred by the trustor (and/or their spouse or registered domestic partner) into a trust of which the trustor remains the *sole present beneficiary*. [Rev. & Tax.C. § 62(d); 18 CCR § 462.160(b)(1)(A); *Reilly v. City & County of San Francisco* (2006) 142 CA4th 480, 488-489, 48 CR3d 291, 296—if trustor remains sole beneficiary during their lifetime, trustor's retained interest is considered "substantially equivalent in value" to fee and no change in ownership occurs until property passes to remainder persons on trustor's death]

1) [13:74.2] **Trustee transfers back to trustor:** Similarly, no change of ownership occurs when a trustee transfers trust property back to the trustor. [Rev. & Tax.C. § 62(d)]

2) [13:74.3] **Compare—transfers to non-excludable persons other than trustor:** On the other hand, if the property is transferred to a trust where persons *other than the trustor* become present beneficiaries of the trust, there *is* a change in ownership … *unless* those persons are excluded from the change in ownership rules (*see ¶ 13:90 ff.*). [18 CCR § 462.160(b)(1)(A)& ex. 1, (d)(1), ex. 5; *Reilly v. City & County of San Francisco* (2006) 142 CA4th 480, 488, 48 CR3d 291, 294-295]

[13:74.4] ***Reserved.***

(b) [13:74.5] **Transfers into and out of revocable trusts:** Transfers of property by the trustor (and/or their spouse or registered domestic partner) into a trust, or by the trustee back to the trustor, do not constitute changes in ownership for so long as the trust is *revocable*. [Rev. & Tax.C. § 62(d); *Steinhart v. County of Los Angeles* (2010) 47 C4th 1298, 1319-1320, 104 CR3d 195, 213-214]

A change in ownership *does occur,* however, when the trust becomes irrevocable, *unless* the trustor remains or becomes the sole present beneficiary (*¶ 13:74.1*) or some other exclusion applies (*see ¶ 13:90 ff.*). [See Rev. & Tax.C. § 61(h); 18 CCR § 462.160(b)(2); *Bohnett v. County of Santa Barbara* (2021) 59 CA5th 1128, 1132, 274 CR3d 119, 122; *Reilly v. City & County of San Francisco* (2006) 142 CA4th 480, 488, 48 CR3d 291, 295]

1) [13:74.6] **Trustee transfers back to trustor:** When the trustee transfers trust property back to the trustor, there is no change in ownership. [Rev. & Tax.C. § 62(d)]

(c) [13:74.7] **Creation or termination of 12-year trustor reversion trusts:** No change in ownership occurs upon the creation or termination of a trust where the trustor retains the reversion and the interest of any other person does not exceed 12 years in duration. [Rev. & Tax.C. § 62(d); 18 CCR § 462.160(b)(1)(B)]

(d) [13:74.8] **Transfers subject to spouse/registered domestic partner exclusion:** No change in ownership occurs where a transfer to trust is subject to the spouse/registered domestic partner exclusion (*¶ 13:97*). [18 CCR § 462.160(b)(3)]

(e) [13:74.9] **Transfers subject to parent-child or grandparent-grandchild exclusions:** Similarly, no change in ownership occurs where a transfer to trust is subject to a timely-filed parent-child exclusion (*¶ 13:98*) or grandparent-grandchild exclusion (*¶ 13:98.1 ff.*). [18 CCR § 462.160(b)(4); *Reilly v. City & County of San Francisco* (2006) 142 CA4th 480, 488, 48 CR3d 291, 295, fn. 4; compare *Bohnett v. County of Santa Barbara* (2021) 59 CA5th 1128, 1133, 274 CR3d 119, 123—initial property transfer to trustors' children exempt from reassessment, but beneficiary's subsequent purchase of trust shares from siblings and co-beneficiaries not exempt, even if purchaser received title from trustee]

(f) [13:74.10] **Transfers where proportional interests remain the same:** When the transfer is to a trust where the proportional interests of the beneficiaries remain the same after the transfer, no change in ownership occurs. [18 CCR § 462.160(b)(5); *Reilly v. City & County of San Francisco* (2006) 142 CA4th 480, 489, 48 CR3d 291, 296]

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(g) [13:74.11] **Transfers between trusts:** No change in ownership occurs if the transfer is from one trust to another and meets the requirements of exclusion set forth at ¶ 13:74.1 ff. [18 CCR § 462.160(b)(6)]

(h) [13:74.12] **Compare—transfers to "sprinkle trust":** However, when a trustor transfers property to a trust under which the trustee has *total discretion* ("sprinkle power") to decide which beneficiaries, including the trustor, will receive trust distributions, a change in ownership occurs … *unless* all of the beneficiaries are exempt from the change in ownership rules. [18 CCR § 462.160(b)(1)(A)& ex. 2]

(i) [13:74.13] **Compare—transfers on death of income beneficiary to another income beneficiary:** A change in ownership of property held by a testamentary trust (or irrevocable inter vivos trust) occurs when an income beneficiary dies and is succeeded by another income beneficiary, unless the transfer between the beneficiaries is subject to an exclusion (*see ¶ 13:90 ff.*). [See *Phelps v. Orange County Assessment Appeals Bd. No. 1* (2010) 187 CA4th 653, 655-656, 114 CR3d 463, 465-466—change in ownership occurred for reassessment purposes when trust's income beneficiary died and his interest in trust-held shopping center transferred to his children]

d. [13:75] **Transfers where transferor retains life estate in property:** No change in ownership occurs when the transferor, or their spouse or registered domestic partner, retains a life estate in the property. [Rev. & Tax.C. § 62(e); 18 CCR § 462.060(a); *Leckie v. County of Orange* (1998) 65 CA4th 334, 338, 76 CR2d 426, 428]

It is immaterial whether the life estate is an interest in income generated by the property or in the property itself. [*Reilly v. City & County of San Francisco* (2006) 142 CA4th 480, 496, 48 CR3d 291, 302]

(1) [13:75.1] **Subsequent transfer of life estate:** However, a change in ownership occurs when the transferor, or their spouse or registered domestic partner, subsequently transfers the life estate to a third party. [18 CCR § 462.060(a); see *Durante v. County of Santa Clara* (2018) 29 CA5th 839, 841, 240 CR3d 302, 303 (taxpayer and sister holding inherited property as tenants-in-common)—change in ownership occurred when taxpayer's sister granted taxpayer life estate in sister's 50% interest; *Leckie v. County of Orange* (1998) 65 CA4th 334, 339, 76 CR2d 426, 428-429—change in ownership occurred on transfer of life estate from owner's revocable trust to owner's nonmarital cohabitant]

(2) [13:75.2] **Termination of retained life estate:** Termination of the retained life estate also constitutes a change in ownership, *unless* the reversion passes to the transferor's spouse or registered domestic partner or is subject to a Rev. & Tax.C. § 62(d) exclusion. [See Rev. & Tax.C. §§ 61(h), 62(e); 18 CCR § 462.060(a); *Leckie v. County of Orange* (1998) 65 CA4th 334, 338, 76 CR2d 426, 428]

The same result occurs where termination of the life estate is followed by the creation of a new life estate; the new life estate qualifies as a remainder interest and is subject to the change in ownership characterization unless otherwise excluded. [*Reilly v. City & County of San Francisco* (2006) 142 CA4th 480, 496, 48 CR3d 291, 302; see also *Steinhart v. County of Los Angeles* (2010) 47 C4th 1298, 1319-1325, 104 CR3d 195, 213-219— change in ownership occurred upon death of trust settlor who retained life estate in residence transferred to her trust with instructions to convey same to her sister at settlor's death (because decedent's *entire equitable estate* in residence transferred upon her death, a "change in ownership" occurred for reassessment purposes)]

[13:75.3 - 13:75.4] ***Reserved.***

e. [13:75.5] **Transfers where transferor retains estate for years:** A change in ownership occurs upon the creation of an estate for years for a term of *35 years or more* … *unless* the estate for years is reserved in the transferor or their spouse or registered domestic partner. [See Rev. & Tax.C. § 62(e); 18 CCR § 462.060(b)]

(1) [13:75.6] **Subsequent transfers:** There is a change in ownership when the transferor, or transferor's spouse or registered domestic partner, subsequently transfers the retained estate for years to a third party. [18 CCR § 462.060(b)]

(2) [13:75.7] **Termination of retained estate for years:** Likewise, termination of the retained estate for years constitutes a change in ownership, *unless* the reversion passes to the transferor's spouse or registered domestic partner or is subject to a Rev. & Tax.C. § 62(d) exclusion. [See Rev. & Tax.C. §§ 61(h), 62(e); 18 CCR § 462.060(b)]

[13:76] ***Reserved.***

f. Transfers involving entities

(1) [13:77] **Transfers to or from entities:** Transferring an interest in real property between a corporation, partnership, limited liability company (LLC) or other legal entity and a shareholder, partner, LLC member or any other person is a change in ownership triggering property tax reassessment. [Rev. & Tax.C. § 61(j); see *Fashion Valley Mall, LLC v. County of San Diego* (2009) 176 CA4th 871, 881-888, 98 CR3d 327, 335-340—corporation's transfer of shopping mall to LLC in which corporation owned 50% interest constituted 100% change in ownership; *Munkdale v. Giannini* (1995) 35 CA4th 1104, 1109-1110, 41 CR2d 805, 808—transfers from dissolved partnership to former partners individually constituted 100% change in ownership]

(a) [13:77.1] **Sham transactions:** Entities may not circumvent the change in ownership rules simply by agreeing to reform their transactions for "property tax purposes only." [See *Fashion Valley Mall, LLC v. County of San Diego* (2009) 176 CA4th 871, 879-881, 98 CR3d 327, 333-335]

• [13:77.2] The corporate owner of a shopping mall ("Equitable") sold 50% of the mall to a property group ("Simon"). Equitable and Simon then each contributed their 50% interests to a limited liability company (FVM). Simultaneously, Equitable and Simon formed Mallco, a wholly-owned subsidiary of FVM, for the purpose of *holding title* to the mall. The county tax assessor determined the transaction resulted in a 100% change in ownership and reassessed the mall accordingly. The parties then entered into a Reformation Agreement seeking to effectuate a transfer of only 50% of the mall; the Reformation Agreement provided, "for property tax purposes only," certain provisions in the parties' original agreement were "rescinded, reformed, restructured," etc.

The parties claimed the Reformation Agreement resulted in Equitable retaining 50% of the beneficial use of the mall due to its membership interest in FVM. The parties further maintained reassessment should not have occurred because the *beneficial* interest in a property must be transferred for a change in ownership to occur. The Reformation Agreement, however, was deemed a sham. Equitable did not, due to its status as a member of FVM, retain a beneficial interest in the mall. In fact, except in fiduciary situations (custodianships, guardianships, trusteeships, etc.), the entity that holds legal title (in this case, Mallco) is the entity that holds beneficial title. Accordingly, the transaction resulted in a 100% change in ownership for property tax reassessment purposes. [*Fashion Valley Mall, LLC v. County of San Diego* (2009) 176 CA4th 871, 874-876, 881-888, 98 CR3d 327, 330-331, 335-340]

(b) [13:78] **Exception—proportional interests the same:** A transfer to or from an entity is *not* a change in ownership if it results solely in a change in the method of holding title and the transferor's proportional interest in each and every property transferred is exactly the same after the transfer as it was before. [Rev. & Tax.C. § 62(a)(2); compare *Prang v. Los Angeles County Assessment Appeals Bd. (Amen)* (2024) 5 C5th 1152, _, _, 321 CR3d 351, 358, 364-366—proportional ownership interest exception inapplicable to real property transfer from corporation to trust that owned corporation's voting stock but not its nonvoting stock (finding "change in ownership" is measured by proportional beneficial ownership interests in corporate real property and could not be limited to analysis of voting stock only)]

(c) [13:79] **Reappraisal upon subsequent transfer of controlling interest in entity:** However, where property was transferred to an entity and proportional interests remained the same, and subsequently there is a cumulative transfer or transfers of more than 50% of the interests in the entity by the original co-owners, that property in the entity is reappraised (i.e., such transfer "shall be a change of ownership of property" owned by the entity). [Rev. & Tax.C. § 64(d); *see also* *¶ 13:81*]

(2) [13:80] **Transfers of interest in entities:** Generally, the purchase or transfer of corporate stock, partnership interests, or LLC interests is *not* a change in ownership of the entity's real property. This rule applies to the purchase or transfer of partnership interests without regard to whether the entity is a continuing or dissolved partnership. [Rev. & Tax.C. § 64(a)]

(a) [13:81] **Exception—transfer of controlling interest to one person or entity:** A change in ownership of real property owned by a corporation, partnership, LLC or other legal entity occurs when any single entity or person acquires (directly or indirectly) more than 50% of the voting stock of the corporation, or a majority interest in the partnership, LLC or other legal entity (as the case may be). [Rev. & Tax.C. § 64(c)(1); *Title Ins. & Trust Co. v. County of Riverside* (1989) 48 C3d 84, 91-95, 255 CR 670, 674-676—acquisition by reverse triangular merger is change of ownership of property in target corporation and also in subsidiaries of target corporation; see also *Ocean Avenue LLC v. County of Los Angeles* (2014) 227 CA4th 344, 350-351, 173 CR3d 445, 450-451—no change in ownership occurred even though all membership interests in property owned by LLC were sold (no *one* person or entity obtained, directly or indirectly, more than 50% interest in company's capital and profits)]

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(b) [13:81.1] **Transfer of minority partnership interests to majority partner:** On the other hand, subject to appropriate application of the step-transaction doctrine, *no* change in ownership of partnership real property occurs when a majority partner acquires all of the remaining partnership interests or otherwise becomes sole partner. [See Rev. & Tax.C. § 64(c)(2)]

(3) [13:82] **Transfers within affiliated groups:** Transfers of property occurring within an affiliated corporate group, whether by a tax-free reorganization or otherwise, are *not* considered a change in ownership. "Affiliated group" means a chain connected by 100% stock ownership. [Rev. & Tax.C. § 64(b)]

(For further discussion of change of ownership rules in connection with transfers involving entities, see Friedman, Soza & Jann, *Cal. Prac. Guide: Corporations* (TRG), Chs. 2, 4, 6 & 8; and Ehrman & Flavin, "Taxing California Property"§ 2.15 (Clark Boardman Callaghan, 4th ed. 2009, and annual supp.).)

g. [13:83] **Security interests:** A change in ownership does *not* include creating or terminating a security interest or substituting a trustee under a security instrument. [Rev. & Tax.C. § 62(c)]

(1) [13:84] **Compare—foreclosures:** While the *foreclosure* of a security interest normally constitutes a change in ownership (18 CCR § 462.120), recordation of a CCP § 729.040(a) certificate of sale for property foreclosed upon and sold subject to a right of redemption does *not* constitute a change in ownership during the period in which the redemption right exists. [See Rev. & Tax.C. § 62.11]

[13:84.1 - 13:84.9] ***Reserved.***

h. [13:84.10] **Taxable possessory interests in tax-exempt property:** The private use of tax-exempt (government-owned) property is subject to property tax if the use constitutes a "possessory interest." [Cal.Const. Art. XIII, § 1; Rev. & Tax.C. §§ 104(a), 107; *Vanguard Car Rental USA, Inc. v. County of San Mateo* (2010) 181 CA4th 1316, 1321, 104 CR3d 911, 915—taxation of possessory interests is "rooted" in belief that holders of such valuable uses should contribute to public entities that make possession possible]

A taxable "possessory interest" is a "[p]ossession of, claim to, or right to the possession of land or improvements that is *independent, durable, and exclusive* of rights held by others in the property, except when coupled with ownership of the land or improvements in the same person." [Rev. & Tax.C. § 107(a) (emphasis added); see also 18 CCR § 21(a)(1); *Seibold v. County of Los Angeles* (2015) 240 CA4th 674, 678, 192 CR3d 575, 577 (analyzing statutory definition of "possessory interests")—ground lease affording taxpayer exclusive right to store his aircraft and equipment on airport premises deemed sufficiently independent of county's retained interests to constitute taxable possessory interest; *Vanguard Car Rental USA, Inc. v. County of San Mateo*, supra, 181 CA4th at 1324-1332, 104 CR3d at 917-924 (analyzing "possession," "independence" and "exclusivity" requirements)—car rental company and other commercial tenants leasing in common certain nonpublic areas within government-owned airport held taxable "possessory interest"; *City of San Jose v. Carlson* (1997) 57 CA4th 1348, 1352-1360, 67 CR2d 719, 721-726 (analyzing "durability," "independence" and "exclusivity" elements)—short-term users of city-owned (tax-exempt) convention center held taxable "possessory interest" when they obtained use permits on more than one occasion]

A "change in ownership" with regard to a taxable possessory interest occurs as follows:

(1) [13:85] **Creation, renewal, extension, assignment:** A change in ownership generally occurs upon the "creation, renewal, extension or assignment" of a taxable possessory interest in tax-exempt real property … subject to the following limitations (Rev. & Tax.C. § 61(b)):

• [13:85.1] An "assignment" of a possessory interest for this purpose means a transfer of all rights held by the transferor in the possessory interest. [Rev. & Tax.C. § 61(b)(3)]

• [13:85.2] A "renewal" or "extension" does *not* include the granting of an option to renew or extend an existing agreement pursuant to which the existing term of possession would, upon exercise of the option, be lengthened, whether the option is granted in the original agreement or thereafter. [Rev. & Tax.C. § 61(b)(1)]

• [13:85.3] Any "renewal" or "extension" of a possessory interest during the reasonably anticipated term of possession used by the assessor to value that interest does not cause a change in ownership until the end of that reasonably anticipated term of possession. At the end of the reasonably anticipated term of possession used by the assessor, a new base-year value, based on a new reasonably anticipated term of possession, "shall be established for the possessory interest." [Rev. & Tax.C. § 61(b)(2)]

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(2) [13:86] **Sublease:** Sublease transactions involving a taxable possessory interest in tax-exempt real property trigger a change in ownership as follows (Rev. & Tax.C. § 61(d)):

• [13:86.1] A change in ownership occurs when a taxable possessory interest in tax-exempt real property is subleased if the sublease term (including renewal options) exceeds half the remaining term of the leasehold (including renewal options). [Rev. & Tax.C. § 61(d)(1)(A)]

• [13:86.2] A termination of the sublease effects a change in ownership if the original term (including renewal options) exceeds half the remaining term of the leasehold (including renewal options). [Rev. & Tax.C. § 61(d)(1)(B)]

• [13:86.3] A change in ownership occurs upon the transfer of a sublessee's interest with a remaining term (including renewal options) exceeding half the remaining term of the leasehold. [Rev. & Tax.C. § 61(d)(1)(C)]

• [13:86.4] Any transfer of a possessory interest in tax-exempt real property subject to a sublease with a remaining term (including renewal options) that does *not* exceed half the remaining term of the leasehold (including renewal options) triggers a change in ownership. [Rev. & Tax.C. § 61(d)(2)]

On the other hand, there is *no* change in ownership where the remaining sublease term (including renewal options) exceeds half the length of the remaining term of the leasehold (including renewal options). [Rev. & Tax.C. § 62(o)]

[13:87 - 13:89] ***Reserved.***

4. [13:90] **Other Rules of Exclusion:** The California Constitution and Revenue and Taxation Code provide exceptions for certain transactions that otherwise would be deemed a change in ownership under the general rule of Rev. & Tax.C. § 60 (transfer of present interest substantially equivalent to value of fee, *¶ 13:66*):

a. [13:91] **Homeowners over age 55, severely and permanently disabled, or wildfire or natural disaster victims—base-year value transfer to replacement primary residence:** Subject to certain limitations (*¶ 13:92 ff.*), homeowners who are (i) over 55 years of age, (ii) "severely and permanently disabled," *or* (iii) victims of a wildfire or natural disaster who reside in property that is eligible for either the homeowners' exemption (*¶ 13:96.5 ff.*) or the disabled veteran's exemption (*¶ 13:96 ff.*) may transfer the base-year value (i.e., "taxable value"; ¶ 13:91.6) of their primary residence to a replacement primary residence (¶ 13:91.5). The replacement primary residence must be located in California and purchased or newly constructed as the homeowner's principal residence within two years of the sale of the original primary residence. Although the replacement primary residence can cost any amount, the difference between the original home's value and the replacement home's value will be added to the original home's taxable value if the replacement home has a greater value than the original home (¶ 13:92). [Cal.Const. Art. XIIIA, § 2.1(b)(1), (2); Rev. & Tax.C. § 69.6(a); *see also* ¶ 13:91.3 (defining "natural disaster") *and* ¶ 13:91.7 (defining "victim of a wildfire or natural disaster")]

(1) [13:91.1] **Compare—pre-April 1, 2021 base-year value transfers to replacement dwellings:** The current base-year value transfer rules took effect on April 1, 2021 (¶ 13:91). Prior to April 1, 2021, only homeowners who were over age 55 *or* "severely and permanently disabled" qualified for a base-year value transfer. Further, the replacement home's value had to be *equal to or less than* the original home's value. [See Cal.Const. Art. XIIIA, § 2(a); Rev. & Tax.C. § 69.5(a), (b) & (g) (definitions); *Grotenhuis v. County of Santa Barbara* (2010) 182 CA4th 1158, 1161, 105 CR3d 918, 920]

(For further discussion, see Ehrman & Flavin, "Taxing California Property"§ 11.11 (Clark Boardman Callaghan, 4th ed. 2009 and current supp.); and "Board of Equalization Questions and Answers About Props. 60, 90 and 110," reproduced in Ehrman & Flavin, supra.)

(2) Definitions

(a) [13:91.2] **"Full cash value":** "Full cash value" means "the county assessor's valuation of real property as shown on the 1975-76 tax bill under 'full cash value' or, thereafter, the appraised value of real property when purchased, newly constructed, or a change in ownership has occurred after the 1975 assessment." [Cal.Const. Art. XIIIA, §§ 2(a) & 2.1(e)(4); Rev. & Tax.C. § 69.6(d)(8)(A)]

Where the original property has been substantially damaged or destroyed by wildfire or natural disaster and the owner does not rebuild on the original property, "full cash value" means its full cash value immediately before its substantial damage or destruction by wildfire or natural disaster, as determined by the assessor of the county in which the property

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is located for the period from the date of its sale by the claimant to the date on which the replacement property was purchased or new construction was completed. [Rev. & Tax.C. § 69.6(d)(8)(B)]

(b) [13:91.3] **"Natural disaster":** "Natural disaster" means "the existence, as declared by the Governor, of conditions of disaster or extreme peril to the safety of persons or property within the affected area caused by conditions such as fire, flood, drought, storm, mudslide, earthquake, civil disorder, foreign invasion, or volcanic eruption." [Cal.Const. Art. XIIIA, § 2.1(e)(6)]

(c) [13:91.4] **"Primary residence":** "Primary residence" means a residence eligible for either (i) the homeowner's exemption (see Cal.Const. Art. XIII, § 3(k); ¶ 13:96.5), or (ii) the disabled veteran's exemption (see Cal.Const. Art. XIII, § 4(a); ¶ 13:96). [Cal.Const. Art. XIIIA, § 2.1(e)(1), (5), (7)]

(d) [13:91.5] **"Replacement primary residence":** "Replacement primary residence" has the same meaning as "replacement dwelling" under Cal.Const. Art. XIIIA, § 2(a)—i.e., "a building, structure, or other shelter constituting a place of abode, whether real property or personal property, and any land on which it may be situated." [Cal.Const. Art. XIIIA, § 2.1(e)(9); Rev. & Tax.C. § 69.6(d)(3)]

Each unit of a multiunit dwelling is considered a separate replacement dwelling. [Rev. & Tax.C. § 69.6(d)(3); compare Rev. & Tax.C. § 69.6(d)(5)—a dwelling is not a multiunit dwelling if claimant occupies one structure as their primary residence and the only other units on the property are accessory or junior dwelling units that are not separately alienable from the title of any other dwelling unit on said property]

(e) [13:91.6] **"Taxable value":** "Taxable value" means (i) the base-year value determined as of the date the original property is sold by the claimant, *or* (ii) where the original property has been substantially damaged or destroyed by wildfire or natural disaster and the owner does not rebuild on the original property, determined as of the date immediately before the wildfire or natural disaster. [Cal.Const. Art. XIIIA, §§ 2(a), (b) & 2.1(e)(10); Rev. & Tax C. § 69.6(d)(2)]

(f) [13:91.7] **"Victim of a wildfire or natural disaster":** "Victim of a wildfire or natural disaster" means the owner of a primary residence (¶ 13:91.4) that has been substantially damaged as a result of a wildfire or natural disaster that amounts to more than 50 percent of the improvement value of the primary residence immediately before the wildfire or natural disaster. This includes diminution of value resulting from restricted access caused by the wildfire or disaster. [Cal.Const. Art. XIIIA, § 2.1(e)(11); Rev. & Tax C. § 69.6(d)(14); see also Cal.Const. Art. XIIIA, § 2.1(e)(12) (incorporating Gov.C. § 51177(j)'s definition of "wildfire")]

(3) [13:92] **Value of replacement primary residence:** Homeowners can qualify for a base-year value transfer (¶ 13:91) on or after April 1, 2021, regardless of the replacement primary residence's value. If the replacement primary residence's value is *equal to or less than* the original primary residence's value, then the replacement primary residence's taxable value (¶ 13:91.6) will be the same as the original primary residence's taxable value. [Cal.Const. Art. XIIIA, § 2.1(b)(1), (2)(A); *see* ¶ 13:91.5 (defining "replacement primary residence")]

If the replacement primary residence's value *exceeds* the original primary residence's value, the replacement primary residence's taxable value will be calculated by adding the difference between the full cash value of the original primary residence and the full cash value of the replacement primary residence to the original primary residence's taxable value. [Cal.Const. Art. XIIIA, § 2.1(b)(2)(B); *see* ¶ 13:91.2 (defining "full cash value")]

(a) [13:92a] **Delayed replacements:** The cost of the replacement house may not exceed (i) 100% of the value of the old house if the new house is purchased or newly constructed prior to the sale of the old house; (ii) 105% of the value of the old house if purchased or newly constructed within the first year following the sale of the old house; or (iii) 110% of the value of the old house if the new house is purchased or newly constructed within the second year following sale of the old house. [Rev. & Tax.C. § 69.6(d)(13)(A), (B) & (C)]

(b) [13:92.1] **Base-year value transferred only if original property sold:** Although the new property can be purchased or constructed before the original property is sold, the base-year value of the original property cannot be transferred to the replacement property until the original property is sold. [Rev. & Tax.C. § 69.6(a)]

(4) [13:93] **Two-year limit:** The replacement house must be purchased or newly-constructed within two years of the sale of the old house. [Rev. & Tax.C. § 69.6(a) & (b)(5)]

If the replacement property is in part purchased and in part newly constructed, the date the replacement property is purchased or newly constructed is the date of purchase or date of completion of construction, *whichever is later.* [Rev. & Tax.C. § 69.6(d)(6)]

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(a) [13:93.1] **Constructed residence valuation:** When a taxpayer purchases land and constructs a residence on it, the property's value (land and house) is measured as of the purchase date or date construction is completed, *whichever is later*. [Rev. & Tax.C. § 69.5(g)(5); *Wunderlich v. County of Santa Cruz* (2009) 178 CA4th 680, 694-700, 100 CR3d 598, 607-611—taxpayer could not transfer former home's base-year value to replacement property (land and house) because its combined value, measured as of construction completion date, exceeded former residence's sale price]

(5) [13:93.2] **Dwelling held in trust:** A dwelling qualifies for the base-year transfer if it or the replacement property is held in a trust, provided the taxpayer who occupies the dwelling is the sole present beneficiary of the trust. [See "Board of Equalization Questions and Answers About Props. 60, 90 and 110," Answer B2, reproduced in Ehrman & Flavin, supra (¶ *13:91*)]

(6) [13:94] **Location of replacement primary residence:** For base-year value transfers that occur on or after April 1, 2021 (¶ 13:91), the replacement primary residence (¶ 13:91.5) can be located anywhere in California. [Cal.Const. Art. XIIIA, § 2.1(b)(1)]

(a) [13:94.1] **Compare—pre-April 1, 2021 base-year value transfers:** Prior to April 1, 2021, the replacement house had to be located either in (i) the same county as the old one *or* (ii) another county wherein the board of supervisors adopted an ordinance that so provided and that met statutorily specified criteria. [See Rev. & Tax.C. § 69.5(a)(2), (b)(6) & (j)(2)]

(7) [13:95] **Number of base-year value transfers:** Homeowners who are over 55 years of age or severely disabled cannot transfer the taxable value (¶ 13:91.6) of a primary residence more than three times. This limit does not apply to homeowners who are victims of wildfire or natural disaster. [Cal.Const. Art. XIIIA, § 2.1(b)(3); Rev. & Tax.C. § 69.6(a), (b)(6)]

(a) [13:95a] **Compare—pre-April 1, 2021 base-year value transfers:** Prior to April 1, 2021, Rev. & Tax.C. § 69.5 property tax relief was available only *once* in the taxpayer's lifetime—*except* as to homeowners who became "severely and permanently disabled" after being granted § 69.5 tax relief for homeowners over age 55. [Rev. & Tax.C. § 69.5(b)(7)]

(8) [13:95.1] **Mandatory application process; general three-year limit:** A person seeking to transfer the taxable value (¶ 13:91.6) of their primary residence on or after April 1, 2021, must file an application with the assessor of the county in which the *replacement primary residence* (¶ 13:91.5) is located within three years of the replacement primary residence's purchase or completion of new construction. [Cal.Const. Art. XIIIA, § 2.1(b)(4); Rev. & Tax.C. § 69.6(e)(1); see also State Board of Equalization, "Proposition 19 Base Year Value Transfer Guidance Questions and Answers" (5/11/21), available at *www.boe.ca.gov*]

(a) [13:95.1a] **Compare—pre-April 1, 2021 base-year value transfers:** Prior to April 1, 2021, homeowners electing Rev. & Tax.C. § 69.5 relief had to complete and file the appropriate State Board of Equalization claim of eligibility form with the county assessor within three years of (i) purchase of the new residence *or* (ii) adoption by a participating county of an ordinance permitting intercounty transfers of base-year value (¶ *13:94*). [Rev. & Tax.C. § 69.5(f)(1) & (k)]

(b) [13:95.2] **Special provision for late claims:** Claims filed after the three-year deadline must also be considered, but certain statutory conditions apply. [See Rev. & Tax.C. § 69.6(c)(2)]

[13:95.3 - 13:95.4] *Reserved.*

(9) [13:95.5] **Pre-April 1, 2021 transfers; no tax assessment if erroneous base-year value transfer:** For transfers prior to April 1, 2021, an assessment of tax liability may *not* be levied if an intercounty transfer of base-year value (¶ *13:94*) has been erroneously granted pursuant to an expired ordinance. [Rev. & Tax.C. § 69.5(*l*)]

(10) [13:95.6] **Application where original home substantially destroyed or damaged by wildfire or natural disaster:** Where the original home of a taxpayer qualifying for Rev. & Tax.C. § 69.6 tax relief is "substantially damaged or destroyed by wildfire or natural disaster," and the taxpayer chooses to purchase a replacement rather than repair or rebuild the original, they may transfer the base-year value of the original home to the replacement home. [See Rev. & Tax.C. § 69.6(a); *see also* ¶ *13:107 ff.*]

The transferred base-year value in such cases is the full cash value of the original home as if it were appraised immediately prior to the damage or destruction. [Rev. & Tax.C. § 69.6(d)(2) & (8)(B)]

(11) [13:95.7] **"Natural person" requirement:** Qualified homeowners must be "natural persons"—i.e., *not* firms, partnerships, associations, corporations, companies or any other legal entity or organization of any kind. [Rev. & Tax.C. § 69.6(d)(12)—"person" includes present trust beneficiary; see also *Grotenhuis v. County of Santa Barbara* (2010) 182

CA4th 1158, 1162, 105 CR3d 918, 920—corporation's sole shareholder tenant not entitled to tax exemption or transfer of base-year value on replacement residence standing in corporation's name (shareholder tenant barred from claiming property tax relief as alter ego of corporation/landlord)]

(12) [13:95.8] **Divorced taxpayers who separately purchase/construct replacement dwellings; *pre-4/1/2021 transactions:*** If replacement dwellings are separately purchased or newly constructed by two co-owners who held the original property as community property, only the co-owner who has reached age 55 (or who is severely and permanently disabled) is eligible to transfer the original home's base year value to that co-owner's replacement dwelling. If both spouses are over 55, they must determine by mutual agreement which one of them is eligible. [IRC § 69.5(d)(3)]

However, if the original dwelling is transferred by one spouse to the other in connection with a marital separation or dissolution, the transfer is *not* considered a change in ownership (¶ 13:97). [Rev. & Tax.C. § 63(c)

Comment: Rev. & Tax.C. § 69.6 (applicable to transactions occurring *on or after 4/1/21*) does not include a divorced taxpayers' section similar to Rev. & Tax.C. § 69.5(d)(3) (above). It is unclear whether this omission was merely an oversight or the Legislature intended to eliminate the provision.

b. [13:96] **Disabled veterans' exemption:** A disabled veteran (¶ 13:96.1) and their spouse are entitled to a $100,000 property tax exemption on the full value of their residence. The exemption increases to $150,000 if the veteran's household income does not exceed $40,000 as adjusted by a specified inflation factor. [Cal.Const. Art. XIII, § 4(a); Rev. & Tax.C. § 205.5(a)]

(1) [13:96.1] **"Disabled veteran":** For purposes of this exemption, a "disabled veteran" is a person who, because of an injury or disease incurred in military service, is blind in both eyes, has lost the use of two or more limbs, is totally disabled and has been discharged under other than dishonorable conditions, or who, as a result of a service-connected injury or disease, died while in active military service. [Cal.Const. Art. XIII, § 4(a); see also Rev. & Tax.C. § 205.5(a), (b)(1)(A), (B), (c)(1)]

(2) [13:96.2] **Applies to principal residence of veteran or veteran's unmarried surviving spouse if either is confined to hospital or care facility:** Property subject to this exemption includes the principal residence of a disabled veteran, or of the unmarried surviving spouse of a deceased veteran, if the veteran or surviving spouse is confined to a hospital or other care facility, so long as the property would be the veteran's or surviving spouse's principal residence but for the confinement and it is neither rented nor leased to a nonfamily member. [See Rev. & Tax.C. § 205.5(b)(2), (c)(2), (3); see also Rev. & Tax.C. § 279(b)(2)(A)]

(3) [13:96.3] **Duration:** Once granted, this exemption remains in effect until:

— Title to the property changes;

— The owner claimant (i.e., veteran or their unmarried surviving spouse) ceases occupancy of the dwelling as their principal residence on the lien date (except when the veteran or surviving spouse is confined to a hospital or other care facility, as provided in Rev. & Tax.C. § 205.5(b)(2), ¶ *13:96.2*);

— The property is altered so that it is no longer a dwelling;

— The veteran is no longer disabled; *or*

— The unmarried surviving spouse remarries. [Rev. & Tax.C. § 279(b)(1)-(5)]

[13:96.4] *Reserved.*

c. [13:96.5] **$7,000 homeowner's exemption:** Taxpayers are entitled to a "*homeowners property tax exemption*" in the amount of $7,000 of the full value of an eligible dwelling. [Cal.Const. Art. XIII, § 3(k); Rev. & Tax.C. § 218]

(1) [13:96.6] **Eligible dwellings:** Eligible dwellings include:

• A single-family dwelling occupied by the taxpayer owner as their principal place of residence. [Rev. & Tax.C. § 218(c)(2)(B)(i)]

• A multiple-dwelling unit occupied by the taxpayer owner as their principal place of residence. [Rev. & Tax.C. § 218(c)(2)(B)(ii)]

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• A condominium occupied by the taxpayer owner as their principal place of residence. [Rev. & Tax.C. § 218(c)(2)(B)(iii); see *Smith v. State Bd. of Equalization of State of Calif.* (1997) 53 CA4th 331, 336-337, 61 CR2d 604, 607-608—owner of leasehold condominium occupied as principal residence is "owner" of condominium entitled to $7,000 exemption to same extent as owner of fee condominium]

• Premises occupied by the taxpayer owner of shares or a membership interest in a cooperative housing corporation (Rev. & Tax.C. § 61(h)) as their principal place of residence. [Rev. & Tax.C. § 218(c)(2)(B)(iv)]

(2) [13:96.7] **Dwellings damaged/destroyed in misfortune/calamity:** A dwelling damaged in a misfortune or calamity is eligible to receive the homeowner's exemption provided the homeowner's absence is temporary and they intend to return when possible. However, the exemption generally is not available for dwellings that have been totally destroyed unless and until the structures are replaced and occupied as dwellings. [Rev. & Tax.C. § 218(b)(2)]

(a) [13:96.7a] **Compare—dwellings totally destroyed in "state of emergency" disasters:** An otherwise qualified dwelling that was totally destroyed in a disaster for which the Governor proclaimed a state of emergency remains eligible to receive the homeowner's exemption if there has been no change in ownership since the disaster date and the homeowner intends to reconstruct a dwelling on the property when possible and occupy it as their principal place of residence. [Rev. & Tax.C. § 218(b)(3)]

(3) [13:96.8] **Not rental or vacation homes; other exclusions:** This homeowners exemption is not available for vacant or rental property, or property under construction. Nor can it be claimed for the owner's vacation or secondary home or for property on which an owner receives the veteran's exemption. [Rev. & Tax.C. § 218(b)(1)]

(4) [13:96.8a] **Owner confined to hospital or other care facility:** Notwithstanding Rev. & Tax.C. § 218(b)(1) (¶ 13:96.8), if the person receiving the exemption is not occupying the dwelling because they are confined to a hospital or other care facility, they will remain eligible for the homeowner's exemption provided:

— they would occupy the dwelling had they not been confined to the hospital or other care facility;

— they intend to return to the dwelling when possible to do so; *and*

— the dwelling is not rented or leased to a person not described in IRC § 267(c)(4) (i.e., an individual's brothers and sisters, whether by whole or half blood, spouse, ancestors and lineal descendants). [See Rev. & Tax.C. § 218(b)(4) (amended Stats. 2023, Ch. 781; eff. 10/11/23)]

(5) [13:96.9] **Timely claim of exemption required:** Taxpayers claiming a homeowner's exemption must file an affidavit therefor with the county assessor. The affidavit may be filed any time after the taxpayer becomes eligible for the exemption; but unless the assessor grants a "good cause" extension (see Rev. & Tax.C. § 255.1), it must be filed no later than 5 p.m. on February 15th. [Rev. & Tax.C. § 255]

(A special extension rule applies for veterans claiming a homeowner's exemption after being disallowed a veteran's exemption on a principal residence. See Rev. & Tax.C. § 255.2.)

(a) [13:96.10] **Partial exemption for late claims:** If the taxpayer misses the February 15th deadline but files the affidavit on or before the following December 10th, an exemption of the lesser of $5,600 or 80% of the full value of the dwelling "shall be granted by the assessor." [See Rev. & Tax.C. § 275(a)]

d. [13:97] **Transfers between spouses or registered domestic partners:** A change in ownership does *not* include *interspousal transfers* … including (but not limited to):

• transfers in trust;

• transfers that take effect on a spouse's death;

• transfers to a spouse or former spouse in connection with marriage dissolution or legal separation;

• the creation, transfer or termination solely between spouses of a co-owner's interest; or

• a legal entity's transfer to a spouse or former spouse in exchange for the latter's interest in the entity in connection with marriage dissolution or legal separation. [Cal.Const. Art. XIIIA, § 2(g); Rev. & Tax.C. § 63(a)-(e); 18 CCR § 462.220]
Likewise, a change of ownership for reassessment purposes does not include transfers between *registered domestic partners* (Fam.C. § 297), including property transfers occurring on or after *1/1/00 to 6/26/15,* inclusive, between "local registered domestic partners," as defined. [Rev. & Tax.C. § 62(p), (q)—"local registered domestic partner" means registered domestic partnership established by city, county, city and county, or special district in which registrants were same sex at time of registration and not in registered domestic partnership with, or married to, any other person at time of transfer; see also *Strong v. State Bd. of Equalization* (2007) 155 CA4th 1182, 1193-1194, 66 CR3d 657, 665-667 (upholding Legislature's constitutional authority to exclude domestic partner transfers from property reassessment)]

e. Transfers between parents and children and grandparents and grandchildren

(1) General statement of exclusions

(a) [13:98] **Parent-child transfers:** On or after February 16, 2021, the purchase or transfer of a family home (i.e., the principal residence) or family farm between parents and their children does *not* result in a "change in ownership" and the property's taxable value remains the same provided (i) the property continues to be the transferee's family home or family farm (or, in the case of a family home, becomes a transferee's principal residence within one year of the transfer), and (ii) the property's assessed value is *less than* the property's taxable value plus $1 million (adjusted for inflation, beginning February 16, 2023). [Cal.Const. Art. XIIIA, § 2.1(c)(1), (3), (4); Rev. Tax.C. § 63.2; see also Cal.Const. Art. XIIIA, § 2.1(e)(2) (defining "family farm" as "any real property which is under cultivation or which is being used for pasture or grazing, or that is used to produce any agricultural commodity" under Gov.C. § 51201), (e)(3) (indicating "family home" has same meaning as "principal residence" under Cal.Const. Art. XIIIA, § 3(k)); *and* ¶ 13:98.3 (family home/family farm's taxable value post-transfer)]

Beginning February 16, 2021, only family homes and family farms qualify for the parent-child (¶ 13:98) and grandparent-grandchild (¶ 13:98.1 ff.) transfer exclusion; post-February 15, 2021 transfers of other real property do *not* qualify. [See Cal.Const. Art. XIIIA, § 2.1(c)]

1) [13:98a] **Compare—pre-February 16, 2021 transfers:** Section 2 of Article XIIIA of the California Constitution continues to apply to purchases and transfers between parents and children that occurred on or before February 15, 2021. [Cal.Const. Art. XIIIA, § 2.1(d)]

For purchases and transfers that occurred between parents and children on or after November 6, 1986, and before February 16, 2021, *no* "change in ownership" occurred upon the purchase or transfer of (i) a "principal residence" between parents and children, or (ii) the first $1,000,000 of full cash value of all other real property between parents and children, as long as a timely claim of exclusion was filed (¶ 13:102 ff.). [Cal.Const. Art. XIIIA, § 2(h); Rev. & Tax.C. § 63.1(a)(1) & (2), (c)(1), (h)(1); *Empire Properties v. County of Los Angeles* (1996) 44 CA4th 781, 789, 52 CR2d 69, 74]

2) [13:98b] **Foster children:** For purposes of both the Rev. & Tax.C. § 63.1 exclusion (applicable to pre-February 16, 2021 transfers) and the Rev. & Tax.C. § 63.2 exclusion, the term "children" includes "foster" children of state-licensed foster parents, provided those children were not adopted by their foster parents due to a "legal barrier" before aging out of the foster care system. [Rev. & Tax.C. §§ 63.1(c)(3)(E), 63.2(e)(1)(E); see also Ltr. to Assessors 2007/048]

Compare: A purchase or transfer of a principal residence from a foster child to their biological parent is *not* excluded under *§ 63.1* (applicable to pre-February 16, 2021 transfers) if the child received the residence (or an interest therein) from a foster parent through a purchase or transfer previously excluded under § 63.1. [Rev. & Tax.C. § 63.1(a)(1)(B)]

(b) [13:98.1] **Grandparent-grandchild transfers:** The same exclusion rules that apply to parent-child transfers (¶ 13:98) apply to post-February 15, 2021 purchases and transfers of family homes and family farms between grandparents and grandchildren provided the grandchildren's parents (i) qualify as the grandparents' children, and (ii) are deceased as of the purchase or transfer date. [Cal.Const. Art. XIIIA, § 2.1(c)(2); Rev. & Tax.C. § 63.2(a)(1)]

1) [13:98.1a] **Compare—pre-February 16, 2021 transfers:** Subject to the timely filing of a claim of exclusion (¶ *13:102 ff.*), "principal residence" transfers from grandparents to grandchildren between March 27, 1996, and February

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15, 2021, were exempt from property tax reassessment. This was so *provided* all of the parents of the grandchildren who qualify as children of the grandparents (excluding, however, the grandparents' sons-in-law and daughters-in-law who are stepparents to the grandchildren) were deceased on the transfer date. The same rules applied to the first $1,000,000 of full cash value of other real property transfers from grandparents to grandchildren that occurred between March 27, 1996, and February 15, 2021. [Rev. & Tax.C. § 63.1(a)(3)(A), (c)(2) & (h)(2); see also *Auerbach v. Assessment Appeals Bd. No. 1 for County of Los Angeles* (2006) 39 C4th 153, 158-159, 45 CR3d 774, 777—where land and building located thereon transferred by trust from grandparents to grandchildren, transfer subject to $1,000,000 exclusion prorated between land and building; *and ¶ 13:100.3*]

2) [13:98.2] **Prior parent-child transfer limitation:** Before February 16, 2021, a grandparent-grandchild "principal residence" transfer was *not* exempt from property tax reassessment if the grandchild previously received an exempt parent-child "principal residence" transfer or interest therein. [Rev. & Tax.C. § 63.1(a)(3)(B)]

In that event, the full cash value of the nonexempt grandparent-grandchild "principal residence" transfer was *added* to the value of other grandparent-grandchild real property transfers when applying the statute's $1 million limitation on other exempt grandparent-grandchild transfers. [Rev. & Tax.C. § 63.1(a)(3)(B)]

(c) [13:98.3] **Family home/farm's taxable value post-transfer:** If a family home or family farm is transferred between a parent and child (¶ 13:98) or grandparent and grandchild (¶ 13:98.1) on or after February 16, 2021, and the property's assessed value upon purchase and transfer is *less than* the sum of the property's taxable value on the date immediately prior to the purchase and transfer date *plus* $1 million, the property's new taxable value will equal the property's taxable value on the date immediately prior to the purchase and transfer date (subject to adjustment by Cal.Const. Art. XIIIA, § 2(b); ¶ 13:65.3). [Cal.Const. Art. XIIIA, § 2.1(c)(1)(A), (B)(i), (3); Rev. & Tax.C. § 63.2(d)(1)(A)]

If the family home/family farm's assessed value upon purchase and transfer is *equal to or more than* the sum of the property's taxable value on the date immediately prior to the purchase and transfer date plus $1 million, the property's new taxable value will equal the property's assessed value upon purchase and transfer *minus* the sum of the property's taxable value on the date immediately prior to the purchase and transfer date and $1 million. [Cal.Const. Art. XIIIA, § 2.1(c)(1)(A), (B)(ii), (3); Rev. & Tax.C. § 63.2(d)(A), (B)]

Beginning February 16, 2023, and every other February 16 thereafter, the State Board of Equalization must adjust the $1 million amount for inflation "to reflect the percentage change in the House Price Index for California for the prior calendar year, as determined by the Federal Housing Finance Agency." [Cal.Const. Art. XIIIA, § 2.1(c)(4)]

(2) Eligible real property

(a) [13:99] **"Principal residence":** For purposes of the Rev. & Tax.C. § 63.1 exclusions (pre-February 16, 2021*) and* Rev. & Tax.C. § 63.2 exclusions (on or after February 16, 2021), a "principal residence" is (i) a dwelling eligible for a homeowner's exemption (*¶ 13:96.5 ff.*) or disabled veterans' exemption (¶ 13:96 ff.) as a result of the transferor's ownership and occupation of the dwelling; and (ii) includes only that portion of the land underlying the residence that consists of an area of "reasonable size" used as the residence site. [Rev. & Tax.C. §§ 63.1(b)(1), 63.2(e)(5)]

(b) [13:100] **$1,000,000 of other real property—pre-February 16, 2021 transfers:** For property transferred before February 16, 2021, the $1,000,000 "full cash value" exclusion applied to the eligible transferor's real property *other than their principal residence;* and covered only the first transfer of $1,000,000 of property by the eligible transferor, regardless of whether made to more than one transferee. [Rev. & Tax.C. § 63.1(b)(2)]

1) [13:100.1] **Joint transferors' option to cumulate $1,000,000 exclusions:** Where the pre-February 16, 2021 purchase or transfer involved two or more eligible transferors, the transferors could elect to *combine* their separate $1,000,000 exclusions … in which event, the combined amount would apply to any property jointly sold or transferred by them (*except that* in no case could the amount of full cash value of real property of any single eligible transferor excluded under the election exceed the amount of their separate unused exclusion on the date of the joint sale or transfer). [Rev. & Tax.C. § 63.1(b)(2)]

2) [13:100.2] **Nonexcluded principal residence transfer from grandparent to grandchild included in applying $1,000,000 limit:** As noted at *¶ 13:98.1a ff.*, the $1,000,000 exclusion limit on a grandparent's pre-February 16, 2021 transfer to a grandchild was calculated by *adding* the full cash value of the grandparent's principal residence transfer

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to the grandchild that failed to qualify for the exclusion under § 63.1(a)(3)(B) (¶ *13:98.2*). [Rev. & Tax.C. § 63.1(a)(3)(B)]

3) [13:100.3] **Could be prorated between transferred property and building located thereon:** Under appropriate circumstances, for property transferred before February 16, 2021, the $1,000,000 exclusion amount could be prorated between the transferred property and any building located thereon. When this was done, the transfer resulted in a greater tax reassessment than if the entire exclusion had been applied to the land. [*Auerbach v. Assessment Appeals Bd. No. 1 for County of Los Angeles* (2006) 39 C4th 153, 157, 160, 45 CR3d 774, 775, 778]

(c) [13:100.4] **Cooperative housing corporation unit or lot:** Real property for purposes of *both* the Rev. & Tax.C. § 63.1 and § 63.2 principal residence exclusion includes an interest in a cooperative housing corporation unit or lot, as defined. [See Rev. & Tax.C. §§ 63.1(c)(8)(A), 63.2(e)(8)(A)]

(d) [13:100.5] **Pro rata ownership interests in mobile home parks/floating home marinas:** Real property for purposes of both the Rev. & Tax.C. § 63.1 and § 63.2 principal residence exclusion also includes pro rata ownership interests in mobilehome parks and floating home marinas, as defined. [See Rev. & Tax.C. §§ 63.1(c)(8)(B), (C), 63.2(e)(8)(B), (C)]

(3) [13:101] **"Eligible" transferors and transferees:** An "eligible transferor" for purposes of the Rev. & Tax.C. § 63.2 exclusion is a grandparent, parent, grandchild, or child of an eligible transferee. An "eligible transferee" is a parent, child, grandparent or grandchild of an eligible transferor. (However, transfers between grandparents and grandchildren do not qualify unless the grandchild's parents are deceased; ¶ *13:98.1*.) [Rev. & Tax.C. § 63.2(e)(2) & (3)]

Thus, parents and children can be eligible transferors *or* eligible transferees in parent-child exempt transfers. As between grandparents and grandchildren, however, grandparents and grandchildren can be transferors or transferees under § 63.2 only if the grandchildren's parents are deceased (¶ 13:98.1).

(a) [13:101a] **Compare—pre-February 16, 2021 transfers:** An "eligible transferor" for purposes of the Rev. & Tax.C. § 63.1 exclusion is a grandparent, parent, or child of an eligible transferee. An "eligible transferee" is a parent, child, or grandchild of an eligible transferor. However, grandparents and grandchildren are not "eligible" unless the grandchild's parents are deceased. [Rev. & Tax.C. § 63.1(a)(3)(A), (c)(2), (6) & (7)]

Thus, parents and children can be eligible transferors or eligible transferees in parent-child exempt transfers. As between grandparents and grandchildren, however, only grandparents can be eligible transferors and only grandchildren can be eligible transferees. [Rev. & Tax.C. § 63.1(c)(1), (3), (6) & (7)]

(4) [13:101b] **"Transfers" covered:** A "transfer" excluded by both Rev. & Tax.C. § 63.1 *and* § 63.2 may occur during the transferor's life or at death and includes, but is not limited to, any transfer of the present beneficial ownership of property from an eligible transferor to an eligible transferee through an inter vivos or testamentary trust. [Rev. & Tax.C. §§ 63.1(c)(9), 63.2(e)(9); see also *Empire Properties v. County of Los Angeles* (1996) 44 CA4th 781, 789, 52 CR2d 69, 74 (decided under Rev. & Tax.C. § 63.1)]

The exclusion applies to both voluntary transfers and those resulting from a court order or judicial decree. [Cal.Const. Art. XIIIA, § 2.1(c)(1)]

(a) [13:101.1] **Direct transfers only; transfers to wholly owned entities distinguished:** Only *direct* transfers are eligible—i.e., the transferor and transferee must be *natural persons* in a familial relationship. The exemption does *not* apply to transfers to or from corporations, partnerships or other legal entities comprised of family members and, therefore, does *not* protect from reassessment a transfer by a parent (or child) to an *entity wholly owned by the parent and parent's children*. [*Penner v. County of Santa Barbara* (1995) 37 CA4th 1672, 1677-1680, 44 CR2d 606, 608-611 (decided under Rev. & Tax.C. § 63.1)—no reassessment exemption for parent's transfer to limited partnership wholly owned by parent and her adult children]

1) [13:101.2] **Comment:** Note that the parent in *Penner*, supra, could have achieved her goals without a reassessment by first transferring an interest in the property to her children, and then having all the owners transfer their interests to the partnership. [*Penner v. County of Santa Barbara* (1995) 37 CA4th 1672, 1678-1679, 44 CR2d 606, 609-610]

(5) [13:102] **Timely exclusion claim required:** In order to receive the parent-child (¶ 13:98) or grandparent-grandchild (¶ 13:98.1) exclusion for a property transfer on or after February 16, 2021, the transferee must claim the homeowner's exemption or disabled veteran's exemption either (i) at the time of purchase or transfer, or (ii) within one year of the purchase or transfer (in which case, the transferee would be entitled to a refund of taxes previously owed or paid between

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the transfer date and the date the transferee claimed the exemption). [Cal.Const. Art. XIIIA, § 2.1(c)(5); Rev. & Tax.C. § 63.2(a)(1)(B)]

(a) [13:102.1] **Compare—pre-February 16, 2021 transfers:** For property transferred before February 16, 2021, the exclusion also had to be *timely claimed* by the eligible transferee on the proper State Board of Equalization form filed with the county assessor. Otherwise, entitlement to the exclusion was forfeited and the property was properly reassessed. [See Rev. & Tax.C. § 63.1(d), (e); *Empire Properties v. County of Los Angeles* (1996) 44 CA4th 781, 789-790, 52 CR2d 69, 74-75 (claim untimely)]

1) [13:103] **General three-year deadline:** For transfers between parents and children occurring before September 30, 1990, the claim had to be filed within three years after the date of the parent-child transfer. [Rev. & Tax.C. § 63.1(e)(1)(A)]

For transfers between parents and children occurring on or after Sept. 30, 1990, but before February 16, 2021, and for transfers between grandparents and grandchildren occurring on or after March 27, 1996, but before February 16, 2021, the deadline for filing the claim was three years after the date of the transfer *or* prior to transfer of the property to a third party (*not including* a transfer to a parent or child of the transferor/original transferee), *whichever was earlier*. [Rev. & Tax.C. § 63.1(e)(1)(B), (4)].

For transfers on or after February 16, 2021, the claim must be filed within three years after the date of the purchase or transfer of real property for which the claim is filed, or prior to the transfer of the real property to a third party, or an eligible transferee no longer occupies the residence, whichever is earlier. [Rev.& Tax.C. § 63.2(f)(1)(A)]

a) [13:103.1] **Pre-February 16, 2021 transfers upon death:** Before February 16, 2021, the date of a transfer between parents and children or between grandparents and grandchildren *under will or by intestate succession* had to be *"the date of the decedent's death*." Thus, the three-year limitations period for filing the exclusion claim (¶ 13:103) commenced immediately upon the death of the eligible transferor without regard to when estate administration was commenced. [Rev. & Tax.C. § 63.1(c)(1) & (2) (emphasis added); see *Empire Properties v. County of Los Angeles* (1996) 44 CA4th 781, 790, 52 CR2d 69, 74-75; see also Ross & Cohen, *Cal. Prac. Guide: Probate* (TRG), Ch. 1]

2) [13:104] **Extension—special "deemed timely filing" rule:** Notwithstanding the three-year rule (¶ 13:103), an exclusion claim is "*deemed to be timely filed*" if filed within *six months* after the date of mailing of a notice of supplemental or escape assessment issued as a result of the real property purchase or transfer for which the claim was filed. [Rev. & Tax.C. §§ 63.1(e)(1)(C); 63.2(f)(1)(B); see *Scott v. State Bd. of Equalization* (1996) 50 CA4th 1597, 1600, 58 CR2d 376, 377 (decided under Rev. & Tax.C. § 63.1) (upholding constitutionality of statute's retroactive extension of filing period for parent-child transfer exclusion)]

3) [13:104.1] **Special provision for late claims:** Unless the property has been transferred to a third party (*not including* a transfer to a parent or child of the transferor/original transferee), an exclusion claim filed after expiration of the Rev. & Tax.C. § 63.1(e)(1) or § 63.2(f)(1) deadlines (¶ 13:103) must be "considered by the assessor." [Rev. & Tax.C. §§ 63.1(e)(2), (4), 63.2(f)(2)]

However, the following conditions apply:

• [13:104.2] The exclusion granted pursuant to the late claim "shall apply commencing with the lien date of the assessment year in which the claim is filed." [Rev. & Tax.C. §§ 63.1(e)(2)(A), 63.2(f)(2)(A)]

• [13:104.3] Under any exclusion granted pursuant to the late claim, the adjusted full cash value (taxable value) of the property must be set at the property's adjusted base-year value in the year of the excluded transfer, adjusted for inflation and the value of any subsequent new construction on the property. [Rev. & Tax.C. §§ 63.1(e)(2)(B), 63.2(f)(2)(B)]

[13:104.4] ***Reserved.***

(b) [13:104.5] **Notice by assessor:** The assessor may notify a transferee in writing of the potential eligibility for exclusion from a change in ownership tax reassessment under the parent-child or grandparent-child exclusions. If so notified, the transferee is statutorily required to file a certified claim for eligibility within 45 days of the date of the notice. [Rev. & Tax.C. §§ 63.1(j)(1), 63.2(g)(1)]

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If no certified claim is filed within 45 days, the assessor may send a second notice of potential eligibility, stating that reassessment will occur unless a certified claim for exclusion is filed within 60 days of the date of the second notice. Failure to file a claim for exemption within 60 days does *not*, however, prevent the transferee from claiming the exemption at a later time. But in this event, the assessor can impose a one-time processing fee when authorized by the county board of supervisors. [See Rev. & Tax.C. §§ 63.1(j), 63.2(g)—processing fee may not exceed lesser of $175 or actual and reasonable costs incurred due to transferee's failure to timely file claim]

➪ [13:104.6] ***PRACTICE POINTER:*** Thorough information comparing the Rev. & Tax.C. § 63.1 (pre-February 16, 2021) and § 63.2 (on or after February 16, 2021) parent-child and grandparent-grandchild exemption is available on the State Board of Equalization website (*https://www.boe.ca.gov/prop19/#Charts*).

(6) [13:104.7] **Stock transfers in family corporations owning real property:** No change in ownership occurs when stock in a "qualified corporation" (¶ 13:104.8) transfers from a parent to a child due to the parent's death and the transfer results in a change in ownership of "qualified property" (¶ 13:104.9) owned by the qualified corporation. [Rev. & Tax.C. § 62(r)]

(a) [13:104.8] **Qualified corporation:** For purposes of the Rev. & Tax.C. § 62(r) exemption (¶ 13:104.7), a "qualified corporation" means a corporation, created between 3/1/75 and 11/6/86, that owns "qualified property" (¶ 13:104.9) and whose only stockholders have been the parents and their children. [Rev. & Tax.C. § 62(r)(4)(A)]

(b) [13:104.9] **Qualified property:** For purposes of the Rev. & Tax.C. § 62(r) exemption (¶ 13:104.7), "qualified property" means a "parcel of property" that satisfies the following conditions (Rev. & Tax.C. § 62(r)(4)(B)):

• The parcel contains the parents' principal residence before their death and has been the continuous residence of a child of those parents since creation of the qualified corporation (¶ 13:104.8); and

• The parcel's full cash value, as defined, does not exceed $1 million as of the date immediately prior to the last surviving parent's death.

f. Joint tenancy property

(1) [13:105] **Transferor remaining joint tenant:** In addition to any other applicable exclusion (e.g., transfers between spouses), no change in ownership occurs upon the creation or transfer of a joint tenancy interest if the transferor remains one of the joint tenants. [Rev. & Tax.C. § 65(b)]

(2) [13:106] **Reappraisal upon termination:** However, upon termination of such transferor's joint tenancy interest, the entire portion of the property held by them before creating the joint tenancy will be reappraised unless it vests (in whole or in part) in any remaining original transferor (in which event, no reappraisal will occur). Upon termination of the last surviving original transferor's interest, the interest then transferred and all other interests held by all original transferors that were previously excluded from reappraisal will be reappraised. [Rev. & Tax.C. § 65(c); see also *Benson v. Marin County Assessment Appeals Bd.* (2013) 219 CA4th 1445, 1458-1461, 162 CR3d 498, 507-509—brother's termination of family joint tenancy with sibling and creation of tenancy in common constituted "change in ownership" allowing reassessment of residential property]

Compare: No reappraisal will occur upon the termination of an interest held by one other than the original transferor in joint tenancy property subject to the Rev. & Tax.C. § 65(b) exclusion if the entire interest is transferred either to an original transferor or to all remaining joint tenants … *provided that* one of the remaining joint tenants is an original transferor. [Rev. & Tax.C. § 65(d)]

g. [13:107] **Property damaged/destroyed by disaster—base-year value transfer to comparable property:** If property is substantially damaged or destroyed by a disaster (i.e., a "major misfortune or calamity" in an area proclaimed by the Governor to be in a "state of disaster"), the base-year value can be transferred to comparable property within the same county provided the comparable property is acquired or newly-constructed as a replacement within five years after the disaster. [Cal.Const. Art. XIIIA, § 2(e), (f); Rev. & Tax.C. § 69(a), (c)(3)]

The five-year period (above) is extended by *two* years if:

— The last day to transfer the base year value of qualified property to comparable property was on or after March 4, 2020, but on or before the COVID-19 emergency termination date or March 4, 2022, whichever is sooner; *or*

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— The property was substantially damaged or destroyed on or after March 4, 2020, but on or before the COVID-19 emergency termination date or March 4, 2022, whichever is sooner. [Rev. & Tax.C. § 69(h)(1), (2)]

The five-year period is extended by *three* years if:

— The property was substantially damaged or destroyed on or after November 1, 2018, but on or before November 20, 2018, as proclaimed by the Governor and described in the "2018 Camp Fire disaster," paragraph (1) of subdivision (c). [Rev. & Tax.C. § 69(i) (amended Stats. 2023, Ch. 443; eff. 10/8/23)]

Moreover, if so authorized by county ordinance, the base-year value of *out-of-county* real property that is substantially damaged or destroyed by a disaster can be transferred to comparable replacement property within the *adopting county* provided the comparable replacement property is acquired or newly-constructed within three years after the damage or destruction of the original property. [Cal.Const. Art. XIIIA, § 2(e)(3); Rev. & Tax.C. § 69.3]

(1) [13:108] **"Substantial" damage or destruction:** Property is deemed "substantially damaged or destroyed" for Rev. & Tax.C. §§ 69 and 69.3 purposes if either the land or improvements sustain physical damage (including by diminution in value due to permanently restricted access occasioned by the disaster) amounting to more than 50% of either the land's or the improvement's full cash value immediately prior to the disaster. [Rev. & Tax.C. §§ 69(c)(1) & 69.3(b)(12)]

(2) [13:109] **"Comparable" replacement:** Where the replacement is within the *same county* as the damaged or destroyed property, "comparable" replacement property refers generally to a replacement that is similar in size, utility and function to the damaged or destroyed property. [See Rev. & Tax.C. § 69(c)(2)]

Where the replacement is in a *new county* authorizing the transfer of base-year valuation pursuant to Rev. & Tax.C. § 69.3, "comparable" replacement means a replacement property that has a "full cash value" satisfying specified criteria for "equal or lesser value." [See Rev. & Tax.C. § 69.3(b)(3), (6), (7) & (8); see also Rev. & Tax.C. § 69.3(b)(11), defining "replacement property" to include any "shelter constituting a place of abode, whether real property or personal property"]

(3) [13:109.1] **Application to homeowners who are (i) over age 55, (ii) severely and permanently disabled, or (iii) wildfire or natural disaster victims:** *See discussion at ¶ 13:91 ff.*

[13:109.2 - 13:109.4] ***Reserved.***

h. [13:109.5] **"Qualified contaminated property"—base-year value transfer to replacement property; or "new construction" reappraisal exclusion:** The base-year value of "qualified contaminated property" (as defined by Cal.Const. Art. XIIIA, § 2(i)(2)) may be transferred to property acquired or newly constructed after 1994 as a replacement if the replacement property has a fair market value not exceeding the fair market value of the qualified contaminated property in its uncontaminated condition. The replacement property must be located within the same county unless the board of supervisors of another county adopted a resolution authorizing intercounty transfer of base-year value pursuant to this provision. Further, the replacement property must be acquired or newly constructed *within five years* after ownership in the qualified contaminated property is sold or otherwise transferred. [See Cal.Const. Art. XIIIA, § 2(i)(1)(A); and Rev. & Tax.C. § 69.4(b)]

In addition, the sale or transfer of the original property must either result in (1) a reappraisal of the property at its current fair market value, or (2) a base year value transferred from another property under the provisions for intracounty disaster relief base year value transfer, intercounty disaster relief base year value transfer, principal residence base year value transfer, or base year value transfer for persons who are over age 55, severely and permanently disabled, or victims of wildfire or natural disaster. (See Rev. & Tax.C. §§ 69.4(c), 69, 69.3, 69.5, 69.6.) Relief is not available, however, if the owner or owners of the original property either (1) rebuild and receive the new construction exclusion for qualified contaminated property, or (2) sign a parent-child or intergenerational transfer claim. [See Rev. & Tax.C. §§ 69.4(d), 74.7, 63.1, 63.2]

Alternatively, where remediation of the environmental problems requires the destruction of, or results in substantial damage to, a structure on the qualified contaminated property, repair or replacement of the affected structure performed after the remediation may be excluded from property tax reappraisal as "new construction." The repaired or replacement structure, however, must be similar in size, utility and function to the original structure. [See Cal.Const. Art. XIIIA, § 2(i)(1)(B)]

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(1) [13:109.6] **Timely claim of exemption required:** Rev. & Tax.C. § 69.4 tax relief is not available unless the taxpayer files a claim therefor with the State Board of Equalization within three years of the date the replacement property was purchased or construction of the replacement property was completed. [Rev. & Tax.C. § 69.4(f)(1)]

The claimant must prove to the assessor that:

• The claimant did not participate or acquiesce in any act or omission that rendered the property uninhabitable or unusable, or is related to any individual or entity that committed that act or omission; *and*

• The qualified contaminated property has been designated as a toxic or environmental clean-up site by the State of California or the federal government. [Rev. & Tax.C. § 69.4(f)(2)]

i. [13:110] **Acquisition to replace condemned property:** The acquisition of real property as a replacement for comparable property from which the acquiring person has been displaced by eminent domain proceedings, public entity acquisition, or governmental action resulting in an inverse condemnation judgment is not a change in ownership. [Cal.Const. Art. XIIIA, § 2(d); Rev. & Tax.C. § 68(a); 18 CCR § 462.5; see also *Olive Lane Industrial Park, LLC v. County of San Diego* (2014) 227 CA4th 1480, 1491, 174 CR3d 577, 586—Article XIIIA's "clear mandate" ensures property owners can maintain same property tax status for replacement property]

For Rev. & Tax.C. § 68 purposes, the adjusted base-year value of the replacement property is the *lower* of:

— the fair market value of the replacement property, or

— the sum of (i) the adjusted base-year value of the displaced property and (ii) the amount by which the full cash value of the replacement property exceeds 120% of the amount received by the displaced person for the displaced property. [Rev. & Tax.C. § 68(a)(1)-(2); see also *Olive Lane Industrial Park, LLC v. County of San Diego,* supra, 227 CA4th at 1492-1494, 174 CR3d at 586-588 (interpreting § 68 to permit prospective relief for base-year value transfer claims filed after statute's four-year deadline)]

j. [13:111] **Tenant acquisitions of mobilehome park:** No change in ownership of mobilehome park rental spaces occurs by a sale to at least 51% of the individual tenants who were renting their spaces before the purchase … provided those tenants form a "resident organization" to operate and maintain the park within one year after the first purchase of a rental space by an individual tenant. [Rev. & Tax.C. § 62.1(a)(2)]

Also exempt from change in ownership reassessment is the transfer of a mobilehome park to a nonprofit corporation or other entity formed by the park tenants for the purpose of purchasing the mobilehome park … provided that, within *one year* of the acquisition, the individual tenants who were renting at least 51% of the spaces before the transfer participate in the transaction through ownership of an aggregate of at least 51% of the voting stock of (or other membership interests in) the entity that acquires the park. [Rev. & Tax.C. § 62.1(a)(1); see also Rev. & Tax.C. § 62.2 for related "step-transfer" exclusion]

(1) [13:111.1] **Compare—transfer of ownership in entity that owns mobilehome park:** Transferring a membership in the entity that owns the mobilehome park constitutes a "change in ownership of a pro rata portion of the real property of the park," requiring reassessment for that fraction of the park. This is so unless the transfer is excluded because it is between registered domestic partners, spouses, parents and their children or, under limited circumstances, grandparents and their grandchildren, or it is part of an intergenerational transfer. [Rev. & Tax.C. §§ 62.1(b), 63, 63.1, 63.2] The accepted method used by the State Board of Equalization (SBE) for valuing such parcels involves "extracting" from the total purchase price the book value of the mobilehome and then allocating the remainder of the purchase price to the interest in the park itself. [See *Holland v. Assessment Appeals Bd. No. 1* (2014) 58 C4th 482, 487, 167 CR3d 74, 77 (deferring to SBE's assessment method absent a statutorily-mandated one)]

[13:111.2 - 13:111.4] ***Reserved.***

k. [13:111.5] **Cotenancy interest transfer upon death:** A change in ownership does not include transfer of a cotenancy interest in real property from one cotenant to the other that takes effect upon the death of the transferor, provided:

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- the transfer is solely between two individuals who together own 100% of the subject property in joint tenancy or as tenants in common;
- as a result of the transferor's death, their interest is transferred to the surviving cotenant, resulting in the surviving cotenant holding 100% ownership in the subject property;
- the subject property was co-owned by the transferor and transferee for the one-year period immediately preceding the transfer, with both cotenants having been record owners;
- the subject property constituted the cotenants' principal residence immediately preceding the transferor's death; and
- the transferee has signed under penalty of perjury an affidavit affirming that they continuously resided with the transferor at the residence for the one-year period immediately preceding the transfer. [See Rev. & Tax.C. § 62.3—applicable only to transfers occurring on or after 1/1/13]

The above exclusion does not apply to any real property transfer for which a separate exclusion applies. [See Rev. & Tax.C. § 62.3(c)]

l. [13:111.6] **Floating home marina transfers:** A change in ownership does not include the transfer of a floating home marina, as defined, to a nonprofit corporation, stock cooperative corporation, limited equity stock cooperative or other entity formed by the tenants for the purpose of purchasing said marina … provided the individual tenants who were renting at least 51% of the berths in the marina prior to the transfer participate in the transaction through the ownership of an aggregate of at least 51% of the voting stock of, or other ownership or membership interests in, the entity that acquires the marina. [Rev. & Tax.C. § 62.5(a)]

(1) [13:111.7] **Compare—transfer of ownership in entity that owns floating home marina:** Transferring a membership in the entity that owns the floating home marina constitutes a "change in ownership of a pro rata portion of the real property of the floating home marina." Thus, the transfer requires reassessment for that fraction of the marina. This is so unless the transfer is excluded because it is between registered domestic partners, spouses, parents and their children, or, under limited circumstances, grandparents and their grandchildren, or it is part of an intergenerational transfer. [Rev. & Tax.C. §§ 62.5(b)(1), 62, 63, 63.1, 63.2]

5. [13:112] **Reporting Obligations:** When California real property, a manufactured home or a floating home is transferred, the transferee has a duty to report the change in ownership to the county assessor. [Rev. & Tax.C. § 480]

The Change in Ownership statement must be filed at the time the document evidencing a change in ownership is recorded or, for property that is not recorded, within 90 days of transfer. [See Rev. & Tax.C. § 480(a), (c), (e)]

If the transfer occurred on the property owner's death, the transferee or trustee (if the property was held in trust) must report the change in ownership to the assessor within 150 days of death. If there is a probate, the deceased owner's personal representative must report the change in ownership to the assessor prior to or at the time the inventory and appraisal is filed with the court clerk. [Rev. & Tax.C. § 480(b), (e)]

➪ [13:113] ***PRACTICE POINTER:*** The reporting requirement exists even when there is doubt as to whether a particular transfer constitutes a change in ownership for purposes of triggering reassessment. Thus, in order to avoid penalties (*¶ 13:114 ff.*), it is important to timely report sufficient facts so the assessor can determine whether an actual change in ownership has occurred. [See Green, "2012 Changes to Property Tax Reporting Requirements for Real Property," Santa Barbara Lawyer 8 (Dec. 2011)]

a. Penalties

(1) [13:114] **For individuals:** Inadvertent failure to timely file a Change in Ownership Statement in response to the assessor's request results in a penalty of either $100 or 10% of the taxes due, whichever is greater, up to a ceiling of $20,000 on property ineligible for the homeowner's exemption or $5,000 on property eligible for the exemption. [See Rev. & Tax.C. §§ 480(c), 482(a)]

(2) [13:115] **For legal entities:** There is an *automatic*, mandatory 10% penalty of the new base-year value for failure to timely file a statement regarding a change in ownership of, or change in control over, property owned by a legal entity. Even if it turns out there was no actual change in ownership or control, a penalty of 10% of the current year's taxes is still imposed. And in either case, there is no ceiling on the total amount due. [Rev. & Tax.C. § 482(b)]

(3) [13:116] **Abatement of penalties:** Although failure to timely notify the assessor of a change in ownership results in penalties, the penalties may be abated if the taxpayer establishes that the failure to file "was due to reasonable cause and circumstances beyond the assessee's control, and occurred notwithstanding the exercise of ordinary care in the absence of willful neglect." [Rev. & Tax.C. § 483(a), (c)]

6. [13:117] **Foreclosure:** If a property owner defaults on its property tax obligations, the county tax collector can sell the property to the highest bidder in a public auction once five years or more have passed since the property was tax defaulted (or three years or more have passed in the case of nonresidential commercial property). [See Rev. & Tax.C. § 3691 et seq.; ¶ 4:351.1]

Although the above auction might produce a price that exceeds the amount of property tax owed, the original owner is entitled to the difference between the property tax due and the proceeds from the foreclosure sale. [See *Tyler v. Hennepin County* (2023) 598 US 631, 647, 143 S.Ct. 1369, 1380—county's retention of excess proceeds from foreclosure sale violated U.S. Constitution's Takings Clause]

[13:118 - 13:119] ***Reserved.***

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California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 13. Real Property
Purchase and Sale Tax Concerns

Part II. Ownership of Real Property

A. Pertinent Tax Issues

1. [13:120.1] Advantages of “Above-the-Line” Deductions for Rental Property
2. [13:120.2] Deduction for Real Estate Business “Start-Up Costs”

[13:120] As an owner of real property, a taxpayer is concerned with the following tax issues, treated in the sections below:

• Depreciation deductions (¶ *13:121 ff.*)

• Tax treatment of repairs vs. improvements (deductions vs. capitalization and depreciation) (¶ *13:150 ff.*)

• Interest deductions (¶ *13:165 ff.*)

• Real property tax deductions (¶ *13:200 ff.*)

• Deductibility of operating losses (¶ *13:205 ff.*)

• Allocation of deductions between co-owners and partners (¶ *13:260 ff.*)

• Tax consequences of leasing transactions (¶ *13:270 ff.*)

• Deductions for home offices and vacation homes (¶ *13:292 ff.*)

1. [13:120.1] **Advantages of “Above-the-Line” Deductions for Rental Property:** Deductions arising from ownership of real property held for *rental* are “above-the-line,” meaning they are deducted from the taxpayer's gross income, as opposed to adjusted gross income (AGI), regardless of whether the rental is classified as a trade or business. [See IRC § 62(a)(1), (4)]

“Above-the-line” deduction status is normally quite advantageous because the taxpayer can take the deductions related to the rental use of the property and also claim the standard IRC § 63(b) deduction. Above-the-line classification also means the deductions are not subject to reduction based on the taxpayer's AGI (see IRC §§ 67, 68, 151(d)(3), 213(a)); and it has a positive effect on IRC § 56(b) alternative minimum tax computations made by the taxpayer.

2. [13:120.2] **Deduction for Real Estate Business “Start-Up Costs”:** A taxpayer may deduct the costs of doing business *only after* the business actually has begun (IRC § 162). A real estate business does not begin when the taxpayer enters into a contract to purchase real property, but *only after the purchase is completed.* Thus, the costs of investigating real estate opportunities, marketing and taking courses, etc., are not deductible unless incurred after active conduct of the real estate business has commenced with the acquisition of real property. [See *Woody v. Commissioner,* TC Memo 2009-93; see also *McPartland v. Commissioner*, TC Summ.Opn. 2012-88—no deductions allowed for expenses relating to property's purchase and renovation incurred two years before property was offered for rent and three years before it was actually rented]

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California Practice Guide: Real Property Transactions | September 2024 Update
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Chapter 13. Real Property Purchase and Sale Tax Concerns

Part II. Ownership of Real Property

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            - (a) [13:124.2] “Push-up” or natural soil golf greens
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5. [13:146] Reduction of Basis
6. [13:147] Compare—Loss Deductions Reducing Basis
7. [13:148] Recapture of Depreciation and Capital Gain Treatment

1. [13:121] **Deduction Eligibility—In General:** The owner of buildings or other improvements to real property (including fixtures) that are either *used in a trade or business* or *held for the production of income* is entitled to an annual depreciation deduction (also called "cost recovery" or ACRS) to measure the "exhaustion"/"wear and tear" of the property over its "useful life" and to match that cost against the annual income produced by the property. [IRC §§ 167, 168]

The term "amortization" is often used to refer to the depreciation of intangible assets (such as the cost of acquiring a lease or a contract right).

a. [13:122] **Notwithstanding appreciating value:** Depreciation deductions are available even though the property is actually appreciating in value. [IRC §§ 167, 168]

b. [13:123] **Property for personal use:** The taxpayer's personal residence and other buildings held for *personal use* are *not* depreciable. [IRC § 167(a); *but see ¶ 13:303.9* for discussion of depreciating property converted from personal to rental use]

c. [13:124] **Underlying land in general:** Land may *not* be depreciated, even if improved by depreciable real property. [See *Lomas Santa Fe, Inc. v. Commissioner* (9th Cir. 1982) 693 F2d 71, 72; *Houston Chronicle Publishing Co. v. United States* (5th Cir. 1973) 481 F2d 1240, 1258]

(1) [13:124.1] **Golf greens preparation costs:** The depreciability of the costs of preparing golf greens depends on whether the greens are part of a "push-up" (natural soil) or "modern" course.

(a) [13:124.2] **"Push-up" or natural soil golf greens:** The costs of preparing land in the original construction or reconstruction of greens on a "push-up" or natural soil golf course (i.e., a course involving some reshaping or regrading of land without a subsurface drainage system) are *not* depreciable. [Rev.Rul. 2001-60, 2001-2 CB 587]

(b) [13:124.3] **"Modern" greens:** On the other hand, land preparation costs undertaken in the original construction or reconstruction of greens on a "modern" course (i.e., a course using technological changes in green design and construction, as well as sophisticated integrated drainage systems) that are *closely associated with depreciable assets*, such as the underlying drainage system that may be periodically excavated and replaced, are depreciable. [Rev.Rul. 2001-60, supra]

However, preconstruction costs of earthmoving, grading, and initial shaping of the area surrounding and under "modern" greens are *inextricably associated with the land*, a nondepreciable asset, and thus are likewise *not* depreciable. [Rev.Rul. 2001-60, supra]

2. [13:125] **Taxpayers Entitled to Claim Depreciation:** Depreciation is claimed by the person who both (a) has made a capital investment in the eligible real property (*United States v. Cocke* (5th Cir. 1968) 399 F2d 433, 446-447) *and* (b) is entitled to the benefits and burdens of ownership. [*Estate of Franklin v. Commissioner* (9th Cir. 1976) 544 F2d 1045, 1049]

- [13:126] As between mortgagor and mortgagee, the mortgagor claims the deduction (even if the mortgagee has title to the property). [Bittker & Lokken, "Federal Taxation of Income, Estates & Gifts"¶ 23.1.8 (3d ed. 1999 and current supp.)]
- [13:127] As between landlord and tenant, the landlord depreciates buildings that the landlord paid for; the tenant depreciates buildings that the tenant paid for. [*Trustees of Graceland Cemetery Improvement Fund v. United States* (Ct.Cl. 1975) 515 F2d 763, 779; Bittker & Lokken, supra at ¶ 23.1.9]
- [13:128] As between buyer and seller, if the seller retains all the benefits and burdens of ownership, the buyer cannot claim depreciation on the property, despite the fact that formal legal title transferred from seller to buyer. [*Arevalo v. Commissioner* (5th Cir. 2006) 469 F3d 436, 439-440 (sale of payphones)]

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3. Amount Subject to Depreciation

a. [13:129] **Percentage measurement; allocation of basis:** Depreciation is measured by applying a percentage each year to the basis of the property. Since land is not depreciable (*¶ 13:124*), basis must be allocated between land and buildings. Salvage value of the property is ignored. The components of a building may not be separately depreciated. [IRC § 168]

b. [13:130] **Personal vs. real property:** Personal property used in business can be depreciated over a much shorter period than real property and a more favorable computation method can be used for personal property. [IRC § 168(b), (c)]

Most personal property ordinarily is depreciated over a five or seven-year period. Appliances, carpets and furniture in rental real estate are depreciated over the shorter five-year period. [See Harmelink & Vandenburgh, "Changes in Depreciation For Rental Real Estate Activities"(Sept. 2000) 78 Taxes 33]

(1) [13:131] **Standards for identifying personal property:** Generally, the distinction between real and personal property for depreciation purposes follows the distinctions drawn under prior law for purposes of the (now-repealed) investment tax credit (the investment tax credit was available only for the purchase of "tangible personal property"). [*Hospital Corp. of America & Subsidiaries v. Commissioner* (1997) 109 TC 21, 55]

In addition, items (other than a building *or its structural components*) used as an integral part of manufacturing, production or extraction, or of furnishing transportation, communication or utility services, are treated as personal rather than real property. [IRC §§ 168(e)(2)(B), 1250(c), 1245(a)(3); Treas.Reg. § 1.1245-3(b)(1); see *Texas Instruments, Inc. v. Commissioner*, TC Memo 1992-306—electrical system that can function separately from general building system is not a "structural component"]

(a) [13:132] **Tangible personal property:** For this purpose, "tangible personal property" includes items affixed to the building or the ground, such as shelves, signs or gasoline pumps, which can be removed without undue damage. [Treas.Reg. § 1.48-1(c); see *Hospital Corp. of America & Subsidiaries v. Commissioner* (1997) 109 TC 21, 56-57; and Bittker & Lokken, "Federal Taxation of Income, Estates & Gifts"¶ 27.2.3 (3d ed. 1999 and current supp.)]

Thus, the distinction between real and personal property for depreciation purposes does *not* follow state law rules for "fixtures." [*Hospital Corp. of America & Subsidiaries v. Commissioner*, supra, 109 TC at 56-57]

• [13:132.1] **Examples:** Outdoor advertising signs, although attached to the ground, are personal property because they are not "inherently permanent structures." [*Whiteco Industries, Inc. v. Commissioner* (1975) 65 TC 664, 670-673]

Similarly, trellises designed for growing grapes and made from posts, stakes and wires, are personal property because they can be moved without undue damage. But underground drip irrigation systems and wells are real property since they cannot be removed without being damaged or destroyed. [*Trentadue v. Commissioner* (2007) 128 TC 91, 106-107]

(b) [13:132.2] **Immediate expensing in year of purchase of tangible personal property:** The entire cost of certain tangible personal property used in a trade or business (including commercial, but not residential, real estate) can be deducted in the year of purchase. The taxpayer must make an election to immediately expense these items. [IRC § 179(a)]

The maximum aggregate cost of these items is $1,000,000. However, there is a phaseout of the maximum allowable amount of IRC § 179 purchases (i.e., the "phaseout level"). The phaseout level is $2,500,000 in 2018, adjusted annually for inflation in $10,000 increments. If the total cost of § 179 purchases exceeds the phaseout level, the maximum § 179 deduction is reduced dollar-for-dollar by the excess of such purchases over the phaseout level. [IRC § 179(a), (b)(1), (2)]

(The above figures may well change through subsequent legislation, so counsel should monitor § 179 carefully.)

(c) [13:132.3] **Immediate expensing of certain real property:** The Code allows taxpayers to elect immediate expensing of purchases of "qualified real property." [IRC § 179(e)(1)-(2)]

"Qualified real property" means depreciable property used in the trade or business that is qualified improvement property (IRC § 168(e)(6); ¶ 13:137.2a), or any improvements to the roofs, heating, ventilation and air conditioning, fire protection and alarm systems, as well as security systems on nonresidential real property placed in service after the property was first placed in service. [IRC § 179(e)(2)]

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4. [13:133] **"Straight-Line" Depreciation Method:** Real property can be depreciated only by the "straight-line method"—i.e., an equal amount of depreciation for every year, not a greater amount in the early years of ownership. [IRC § 168(b)(3)]

a. Applicable percentages (depreciation period)

(1) [13:134] **Normal periods:** Generally, there are two applicable "recovery" (depreciation) periods, depending on whether the property is residential or nonresidential:

(a) [13:135] **Residential rental property** (such as an apartment building) is depreciated over 27.5 years (or. 036363 per year except for the year of acquisition and disposition). [IRC § 168(c)]

A building or structure is "residential rental property" for depreciation purposes if at least 80% of the gross rental income for the taxable year is rental income from dwelling units (i.e., houses or apartments used for living accommodations). Hotels, motels and other structures hired out on a *transient* basis are *not* residential rental property. [IRC § 168(e)(2)(A)]

(b) [13:136] **Nonresidential real property**—i.e., property which is not residential rental property (such as a factory or office building)—is depreciated over 39 years (or. 025641 per year except for the year of acquisition and disposition). [IRC § 168(c)]

This provision applies to property placed in service on or after May 13, 1993. The recovery period was 31.5 years for property placed in service prior to that date.

(2) [13:137] **Improvements:** Improvements constructed by a lessor or lessee ordinarily are depreciated over 27.5 or 39-year periods, depending on whether the property is residential or nonresidential (¶ 13:134 ff.), regardless of the age of the building or the term of the lease. [IRC § 168(i)(6), (8)]

(a) [13:137.1] **Example:** Tenant leases for five years a nonresidential building that was constructed 10 years before the lease began, and pays $1,000,000 to improve the building. Tenant's improvements must be depreciated over 39 years from the date they were placed in service.

(b) [13:137.2] **"Bonus depreciation":** Property acquired and placed in service *after* 9/27/17 *and before* 1/1/23 with a useful life of 20 years or less qualifies for *bonus depreciation*, meaning that 100% of the purchase price can be deducted in the year of purchase (or the year costs were incurred in the case of construction). [See Field Agent Advice 2014202F—bonus depreciation denied to owner of new hotel complex for failure to demonstrate when each cost was incurred]

For qualified property placed in service by a taxpayer during the first taxable year ending *after* 9/27/17, the taxpayer may elect to use the former 50% recovery rate instead of the 100% rate (IRC § 168(k)(10)). For qualified property placed in service *after* 12/31/22, the recovery rate will be phased out as follows: 80% in 2023, 60% in 2024, 40% in 2025 and 20% in 2026. [IRC § 168(k)(6)(A)]

1) [13:137.2a] **Qualified improvement property (QIP):** QIP means any improvement made by the taxpayer to an interior portion of a building that is non-residential real property if the improvement is placed in service after the date the building was first placed in service (IRC § 168(e)(6)(A)). It does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building. [IRC § 168(e)(6)(B)]

QIP is classified as "15-year property," and therefore qualifies for 100% bonus depreciation. [IRC § 168(e)(3)(E)(vii)]

Caution: The 2017 Tax Act (Pub.L. 115-97) eliminated the special provisions for Qualified Leasehold Improvement Property (¶ 13:137.3 ff.), Qualified Restaurant Property (¶ 13:137.10 ff.) and Qualified Retail Improvement Property (¶ 13:137.12). Thus, the following discussion applies only to QIPs placed in service *after 9/27/17*, when bonus depreciation begins, and *before 1/1/18*, when these former categories were eliminated.

2) [13:137.3] **Qualified leasehold improvement property (QLIP):** QLIP means improvements made by the lessor or lessee (including a sublessee) to an *interior* portion of a *nonresidential* building. The improved portion must be occupied *exclusively* by the lessee (or sublessee). And the improvement must have been placed in service *more than three years* after the date the building was first placed in service by any person. [Former IRC § 168(k)(3)(A)]

A QLIP does *not* include any improvement for which the expenditure is attributable to enlargement of the building, an elevator or escalator, a structural component benefiting a common area or the internal structural framework of the building. And a lease between "related persons" is not treated as a lease. [Former IRC § 168(k)(3)(B), (C)]

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3) [13:137.4] **50% of purchase price can be expensed; 15-year depreciation period for remainder—effective dates:** As stated, 50% of the purchase price (100% if acquired and placed in service *after* 9/27/17) of a QLIP can be deducted as an expense in the year of purchase. This tax treatment applies to property acquired and placed into service before January 1, 2018 (or acquired by the taxpayer pursuant to a binding written contract entered into before January 1, 2013 and placed in service before January 1, 2014; or, in the case of certain property having longer production periods, before January 1, 2018). [IRC § 168(k)(2)(A), (B)]

The remaining 50% of the purchase price is subject to depreciation over a 15-year period (much shorter than the normal useful life of 39 years; ¶ 13:137). To qualify for 15-year depreciation, the QLIP must be placed in service before January 1, 2018. [Former IRC § 168(e)(3)(E)(iv)]

a) [13:137.5] **Limitation as to lessor's successor in interest:** If the lessor paid for the QLIP, a person who acquires the property from the lessor by means of a taxable purchase may *not* use the 15-year write-off period. However, if the transferee acquired the property through a nontaxable transfer (e.g., a § 1031 exchange), the transferee may continue to use the 15-year period. [Former IRC § 168(e)(6)(B)]

[13:137.6 - 13:137.9] ***Reserved.***

(c) [13:137.10] **15-year depreciation for qualified restaurant property:** Unlike QLIPs (¶ 13:137.3 ff.), “qualified restaurant property” (¶ 13:137.11) is not eligible for 50% (100% if acquired and placed in service *after* 9/27/17) bonus depreciation unless it separately qualifies as QLIP (former IRC § 168(e)(7)(B)). However, the 15-year depreciation period applicable to QLIPs (¶ 13:137.4) also applies to these properties. [Former IRC § 168(e)(3)(E)(v)]

1) [13:137.11] **Qualified restaurant property (QRP):** QRP means a building, or improvement to a building, if more than 50% of the building's square footage is devoted to preparation of, and seating for, on-premises consumption of prepared meals. [Former IRC § 168(e)(7)]

Unlike QLIPs, a QRP improvement may be made to the exterior of the building; indeed, it can be construction of the building itself. And the building can be new, as opposed to QLIPs where the building must be at least three years old (¶ *13:137.3*).

(d) [13:137.12] **Qualified retail improvement property (QRIP):** QRIP means any improvement to an interior portion of a nonresidential building if it is open to the general public and is used in the retail trade or business of selling tangible personal property to the general public. These improvements must be placed in service more than three years after the date the building was first placed in service. Thus, QRIP resembles QLIP, but the primary difference is that QRIP applies to owner-occupied space (there need not be a lease). Like QLIPs, QRIPs do not include improvements for which the expenditure is attributable to an enlargement of the building, an elevator or escalator, any structural component benefiting a common area or the internal structural framework of the building. [Former IRC § 168(e)(8)]

(e) [13:138] **Abandonment of leasehold improvements at lease termination:** A lessee who abandons leasehold improvements at termination of the lease before the basis of the improvements has been recovered through depreciation may claim a loss deduction for the improvements' remaining basis. Likewise, a lessor who disposes of or abandons the improvements at the lease's termination may claim a loss deduction. [IRC § 168(i)(8)(B)]

[13:138.1 - 13:138.4] ***Reserved.***

(3) [13:138.5] **Intangibles:** “Intangible” assets purchased by a taxpayer can be depreciated over *15 years* (rather than the 27.5 or 39-year periods normally applicable to real property). [IRC § 197]

(a) [13:138.6] **Types of “intangible” assets:** Intangibles include goodwill and going concern value, workforce in place, favorable contracts with customers, favorable market position, favorable contracts with suppliers of goods and services, covenants not to compete, business books and records, trademarks and tradenames, and customer lists. However, IRC § 197 does *not* cover interests in land (broadly defined).

(b) [13:138.7] **Allocation:** It *may* be possible to allocate part of the purchase price of *certain* real property to intangibles, particularly where the owners render substantial services (as in the case of a hotel).

However, the legislative history of IRC § 197 creates substantial doubt whether purchasers of *rental* real property can allocate anything to intangibles. And the Code explicitly *prohibits* allocation of any part of the purchase price of real estate to a *lease* to which the property is subject. [IRC § 167(c)(2); see *Union Carbide Foreign Sales Corp. v.*

Commissioner (2000) 115 TC 423, 439-440 (disagreed with by *ABC Beverage Corp. v. United States* (6th Cir. 2014) 756 F3d 438, 446)—taxpayer could not allocate any portion of tanker's purchase price to deduction for termination of burdensome lease; *but see ¶ 13:283.2* (deductibility of lease cancellation payments to lessee)]

Therefore, this issue must be approached very cautiously. [See Stara & Schnee, "Maximizing Deductions When Acquiring Real Property Leases" (1996) 27 The Tax Adviser 166]

(4) [13:139] **Election to use 40-year term:** A taxpayer can elect to depreciate eligible real property over a 40-year useful life instead of the shorter terms normally applicable. [IRC § 168(g)]

The same longer life applies in certain circumstances to property used outside the United States, leased to a tax-exempt entity or financed by tax-exempt bonds (¶ 13:140 ff.). [IRC § 168(h)]

(5) [13:140] **Special rule for tax-exempt use property:** Nonresidential real property leased to a tax-exempt entity under a "disqualified lease" (¶ *13:143*) can be depreciated only over 40 years (or a term of 125% of the lease if that is longer than 40 years). [IRC § 168(g)(1)(C), (2), (3)(A)]

(a) [13:141] **35% threshold limitation:** This rule applies only if the portion of the property leased to a tax-exempt entity is more than 35% of the property. [IRC § 168(h)(1)]

(b) [13:142] **Tax-exempt lessee:** For purposes of the tax-exempt use property rule, a tax-exempt lessee is a government or any other tax-exempt entity (including, but not limited to, charitable organizations). Also, under certain circumstances, foreign persons or entities are treated as tax-exempt lessees if most of their income is not subject to U.S. taxation. [IRC § 168(h)(2)]

(c) [13:143] **"Disqualified lease":** A lease is "disqualified" within the meaning of IRC § 168(h) only if (i) the property was financed directly or indirectly by the use of tax-exempt bonds, *or* (ii) the property is subject to an option to purchase or sell at a fixed or determinable price to the tax-exempt entity (or a related entity), *or* (iii) the lease term exceeds 20 years, *or* (iv) the property was sold or leased by the tax-exempt entity (after the tax-exempt entity had used the property for at least three months) and leased back. [IRC § 168(h)(1)(B)(ii)]

Leases of fewer than three years are *not* "disqualified." [IRC § 168(h)(1)(C)]

b. [13:144] **Year of acquisition or disposition:** During the year property is acquired, the available depreciation amount must be allocated monthly. The taxpayer is treated as having purchased the property in the middle of the month in which it is actually purchased. The same rule applies to the year of disposition: Property is deemed disposed of in the middle of the month in which the disposition occurs. [IRC § 168(d)(2) & (4)(B)]

• [13:145] **Example:** T buys a shopping center building for $1,000,000 on June 30 in Year 1. The applicable percentage is 0.025641; thus, in Year 2, T can deduct depreciation of $25,641. In Year 1, however, T is treated as having purchased the property on June 15, meaning T can deduct 11/24 of a full year's depreciation. Thus, in Year 1, T deducts depreciation of only $11,752.

5. [13:146] **Reduction of Basis:** The basis of property is reduced by depreciation allowed *or allowable,* whichever is *greater*. Thus, if a taxpayer fails to deduct the full amount of depreciation available in a given year and the statute of limitations has run on filing an amended return for that year, the basis is reduced by the amount that should have been claimed. [IRC § 1016(a)(2)]

6. [13:147] **Compare—Loss Deductions Reducing Basis:** The basis of property is also reduced by loss deductions, such as casualty losses. In addition, the taxpayer is entitled to a deduction for abnormal retirement of a building that is abandoned. [Treas.Reg. § 1.167(a)-8(a)(4)] Basis would be reduced by such a deduction. Although no deduction is allowed for demolition of a building (IRC § 280B; *see* ¶ *13:41*), a taxpayer can avoid this problem by taking a loss deduction for abnormal retirement before abandoning the building. [*De Cou v. Commissioner* (1994) 103 TC 80, 86-87; *see* ¶ *13:41.2*]

7. [13:148] **Recapture of Depreciation and Capital Gain Treatment:** When depreciable real property is sold at a gain, part or all of the gain is attributable to prior depreciation deductions. Capital gain attributable to depreciation is taxed at the rate of 25% instead of the 20% rate normally applicable to long-term capital gain (¶ 13:416 ff., 13:457 ff.). Only gain (if any) that exceeds prior depreciation is taxed at the 20% rate. [IRC § 1(h)(6); *see* ¶ *13:417.5 ff.*]

• [13:148.1] P bought Factory in 1995 for $1,000,000 and sold it in 1999 for $960,000. P correctly claimed depreciation of $100,000 on Factory, so P's adjusted basis at the time of sale was $900,000. The long-term capital gain on the sale is $60,000. Because $60,000 was less than the depreciation previously taken on Factory, the entire gain is taxed at the rate of 25%.
• [13:148.2] Suppose instead that Factory was sold in 1999 for $1,150,000. The gain is $250,000, of which $100,000 would be taxed at 25% and $150,000 at 20%.

Cross-refer: For a detailed discussion of the treatment of capital gains and losses, *see ¶ 13:416 ff.*

[13:149] ***Reserved.***

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Chapter 13. Real Property Purchase and Sale Tax Concerns

Part II. Ownership of Real Property

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1. [13:150] **Deductible Expense vs. Capitalized Cost:** A *repair* to property held for *use in a trade or business* or for *production of income* is currently deductible. On the other hand, an *improvement* must be capitalized, added to basis and depreciated. [IRC §§ 162(a), 263(a); see *Smith v. Commissioner* (9th Cir. 2002) 300 F3d 1023, 1028-1029—characterization of payment as business expense or capital expenditure concerns timing of taxpayer's cost recovery]

(Repairs to property held for *personal use*—such as a personal residence—cannot be deducted. But improvements to such assets should be capitalized and added to the property's basis.)

a. [13:150.1] **Regulations:** To provide guidance on various issues relating to capitalization of repair costs, the Treasury Department issued extensive temporary regulations in 2011 that replaced numerous existing regulations. These regulations were first proposed in 2006, reissued in modified form in 2008, and finally issued as temporary regulations in 2012, with the effective date scheduled for January 1, 2014. In September 2013, however, new final regulations were issued to largely replace the temporary regulations. [Treas.Decis. 9636; Treas.Reg. §§ 1.162 & 1.263]

2. [13:151] **Distinguishing "Repairs" From "Improvements":** Many cases have confronted the problem of distinguishing "repairs" from "improvements" for tax purposes. The regulations provide that a "taxpayer may deduct amounts paid for repairs and maintenance to tangible property if the amounts paid are not otherwise required to be capitalized." [Treas.Reg. § 1.162-4(a)]

In determining whether an expense item must be capitalized, the regulations further provide that no deduction is allowed for "(1) Any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate; or (2) Any amount paid in restoring property or in making good the exhaustion thereof for which an allowance is or has been made." [Treas.Reg. § 1.263(a)-1(a)]

a. [13:151.1] **Factors considered:** In determining whether costs should be classified as deductible repairs or capital expenditures, the purpose, physical nature and effect of the work are considered. Although the "high cost" of work performed may be relevant to whether it is capital in nature, cost *alone* is *not* dispositive. Similarly, the fact that a regulatory agency requires a taxpayer to make certain repairs or perform certain maintenance does *not* mean the work is a capital improvement. [Rev.Rul. 2001-4, 2001-1 CB 295]

b. [13:151.2] **"Safe harbor" for small businesses:** The regulations permit taxpayers with average gross receipts of less than $10,000,000 over the preceding three years to deduct, rather than capitalize, amounts for "repairs, maintenance,

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improvements, and similar activities performed on the eligible building property." This is so *provided* the total amount paid does not exceed the lesser of 2% of the unadjusted basis of the eligible building property or $10,000. [Treas.Reg. § 1.263(a)-3(h)]

3. Tests Under Regulations

a. [13:152] **Routine maintenance:** Clearly, items of routine and recurring maintenance that simply keep the building in shape so that it can be used for its designated purpose can be currently deducted as "repair" costs. [Treas.Reg. § 1.162-4; Rev.Rul. 94-12, 1994-1 CB 36]

Deductible "repair" costs are those incurred for the purpose of keeping the property in "an ordinarily efficient operating condition over its probable useful life for the uses for which the property was acquired." [Rev.Rul. 2001-4, 2001-1 CB 295]

(1) [13:152a] **"Safe harbor":** The regulations set forth a "safe harbor" for routine property maintenance, defining it as "the recurring activities that a taxpayer expects to perform as a result of the taxpayer's use [of the property] … to keep the building structure or each building system in its ordinarily efficient operating condition." Moreover, the "amount paid for routine maintenance … is deemed not to improve that unit of property." [Treas.Reg. § 1.263(a)-3(i)(1)(i)]

By the same token, "activities are routine only if the taxpayer reasonably expects to perform the activities more than once during the 10-year period beginning at the time the building structure or the building system upon which the routine maintenance is performed is placed in service by the taxpayer," or in the case of a unit of property, more than once during the class life of that property. [See Treas.Reg. § 1.263(a)-3(i)(1)(i), (ii); Sapirie, "Final Repair Regs Finally Released in 2013" (Jan. 6, 2014) Tax Notes at 31]

(2) [13:152b] **Examples:** The regulations set forth numerous examples of activities that fall within the routine maintenance "safe harbor," including:

— Inspections;

— Cleaning;

— Testing; and

— Replacement of damaged or worn parts with comparable and commercially available parts for property units. [See Treas.Reg. § 1.263(a)-3(i)(1)(i)]

(3) [13:152c] **Exceptions:** Routine maintenance does *not* include amounts paid for:

— Betterment of a property unit under Treas.Reg. § 1.263(a)-3(j);

— Replacing a property unit component for which the taxpayer has properly deducted a loss;

— Replacing a property unit component for which the taxpayer has properly taken into account the component's adjusted basis in realizing gain or loss from its sale or exchange;

— Restoring a damaged property unit for which the taxpayer is required to take a basis adjustment as a result of a casualty loss;

— Returning a property unit to its ordinarily efficient operating condition where it has deteriorated to a state of disrepair and is no longer functional for its intended use;

— Adapting a property unit to a new or different use; and

— Repairing, maintaining or improving network assets under Treas.Reg. § 1.263(a)-3(e)(3)(iii). [See Treas.Reg. § 1.263(a)-3(i)(3)]

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b. [13:152.1] **Amounts paid to "improve" property:** Under the regulations, a building is "improved" if the amount paid (1) results in a "betterment" to the property; (2) "restores" the property; or (3) "adapts the [property] to a new or different use." [Treas.Reg. § 1.263(a)-3(j), (k), (*l*)]

(1) [13:152.2] **Betterments:** A taxpayer must capitalize the cost of a betterment. Under the regulations, a "betterment":

- Ameliorates a material condition or defect that either existed prior to the taxpayer's acquisition of the property unit or arose during production of the property unit, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production;

- Is a material addition to the property unit, including a physical enlargement, expansion, extension or addition of a major component;

- Is a material increase in the property unit's capacity (including additional cubic or linear space); *or*

- Is reasonably expected to materially increase the productivity, efficiency, strength, quality or output of the property unit. [Treas.Reg. § 1.263(a)-3(j)(1)]

(a) [13:152.3] **Example:** X owns a chain of retail stores. X periodically changes the layout and appearance of its stores (e.g., by reconfiguring them to better display merchandise). The amounts paid for updating the buildings are not treated as betterments and can be deducted currently even though X capitalized the cost of the work on its financial statements.

Comment: The expenditure undoubtedly increased the value of the stores and improved their appearance, but it did *not result in a material increase in capacity or quality and thus did not qualify as a "betterment."* [Treas.Reg. § 1.263(a)-3(j)(3), ex. 6]

(b) [13:152.4] **Expenditures required due to wear and tear, etc.:** If an expenditure is required due to normal wear and tear or damage that occurred during the taxpayer's use of the property, the determination of whether the expenditure results in a "betterment" is made by comparing the property's condition immediately after the expenditure with its condition *immediately prior to the circumstances necessitating the expenditure.* [Treas.Reg. § 1.263(a)-3(j)(2)(iv)]

1) [13:152.5] **Example:** X owns a building that it uses for its retail business. Over time, the waterproof membrane (top layer) on the roof wears out and the roof starts to leak. To fix the leak, X installs a new rubber membrane on the roof. The new membrane is comparable to the original membrane when it was placed on the roof. This is not considered a betterment. It is not an addition and it does not increase the capacity of the building. Moreover, it is not reasonably expected to materially increase the productivity, efficiency, strength, quality or output of the building when compared with the building's condition before the original membrane deteriorated. [Treas.Reg. § 1.263(a)-3(j)(3), ex. 13]

(2) [13:152.6] **Restoration:** A taxpayer must capitalize the cost of a restoration. Under the regulations, a restoration:

- Replaces a property unit component for which the taxpayer properly deducted a loss;

- Replaces a property unit component for which the taxpayer properly took into account the component's adjusted basis in realizing gain or loss resulting from its sale or exchange;

- Repairs damages for which the taxpayer properly took a casualty loss deduction;

- Returns the property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;

- Results in the rebuilding of the property to a like-new condition at the end of its class life; or

- Replaces a major component or a substantial structural part of the property unit. [Treas.Reg. § 1.263(a)-3(k)(1)]

(a) [13:152.7] **Example:** X owns a retail store and finds a leak in the roof. The sheathing and rafters have rotted and the entire roof must be replaced. Under these circumstances, the new roof is a "major component or substantial structural part" of the store. Thus, X is required to capitalize the amount paid to replace the roof. [Treas.Reg. § 1.263(a)-3(k)(7), ex. 14]

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(3) [13:152.8] **Adaptation to new or different use:** Taxpayers must capitalize any cost that "adapt[s] a unit of property to a new or different use." This occurs if "the adaptation is not consistent with the taxpayer's intended ordinary use of the unit of property at the time originally placed in service." [Treas.Reg. § 1.263(a)-3(l)(1)]

• [13:152.9] The cost of converting a factory to a showroom must be capitalized because the conversion results in a "new and different use." [Treas.Reg. § 1.263(a)-3(l)(3), ex. 1]

• [13:152.10] The cost of removing walls in a shopping center to enlarge the space needed by a new tenant need not be capitalized since the use (leasing for retail stores) remains the same. [Treas.Reg. § 1.263(a)-3(l)(3), ex. 2]

• [13:152.11] X repaints the interior walls and refinishes the hardwood floors of a shopping center in anticipation of its sale. The costs need not be capitalized because preparing the building for sale as a shopping center does not constitute a "new or different use." [Treas.Reg. § 1.263(a)-3(l)(3), ex. 3]

c. [13:153] **Unexpected repairs:** Some cases allow nonroutine, highly extraordinary items to be deducted as repairs, rather than capitalized as improvements, because they result from an unexpected problem. Thus, the expenditure merely returns the property to the same value it had before the problem arose, as opposed to making it more valuable. [See *Plainfield-Union Water Co. v. Commissioner* (1962) 39 TC 333, 338-339 (relining pipes damaged by acidic water is deductible); *Midland Empire Packing Co. v. Commissioner* (1950) 14 TC 635, 642, acq. 1950-2 CB 3 (oil proofing basement was deductible because expenditure served only to permit continued use of property for normal operations rather than prematurely closing plant)]

The regulations (¶ *13:150.1*) incorporate the above case analyses. If the unexpected event requires repairs and the post-repair property is neither adapted to a different use nor increased in capacity, the taxpayer will not need to capitalize the repair. [See Treas.Reg. § 1.263(a)-3(j)(3), ex. 12 (similar to *Midland Empire* facts)]

(1) [13:153.1] **Compare—items that initially should have been in place:** If the particular item should have been built into the structure in the first place, its cost probably must be capitalized even though it was installed in response to a later-arising problem or regulatory demand. [*Mt. Morris Drive-In Theatre Co. v. Commissioner* (6th Cir. 1956) 238 F2d 85, 86 (drainage system); *Hotel Sulgrave, Inc. v. Commissioner* (1954) 21 TC 619, 621 (sprinkler system)]

(a) [13:153.2] **"Betterments" under regulations:** The regulations (¶ *13:150.1*) treat the items described at ¶ 13:153.1 as betterments. Again, a betterment ameliorates a material condition or defect that existed *prior* to the taxpayer acquiring the subject property, regardless of whether the taxpayer was aware of the condition or defect at the time of acquisition (¶ *13:152.2*). [Treas.Reg. § 1.263(a)-3(j)(1)(i)]

[13:153.3] **Example:** X buys a store on land that contains underground gasoline storage tanks left by the prior occupants. The tanks have leaked, causing soil contamination. X's remediation costs must be capitalized. [Treas.Reg. § 1.263(a)-3(j)(3), ex. 1]

[13:153.4 - 13:153.5] ***Reserved.***

d. Environmental remediation

(1) [13:154] **Nonstatutory authority for environmental remediation deduction:** Under the general authority of the cases noted at ¶ 13:153 (unexpected major, nonroutine repairs), numerous rulings and cases have allowed deductions for certain *environmental clean-up costs* because the clean-up restores the property to the value it had before the problem arose (but does not otherwise significantly enhance the value of the property). [Rev.Rul. 94-38, 1994-1 CB 35]

The regulations (¶ *13:150.1*) endorse this approach—i.e., environmental clean-up costs would be deductible (*see* ¶ *13:152.2 and 13:153*).

(a) [13:154.1] **Removal of polluted soil; groundwater treatment expenditures:** The IRS has allowed a current deduction for the cost of removing polluted soil from the taxpayer's land. The pollution resulted from the taxpayer's own operations; and the removal was necessary to comply with environmental laws. The costs were deductible because the removal returned the property to the same state it was in before it was polluted and allowed the taxpayer to continue its manufacturing operations. [Rev.Rul. 94-38, supra (also allowing ongoing groundwater treatment expenditures other than those used to construct permanent treatment facility and monitoring costs as a current deduction)]

The regulations (¶ *13:150.1*) endorse the Rev.Rul. 94-38 approach (above). [See Treas.Reg. § 1.263(a)-3(l)(3), ex. 4—costs incurred for cleaning up land so it can be sold for residential subdivision are deductible by polluting taxpayer (but costs incurred for subdivision purposes must be capitalized)]

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1) [13:154.1a] **Compare—clean-up resulting from inventory production:** If the pollution arose from the operation of a manufacturing plant that produces inventory (i.e., property held for sale to customers in the ordinary course of business), the clean-up cost must be *capitalized* as part of the indirect costs of producing the inventory. [Rev.Rul. 2005-42, 2005-2 CB 67; Rev.Rul. 2004-18, 2004-1 CB 509]

(b) [13:154.2] **Replacement of underground storage tanks:** For the same reasons, costs incurred to replace underground storage tanks (USTs) containing waste by-products (including the cost of removing, cleaning, and disposing of the old USTs, and acquiring, installing and filling new USTs) are deductible as ordinary and necessary business expenses under IRC § 162. (The same rule would apply to storage tanks designed to store waste above ground.) [Rev.Rul. 98-25, 1998-1 CB 998]

Compare: Under the regulations, the cost to clean up soil contamination resulting from leaking USTs is considered a betterment regardless whether the taxpayer knew of the contamination at the time the land was acquired. Thus, the clean-up costs must be capitalized. [See Treas.Reg. § 1.263(a)-3(j)(3), ex. 1]

(c) [13:154.3] **Construction of groundwater treatment plan:** On the other hand, the taxpayer was required to *capitalize* costs incurred in constructing a treatment facility to clean up polluted groundwater. The IRS reasoned that the useful life of the plant would extend substantially beyond the end of the year in which it was built (¶ *13:152.1*). [Rev.Rul. 94-38, supra]

(d) [13:154.4] **Asbestos clean-up:** Expenses for asbestos removal and encapsulation are deductible "repairs" if they represent only a "small fraction" of the property's overall value and do not appreciably increase its value, substantially prolong its "useful life," or adapt it to a "new or different use." [*Cinergy Corp. v. United States* (Fed.Cl. 2003) 55 Fed.Cl. 489, 517, 91 AFTR2d 2003-1229]

Similarly, Tax Court dictum suggests that asbestos removal expense might be deductible if the job was done in *isolation* as opposed to being performed in conjunction with a general plan of rehabilitation of the building (*see* ¶ *13:156*). [*Norwest Corp. & Subsidiaries v. Commissioner* (1997) 108 TC 265, 280]

1) [13:154.5] **Asbestos remediation to permit new use:** The cost of environmental remediation must be *capitalized* if it allows the taxpayer to adapt the asset to a *new use*. [*Dominion Resources, Inc. v. United States* (4th Cir. 2000) 219 F3d 359, 370-372—cost to remove asbestos in land formerly but no longer used for electric generating plant must be capitalized where it permits property to be used for different purpose or sold for real estate development]

2) [13:154.5a] **Regulations view:** Under the regulations (¶ *13:150.1*), a taxpayer may deduct the cost of removing asbestos in a building and replacing it with new insulation that is safer, but no more efficient or effective, than asbestos insulation. [Treas.Reg. § 1.263(a)-3(j)(3), ex. 2]

(e) [13:154.6] **Pollution of taxpayer's former property?** It is unsettled whether a taxpayer can deduct the costs incurred in cleaning up property that it *formerly owned or operated*. Arguably, such costs should be deductible since they do not increase the value of any asset presently owned by the taxpayer. [See Priv.Ltr.Rul. 9627002—taxpayer that contaminated land, donated it to city and then reacquired it, allowed to deduct clean-up costs]

The rationale underlying Letter Ruling 9627002 (above) apparently has been adopted by the Court of Federal Claims. [See *Kerr-McGee Corp. v. United States* (Fed.Cl. 2007) 77 Fed.Cl. 309, 317-318—remediation of pollution caused by taxpayer during former period of ownership may be deductible after taxpayer reacquires property (but remediation of pollution caused by prior owner may not)]

(f) [13:154.7] **Pollution caused by prior owner:** Costs incurred by a taxpayer in remediating pollution caused by a *prior owner* must be *capitalized* rather than expensed. Such costs are treated as part of the property's purchase price, making Rev.Rul. 94-38 inapplicable. [*United Dairy Farmers, Inc. v. United States* (6th Cir. 2001) 267 F3d 510, 517; see also Treas.Reg. § 1.263(a)-3(j)(1)(i), (3), ex. 1; *and* ¶ *13:153.2 ff.*]

(2) [13:155] **Statutory authority for environmental remediation deduction:** A taxpayer may elect to deduct "qualified environmental remediation expenditures" paid or incurred prior to 2011. [IRC § 198(a), (h)]

This provision covers costs for abating or controlling hazardous substances at qualified contaminated sites where there has been a release, threatened release or disposal of a hazardous substance. To claim the deduction, a certificate from a state environmental agency is required. [IRC § 198(b)(1), (c)]

(Counsel should monitor legislative action for a possible extension of the deduction to expenditures paid or incurred after 2011.)

e. [13:156] **Rehabilitation:** Specific items of renovation (such as repainting) are deductible as repairs. When these items are incurred as part of a *general plan of rehabilitation* of a building, however, courts often find that they must be capitalized. [See *Moss v. Commissioner* (9th Cir. 1987) 831 F2d 833, 836—expenditure made as part of general plan of rehabilitation must be capitalized even though, standing alone, item may be classified as repair; *Norwest Corp. & Subsidiaries v. Commissioner* (1997) 108 TC 265, 284-285—asbestos removal capitalized because removal and building remodeling "part of one intertwined project, entailing a full-blown general plan of rehabilitation, linked by logistical and economic concerns"; Rev.Rul. 2001-4, 2001-1 CB 295—taxpayer required to capitalize otherwise deductible repair and maintenance expenses where taxpayer has "plan to make substantial capital improvements to property and the repairs are incidental to that plan"; and see generally, John W. Lee, Jr., "Deconstructing the General Plan of Rehabilitation Doctrine"(Nov. 11, 2002) 97 Tax Notes 803; Raby & Raby, "IRS Splits on 'General Plan of Renovation' Argument" (Aug. 4, 1997) 76 Tax Notes 669]

➪ [13:156a] ***CAUTION—REGULATIONS APPROACH*:** The regulations do *not* adopt the "plan of rehabilitation" doctrine described in the cases at ¶ 13:156. Instead, they provide that a taxpayer must capitalize both the direct costs of an improvement as well as the indirect costs that directly benefit or are incurred because of the improvement. Indirect costs, such as repair and maintenance costs, that "do not directly benefit and that are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are incurred at the same time as an improvement." [Treas.Decis. 9636, "Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property," Section VI.D.1 ("Costs Incurred During an Improvement")]

(1) [13:156.1] **"Facts and circumstances" test:** Whether a general plan of rehabilitation exists, and whether a particular repair or maintenance item is part of it, are questions of fact determined by the "surrounding facts and circumstances, including, but not limited to, the purpose, nature, extent, and value of the work done." [Rev.Rul. 2001-4, 2001-1 CB 295—"heavy maintenance visit" expenses incurred to make major *and* minor repairs to aircraft in order to prolong its use capitalized as part of general rehabilitation plan]

(2) [13:156.2] **Effect of *nonstructural improvements:*** Traditionally, the rehabilitation doctrine has been applied in cases involving "substantial capital improvements and repairs to the same specific asset, usually, a structure in a state of disrepair." Thus, applying the doctrine when the rehabilitation plan does *not involve any structural renovation* "marks a broad extension of [the] doctrine's historical scope." [*Moss v. Commissioner* (9th Cir. 1987) 831 F2d 833, 839-840 & fn. 12 (discussing cases)—fact taxpayer's hotel remodeling plan involved no structural improvements was "significant factor" weighing *against* applying rehabilitation doctrine]

(3) [13:156.3] **Effect of property's "suitability for intended use" during rehabilitation:** The fact that the property remains in good operating condition and is "suitable for its intended use" while being "rehabilitated" is *not dispositive* of whether the rehabilitation doctrine should be applied. However, that fact may show the rehabilitation plan is consistent with the kind of activities necessary to *maintain*, as opposed to improve, the property, thereby allowing expenses incurred pursuant to the plan to be deducted rather than capitalized. [*Moss v. Commissioner* (9th Cir. 1987) 831 F2d 833, 840-842—taxpayers properly deducted expenses incurred pursuant to hotel remodeling plan because plan consistent with type of repair expenses that hotel required to make to remain competitive and in first-class condition]

(4) [13:156.4] **Written plan not dispositive:** The fact that repair and maintenance expenses are incurred pursuant to an overall written plan will not automatically trigger the "rehabilitation doctrine" so as to require that the expenditures be capitalized. [*Moss v. Commissioner* (9th Cir. 1987) 831 F2d 833, 842—"mere existence of a written plan is not sufficient to trigger the rehabilitation doctrine"; Rev.Rul. 2001-4, 2001-1 CB 295]

(5) [13:156.5] **Application:** Taxpayers incurred repainting and repapering expenses as part of a general remodeling plan for replacing a hotel's carpets, drapes and furniture (but not modifying the hotel structure). During the remodel, the hotel enjoyed high ratings and remained in good operating condition. As such, the rehabilitation doctrine did *not* apply, and Taxpayers properly deducted the repainting and repapering expenses as ordinary and necessary repairs. [*Moss v. Commissioner* (9th Cir. 1987) 831 F2d 833, 840-843]

> "[I]t would be anomalous to require the taxpayers to depreciate normally deductible repairs over thirty years merely because the repairs were made in conjunction with the installation of furnishings having a three-to-five-year useful life." [*Moss v. Commissioner*, supra, 831 F2d at 842—"In applying the rehabilitation doctrine, the court must evaluate the taxpayers' expenditures in the context of the taxpayer's particular business enterprise"]

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(6) [13:157] **Compare—credit:** In certain cases, the taxpayer can take a credit for a percentage of rehabilitation costs. In the case of a certified historic structure, the credit is 20%. [IRC § 47(a)]

However, there are elaborate restrictions on these credits. Moreover, the government has successfully attacked several so-called "tax credit partnerships" involving private equity investors seeking to effectively purchase historic rehabilitation credits. [See *Historic Boardwalk Hall, LLC v. Commissioner* (3rd Cir. 2012) 694 F3d 425, 429; *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner* (4th Cir. 2011) 639 F3d 129, 132; and for further discussion, see Robinson, Federal Income Taxation of Real Estate ¶ 11.12 (6th ed. 1995 and current supp.)]

(a) [13:157.1] **Guidance for tax credit partnerships:** In the wake of *Historic Boardwalk* and other decisions (*¶ 13:157*), the IRS has issued guidance that provides a "safe harbor" for partnerships seeking to allocate rehabilitation tax credits. To qualify:

— the developer and investor must maintain a minimum interest in the partnership (1% and 5% respectively);

— the investor must contribute at least 20% of its total expected capital contributions unconditionally prior to the building being placed in service;

— the investor must maintain the above contribution throughout its ownership of the partnership interest; and

— at least 75% of the investor's total expected capital contributions must be fixed in amount, rather than contingent, before the building is placed in service. [See Rev.Proc. 2014-12, 2014-3 IRB 1 (also specifying permissible and impermissible guarantees that essentially prohibit funded guarantees); see also Breed & DeMartino, "Tax Credits: Historic Boardwalk Guidance, Recommended Practices" (2015) 147 Tax Notes at 1545; Elliott, "IRS Provides Historic Boardwalk Safe Harbor for Rehab Credits"(2014) 142 Tax Notes at 69]

(b) [13:157.2] **Treating lessee as owner for credit purposes:** If the lessor of rehabilitated property elects to treat the lessee as owner for purposes of the rehabilitation tax credit, the lessee must include ratably in gross income an amount equal to 100% of the credit determined under IRC § 47. [Chief Counsel Advice Memo 201505038]

[13:157.3 - 13:157.4] ***Reserved.***

f. [13:157.5] **ADA compliance improvements:** Improvements made to bring an existing building into compliance with the Americans with Disabilities Act (such as removal of barriers impeding access by disabled persons) may qualify for a tax credit (IRC § 44) or for expense treatment (IRC § 190). Normally, such outlays would have to be capitalized.

(1) Disabled access tax credit

(a) [13:157.6] **Qualifying business:** A business is eligible for the IRC § 44 disabled access tax credit if *either* (i) its gross receipts for the preceding taxable year did not exceed $1 million; *or* (ii) it did not employ more than 30 full-time employees during the preceding taxable year. [IRC § 44(b)(1)]

(b) [13:157.7] **Election required:** An eligible business (¶ 13:157.6) must *elect* the IRC § 44 credit for the taxable year. [IRC § 44(b)(2)]

(c) [13:157.8] **Amount of credit:** The amount of the disabled access credit is 50% of so much of the eligible access expenditures for the taxable year as exceed $250 but do not exceed $10,250. [IRC § 44(a)]

(2) [13:157.9] **Expense deduction for removal of barriers to the disabled:** Under IRC § 190, similar expenditures (for "qualified architectural and transportation barrier removal") of up to $15,000 per year can be deducted. [See IRC § 190(a), (b), (c)]

(3) [13:157.10] **Electing credit vs. deduction:** Of course, a taxpayer cannot claim both the IRC § 44 credit and the IRC § 190 deduction; nor can a taxpayer claim depreciation on an amount that qualified for either the credit or the deduction. [IRC § 44(d)(7)]

An election to take the credit vs. the deduction should be based on whichever treatment yields the most favorable tax consequences.

(a) [13:157.11] **Example:** T is an attorney who employed 10 people last year. T spent $12,000 to make bathrooms accessible to persons in wheelchairs. Normally, T would have to capitalize and depreciate the $12,000. Under IRC §

44, however, T can elect to take a $6,000 income tax credit for this outlay; the credit reduces T's taxes by $6,000. Alternatively, under IRC § 190, T can deduct the $12,000. T is in the 31% tax bracket and thus would save $3,720 by electing the deduction. T should take the credit, not the deduction.

4. [13:158] **Uniform Capitalization Rules:** Taxpayers constructing buildings for their own business use, or constructing or acquiring real property for resale, must *capitalize* rather than deduct costs relating to the construction. Items to be capitalized include direct labor and material costs, and also indirect costs allocable to the property. [IRC § 263A]

Thus, a taxpayer who constructs houses for resale must add various "overhead" costs to the basis of the houses rather than claiming these items as deductions. [See *Von-Lusk v. Commissioner* (1995) 104 TC 207, 213]

The capitalization rules cover costs incurred *before* as well as during the development period. [See *Von-Lusk v. Commissioner*, supra, 104 TC at 213—developer required to capitalize building permit costs even though construction had not yet begun; *Reichel v. Commissioner* (1999) 112 TC 14, 18-19—developer who purchased property with intent to develop required to capitalize real estate taxes paid *even if property never actually developed; Frontier Custom Builders, Inc. v. Commissioner* (5th Cir. 2015) 116 AFTR2d 2015-6146—developer required to capitalize sales, marketing and design elements on custom homes]

• [13:159] For example, repairs on building equipment, utilities relating to building equipment, wages of contract supervisors, and many other overhead items all must be capitalized. [IRC § 263A; Treas.Reg. § 1.263A-1(e)]

• [13:159.1] Property taxes must be capitalized if at the time the taxes are incurred it is "reasonably likely" the property subsequently will be developed. [Treas.Reg. § 1.263A-2(a)(3)(ii)]

• [13:160] Additionally, in some circumstances, interest costs incurred to finance production of the property, and allocable to the construction period, must be capitalized. [IRC § 263A(f); Treas.Reg. § 1.263A-8; see *Wasco Real Properties I, LLC v. Commissioner* (2016) TC Memo 2016-224 (requiring capitalization of interest costs incurred on land used to grow almond trees)]

(For a detailed treatment of the uniform capitalization rules, see Manolakas & Anderson, "Tax Factors in Real Estate Operations" 845-870 (Prentice Hall, 7th ed. 1990).)

5. [13:161] **Credits for Personal Residence Energy Efficiency Improvements:** The Code provides two different *credits* for taxpayers who incur expenditures to improve the energy efficiency of their personal residences. Taxpayers should claim the credits on IRC Form 5695. [See IRS FS-2024-15—Fact Sheet: Updates to Frequently Asked Questions about Energy Efficient Home Improvements and Residential Clean Energy Property Credits]

a. [13:161.1] **Energy efficient home improvement credit:** An individual is entitled to a credit for 30% of the amount paid for "qualified energy efficiency improvements" and "residential energy property expenditures" up to an annual limit of $1,200. An individual also is entitled to a credit for 30% of the amount paid for "home energy audits" up to an annual limit of $150.00. [IRC § 25C(a)(1)-(3), (b)(1), (6) & (e)]

The credit for "residential energy property expenditures" is capped at $600 for any "qualified energy property," such as any qualified electric, natural gas, propane, or oil furnace or hot water boiler, heat pump, heat pump water heater, or central air conditioner, biomass stove or boiler, or energy efficient improvement or replacement of a panelboard, sub-panelboard, branch circuit, feeder, or exterior window or skylight, and $250 for any exterior door up to a maximum of $500 for all exterior doors. [IRC § 25C(a)(2), (b)(2)-(5), (d)(2)]

The IRC § 25C credits expires on December 31, 2032. [IRC § 25C(i)(2)]

(1) [13:161.2] **Qualified energy efficiency improvements:** These improvements, which must meet various efficiency standards, are energy-efficient "building envelope components" for insulating buildings, doors, and windows. [IRC § 25C(c)]

(2) [13:161.3] **Residential energy property expenditures:** These expenditures, which must meet various efficiency standards, include qualified furnaces, heat pumps, stoves, boilers and central air conditioners. [IRC § 25C(d)]

b. [13:162] **Residential clean energy credit:** An individual is entitled to a credit for 30% of qualified solar, fuel cell, wind, geothermal and battery storage technology expenditures (but not to heat a swimming pool or hot tub) for property placed in service after December 31, 2016 and before January 1, 2020, 26% for property placed in service after December 31, 2019 and before January 1, 2022, 30% for property placed in service after December 31, 2021 and before January 1, 2033, 26%

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for property placed in service after December 31, 2032 and before January 1, 2034, and 22% for property placed in service after December 31, 2033 and before January 1, 2035. There is no limit on the amount subject to the credit (except in the case of fuel cells). This credit covers the cost of installation as well as materials, and only applies to property placed into service through 2034. [IRC § 25D]

(For further discussion regarding IRC §§ 25C & 25D tax credits, see IRS Notices 2013-70, 2013-47 IRB 1, "Q&A on Tax Credits for Sections 25C and 25D"; IRS News, "Energy Incentives for Individuals: Residential Property Updated Questions and Answers" (May 4, 2021), available at *www.irs.gov*)

[13:163 - 13:164] ***Reserved.***

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Chapter 13. Real Property Purchase and Sale Tax Concerns

Part II. Ownership of Real Property

D. Deduction for Interest

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e. [13:189] Election to capitalize

1. [13:165] **Deductibility Generally:** A taxpayer can deduct interest expense incurred in a *trade or business* or *for the production of income*. Interest expense on a taxpayer's "qualified residence" is also deductible. [IRC § 163]

However, as developed at ¶ 13:166 ff., interest deductions are subject to numerous restrictions.

2. [13:165.1] **Limitation on business interest:** As of 2018, the deduction for business interest payments is capped at the sum of the taxpayer's business interest income for the taxable year, 30% of the taxpayer's adjusted taxable income for the taxable year, and the floor plan financing interest for the taxable year. Disallowed interest may be carried forward and treated as business interest in the succeeding taxable year. [IRC § 163(j)(1), (2)]

For 2019 and 2020, subject to a "special rule" for partnerships, the cap on deductibility of business interest payments is raised to 50% of the taxpayer's adjusted taxable income. [IRC § 163(j)(10)(A)] A taxpayer also may use their adjusted taxable income for 2019, which may be greater than it is for 2020, for purposes of determining their business interest deduction limitation for 2020. [IRC § 163(j)(10)(B)]

a. [13:165.1a] **Small business exemption:** The limitation on business interest does not apply to a taxpayer with average annual gross receipts for the three-taxable-year period ending with the prior taxable year that does not exceed $25 million. [IRC §§ 163(j)(3), 448(c)]

b. [13:165.2] **Business interest defined:** The term "business interest" means any interest paid or accrued on indebtedness properly allocable to a trade or business. It does not include investment interest. [IRC § 163(j)(5)]

(1) [13:165.3] **"Electing real property trade or business" exception:** A person who pays or accrues interest allocable to "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business" may make an irrevocable election to be excluded from the limitation on business interest deductibility. This includes trades or businesses that manage or operate qualified residential living facilities that meet certain requirements. [IRC §§ 163(j)(7)(A)(ii), (B) & 469(c)(7)(C); IRS Notice 2020-59, 2020-40 IRB 782]

Because the temporary increase to 50% in the interest deduction cap may have affected some taxpayers' decisions about whether to make an election to be excluded from the limitation, the IRS is allowing taxpayers to make a late election or to apply to withdraw their otherwise irrevocable election. [Rev. Proc. 2020-22, 2020-18 IRB 745]

(a) [13:165.4] **Mandatory alternative depreciation system recovery periods:** The trade-off for making the election described at ¶ 13:165.3 is that the real property trade or business opting out of the limitation on the deduction for business interest (¶ 13:165.1) must use the alternative depreciation system's longer recovery periods to depreciate any of its nonresidential real property, residential rental property and qualified improvement property. [H.R. Rep. No. 115-466, at 367, n. 569; IRC § 168(g)(1)(F) & (8); see also Yauch, "Interest Expense Rules Require Holistic Look at TCJA Changes," 162 Tax Notes 1654 (2018)]

3. [13:166] **Definition of Interest:** "Interest" for tax purposes is given its ordinary meaning—i.e., an amount paid for the *use* of borrowed money. [*Deputy v. du Pont* (1940) 308 US 488, 498, 60 S.Ct. 363, 368]

By contrast, "interest" does *not* include payments to lenders for various *loan services*, such as title reports, appraisals, commitment fees, credit investigation and other processing expenses. Such items are treated as the cost of obtaining the loan and are *capitalized* along with other expenses incurred in obtaining the loan. If these service charges are trade, business or investment expenses, they can be amortized over the period of the loan; but if incurred in connection with a personal loan, they cannot be deducted. [Asimow, "The Interest Deduction"(1977) 24 UCLA L.Rev. 749, 764-767]

4. [13:167] **Timing of Interest Deduction:** Interest is deductible when paid (for a cash method taxpayer) or when incurred (for an accrual basis taxpayer). [IRC § 163(a); *James Bros. Coal Co. v. Commissioner* (1964) 41 TC 917, 921-922 (accrual of interest on straight-line basis); *Helvering v. Price* (1940) 309 US 409, 413, 60 S.Ct. 673, 675—giving promissory note not "payment" for cash basis taxpayer]

a. [13:168] **Payment by taxpayer:** Cash method taxpayers must actually pay the interest; amounts added to the principal of the loan by the lender are not considered paid. [*Cleaver v. Commissioner* (7th Cir. 1946) 158 F2d 342, 343-344; *Wilkerson v. Commissioner* (9th Cir. 1981) 655 F2d 980, 982—interest not paid by giving lender promissory note to pay at future

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date; *Smoker v. Commissioner,* TC Memo 2013-56; *Hargreaves v. Commissioner,* TC Summ.Opn. 2013-37—California homeowners who obtained negative amortization loan denied deduction for interest not paid even though it increased loan balance]

➪ [13:169] ***PRACTICE POINTER:*** To ensure deductibility, the taxpayer should actually write a check for interest to the lender, using funds derived from some source other than that same lender.

b. [13:170] **Limitation re prepaid interest:** *Prepaid* interest is not currently deductible; instead, it is treated as having been paid in the period to which it is allocable. [IRC § 461(g)(1); see *United States v. Clardy* (9th Cir. 1980) 612 F2d 1139, 1151-1152]

In some circumstances, interest represented by a loan discount (so called “original issue discount”) is amortized and deducted over the period of the loan. [See IRC § 163(e)]

(1) [13:171] **Exception for “points”:** “Points” paid with respect to a debt incurred in connection with the purchase or improvement of, and secured by, a principal residence can be currently deducted. [IRC § 461(g)(2); *see ¶ 13:58*]

5. [13:172] **Bona Fide Debt Requirement:** Interest is deductible only if paid with respect to a valid, enforceable, noncontingent indebtedness (which can be recourse or nonrecourse). [See *Estate of Franklin v. Commissioner* (9th Cir. 1976) 544 F2d 1045, 1049—debt must be existing, unconditional and legally enforceable obligation for payment of money; *BB&T Corp. v. United States* (4th Cir. 2008) 523 F3d 461, 475-477—money borrowed and immediately repaid to lender as part of “lease-in-lease-out” transaction creates no genuine debt and cannot support interest deduction]

Many cases have denied interest deductions because the transaction giving rise to the underlying debt lacked substance. [See, e.g., *Estate of Franklin v. Commissioner*, supra, 544 F2d at 1049; *Guardian Inv. Corp. v. Phinney* (5th Cir. 1958) 253 F2d 326, 329-330 (contingent debt)]

For example:

• [13:173] Corporations are frequently denied deductions for interest on debt owed to shareholders because the debt is considered to be equity rather than debt. [See, e.g., *Hardman v. United States* (9th Cir. 1987) 827 F2d 1409, 1411]

• [13:174] Family members are denied deductions for interest on debts owed to other family members where there was no intention to repay the debt. [See *Winter v. United States* (Cl.Ct. 1991) 23 Cl.Ct. 758, 760 (intrafamily interest-free demand loan)]

• [13:175] And interest deductions have been disallowed in a vast variety of “tax shelter” transactions, because the underlying transaction was not entered into for profit or lacked economic substance, or the amount of a nonrecourse debt exceeded the value of the property that secured the debt. [See, e.g., *Lukens v. Commissioner* (5th Cir. 1991) 945 F2d 92, 97-99; *Estate of Franklin v. Commissioner* (9th Cir. 1976) 544 F2d 1045, 1049]

6. [13:176] **Qualified Residence Interest (QRI):** For the most part, no deduction is allowed for interest incurred on personal debts. [IRC § 163(h)(1) & (2)] However, subject to specified limitations (¶ 13:178 ff.), taxpayers may deduct “qualified residence interest” (QRI). [IRC § 163(h)(2)(D), (3)]

QRI is interest incurred on “acquisition indebtedness” or “home equity indebtedness” with respect to a “qualified residence.” [IRC § 163(h)(3)]

a. Qualifying debt

(1) [13:177] **“Acquisition indebtedness”:** A debt is “acquisition indebtedness” if (a) incurred to acquire, construct or substantially improve a qualified residence *and* (b) secured by the residence. [IRC § 163(h)(3)(B)(i)]

(a) [13:178] **$1,000,000/$750,000 debt ceiling:** For debt incurred *before 12/16/17,* the aggregate amount treated as acquisition indebtedness cannot exceed $1,000,000 ($500,000 in the case of a married person filing a separate return). [IRC § 163(h)(3)(B)(ii); *Bronstein v. Commissioner* (2012) 138 TC 382, 387]

For debt incurred *after* 12/15/17 and *before* 1/1/26, the aggregate amount treated as acquisition indebtedness cannot exceed $750,000 ($375,000 in the case of a married person filing a separate return). [IRC § 163(h)(3)(F)(i)]

1) [13:178.1] **Per-house limitation:** Under the *express terms* of IRC § 163(h)(3), married couples filing joint returns who own a home together (whether as community property or in joint tenancy) may only deduct interest on $1,000,000/$750,000 of debt. And married couples filing separate returns who own a home together are limited to

each deducting interest on $500,000/$375,000 of debt on their individual returns. The statute, however, is silent as to how its debt limit provisions apply when two or more unmarried co-owners of a residence claim the home mortgage interest deduction.

The Ninth Circuit determined in a case of "first impression" that *domestic partners and other unmarried persons* who own a home together could each deduct interest on $1,000,000 of debt on their individual returns; thus, when there are two unmarried co-owners, there is an allowable aggregate deduction of interest on up to $2,000,000/ $1,500,000 of debt used to acquire the same residence. [See *Voss v. Commissioner* (9th Cir. 2015) 796 F3d 1051, 1057-1061—IRC § 163(h)(3)'s debt limits apply to unmarried co-owners on a *per-taxpayer* basis; see also AOD 2016-2, 2016-31 IRB 193 (acquiescing in *Voss* decision)]

a) [13:178.2] **Comment:** Prior to *Voss*, supra, the Tax Court and the IRS took the position that the limitation applied on a per-house basis, effectively barring unmarried individuals from each deducting interest on the maximum amount of debt. The Ninth Circuit acknowledged its interpretation of the mortgage deduction rule created a "marriage penalty," but noted, "Congress presumably allows the marriage penalty because the couple also receives offsetting benefits available only to married couples filing a joint return." [See *Voss v. Commissioner* (9th Cir. 2015) 796 F3d 1051, 1065]

(b) [13:179] **Refinancing:** If acquisition indebtedness is refinanced, the debt resulting from the refinancing is also treated as acquisition indebtedness up to the amount of the refinanced debt. However, points paid in connection with the refinancing transaction are not currently deductible. [IRC § 461(g)(1); *see ¶ 13:57*]

(2) [13:180] **"Home equity indebtedness":** "Home equity indebtedness" means any other debt secured by a qualified residence to the extent the aggregate amount does not exceed the fair market value of the residence reduced by the acquisition indebtedness with respect to the residence. [IRC § 163(h)(3)(C)(i)]

(a) [13:181] **$100,000 debt ceiling:** The aggregate amount of home equity indebtedness cannot exceed $100,000 ($50,000 in the case of a married person filing a separate return). [IRC § 163(h)(3)(C)(ii)]

However, acquisition indebtedness (*¶ 13:177*) that exceeds $1,000,000 can be treated as home equity indebtedness. [Rev.Rul. 2010-25, 2010-44 IRB 571] Thus, a taxpayer can deduct interest on acquisition debt up to $1,100,000.

As with "acquisition indebtedness" (*¶ 13:178.1*), IRC § 163(h)(3)'s "home equity" debt limits apply to unmarried co-owners on a per-taxpayer basis. [See *Voss v. Commissioner* (9th Cir. 2015) 796 F3d 1051, 1057]

(b) [13:181.1] **No deduction for certain home equity indebtedness from 2018 through 2025:** Under the 2017 Tax Act (Pub.L. 115-97), Congress eliminated the $100,000 home equity deduction (IRC § 163(h)(3)(F)(i)(I)). If, however, home equity indebtedness otherwise qualifies as acquisition indebtedness (e.g., debt incurred to substantially improve the taxpayer's home), interest paid on it still may be deductible, subject to the limits on the aggregate amount of debt that may be treated as acquisition indebtedness. [IRC § 163(h)(3)(B)(i)(I); see also IR-2018-32 ("Interest on Home Equity Loans Often Still Deductible Under New Law")]

b. [13:182] **"Qualified residence":** A "qualified residence" is the taxpayer's *principal residence and one other residence* selected by the taxpayer which is used as a residence (such as a vacation home). If a married couple does not file a joint return for the taxable year, each of them can take into account one residence, *unless* both individuals consent in writing to one individual taking into account the principal residence and one other residence. [IRC § 163(h)(4)(A); see also IRC § 280A(d)(1) (defining "used as a residence"); *McCarthy v. Commissioner*, TC Memo 2020-74—petitioner barred from claiming mortgage interest deductions for two properties because no record petitioner and his wife both consented in writing to petitioner claiming such deductions for more than one residence]

c. [13:182.1] **Qualified mortgage insurance:** Payments of qualified mortgage insurance premiums on acquisition indebtedness are deductible as qualified residence interest. [See IRC § 163(h)(3)(E)—deduction not applicable to insurance contracts made before January 1, 2007 or to payments made after December 31, 2021]

(1) [13:182.2] **Defined:** Qualified mortgage insurance means mortgage insurance provided by:

— Department of Veterans Affairs (VA);

— Federal Housing Administration (FHA);

— Rural Housing Service (RHS); or

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— Private mortgage insurance as defined in § 2 of the Homeowners Protection Act, 12 USC § 4901. [IRC § 163(h)(4)(E)]

(2) [13:182.3] **Treatment of prepaid mortgage insurance premiums:** If a taxpayer pays mortgage insurance premiums applicable to years after the year in which they are paid, the prepaid portion must be allocated to the future years to which they apply. [IRC § 163(h)(4)(F)] Generally, such amortization is over a seven-year period, or the remaining term of the mortgage, whichever is shorter. [Treas.Reg. § 1.163-11]

(3) [13:182.4] **Deductible amount phaseout:** The deductible amount is phased out at the rate of 10% for each $1,000 that adjusted gross income exceeds $100,000 ($50,000 for married persons filing separately). And, except for insurance provided by the VA or RHS, prepaid mortgage insurance premiums must be capitalized and amortized over the years for which the prepayment applies (or 84 months, whichever period is shorter). [See IRC § 163(h)(3)(E)(ii), (4)(F)]

d. [13:183] **Examples:** In 2018, T acquires Home as her principal residence for $400,000. She borrows $320,000 to make the purchase and the debt is secured by Home. All interest on the loan is deductible ("acquisition indebtedness," *¶ 13:177*).

T then acquires Skilodge and uses it for personal purposes. She pays $120,000 for Skilodge and borrows $90,000 of the purchase price. The interest on this loan is deductible (since T can designate one residence as a second home and her total acquisition indebtedness is less than $750,000).

In addition, T takes out a home equity loan for $30,000, secured by Home for the purpose of adding a room to Home. The interest on this loan also is deductible (¶ 13:181.1).

7. Other Restrictions on Interest Deductions

a. [13:184] **Interest from passive activities:** Interest on loans incurred to make investments in real estate rental properties normally are covered by the "at-risk" and "passive loss" rules. [IRC § 469] If the interest and other costs exceed the amount at risk or exceed the income from passive activities, none of those costs are currently deductible.

Cross-refer: For a discussion of the at-risk and passive loss rules, *see ¶ 13:230 ff.*

b. [13:185] **Uniform capitalization rules:** In some circumstances, interest incurred on loans allocable to construction of property and to the construction period must be capitalized as part of the cost of the property. [IRC § 263A, *¶ 13:158 ff.*; see Ichel & Kahen, "Proposed Regulations Issued Regarding Capitalization of Interest under Section 263A(f) of the Code"(1992) 20 J. of Real Est. Tax 197]

c. [13:186] **Tax-exempt or nonbusiness investment income:** Interest on debt incurred to purchase or carry tax-exempt bonds is not deductible. [IRC § 265(a)(2)]

Interest on debt incurred to purchase or carry nonbusiness investments (such as stock, bonds or raw land) is deductible only to the extent of nonbusiness investment income. [IRC § 163(d); see *Morley v. Commissioner* (1986) 87 TC 1206, 1211-1213—raw land held for sale is business, not investment, so interest is not investment interest; compare *Polakis v. Commissioner* (1988) 91 TC 660, 667-673—raw land held for investment, so interest is investment interest]

d. [13:187] **Tracing:** Because of the numerous rules restricting the deductibility of interest, the Regulations create elaborate tracing rules. In general, borrowed proceeds are traced into and out of bank accounts to the various uses of the funds and interest is then deductible based on those allocations. [See Treas.Reg. § 1.163-8T]

➪ [13:188] ***PRACTICE POINTER:*** It is advisable to maintain separate bank accounts for borrowed funds.

In this fashion, the borrowed funds can be readily traced into various uses which permit tax deductions and distinguished from uses as to which deductibility is restricted.

For example, borrowed funds which are to be used for the taxpayer's trade or business should not be mixed with funds used for passive activities.

e. [13:189] **Election to capitalize:** Taxpayers can elect to capitalize rather than deduct interest, taxes and other "carrying charges" on unproductive property. [IRC § 266]

[13:190 - 13:199] ***Reserved.***

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Cal. Prac. Guide Real Prop. Trans. Ch. 13(II)-E

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 13. Real Property
Purchase and Sale Tax Concerns

Part II. Ownership of Real Property

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1. [13:200] **Deductibility—In General:** State, local, and foreign real property taxes are deductible whether or not the subject property is held for profit. [IRC § 164(a)(1)]

Thus, real property taxes on a personal residence or vacation home are deductible. Likewise, real property taxes assessed on business or investment property are deductible, but *subject to* the "at-risk" and "passive loss" rules (*¶ 13:230 ff.*).

a. [13:200.1] **Deduction from adjusted gross income:** The property tax deduction is "below the line," meaning that it is deducted *from* adjusted gross income. A taxpayer who claims the standard deduction is not entitled to also claim below-the-line expenses. [IRC §§ 62(a), 63(c)]

b. [13:200.2] **Cap on aggregate deduction amount:** From 2018 through 2025, the aggregate amount of property, sales, and state and local income taxes that may be deducted on a federal return may not exceed $10,000 ($5,000 in the case of a married individual filing a separate return). [IRC § 164(b)(6)]

Comment: For taxpayers subject to California's top marginal income tax rates, this limitation negates much, if not all, of the value derived from deducting real property taxes on federal returns. Moreover, the Treasury has foreclosed attempts to locate a "work-around" to this limitation by permitting a deductible charitable contribution in exchange for a state or local tax credit. [See Reg. § 1.170A-1(h)(3)—charitable contribution deduction reduced by amount of state/local tax credit received]

c. [13:200.3] **What constitutes "real property tax":** There has been some confusion as to the nature of a "real property tax" for purposes of the IRC § 164 deduction. The 2011 instructions for the Form 1040 Schedule A Itemized Deductions stated real property taxes are only deductible "if the taxes are based on the assessed value of the property." This, however, contradicted at least one prior Chief Counsel Memorandum issued in 2003 regarding deductibility of California Mello-Roos taxes, and prompted the California Franchise Tax Board to seek clarification.

In a March 30, 2012 Chief Counsel Letter, the IRS concluded "[a]ssessments on real property owners, based other than on the assessed value of the property, may be deductible if they are levied for the general public welfare by a proper taxing authority at a like rate on owners of all properties in the taxing authority's jurisdiction, and if the assessments are not for local benefits (unless for maintenance or interest charges)." [Chief Counsel Letter, No. 2012-0018]

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The Franchise Tax Board subsequently announced it will make conforming changes to the California tax form instructions. [See "Franchise Tax Board Updates Guidance on Real Estate Tax Deductions," FTB Tax News Flashes, May 2012]

2. [13:201] **Sale Transactions—Allocation of Property Tax:** Where property is sold, real property taxes must be allocated on a daily basis throughout the "real property tax year" (meaning the period to which the tax imposed relates). Taxes allocated to days before the date on which title passes are deductible by the seller, even if paid by the purchaser. Taxes allocable to the day of sale and thereafter are deductible by the purchaser, even if paid by the seller. [IRC § 164(d)]

3. [13:202] **Capitalization of Special Assessments:** No deduction is allowed for taxes of a kind tending to increase the value of the property assessed (such as special assessments for street lighting). Such payments must be capitalized. [IRC § 164(c)(1); Treas.Reg. § 1.164-4]

4. [13:203] **Property Held for Development:** Similarly, the payment of real property taxes must be capitalized if at the time the taxes are incurred it is "reasonably likely" the property will subsequently be developed (¶ *13:159.1*).

5. [13:204] **Alternative Minimum Tax:** Many taxpayers are subject to the alternative minimum tax (AMT), which applies if it produces a higher tax than the regular income tax. Under the AMT, real property taxes on property held for personal use are *not* deductible (IRC § 56(b)(1)(A)(ii)). Consequently, for many taxpayers property taxes on their personal residence generate no tax benefit.

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Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 13. Real Property
Purchase and Sale Tax Concerns

Part II. Ownership of Real Property

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[13:205] Real estate investments frequently operate at a loss … meaning the various tax-deductible costs of operation (including interest, property taxes and depreciation) exceed the income from the property. The owners generally wish to deduct such losses against income from non-real estate sources. However, the Code contains a variety of restrictions on the deduction of operating losses against income from other sources.

1. [13:206] **Pass-Through of Partnership, LLC and S Corporation Losses—Basis Limitation on Deductibility:** Losses incurred by a partnership, a limited liability company (LLC) taxed as a partnership, or an S corporation flow through to the partners, LLC members or shareholders. [IRC §§ 702(a), 1366(a)] However, the ability to deduct the entity's losses is limited by the basis of the partner, LLC member or shareholder in the entity ("outside basis"). If "outside basis" is reduced to zero, the losses become nondeductible. [IRC §§ 704(d), 1366(d)(1)]

a. [13:207] **"Outside basis":** In a partnership, "outside basis" is increased by contributions of money or property to the partnership and by partnership profits. It is decreased by partnership losses and withdrawals. The same rules apply to the outside basis of S corporations. [IRC §§ 722, 705, 1367]

b. [13:208] **Increasing outside basis by partnership debts:** Outside partnership basis is increased by a partner's pro rata share of partnership liabilities. [IRC § 752(a); see Treas.Reg. § 1.752-2 (explaining how to allocate partnership debts between partners)] As a result, when a partnership takes on additional debt, each partner's outside basis increases and the partners can deduct a larger amount of partnership loss.

Caution: In the case of partner guarantees (including capital contribution obligations and deficit restoration obligations), the increase in outside basis only applies if the partner is obligated to make the full capital contribution or fully restore the deficit in the partner's capital account. [See Treas.Reg. 1.752-2(b)(3)(ii) (describing so-called "bottom dollar" obligations)]

(1) [13:209] **Compare—S corporations:** The same is not true of S corporations: The shareholders' outside basis does *not* increase by reason of corporate debts.

c. [13:210] **Deducting S corporation losses:** Although S corporation shareholders cannot increase outside basis by reason of corporate debts (¶ 13:209), they are permitted to deduct corporate losses against the basis of their stock and also of debts owed to them by the corporation. [IRC § 1366(d)(1); see also Clark, "A Survival Guide for Real Property in an S Corporation" (2013) 40 J. Real Est. Tax. 108]

(1) [13:211] **Basis from shareholder guarantees:** However, a stockholder does not acquire any basis simply by *guaranteeing* a corporate debt. In regard to guarantees, a shareholder acquires basis against which corporate losses may be deducted *only* when the shareholder *makes good* on the guarantee. [*Estate of Leavitt v. Commissioner* (4th Cir. 1989) 875 F2d 420, 422-423]

d. [13:212] **Suspension of losses:** Losses that are not deducted because the partner or shareholder exhausts outside basis are suspended and become deductible when outside basis rises above zero. [IRC §§ 704(d), 1366(d)(2)]

2. [13:213] **Hobby Losses—Profit Activity Limitation:** A taxpayer cannot deduct operating losses from any business or investment *unless* the activity was *engaged in for profit*. The taxpayer must establish by objective standards that they entered into or continued the activity with the purpose of making a profit. [IRC § 183; Treas.Reg. § 1.183-2; see also *Verrett v. Commissioner*, TC Memo 2012-223—no deductions allowed for construction business losses claimed by unlicensed taxpayer who had no profits in 17 years because, among other things, he primarily undertook uncompensated projects for his friends

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and church (losses also benefited taxpayer because they were used to offset his spouse's "substantial wage income from her medical practice")]

Making a profit must be the *primary or dominant purpose* of the activity. However, it is not necessary to prove that a reasonable person would expect a profit. [*Nickerson v. Commissioner* (7th Cir. 1983) 700 F2d 402, 404]

a. [13:214] **Example:** T owns and operates a farm that persistently loses money. T, who has substantial income from a profession other than farming, visits the farm only on weekends and employs a resident manager to run the farm. There are significant recreational benefits from ownership. T has no training or experience as a farmer and does not install modern farming methods. It will probably be held that T's primary purpose was not to make a profit; therefore, T's farming losses are not deductible.

b. [13:215] **Relevant factors in determining profit motive:** The Regulations list several factors to consider in deciding whether a taxpayer's objective was to make a profit as distinguished from other objectives (Treas.Reg. § 1.183-2(b); see *Whatley v. Commissioner*, TC Memo 2021-11—bank president and CEO who also ran farm side business with no formal business plan was not engaged in "farming for profit" based on § 1.183-2(b) factors):

(1) [13:216] Whether the activity is carried out in a business-like manner.

(2) [13:217] Expertise of the taxpayer or taxpayer's advisers.

(3) [13:218] Time and effort expended in carrying on the activity.

(4) [13:219] Expectation that assets may appreciate in value: An activity that produces annual losses might still be carried on for profit if an overall profit is expected from appreciation in the property.

(5) [13:220] Taxpayer's success in carrying on similar ventures.

(6) [13:221] History of income or losses with respect to the activity: A long history of losses is a powerful argument against the taxpayer. Conversely, if the taxpayer has made a profit in three of the last five years, the activity is presumed to be carried on for profit. [IRC § 183(c)]

(7) [13:222] Amount of occasional profits: An occasional small profit interrupting a long period of losses will not itself establish that an activity is carried on for profit. However, a *substantial*, though occasional, profit is a favorable factor.

(8) [13:223] Taxpayer's financial status: Substantial income from sources other than the activity tends to indicate the activity is not for profit … especially if substantial personal or recreational elements are involved in the activity.

(9) [13:224] Elements of personal pleasure or recreation tend to show the activity was not entered into for profit … although this factor is not dispositive if other factors point in a different direction.

c. [13:225] **Amount deductible for "hobby" activities:** If an activity is engaged in as a hobby, rather than as a trade or business, the owner can deduct any expenses that are normally deductible without regard to whether the activity is engaged in for profit (such as real property taxes). In addition, the owner can deduct an amount equal to the income from the property less the items referred to in the previous sentence. [IRC § 183(b)]

(1) [13:226] **Example:** T's farm has an income of $20,000. T pays property taxes of $6,000 on the farm. Other expenses and deductions total $34,000. T can deduct $6,000 plus $14,000 of the additional expenses.

(2) [13:227] **2% floor:** However, this deduction is considered a "miscellaneous itemized deduction," meaning that together with other such items it is deductible only to the extent the total exceeds 2% of the taxpayer's adjusted gross income. [IRC § 67]

d. [13:228] **Generic tax shelters:** Courts have disallowed tax deductions in a wide variety of transactions for which taxpayers sought deductions and credits in amounts that far exceeded their cash investments, where tax avoidance was obviously the primary purpose of the deal, the property was overvalued, and taxpayers sought leverage based on nonrecourse notes. Sometimes these cases are based on the absence of a profit motive under IRC § 183; sometimes on a holding that the taxpayer was not engaged in a trade or business; and, in other cases, because overvalued property does not give rise to depreciation or interest deductions. [See, e.g., *Rose v. Commissioner* (1987) 88 TC 386, aff'd (6th Cir. 1989) 868 F2d 851, 852-854 (declined to follow by *United States. v. Wexler* (3rd Cir. 1994) 31 F3d 117, 127)—lithographic plates used as tax shelter]

In any event, under current law, deductions generated by such activities would be precluded by the "at-risk" and "passive loss" rules discussed at ¶ 13:230 ff. [IRC §§ 469, 465]

[13:229] ***Reserved.***

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3. [13:230] **“At-Risk” Rules:** Loss from any business or investment activity is limited to the amount a taxpayer has “at risk” in the activity. The “at-risk” restriction applies to an individual (including the individual's losses passed through from an S corporation or a partnership or LLC taxed as a partnership) and to closely held C corporations (more than 50% of stock owned directly or indirectly by five or fewer individuals; see IRC § 542(a)(2)). [IRC § 465(a)]

(The at-risk rules are overviewed at ¶ 13:231 ff. For a thorough treatment of the subject, see IRS Pub. 925, “Passive Activity and At-Risk Rules.”)

a. [13:231] **Meaning of “at risk”:** The amount “at risk” means the amount of money and adjusted basis of property contributed to the activity. It also includes amounts borrowed for use in the activity to the extent the taxpayer is personally liable for repayment of the loan (a “recourse” loan). Alternatively, a taxpayer is at risk on a nonrecourse loan to the extent of property pledged as security for repayment of the loan if the property is not used in the activity. [IRC § 465(b)]

(1) [13:232] **Limitation—related party borrowing:** An amount is *not* “at risk” if borrowed from any person who has an interest in the activity or from a person related to someone who has an interest in the activity. [IRC § 465(b); Treas.Reg. § 1.465-8; see *Waddell v. Commissioner* (1986) 86 TC 848, 915, aff'd (9th Cir. 1988) 841 F2d 264, 266—borrower not at risk where creditor had profit participation; *Van Wyk v. Commissioner* (1999) 113 TC 440, 446—amount borrowed by S corporation shareholder from other shareholder and contributed to corporation not at risk]

(2) [13:233] **Limitation—protection against loss:** A taxpayer is *not* “at risk” with respect to amounts protected against loss through guarantees, stop loss agreements, or similar arrangements. [IRC § 465(b)(4); Prop.Regs. § 1.465-6; *Whitmire v. Commissioner* (9th Cir. 1999) 178 F3d 1050, 1054 & fn. 3]

(a) [13:233.1] **“Economic realities” test:** The IRC § 465(b)(4) exception is intended “to suspend at risk treatment where a transaction is structured—by whatever method—to remove any *realistic* possibility that the taxpayer will suffer an economic loss if the transaction turns out to be unprofitable.” [*Whitmire v. Commissioner* (9th Cir. 1999) 178 F3d 1050, 1054 (emphasis added; internal quotes and citation omitted)]

Consequently, in determining whether a IRC § 465(b)(4) arrangement exists, courts are guided by *economic realities* rather than “worst case scenarios.” “[A] mere theoretical possibility that a taxpayer will suffer loss is *insufficient* to avoid the exception.” [*Whitmire v. Commissioner*, supra, 178 F3d at 1054 (emphasis added; internal quotes and citation omitted)—remote contingencies presented no realistic risk of loss]

b. [13:234] **Qualified nonrecourse financing:** In the case of real estate investments, a taxpayer is at risk with respect to “qualified nonrecourse financing”—i.e., a nonrecourse loan secured by the property if the loan is from a “qualified person” or a government agency (or is guaranteed by a government agency). [IRC § 465(b)(6); see Kalinka, “Qualified Nonrecourse Financing Regulations Offer Guidance But Leave Unanswered Questions”(Oct. 1998) 76 Taxes 17]

A “qualified person” is any person actively and regularly engaged in the business of lending money and who is not the person from whom the taxpayer acquired the property. [IRC §§ 49(a)(1)(D)(iv), 465(b)(6)(D)] The qualified person can be a person related to the taxpayer, but only if the financing is commercially reasonable and on substantially the same terms as loans involving unrelated persons. [IRC § 465(b)(6)(D)(ii)]

c. [13:235] **Treatment of disallowed loss:** Losses disallowed under the at-risk rules can be deducted in a subsequent year when the amount at risk rises above zero. [IRC § 465(a)(2), (e)] The at-risk rules are applied before the “passive loss” rules; losses that survive the at-risk test may then be disallowed under the passive loss rules (¶ *13:240 ff.*).

d. [13:236] **Profit and loss adjustments to at-risk amount:** The amount at risk is increased by net income received from the activity but is reduced by withdrawals of money from the activity. [Prop.Regs. § 1.465-22(c)]

• [13:237] **Examples:** T and U are equal shareholders of S Co., an S corporation that purchases a rental house for $200,000. T and U each contributed $10,000 to S Co. S Co. makes a downpayment of $20,000 and borrows the remaining $180,000 nonrecourse from the seller of the house. T and U each have only $10,000 at risk; the $180,000 loan is not qualified nonrecourse financing (¶ *13:234*).

During the first year of ownership, S Co. loses $22,000 on renting the house. T and U can each deduct only $10,000; the remaining $2,000 is deductible only in the year that T's or U's amount at risk rises above zero (¶ *13:235*).

During the second year, S Co. earns net income of $6,000, which is not withdrawn from the corporation. This increases T's and U's amount at risk by $3,000 each. Consequently, in Year 2, T and U can each deduct the $1,000 of loss from Year 1 that was not previously deducted. Thereafter, T and U each have $2,000 at risk.

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[13:238 - 13:239] ***Reserved.***

4. [13:240] **"Passive Loss" Rules:** Aggregate loss from a "passive activity" can be deducted only against aggregate income from passive activities. [IRC § 469; *Beecher v. Commissioner* (9th Cir. 2007) 481 F3d 717, 721—§ 469 enacted to prevent taxpayers from applying losses from rental properties and other passive business activities to offset and shelter nonpassive income, such as wages]

(Key provisions of the passive loss rules are overviewed at ¶ 13:241 ff. For a comprehensive treatment of the subject, see IRS Publication 925, "Passive Activity and At-Risk Rules" (downloadable from the IRS website at *www.irs.gov*).)

a. [13:241] **Definition of "passive activity":** A "passive activity" is a trade or business in which a taxpayer does *not* "materially participate." [IRC § 469(c)(1)]

(1) [13:242] **"Material participation":** Generally, a taxpayer will be treated as "materially participating" in the trade or business only if the taxpayer is involved in operation of the activity on a *regular, continuous and substantial basis*. [IRC § 469(h)(1); Priv.Ltr.Rul. 200733023—intermittent management role insufficient]

(a) [13:242.1] **Regs.—"safe harbors":** The regulations provide various guidelines and "safe harbors" specifying what does and does not constitute "material participation." [See Treas.Reg. § 1.469-5T]

1) [13:242.2] **500-hour rule:** Participation in the activity for more than 500 hours per year is "material." [Treas.Reg. § 1.469-5T(a)(1); see *Ackerman v. Commissioner*, TC Memo 2009-80— taxpayer failed to prove he spent 500 hours working in investment consulting business (testimony of associates rejected; travel itineraries showed he was in town but did not prove he actually worked in business); *Assaf v. Commissioner*, TC Memo 2005-14—taxpayer satisfied material participation requirement by showing through exhibits and testimony that time spent on office leasing activities was about 1,340 hours/year; *Mordkin v. Commissioner*, TC Memo 1996-187—75-130 hours per year in managing ski facility meets neither the "regular, continuous, and substantial" test nor the 500-hour/year test]

2) [13:242.3] **Taxpayer does all/most of work rule:** A taxpayer "materially participates" in an activity if their participation constitutes substantially all the participation of all other individuals (including nonowners) for the taxable year. [Treas.Reg. § 1.469-5T(a)(2)]

3) [13:242.4] **100-hour rule:** A taxpayer "materially participates" if the taxpayer participates in an activity for more than 100 hours during the taxable year, and that participation is not less than the participation of any other individual (including nonowners) for the year. [Treas.Reg. § 1.469-5T(a)(3); see *Pohoski v. Commissioner*, TC Memo 1998-17—taxpayer's narrative summary of time spent in managing rental condo was sufficient to meet 100-hour test; *Bailey v. Commissioner*, TC Memo 2001-296—taxpayers failed to present evidence proving participation of management company did not exceed taxpayers' participation]

4) [13:242.5] **Significant participation rule:** A taxpayer "materially participates" in an activity if the taxpayer participates for more than 100 hours during the year and their aggregate participation in all such activities during the year exceeds 500 hours. [Treas.Reg. § 1.469-5T(a)(4), (c)]

5) [13:242.6] **Five-year rule:** A taxpayer "materially participates" by participating in an activity for any five taxable years, whether or not consecutive, during the 10 taxable years immediately preceding the subject taxable year. [Treas.Reg. § 1.469-5T(a)(5); see *Bailey v. Commissioner*, TC Memo 2001-296—taxpayers failed to present evidence of material participation for 5 of prior 10 years]

6) [13:242.7] **Three-year rule (personal service business):** A taxpayer "materially participates" in a personal service business if the taxpayer materially participates in the activity for any three taxable years preceding the taxable year. [Treas.Reg. § 1.469-5T(a)(6)]

7) [13:242.8] **"Facts and circumstances" test:** A taxpayer also is deemed to have "materially participated" when "based on all facts and circumstances," the taxpayer participated in the activity on a "regular, continuous, and substantial basis during such year." [Treas.Reg. § 1.469-5T(a)(7); see *Bailey v. Commissioner*, TC Memo 2001-296—taxpayers failed "facts and circumstances" test based on commission agreement with realty company to manage rental of purported business property]

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8) [13:242.9] **Limited partner rule:** Limited partners generally are not treated as material participants. [IRC § 469(h)(2)] However, the regulations permit limited partners to establish "material participation," but only if they meet the 500-hour, five-year or personal service three-year rules (¶ *13:242.6 ff.*). [Treas.Reg. § 1.469-5T(e)(2)]

a) [13:242.9a] **Compare—limited liability companies and partnerships:** Interests in limited liability companies (LLCs) and limited liability partnerships (LLPs) are treated as general partnerships for purposes of calculating "material participation." Thus, the narrower, limited partner rule (¶ *13:242.9*) does not apply to LLC or LLP members. [*Garnett v. Commissioner* (2009) 132 TC 368; *Thompson v. United States* (Fed.Cl. 2009) 87 Fed.Cl. 728, 734, 104 AFTR2d 2009-5381; *Newell v. Commissioner,* TC Memo 2010-23]

(b) [13:242.10] **Evidence of material participation:** To prove "material participation" under IRC § 469(h)(1), the taxpayer should maintain accurate and complete *contemporaneous* records of the time spent on the subject trade or activity. [See *Newhart v. Commissioner*, TC Memo 2001-289—taxpayer's noncontemporaneous logs of time spent on restaurant business disregarded because of inconsistencies and lack of information; see also *Merino v. Commissioner,* TC Memo 2013-167—"postevent reconstruction from memory" that is "less of an approximation and more of a ballpark guesstimate" cannot be used to prove "material participation"; *Bailey v. Commissioner*, TC Memo 2001-296 (same); Hamill, "How to Prove Material Participation" (2nd Quarter 2017) Real Estate Tax'n 112]

Contemporaneous records are not required, however, if the extent of participation can be shown by other "reasonable means," such as books, calendars or narrative summaries. [See *Montgomery v. Commissioner*, TC Memo 2013-151; *Assaf v. Commissioner,* TC Memo 2005-14]

(c) [13:242.11] **Trusts:** The sole means by which a trust can establish "material participation" in a business is for its *fiduciaries* (i.e., the trustees themselves) to be involved in the business operations on a regular, continuous and substantial basis. [See Priv.Ltr.Rul. 200733023—trustees' time spent merely negotiating sale of trust's interest in business and in connection with related tax dispute insufficient to establish material participation]

(2) [13:243] **Any rental activity:** Notwithstanding the general rule (¶ 13:241 ff.), *all rental activity* (including real estate rentals) is deemed a "passive activity" … regardless of how much time and effort the taxpayer devotes to it. [IRC § 469(c)(2) & (4); see *Kessler v. Commissioner*, TC Memo 2003-185—"Rental activities are presumptively passive activities, regardless of whether the taxpayer materially participates"]

(a) Exceptions

1) [13:243.1] **Seven-day rental:** Rental activity is *not* automatically treated as a passive activity if the average rental for the property does not exceed seven days. Instead, the general "material participation" rule applies (¶ *13:242*). [Treas.Reg. § 1.469.1T(e)(3); see *Bailey v. Commissioner*, TC Memo 2001-296—rental of lake property for less than 7 days average not passive activity; *Pohoski v. Commissioner*, TC Memo 1998-17—where taxpayer materially participated in management of vacation condo rented for average of 5 days, loss not passive]

2) [13:243.2] **30-day average rental and "significant personal services" provided by or for owner:** Rental activity is not treated as passive if the average rental period is 30 days or less, *and* "significant personal services" (as defined in Treas.Reg. § 1.469-1T(e)(3)(iv)) are provided by or on behalf of the property owner in connection with making the property available for rental. [Treas.Reg. § 1.469-1T(e)(3)(ii)(B)]

3) [13:243.3] **Rental incidental to "extraordinary personal services" provided by or for owner:** Property rental is not passive activity if it is *incidental* to "extraordinary personal services" provided by or on behalf of the property owner in connection with making the property available for rental. [Treas.Reg. § 1.469-1T(e)(3)(ii)(C), (v)]

• [13:243.4] Taxpayers' limited liability company leased space in its office building to attorneys, but also provided services to them, such as legal research, medical consulting, document filing, and the use of a library and secretarial staff. Testimony established that these services were the "crucial determinant" in the attorneys' choosing to lease in the building. Thus, the lease payments were principally for the *services* provided and not for the space leased, thereby qualifying Taxpayers for the "extraordinary personal services" exception. [*Assaf v. Commissioner*, TC Memo 2005-14]

• [13:243.4a] Students' use of a boarding school's dormitories is *incidental* to their receipt of educational services. Therefore, income received from renting the dormitories to the students is *not* passive income. [Treas.Reg. § 1.469-lT(e)(3)(v)]

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4) [13:243.5] **Rental incidental to nonrental activity:** Property rental that is incidental to *nonrental* activity of the taxpayer (as defined in Treas.Reg. § 1.469-1T(e)(3)(vi)) is not passive activity. [Treas.Reg. § 1.469-1T(e)(3)(ii)(D); see *Misko v. Commissioner*, TC Memo 2005-166—taxpayer satisfied requirements of exception; compare *Kessler v. Commissioner*, TC Memo 2003-185—taxpayers failed to meet exception's requirements]

5) [13:243.6] **Nonexclusive use during defined business hours:** Customarily making rental property available during defined business hours for nonexclusive use by various persons does not constitute passive activity. [Treas.Reg. § 1.469-1T(e)(3)(ii)(E)]

6) [13:243.7] **Taxpayer's nonrental trade or business activity:** Making rental property available for use in a *nonrental* activity conducted by a partnership, S corporation, or joint venture in which the *taxpayer owns an interest* is not passive rental activity. [Treas.Reg. § 1.469-1T(e)(3)(ii)(F), (vii)]

[13:243.8 - 13:243.9] ***Reserved.***

(b) [13:243.10] **"Self-rental" (or "recharacterization") rule:** Rental *income* is not passive if the property is rented for use in a trade or business activity in which the taxpayer *materially participates*, including rental to either an S or C corporation. [Treas.Reg. § 1.469-2(f)(6); *Beecher v. Commissioner* (9th Cir. 2007) 481 F3d 717, 721—in essence, when taxpayer rents property to own business, income is not passive activity income; *Krukowski v. Commissioner* (7th Cir. 2002) 279 F3d 547, 551; *Fransen v. United States* (5th Cir. 1999) 191 F3d 599, 601—applies to income taxpayer and spouse receive from C corporation of which taxpayer is sole shareholder]

The rental income is not passive in these circumstances even if the taxpayer has a "bona fide business purpose" for leasing the property to the trade or business. [*Beecher v. Commissioner*, supra, 481 F3d at 724]

However, any *loss* sustained by the taxpayer in renting property to a trade or business in which the taxpayer materially participated would be a passive loss. [See Fellows, Yuhas & Jewell, "Passive Activity Losses: Learning to Live with the Self-Rental Rule" (2008) 108 J. of Tax 16]

• [13:243.11] T owned buildings A and B, both of which were leased to businesses in which T materially participated. Rental from A produced income of $100, but rental from B produced a $60 loss. T properly treated the leasing activities of the buildings as a single "activity" (¶ 13:243.13). The $100 of income was *not* passive, but the $60 loss was. As such, T had no passive income against which the $60 loss could be offset, and the entire $100 income was taxable. T could *not* net the income and loss from the two activities to reduce his tax liability (i.e., subtract the $60 loss from the $100 of income for a net taxable income from nonpassive activity of $40). [*Carlos v. Commissioner* (2004) 123 TC 275, 280-283]

1) [13:243.12] **Exception—pre-2/19/88 written, binding contracts:** The "self-rental" rule does not apply to a written, binding contract entered into prior to February 19, 1988, *provided the contract is still binding under state law*. [See Treas.Reg. § 1.469-11(c)(1)(ii); *Samarasinghe v. Commissioner,* TC Memo 2012-23—H and W taxpayers could not offset their accumulated unused passive losses against rent paid by H for space in their commercial building where rental arrangement for years in question was "completely ad hoc" and no evidence showed original contract between H and W as landlord and H as tenant remained in effect under state law]

(c) [13:243.13] **Treatment of multiple rental activities as single "activity":** For purposes of the passive loss rules, multiple rental activities may be treated as a single activity if they constitute an "appropriate economic unit." [Treas.Reg. § 1.469-4(c)(1)]

Whether activities are an "appropriate economic unit" is determined on a case-by-case basis by any reasonable method. [Treas.Reg. § 1.469-4(c)(2); see also *Veriha v. Commissioner* (2012) 139 TC 45—taxpayer could not treat property leases as single activity where each was covered by separate agreement; *Senra v. Commissioner,* TC Memo 2009-79— taxpayer could not treat C corporation and LLC as single activity where corporation rented property from LLC]

[13:243.14] ***Reserved.***

(3) [13:243.15] **Special rule for "real estate professionals":** Taxpayers who qualify as "real estate professionals" under the Code can deduct losses without restriction by the passive loss rules. *See ¶ 13:257 ff.*

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(4) [13:243.16] **Special rule for "self-charged" transactions:** The passive activity rules do not apply in certain situations where the income to be offset against a passive activity loss is essentially a payment by the taxpayer to himself or herself. *See ¶ 13:258 ff.*

b. Examples

• [13:244] T, a doctor whose adjusted gross income is $300,000 per year, owns Black Arms, an apartment house. T is not a real estate professional (*see ¶ 13:257 ff.* re exception to passive loss limitations for real estate professionals). The various deductions attributable to this activity exceed income in Year 1 by $28,000. T has an amount at risk that exceeds $28,000. This is his only real estate investment, but he has stocks and bonds that produce net income of $40,000.

The $28,000 is passive loss and is not deductible against T's income from practicing medicine or against his income from stocks and bonds. The income from stocks and bonds is considered portfolio income, not passive income, and cannot be offset by the real estate losses.

• [13:244.1] T has $50,000 of passive losses from rental property and owns an interest in J Co., which is a profitable pass-through entity (a partnership, S Corp. or limited liability company). T's share of J Co.'s profits is $70,000. Now, the usual roles are reversed: T contends that he did *not* materially participate in J Co., so that it becomes a passive activity. If so, J Co. becomes a "passive income generator" (or PIG) and T's real estate losses can be offset against his share of J Co.'s profits. [See *Carlstedt v. Commissioner*, TC Memo 1997-331—T did not carry burden of proving he failed to render more than 500 hours of service to J Co.]

c. [13:245] **Taxpayers subject to passive loss rules:** The passive loss rules apply to individuals, estates and trusts, any closely held C corporation, or any personal service corporation. [IRC § 469(a)(2); see also IRC § 469(j)(1) & (2) (definitions), IRC § 469(c)(7)(D)(i) (applying "real estate professional" exemption from passive loss limitations (*¶ 13:257 ff.*) to C corporations if more than 50% of gross receipts are from real property trades or businesses in which corporation materially participates)]

In the case of partnerships or S corporations, the rules are applied on a partner-by-partner or shareholder-by-shareholder basis.

d. Treatment of disallowed loss

(1) [13:246] **Carryforward to passive income in future years:** A taxpayer's passive loss that exceeds passive income is not currently deductible. Such disallowed loss is "suspended"—i.e., it is *carried forward* and deducted against passive income (if any) in future years. [IRC § 469(b); see *Hillman v. I.R.S.* (4th Cir. 2001) 250 F3d 228, 233]

(2) [13:247] **Deduction upon fully taxable disposition of activity:** Ultimately, amounts of disallowed passive loss with respect to a particular passive activity that was not previously deductible are deducted at the time the taxpayer makes a fully taxable disposition of the activity. [IRC § 469(g)]

If the investment in the activity becomes totally worthless, it is treated as a fully taxable disposition in the year of worthlessness. [IRC § 469(g); see *Bilthouse v. United States* (7th Cir. 2009) 553 F3d 513, 518 (S corporation stock became worthless in year earlier than that claimed by taxpayer)]

(a) [13:248] **Definition of "activity":** A taxpayer may use any reasonable method of grouping several activities into a single activity, based on such factors as business similarities, common ownership and control, geographic location, and interdependencies. But, the taxpayer's method must be consistent from one year to the next absent a change in circumstances. [See Treas.Reg. § 1.469-4(c); *Brumbaugh v. Commissioner*, 2018-40 TC Memo—(denying taxpayers ability to group real estate business with aircraft chartering business since no functional similarity existed between businesses and they were not interdependent)]

If the taxpayer disposes of substantially all of an activity, suspended losses attributable to that part can be currently deducted if it is possible to allocate income and loss between the part sold and the part remaining. [Treas.Reg. § 1.469-4(g)]

(b) [13:248.1] **Grouping disclosure:** Taxpayers must file written statements with their tax return indicating that they intend to group or regroup certain activities together for purposes of measuring gain or loss under IRC § 469 or that they intend to add new activities to an existing grouping. [Reg. § 1.469-4(e); Rev. Proc. 2010-13, 2010-1 CB 329]

(3) [13:249] **Disposition by tax-free exchange:** Where passive activity property is exchanged for property in a tax-free (like-kind) exchange under IRC § 1031 (*see ¶ 13:304 ff.*), the taxpayer cannot deduct any portion of the suspended passive

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loss with respect to the property transferred in the exchange. [IRC § 469(g)(1)] Instead, the loss remains suspended until the taxpayer has passive income or until the taxpayer makes a fully taxable disposition of the new passive activity.

(E.g., if, in the example at ¶ *13:244*, T exchanges Black Arms for White Arms in a IRC § 1031 tax-free exchange, T cannot deduct any of the suspended passive loss with respect to Black Arms. The loss remains suspended until T has passive income or makes a fully taxable disposition of White Arms.)

(4) [13:250] **Disposition by death:** If the activity is transferred by reason of the taxpayer's death, the suspended losses are never deductible except to the extent they exceed the step-up in basis that occurs by reason of death. [IRC § 469(g)(2)]

• [13:251] **Example:** T owns Blackacre, which had a basis of $200. There were suspended passive losses of $80 with respect to Blackacre. T dies and bequeaths Blackacre to U. At the date of death, the value of Blackacre is $255. U's basis for Blackacre is $255. [IRC § 1014]

On T's final return, T can deduct only $25 of the suspended passive loss. Because Blackacre's basis was stepped up by $55, only the excess of the $80 suspended passive loss over $55 is deductible. [IRC § 469(g)(2)]

(5) [13:252] **Disposition by gift:** Where the taxpayer disposes of their passive activity interest by gift, the suspended passive losses are added to the basis of the property in the hands of the donee. They cannot be deducted in any taxable year. [IRC § 469(j)(6)]

Presumably, the same rule applies to property transferred between spouses or former spouses incident to divorce, since such transfers are treated as gifts (¶ *13:386*). [IRC § 1041(b)(1)]

• [13:253] **Example:** H and W own Blackacre as community property. H transfers his interest in Blackacre to W incident to their divorce. The basis of Blackacre in the hands of H and W was $200. The suspended passive loss with respect to Blackacre was $80. W retains her basis of $100 for her half of Blackacre and continues to hold $40 of the suspended passive loss in suspension. Her basis for the half acquired from H is $140. Even if W has passive income of $100, she can deduct only the $40 of suspended loss on her half—not the suspended loss on H's half. [IRC § 469(j)(6)]

e. Exceptions to passive loss rules

(1) [13:254] **$25,000 offset for certain rental real estate:** Notwithstanding the general passive loss rules (¶ 13:240 ff.), a taxpayer can deduct *up to $25,000* of passive loss from a *rental real estate* activity in which the taxpayer "*actively participates*," provided they own *at least 10%* of all interests in the activity. [IRC § 469(i)(1), (2) & (6); see *Madler v. Commissioner*, TC Memo 1998-112—"active participation" standard is met so long as taxpayer participates in significant and bona fide sense—i.e., by making management decisions or arranging for others to provide services such as repairs (test not met in *Madler* because third party conducted all management)]

(a) [13:255] **Phaseout:** However, the $25,000 figure is phased out at the rate of 50% of the amount by which the taxpayer's adjusted gross income exceeds $100,000. [IRC § 469(i)(3)]

For purposes of making the above calculation, adjusted gross income is *not* first reduced by passive losses. [*Moss v. Commissioner* (2010) 135 TC 365, 371-372]

(b) [13:256] **Example:** T and U each own a 50% interest in Black Arms, an apartment house. Black Arms loses $30,000 in Year 1. T's adjusted gross income is $220,000. T manages Black Arms. U's adjusted gross income is $120,000. U is inactive with respect to Black Arms. Neither T nor U has any passive income and neither is a real estate professional (*see* ¶ *13:257 ff.*).

Neither T nor U can deduct any portion of the loss from Black Arms. T actively participates in Black Arms but the available $25,000 deduction is completely phased out in T's case (¶ *13:255*). U would be able to deduct $15,000 (i.e., the $25,000 is reduced by $10,000—50% of the excess of AGI over $100,000) but U did not actively participate in the management of Black Arms (¶ *13:254*).

(2) [13:257] **Real estate professionals:** If the taxpayer falls under the special rule for real estate professionals, loss from a rental real estate activity in which the taxpayer materially participates can be deducted *without limitation by the passive loss rules.* [IRC § 469(c)(7); Treas.Reg. § 1.469-9; see also *Gragg v. United States* (9th Cir. 2016) 118 AFTR2d 2016-5364—real estate professional denied rental property loss deductions for failure to prove material participation; *Perez v. Commissioner*, TC Memo 2010-232—real estate professionals (including real estate brokers) must demonstrate material participation in rental activity to deduct losses; Barackman, "Real Estate Professionals—Passing the Test" (2016) 43 Real Est. Tax'n 173]

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A real estate professional is defined as a taxpayer who performs *more than 750 hours of services* during the taxable year in "real property trades or businesses" (¶ 13:257.4) in which the taxpayer *materially participates*. These services also must be more than one-half of the taxpayer's business services for the taxable year. [IRC § 469(c)(7)(B)(i) & (ii); see also Jenkins, "Section 469 Activity and Participation Conclusive Presumptions" (2016) 125 J. Tax'n 168]

(a) 750-hour requirement

1) [13:257.1] **Joint return—aggregation of spouses' hours not permitted:** On a joint return, real property trade or business services performed by the spouses cannot be combined. To be treated as a "real estate professional" under IRC § 469, one spouse individually must satisfy the 750-hour test. [IRC § 469(c)(7)(B); see *Harnett v. Commissioner,* TC Memo 2011-191—duties performed by taxpayer's wife and others while he was ill did not count for purposes of 750-hour requirement]

2) [13:257.2] **Services as employee:** Services performed as an employee do not count toward satisfaction of the 750-hour requirement unless the employee owns at least 5% of the employer's stock or more than a 5% partnership interest. [IRC § 469(c)(7)(D)(ii); *Pungot v. Commissioner*, TC Memo 2000-60—employed taxpayer not real estate professional because he did not own at least 5% of employer firm; see also *Stanley v. United States* (WD AR 2015) No. 5-14-cv-05236, 116 AFTR2d 2015-6766—employed taxpayer who owned 10% of employer firm was real estate professional even though he made no capital contribution and was obligated to return stock at end of his employment or within five years after disability or death]

Caution: The IRS has announced it will not acquiesce in *Stanley* (above); see AOD 2017-07.

3) [13:257.3] **C corporations:** Closely held corporations can meet the "real estate professional" test (and deduct their rental real estate losses) if more than 50% of the corporation's gross receipts are derived from real property trades or businesses. [IRC § 469(c)(7)(D)(i)]

4) [13:257.3a] **Evidence of time spent on real estate activity:** Evidence of the extent of the taxpayer's personal services on real estate activity may be established by any reasonable means. Daily time reports or logs are not necessarily required where there is other competent evidence, such as appointment books, calendars or narrative summaries. [Treas.Reg. § 1.469-5T(f)(4); see *Franco v. Commissioner*, TC Summ.Opn. 2018-9 (finding numerous receipts and email exchanges sufficient to corroborate taxpayer's testimony and rental activity log); Jurinski & Grinko, "Overcoming Proof Problems in Establishing 'Real Estate Professional Status'" (4th Quarter 2017) Real Estate Tax'n 4]

However, time records made *after the fact* are likely to be disregarded. [See *D'Avanzo v. United States* (Fed. Cl. 2005) 67 Fed.Cl. 39, 42-44, aff'd (Fed. Cir. 2007) 215 Fed.Appx. 996 (discussing cases)—Tax Court has uniformly disallowed post-event "ballpark guesstimates"; *Vandegrift v. Commissioner*, TC Memo 2012-14—taxpayer's claim of spending more than 750 hours per year on real estate activities deemed "suspect" given his employment in unrelated business and "lack of contemporaneous verification by records or other evidence"]

Similarly, time records must be accurate and not inflated or rounded up excessively. [See *Hairston v. Commissioner*, TC Memo 2019-104—inflated estimates for "trivial" tasks, such as paying mortgage or receiving rent, that were uniformly recorded as taking 1 hour, failed to satisfy 750-hour service requirement]

5) [13:257.3b] **"On-call" time:** Only the time spent *actually performing* real property services can be counted for purposes of the 750-hour requirement. Thus, "on-call" time during which the taxpayer was simply *available* to perform the services does *not* count. [*Moss v. Commissioner* (2010) 135 TC 365, 367-370]

6) [13:257.3c] **Sole participation in activity:** A taxpayer can establish material participation in the activity by showing their participation constituted substantially all of the participation in the activity by all individuals for the year. [Treas.Reg. § 1.469-5T(a)(2); see *Wilson v. Commissioner*, TC Memo 2012-101—taxpayers who contracted with one company to install their solar equipment, and another company to collect ratepayer monthly installments for using said equipment, failed to establish their participation was sole participation in micro-utility activity]

7) [13:257.3d] **Investor activities:** Hours spent on "investment activities" do not count toward the 750-hour requirement. Work done by an individual in their capacity as an "investor" includes (i) studying and reviewing financial statements or reports on the activity's operations; (ii) preparing or compiling summaries or analyses of the activity's finances or operations for the individual's own use; and (iii) monitoring the activity's finances or

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operations in a nonmanagerial capacity. [Reg. § 1.469-5T(f)(2)(ii); see *Antonyshyn v. Commissioner,* TC Memo 2018-169—real estate professional status denied where day-to-day management of taxpayer's rental properties was carried out by management companies rather than by taxpayer herself who performed only "nonmanagerial" activities (i.e., "investment-type activities"); compare *Birdsong v. Commissioner*, TC Memo 2018-148—although taxpayer occasionally hired contractors to perform tasks she could not complete herself (e.g., a handyman or plumber), real estate professional status granted where she was sole party actively involved in day-to-day management of rental properties]

(b) [13:257.4] **"Real property trades or businesses":** A "real property trade or business" within the meaning of IRC § 469 is any real estate development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business. [IRC § 469(c)(7)(C)]

While real estate agents are considered to be engaged in a "real property trade or business," mortgage brokers and other financial professionals are not. [Chief Counsel Advice Memo 201504010]

(c) [13:257.5] **Consolidation of rental real estate activities:** For purposes of IRC § 469(c)(7), a taxpayer must establish that they materially participated in *each* of the rental activities in which the taxpayer is engaged (¶ *13:242 ff.*). However, the taxpayer is permitted to elect to treat *all interests in rental real estate as a single activity*, including interests held as a limited partner. [IRC § 469(c)(7)(A); Treas.Reg. § 1.469-9(e); see also *Adeyemo v. Commissioner,* TC Memo 2014-1; Chief Counsel Advice Memo 201427016]

1) [13:257.6] **Properties rented for less than seven days *excluded:*** In electing to treat all interests in real estate rental activity as a single activity, the taxpayer cannot include properties rented for an average of seven days or less (*see* ¶ *13:243.1*). [*Bailey v. Commissioner*, TC Memo 2001-296—taxpayer's activity regarding property rented for average of less than 7 days excluded in determining taxpayer's status as "real estate professional"]

The above exclusion also means that time spent on such short-term rental activities is excluded for purposes of satisfying the 750-hour requirement (¶ *13:257 ff.*). [*Bailey v. Commissioner*, TC Summ.Opn. 2011-22; but see Castelli & Barnett, "Short-Term Rentals – Do They Count for Real Estate Professionals?" (1st Quarter 2024) Real Estate Tax'n 16 (arguing that although short-term rentals may not be considered "rental activities" under Treas.Reg. § 1.469-1T(e)(3), they should still come within the definition of real property rental, management, or operation for purposes of satisfying the 750-hour requirement)]

2) [13:257.7] **Election to treat all real estate interests as one activity:** The election to treat all real estate interests as one activity for purposes of IRC § 469(c)(7) must appear on the *original* return for the first year the taxpayer qualifies under that section. Merely combining the losses from several rental activities on the tax return does not constitute an election. [*Trask v. Commissioner*, TC Memo 2010-78; *Kosonen v. Commissioner*, TC Memo 2000-107; see Holo, "How to Avoid Section 469—All of It" (June 19, 2000) 87 Tax Notes 1665; Hausman, "Passive Activities and Real Estate Professionals" (2007) 34 J. Real Estate Tax 134]

The election must contain a declaration that the taxpayer is a § 469(c)(7) qualifying taxpayer. Thereafter, the election will apply to all subsequent years, including those in which the taxpayer is not a qualifying taxpayer. [Treas.Reg. § 1.469-9(g)(3)]

a) [13:257.8] **Revocation of election:** The election can be revoked if the taxpayer experiences a material change of circumstances. The revocation is in the form of a declaration stating the taxpayer's intention to revoke the election and explaining the material change of circumstances. [Treas.Reg. § 1.469-9(g)(3)]

3) [13:257.9] **Election to treat all real estate interests as one activity on amended return:** The election to treat all real estate interests as one activity may be made on an *amended return* if the taxpayer filed returns consistently with having made that election on the return for the year in which the taxpayer qualified under IRC § 469(c)(7) and on subsequent returns. The taxpayer must establish that they acted reasonably and in good faith in failing to make the election on the original return (e.g., taxpayer relied on a qualified tax professional who failed to make the election or advise the taxpayer that it should have been made). [Rev.Proc. 2011-34, 2011-24 IRB 875]

a) [13:257.10] **Procedure:** The election must state at the top, "FILED PURSUANT TO REV. PROC. 2011-34." It also must explain why the taxpayer had reasonable cause for failing to make the election on the original return, and it must be accompanied by a dated declaration, signed by the taxpayer, stating, "[U]nder penalties of perjury I (we) declare that I (we) have examined this election, including any accompanying documents, and, to the best of

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my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete." [Rev.Proc. 2011-34, 2011-24 IRB 875]

As with any declaration, the individual(s) who sign(s) must have personal knowledge of the facts and circumstances related to the election. [Rev.Proc. 2011-34, 2011-24 IRB 875] Indeed, unless the taxpayer complies with all the foregoing requirements, the IRS will not accept an election on an amended return. [*Trask v. Commissioner,* TC Memo 2010-78—election must appear clearly on original return, *not* on document handed to IRS at later time]

(3) [13:258] **"Self-charged" transactions:** In a so-called "self-charged" transaction, the taxpayer is essentially both the payor and recipient of an expense/income item. Here, the passive loss rules may produce inequitable results depending on the nature of the "self-charged" item.

Example: S Corp. owns and leases apartments. T is the sole shareholder of S Corp. T loans $100,000 to S Corp., and also manages S Corp.'s business for an annual $10,000 management fee. In year 1, S Corp. pays T $5,000 interest on the loan and $10,000 for the annual management fee. S Corp. has a net loss in year 1 of $35,000 (including the $5,000 interest payment and the $10,000 management fee).

(a) [13:258.1] **Interest:** In a lending transaction between a taxpayer and a passthrough entity in which the taxpayer owns a direct or indirect interest (e.g., partnership, limited liability company or S corporation), the taxpayer's self-charged *interest income* and the passthrough entity's *interest deduction* offset each other. [Treas.Reg. § 1.469-7]

Therefore, in the example at ¶ 13:258, T's $5,000 interest income would be *offset* by T's $5,000 interest loss flowing to him from S Corp. The result would be an economic and taxable "wash" to T with respect to the interest received and paid on the loan.

(b) [13:258.2] **Other "self-charged" items:** So far, the Treasury has only adopted regulations treating self-charged interest as passive income where the taxpayer receives interest from a passthrough entity. Therefore, other self-charged income, such as *management fees*, *cannot* be treated as passive income and offset against passive losses. [*Hillman v. I.R.S.* (4th Cir. 2001) 250 F3d 228, 232; Melone, "Self-Charged Items in Light of Hillman" (2002) 29 J. Real Est. Tax 71; Raby & Raby, "Generating Income by Doing Business with Yourself"(May 7, 2001) 91 Tax Notes 957]

Accordingly, in the example at ¶ *13:258*, T *cannot deduct* the $10,000 management fee loss flowing to T from S Corp. because it is a *passive loss*. However, T *must include* the $10,000 management fee in income. As a result, a transaction that is economically a "wash" produces *negative* tax consequences.

[13:258.3 - 13:258.10] ***Reserved.***

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Chapter 13. Real Property Purchase and Sale Tax Concerns

Part II. Ownership of Real Property

G. Deduction for Qualified Business Income

1. [13:258.11] Generally
2. [13:258.12] "Qualified Business Income"
3. [13:258.13] "Qualified Trade or Business"
    a. [13:258.14] "Specified service trade or business"
    b. [13:258.15] Compare—income below threshold amount
    c. [13:258.16] Phaseout
    d. [13:258.16a] Rental property owners
        (1) [13:258.16b] Rental services
4. [13:258.17] Qualified REIT dividends

1. [13:258.11] **Generally:** Taxpayers other than corporations may deduct an amount equal to:

• the lesser of up to 20% of their "qualified business income";

• the greater of 50% of the W-2 wages with respect to a "qualified trade or business"; *or*

• 25% of the W-2 wages plus 2.5% of the original purchase price immediately after acquisition of all qualified property, defined generally as the tangible, depreciable property used in the business. [See IRC § 199A(a), (b)(2)]
Comment: The above provision was prompted by the reduction in the corporate rate from 35% to 21%. It effectively reduced the marginal rate on qualified business income from 37% to 29.6% for taxpayers subject to the top marginal rate who are operating in noncorporate form. See Abdo-Gomez, "Navigating the New Deduction for Qualified Business Income"(2018) 158 Tax Notes 1627.

2. [13:258.12] **"Qualified Business Income":** To be deductible, the income must be effectively connected with the conduct of a qualified U.S. trade or business and be included or allowed in determining taxable income for the taxable year. Reasonable compensation for services rendered by the taxpayer is excluded. [See IRC § 199A(c)(3)(A), (4)]

3. [13:258.13] **"Qualified Trade or Business":** Not every trade or business is eligible for the deduction. Indeed, a "specified service trade or business" (¶ 13:258.14) and the trade or business of performing services as an employee are excluded. This is so because the deduction is designed to roughly equalize the burden on corporate and noncorporate businesses and *not* to reduce the income tax rate on individual compensation on earned income. [See IRC § 199A(d)]

a. [13:258.14] **"Specified service trade or business":** A "specified service trade or business" is a "trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees [or owners]." [IRC §§ 199A(d)(2)(A) & 1202(e)(3)(A)]

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A "specified service trade or business" also includes a trade or business that "involves the performance of services that consist of investing and investment management, trading, or dealing in securities …, partnership interests, or commodities" as defined. [IRC § 199A(d)(2)(B)]

b. [13:258.15] **Compare—income below threshold amount:** For taxpayers with income below $315,000 on a joint return ($157,000 in the case of single filers), the "specified service trade or business" limitation based on the field of activity does *not* apply. (Nonetheless, the income of these taxpayers still is excluded if based on the investing or management of investments exclusion; *see ¶ 13:258.14*.) [IRC § 199A(d)(3)(A)]

c. [13:258.16] **Phaseout:** For taxpayers with income above $315,000 but below $415,000 on a joint return (above $157,500 but below $207,000 for single filers), the deduction amount is phased out. [See IRC § 199A(d)(3)(B)]

d. [13:258.16a] **Rental property owners:** It is not always clear when owners of rental property are a qualified "trade or business." To provide clarity, the IRS created the following safe harbor (Rev. Proc. 2019-38, 2019-42 IRB 942):

- For rental real estate enterprises in existence less than four years, the owner (or employees, agents, and/or independent contractors of the owner) must perform at least 250 hours of "rental services" per year;

- If the rental real estate enterprise has been in existence for four years or more, the 250 hours of rental services must be performed in any three of the five consecutive years that end with the current taxable year.

(1) [13:258.16b] **Rental services:** Under the safe harbor (¶ 13:258.16a), "rental services" are defined to include (i) advertising to rent or lease real estate; (ii) negotiating and executing leases; (iii) verifying information contained in prospective tenant applications; (iv) collecting rent; (v) daily operation, maintenance, and repair of property, including purchasing materials and supplies; (vi) managing real estate; and (vii) supervising employees and independent contractors. [Rev. Proc. 2019-38, 2019-42 IRB 942]

Compare: The term "rental services" *does not* include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; improving property under Treas.Reg. § 1.263(a)-3(d); or hours spent traveling to and from the real estate. [Rev. Proc. 2019-38, 2019-42 IRB 942]

4. [13:258.17] **Qualified REIT dividends:** In addition to the deduction for qualified business income (¶ 13:258.11 ff.), taxpayers may deduct 20% of the aggregate amount of qualified REIT dividends, or REIT dividends not eligible for taxation at capital gains rates, either individually or as qualified dividend income. [See IRC § 199A(b)(1)(B), (e)(3)]

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Chapter 13. Real Property Purchase and Sale Tax Concerns

Part II. Ownership of Real Property

H. Allocation of Deductions Between Co-Owners and Partners

1. [13:259] Preliminary Determination—Co-Ownership vs. Partnership
   - a. [13:259.1] When co-ownership treated as partnership
     - (1) Examples
   - b. [13:259.4] Conditions for obtaining private letter ruling on co-ownership
2. [13:260] Co-Ownership
3. [13:262] Partnerships
   - a. [13:263] “Substantial economic effect”

1. [13:259] **Preliminary Determination—Co-Ownership vs. Partnership:** Whether taxpayers own property as co-owners (cotenants) or partners is significant for tax purposes. When the property is owned by a partnership, the complex partnership taxation rules apply, including the partners' entitlement to specially allocate income or expense items (*see ¶ 13:262*), the requirement of filing a partnership tax return, and the unavailability of IRC § 1031 treatment of partnership interests (¶ 13:309.1). [See generally, Borden, Favelukes & Molz, “A History and Analysis of the Co-Ownership-Partnership Question” (March 7, 2005) 106 Tax Notes 1175]

a. [13:259.1] **When co-ownership treated as partnership:** Taxpayers considering themselves co-owners rather than partners may nonetheless be taxed as partners. Whether the co-ownership is considered a partnership for tax purposes depends on whether the co-owners actively conduct a trade, business, financial operation, or venture and divide any profits generated thereby. [Treas.Reg. § 301.7701-1(a)(2)]

(1) Examples

• [13:259.2] When cotenants own an apartment building and provide only customary service to renters, such as utilities and repairs, the cotenancy is *not* treated as a partnership. But if the cotenants or their agents provide additional services, such as valet parking, cleaning services or meals, the cotenancy may be treated as a partnership. [Rev.Rul. 75-374, 1975-2 CB 261]

• [13:259.3] Taxpayers entered into a subscription agreement whereby they acquired tenancy in common interests in certain computer equipment. Each taxpayer claimed losses and deducted depreciation expenses arising from their co-ownership interest in the equipment. For tax purposes, the taxpayers were treated as partners because they were acting together in a long-term venture to finance, lease and remarket the equipment, they were restricted in their ability to sell their interests, and the manager of the venture had an interest in its profits and losses. [*Bergford v. Commissioner* (9th Cir. 1993) 12 F3d 166, 169-170]

b. [13:259.4] **Conditions for obtaining private letter ruling on co-ownership:** The Service will consider a request for a private letter ruling that an “undivided fractional interest” in rental property is a cotenancy rather than a partnership provided the following conditions are satisfied (Rev.Proc. 2002-22, 2002-1 CB 733):

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- *Title:* The co-owners must hold title to the property as *tenants in common*.
- *Number of co-owners:* The number of co-owners may *not exceed 35*. A husband and wife are treated as a single person, and all persons who acquire interests from a co-owner by inheritance are treated as a single person.
- *Treatment of entity:* The co-ownership may not file a partnership or corporate tax return, or otherwise hold itself out as a partnership or other form of business entity. The Service generally will not issue a ruling under this procedure if the co-owners held interests in the property through a partnership or corporation *immediately prior* to the co-ownership's formation.
- *Co-ownership agreement:* A limited co-ownership agreement running with the land (i.e., an agreement that a co-owner must offer their co-ownership interest for sale to the other co-owners at fair market value before exercising a right to partition, or that certain actions on behalf of the co-ownership must be approved by the co-owners holding more than 50% of the interests in the property) does *not* preclude a ruling under this procedure.
- *Approvals:* Co-owners must approve *unanimously* the hiring of any manager, sale, lease, or other disposition of the property, or the creation or modification of a blanket lien on the property. For all *other* actions, the co-owners may agree that approval by only those holding more than 50% of the interests in the property is required.
- *Alienation restrictions:* Each co-owner must have the right to transfer, partition and encumber their interest without the approval of any person. However, restrictions on these rights required by a lender that are consistent with customary commercial lending practices are not prohibited.
- *Sharing sale proceeds:* If the property is sold, after paying off any debt secured by a blanket lien on the property, the remaining proceeds must be distributed to the co-owners.
- *Proportionate sharing of revenue and expenses:* Each co-owner must share in all revenues generated by the property and costs associated with the property in proportion to their interest. Funds may not be advanced to a co-owner to meet expenses unless the advance is recourse *and* is not for a period exceeding 31 days.
- *Proportionate debt sharing:* Co-owners must share in any debt secured by a blanket lien on the property in proportion to their interests.
- *Issuing and selling options:* A co-owner may issue an option to *purchase* their interest provided the price for exercising the option reflects the property's fair market value when the option is exercised. But a co-owner may not acquire an option to *sell* their interest to the co-ownership's “sponsor,” lessee, another co-owner, or the lender, or anyone related to such persons and/or entities.
- *Co-owners' maintenance and repair activities:* The co-owners' activities must be *limited* to those customarily performed in connection with the *maintenance and repair of rental property*. In determining whether the co-owners' activities are so limited, all activities of the co-owners, their agents and any persons related to the co-owners with respect to the property are considered. *See ¶ 13:259.2*.
- *Annually renewable management and brokerage agreements:* Co-owners may enter into management or brokerage agreements with an agent (who may be the sponsor or a co-owner or any person related thereto, but *not* a lessee) so long as the agreements are renewable no less frequently than annually. Any such management agreement may authorize its manager to maintain a common bank account to collect revenues generated by the co-ownership and pay the co-ownership's expenses. Fees paid to the manager may *not* depend on the income or profits derived from the property and may *not* exceed the fair market value of the manager's services.

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- *"Bona fide" lease agreements:* All agreements for leasing the property must be "bona fide leases" for federal tax purposes. As such, rents paid under any such agreements must reflect the property's fair market value and may not depend on the income or profits derived by the property.

- *Unrelated lenders:* A lender with respect to any debt encumbering or incurred to acquire an interest in the property may *not* be related to any co-owner, the sponsor, the manager or any lessee of the property.

- *Sponsor payments:* Fees paid to the sponsor, either to acquire an interest in the property or for services, must reflect the fair market value of the acquired interest or services rendered, and may *not* depend on the income or profits derived from the property. [Rev.Proc. 2002-22, 2002-1 CB 733; see Borden, Favelukes & Molz, "A History and Analysis of the Co-Ownership-Partnership Question" (March 7, 2005) 106 Tax Notes 1175; Lipton, "The 'State of the Art' in Like-Kind Exchanges, Revisited" (2003) 98 J. of Tax. 334, 345-350; Witner, "Jointly Owned Rental Real Property: Tenants in Common or Separate Entity"(August 2003) 81 Taxes 49; Carman, "The Increasing Tension Between Tenancies in Common, Tax Shelters, REITS, and Legitimate Investment Partnerships" (2002) 30 Real Estate Taxation 4]

2. [13:260] **Co-Ownership:** In the case of *tenancy in common* property, deductions are apportioned in accordance with the ownership interests in the property, regardless of which co-owner makes the payments. However, in the case of *joint tenancy* property, whichever taxpayer makes the payment is entitled to the deduction. [Rev.Rul. 62-39, 1962-1 CB 17; Rev.Rul. 62-38, 1962-1 CB 15]

- [13:261] **Example:** T and U, brother and sister, own Blackacre as equal tenants in common. The interest payments on a loan secured by Blackacre are $2,000 per year and T makes the entire payment. T can deduct $1,000 as interest (assuming all requirements for interest deductions are met). The other $1,000 is treated as if T transferred $1,000 to U and U paid the $1,000 to the lender. [Rev.Rul. 62-39, 1962-1 CB 17] Thus, U can deduct her half of the interest even though she did not pay it. Presumably, T's hypothetical transfer of $1,000 to U is not taxable to U because it was a gift. [IRC § 102]

  Compare: If T and U held the property as joint tenants, T could deduct the entire $2,000 as interest. [Rev.Rul. 62-38, 1962-1 CB 15]

3. [13:262] **Partnerships:** Normally, the income and deductions passed through from a partnership to the partners are reflected on each partner's individual returns in accordance with their respective profit and loss shares under the partnership agreement. However, taxpayers are entitled to specially allocate any item of income or deduction, provided the special allocation has "substantial economic effect" (¶ 13:263). [IRC § 704(b)]

   a. [13:263] **"Substantial economic effect":** "Substantial economic effect" generally means the allocation has an economic effect *other than a tax effect*. In other words, the allocation must be fully reflected in the capital accounts. [Treas.Reg. § 1.704-1(b)(1)]

   ➪ [13:264] ***PRACTICE POINTER:*** This major and complex subject is beyond the scope of this Practice Guide. Before drafting partnership agreements with special allocations, counsel should consult the Regulations and the many excellent treatments of the subject. [See Treas.Reg. § 1.704-1; McKee, Nelson & Whitmire, "Federal Taxation of Partnerships and Partners," Ch. 10 (3d ed. 1997 and current supp.); Willis, Pennell, & Postlewaite, "Partnership Taxation," Part 10 (6th ed. 1997 and current supp.)]

[13:265 - 13:269] ***Reserved.***

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Chapter 13. Real Property Purchase and Sale Tax Concerns

Part II. Ownership of Real Property

I. Tax Consequences of Leasing Transactions

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  - c. [13:290] Dealing with tenant's old lease

[13:270] Numerous tax issues center on real property leasing transactions. Some of the most important issues are discussed at *¶ 13:271 ff.*

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1. Increasing Rent—Timing of Income and Deductions

a. [13:271] **General cash basis/accrual basis accounting:** Normally, cash method lessees deduct rent when paid and cash method lessors include rent when received. Accrual method lessees deduct rent on a daily basis (regardless of when it is actually paid) and accrual method lessors include rent on a daily basis (regardless of when it is actually received). [Bittker & Lokken, "Federal Taxation of Income, Estates & Gifts"¶ 105.4 (2d ed. 1989 and current supp.)]

b. [13:272] **Exception—deferred or stepped rents (Section 467 rental agreements):** An exception requires both landlord and tenant to account for rents on a modified accrual basis. [IRC § 467] This rule applies when the rental agreement or lease calls for total payments of more than $250,000 ("Section 467 rental agreements"). [IRC § 467(d)(2); Treas.Reg. § 1.467; see *Stough v. Commissioner* (2015) 144 TC 306, 317-318 (denying Section 467 treatment because specific allocation absent from rental agreement); see also Burton, "Tax Court Levels Taxpayer's Weak Theories in Rent Accrual Case" (Sept. 28, 2015) Tax Notes 1521; Melone, "Final Section 467 Regulations Expand and Clarify Proposed Rules" (2000) 27 J. Real Est. Tax. 65]

If such a rental agreement requires either (1) deferral of rent so that a rent payment is made after the calendar year to which it applies, or (2) increasing (or "stepped") rents over the lease term, both landlord and tenant must account for rental payments consistently. [IRC § 467(b)(1), (d)(1)]

(1) [13:273] **Normal rule—allocations respected:** If the rental agreement allocates particular rent payments to particular periods, those allocations are respected for tax purposes. Both landlord and tenant must take rent into account for such periods. [IRC § 467(b)(1); *Piccadilly Cafeterias, Inc. v. United States* (Fed.Cl. 1996) 36 Fed.Cl. 330, 334-335, 96-2 USTC ¶ 50487—lessee required to respect lease's escalating allocation of rentals]

(a) [13:274] **Example:** Lease calls for payments of zero rent during the first year and $100,000 per year for the next four years. IRC § 467 applies since this agreement calls for stepped rents and for total payments of more than $250,000. Neither landlord nor tenant can deduct anything for Year 1 and each will deduct or include in income $100,000 for the next four years. [IRC § 467(b)(1)(A)]

(b) [13:275] **Deferred rents:** If the rental agreement calls for payment of rent in a year after the year to which the rent is allocable, both parties must take the present value of the rent payment into account during the year to which it is applicable (rather than the year paid) and must also impute interest on the deferred payment. [IRC § 467(a), (b)(1)(B)]

(2) [13:276] **Special rule—tax avoidance transactions:** In the case of either long-term leases (lease with terms exceeding 14 1/4 years) or sale-leasebacks, if the schedule of increasing rents is tainted by a tax avoidance purpose, or if there is no rent allocation to particular periods, the rents are accounted for on a "constant rental amount" basis. This means that in each period an identical amount is treated as rental deductions and rental income. That amount is the amount which would result in the same aggregate present value as the present value of the payments called for by the lease. [IRC § 467(b)(2), (3) & (e)(1)]

(a) [13:276.1] **Exceptions:** The provision concerning "constant rental amounts" does not apply to changes in amounts determined by price indexes, rents based on a percentage of lessee receipts, reasonable rent holidays, or changes in amounts paid to unrelated third parties. [IRC § 467(b)(5); see *Republic Plaza Properties Partnership v. Commissioner* (1996) 107 TC 94, 105-108—interpreting "reasonable rent holiday" to include 11.5-month period at beginning of 26-year lease]

2. Prepaid Rent and Leasing Costs

a. [13:277] **Not currently deductible by lessee; currently includible by lessor:** A lessee who prepays rent is not allowed to deduct the prepayment but must capitalize and amortize it over the lease period. Similarly, the lessee should capitalize and amortize costs incurred in negotiating the lease. [Rev.Rul. 73-421, 1973-2 CB 33]

However, the landlord must include the entire rent prepayment in income whether the landlord uses the cash or accrual method of taxation. [See *Schlude v. Commissioner* (1963) 372 US 128, 136-137, 83 S.Ct. 601, 606—prepaid dancing lessons immediate income to accrual basis taxpayer]

b. [13:278] **Compare—security deposit:** A security deposit is not income to the lessor. Nor is it deductible by the lessee until such time as it is applied to the rent.

Reason: A security deposit is treated as a loan from lessee to lessor; and loans are not income to the borrower. A security deposit is intended to secure the lessee's performance of contractual duties under a lease and must be returned to the lessee if the lessee performs those duties. The deposit can be commingled with the lessor's other funds; it need not be segregated. The fact the lessee might choose to apply the deposit to future rent does not, by itself, turn the deposit into immediately taxable rent. [*Commissioner v. Indianapolis Power & Light Co.* (1990) 493 US 203, 212-214, 110 S.Ct. 589, 595]

(For a comprehensive treatment of tenant security deposits, see Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 2E.)

3. Tenant Improvements

a. [13:279] **Depreciation by tenant:** As earlier discussed, a tenant who makes improvements to leased property must depreciate the improvements over the normal term (27.5 years for residential real property; 39 years for nonresidential property), regardless of the remaining term of the lease. (*See ¶ 13:137 ff.*) (Similarly, if the lessor pays for (and owns) the improvements, the lessor depreciates the improvements over the normal term (regardless of the lease term).)

Where the lease terminates prior to full recovery of the cost of the improvements through depreciation, the tenant is entitled to a loss deduction for the remaining basis. [IRC § 165]

(1) [13:279.1] **Transitional rules:** Under transitional provisions that must be renewed frequently by Congress, the party who constructs "qualified leasehold improvements," "qualified restaurant improvements" or "qualified retail improvement property" can in some cases immediately deduct 50% of the improvement, and in other cases depreciate the improvement over a 15-year period (*see discussion at ¶ 13:137.2 ff.*).

b. [13:280] **Not income to lessor:** A lessor does not recognize income or increase basis when the lessee constructs improvements, nor when the lease terminates and the landlord takes control of the improvements. [IRC §§ 109, 1019]

(1) [13:281] **Likewise for tenant reimbursements:** A lessor also does not recognize income when a tenant reimburses the lessor for improvements made to the building on the tenant's behalf. [Chief Counsel Advice Memo 201436048]

(2) [13:281.1] **Exception—tenant improvements as rent substitute:** If the tenant's construction of improvements is intended as a substitute for rent, the landlord must include the value of the improvements in income. [Treas.Reg. § 1.109-1]

[13:281.2 - 13:281.4] ***Reserved.***

4. [13:281.5] **Retail Space Improvements Paid for by Lessor:** If the lessor *reimburses the tenant of retail space* (whether in cash or through a rent reduction) for improvements to the property paid for by the tenant, the tenant does *not* include those payments in gross income. [IRC § 110 (eff. for leases entered into after 8/5/97)]

a. [13:281.6] **"Short-term lease" limitations:** IRC § 110 applies only if the lease is for *15 years or less*. [See IRC § 110(a)(1) & (c)(2)] By implication, therefore, if the lease *exceeds* 15 years, the lessor's payments would be income to the tenant unless the payments qualified for exclusion as a contribution to capital. [IRC § 118; see generally, Raby & Raby, "Reimbursed Construction Costs: Income or Not?" (Sept. 22, 1997) 76 Tax Notes 1603]

5. Lease Cancellation Payments

a. [13:282] **Payment by lessor to lessee:** Where a lessor pays a tenant to terminate an otherwise unexpired lease so that the lessor can relet to another tenant, the tenant can treat the gain on transfer of the lease as capital gain. [IRC § 1241; *Commissioner v. Golonsky* (3rd Cir. 1952) 200 F2d 72, 73-74; Rev.Rul. 72-85, 1972-1 CB 234] The landlord must capitalize the payment as a lease acquisition cost. However, it is unclear whether the amortization period is the old lease or the new lease. [See *Handlery Hotels, Inc. v. United States* (9th Cir. 1981) 663 F2d 892, 895 (old lease); *Montgomery Co. v. Commissioner* (1970) 54 TC 986, 1002-1004 (new lease)]

b. Payment by lessee to lessor

(1) [13:283] **Lessor's tax treatment:** A payment made by a lessee to the lessor to terminate its otherwise unexpired lease is ordinary income to the lessor; the lessor is not entitled to any recovery of basis since the payment is viewed as a substitute for rent. [*Hort v. Commissioner* (1941) 313 US 28, 32-33, 61 S.Ct. 757, 759; *see also ¶ 13:436*]

(a) [13:283.1] **Comment:** Pursuant to IRC § 1234A, gain or loss attributable to the "cancellation, lapse, expiration, or other termination" of an obligation pertaining to property that is "a capital asset in the hands of the taxpayer" is treated as gain or loss from the sale of a capital asset. Arguably, under this statute, income received by a lessor from a lessee to cancel a lease should be treated as capital gain, but the IRS has not yet stated its position on the issue.

(2) [13:283.2] **Lessee's tax treatment:** Normally, a lessee's payments to cancel a lease are deductible to the lessee. [Rev.Rul. 69-511, 1969-2 CB 24] But if the payment is part of a plan to cancel the old lease and enter into a new lease with the same lessor, the payment must be capitalized and amortized over the period of the new lease. [See *U.S. Bancorp v. Commissioner* (1998) 111 TC 231, 242—computer lessee must capitalize cost of canceling lease in order to lease newer computer from same lessor]

Also, where a lease is terminated as a result of the lessee purchasing the leased property from the lessor, no portion of the purchase price can be deducted as a lease cancellation payment. [*Union Carbide Foreign Sales Corp. v. Commissioner* (2000) 115 TC 423, 439-440 (disagreed with by *ABC Beverage Corp. v. United States* (6th Cir. 2014) 756 F3d 438, 446) —lessee purchased tanker from lessor to terminate burdensome lease; see Maynard & Lipton, "The Tax Court Misses the Boat in Requiring Capitalization of Lease Termination Payments" (Jan.-Feb. 2003) 6 J. of Passthrough Entities 5]

6. [13:284] **Lease Inducements:** In a market where there is a surplus of rental space, tenants have substantial leeway to negotiate for various lease inducements or "rental concessions." [See generally, Frydland & Shapack, "Maximizing Benefits of Commercial Real Estate Lease Inducements" (1992) 76 Journ. of Tax. 372; Murphy, "Lease Inducements: Consider the Tax Consequences" (1992) 2 Calif. Tax Lwyr. No. 2, p. 32; see also Friedman, Garcia & Hoy, *Cal. Prac. Guide: Landlord-Tenant* (TRG), Ch. 2B]

a. [13:285] **Cash payment:** Inducement to sign the lease might be by way of a cash payment to the tenant. In such event, the landlord must capitalize the payment and amortize it over the lease term. [See *Bonwit Teller & Co. v. Commissioner* (2nd Cir. 1931) 53 F2d 381, 384—brokerage fee incurred in leasing property must be capitalized] The tenant must include the payment in income when received. [Cf. *John B. White, Inc. v. Commissioner* (1971) 55 TC 729, 734-735, aff'd (3rd Cir. 1972) 458 F2d 989, 990—Ford's payment to auto dealer to relocate is income to dealer]

b. [13:286] **Rent holidays:** A common concession to induce tenants to execute a lease (particularly in connection with commercial property rentals) is free rent (or a "rent holiday") for a significant period. As discussed at ¶ 13:272 ff., IRC § 467 applies to lease agreements that call for increasing rental payments and involve more than $250,000 of rent during the entire lease term. A lease calling for a rent holiday in the early periods of the lease would therefore fall under § 467 (assuming the $250,000 standard is met).

(1) [13:287] **General rule:** In cases of increasing payments, the allocation in the rental agreement of rent payments to rental periods is normally respected. Both landlord and tenant must account consistently for all payments. Thus, there will be no rent deductions or income during the rent holiday, whether the landlord or tenant uses the cash or accrual method of accounting (*see ¶ 13:273 ff.*).

(2) [13:288] **Exception:** If the rent holiday agreement allocates rent to the holiday period and provides that this rent will be deferred and payable after the holiday period, the tenant must deduct and the landlord must include in income the present value of the deferred rent during the holiday period (as well as imputed interest on the deferral). [IRC § 467(a)(2), (b)(1)(B); *see ¶ 13:275*]

Moreover, if the lease does not contain any allocation of rent payments to specific periods, a "constant rental amount" must be imputed, which may create even larger deductions for the tenant during the rent holiday period. [IRC § 467(b)(2), (3) & (e)(1); *see ¶ 13:276*]

➪ [13:289] ***PRACTICE POINTER:*** Tenants in a relatively stronger negotiating position may wish to bargain for one of these arrangements, as it would permit the tenant a deduction for rent during a period in which none is payable.

c. [13:290] **Dealing with tenant's old lease:** To induce a new tenant to enter into a lease, the lessor may agree to be the assignee of the tenant's old (as yet unexpired) lease. Apparently, the lessor-assignee can deduct currently the lease payments

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on the assigned lease, although the IRS may argue these payments should be capitalized as the acquisition cost of the new lease. [See *379 Madison Ave. v. Commissioner* (2nd Cir. 1932) 60 F2d 68, 69]

[13:291] ***Reserved.***

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Cal. Prac. Guide Real Prop. Trans. Ch. 13(II)-J

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 13. Real Property
Purchase and Sale Tax Concerns

Part II. Ownership of Real Property

J. Deductions for Home Offices and Vacation Homes

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3. [13:294] Vacation Home Deductions
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        - (2) [13:294.11] Application of passive loss/at-risk limitations
    - d. [13:294.12] Disqualifying limited rental use

1. [13:292] **General Rule—No Business Deductions:** Business deductions (such as depreciation, repairs or insurance) are not allowed for part or all of the costs relating to a taxpayer's personal residence. [IRC § 280A(a)]

Of course, this rule does not preclude deductions of "qualified residence interest," real property taxes or casualty losses, which need not be connected to business or investment. [IRC § 280A(b)]

2. [13:293] **Deduction for Home Office Costs:** The costs of a portion of a taxpayer's residence *can* be deducted if that portion is used *exclusively on a regular basis* as:

• the taxpayer's principal place of business; *or*

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• a place of business used by patients, clients or customers, when visiting the taxpayer in the normal course of business; *or*

• in the case of a separate structure not attached to the dwelling, in connection with the taxpayer's trade or business. [IRC § 280A(c)(1)(A), (B) & (C)]

a. [13:293.1] **"Exclusive use":** The portion of the home used for business cannot be used for *any purpose other than business* during the taxable year. [See *Langer v. Commissioner*, TC Memo 2008-255—only 5% and 7% of residence used exclusively for H's and W's businesses deemed deductible (they had claimed 15% and 27%); *Mullin v. Commissioner,* TC Memo 2001-121—given size and layout of 400 square foot apartment, taxpayer's argument that 1/4 was used exclusively for business purposes was rejected]

(1) [13:293.1a] **Additional requirement for employee taxpayers:** If the taxpayer is an *employee*, the "exclusive use" of their residence for one of the purposes described at ¶ 13:293 must be for *the convenience of the employer*. [IRC § 280A(c)(1)]

For example, if no space is provided at work for necessary job tasks, the employee's home office serves the convenience of the employer. On the other hand, when there is space at work but the employee simply prefers to work at home, the home office is *not* for the employer's convenience. [See *Drucker v. Commissioner* (2nd Cir. 1983) 715 F2d 67, 70—where concert violinist employed by orchestra required to practice at home because no such space provided at concert hall, home practice room maintained for employer's convenience]

(a) [13:293.1b] **Compare—home rented to employer:** *No* deductions are available with respect to a portion of the taxpayer's residence *rented to their employer* where the taxpayer performs services for the employer as an employee. [IRC § 280A(c)(6)]

b. [13:293.2] **Principal place of business—business conducted at several locations:** If a taxpayer has several businesses, the residence qualifies for a home office deduction if it is the *principal location* of *any* of the businesses. A problem arises, however, when the taxpayer uses both their home *and* other sites as locations for a single business:

(1) [13:293.2a] **Determining "principal place of business":** The most important factors in determining whether a taxpayer's residence is a "principal place of business" are the relative importance of the activities performed at the site and the time spent there. [*Commissioner v. Soliman* (1993) 506 US 168, 174-175, 113 S.Ct. 701, 706; see also Wood, "Developments in Home Offices"(2002) 29 J. Real Est. Tax 116]

• [13:293.2b] **Example:** T is a self-employed concert violinist who practices four to five hours a day in a studio in her home used exclusively for that purpose. She performs concerts and makes recordings at separate locations away from her home. She spent 1200 hours per year practicing at home and 280 hours performing and recording. Because of the great importance of practice to a professional musician and the time spent practicing compared to the time spent doing other activities related to her profession, her home was determined to be her "principal place of business." [*Popov v. Commissioner* (9th Cir. 2001) 246 F3d 1190, 1194]

(2) [13:293.3] **Business administration and management from home office:** The home is considered the principal place of business if the taxpayer performs *administrative or management activities* for the business at home, and there *is no other fixed location* of such business where the taxpayer conducts substantial administrative or management activities. [IRC § 280A(c)(1), last sent. (eff. tax years beginning 1/1/99; overruling *Commissioner v. Soliman*, supra, on issue)]

When the taxpayer meets this test, the home is considered the taxpayer's "principal place of business" regardless of where the goods or services are delivered or the relative time spent at each location.

• [13:293.3a] **Example:** An anesthesiologist uses his home office exclusively for business, spending up to three hours a day performing administrative and managerial tasks, such as billing patients, maintaining records, making business phone calls, and arranging appointments. He spends the majority of his working time at various hospitals caring for patients. Nonetheless, because there is no fixed location other than his home where he performs administrative and management activities, the anesthesiologist's home office is his "principal place of business."

(3) [13:293.4] **Related deduction for related travel costs:** A taxpayer whose principal place of business is their home can deduct transportation expenses between home and any other work location, regardless of the distance or whether the other work location is regular or temporary. (This is an exception to the normal rule that commuting costs are nondeductible.) [Rev.Rul. 99-7, 1999-1 CB 361]

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For example, a professional musician whose principal place of business is her home (because she performs administrative and management activities there) can deduct the costs of driving from home to a recording studio or concert hall.

c. Other uses

(1) [13:293.5] **Business inventory storage:** A taxpayer can deduct the costs of a portion of a residence that is used for *storage of an inventory held for sale in a business*—but only if the dwelling is the *sole fixed location* of that business. [IRC § 280A(c)(2)]

(2) [13:293.6] **Day care services:** Also, a deduction is allowed for a portion of the costs attributable to that portion of the taxpayer's residence used as a day care facility. [See IRC § 280A(c)(4)]

(3) [13:293.7] **Compare—use for investment activities:** The management of investments is *not* a "trade or business." Therefore, a taxpayer *cannot* deduct any portion of the costs of a home office used exclusively to manage an investment portfolio—even though the taxpayer performs such investment management full-time. [*Moller v. United States* (Fed. Cir. 1983) 721 F2d 810, 814]

However, a *trader in securities*, as distinguished from an investor, *is engaged* in a trade or business for home office deduction purposes. The distinction is that a trader looks to quick turnover and short-term profits, rather than to long-term profits or earning dividends or income. [*Estate of Yaeger v. Commissioner* (2nd Cir. 1989) 889 F2d 29, 33; see also *Moller v. United States*, supra, 721 F2d at 813]

[13:293.8 - 13:293.9] ***Reserved.***

d. [13:293.10] **Limitation on amount deductible:** Taxpayers eligible to claim a home office deduction under the rules set forth at ¶ 13:293 ff. cannot deduct more than the gross income from the eligible use, less the deductions allowed without regard to business (e.g., qualified residence interest, property tax or casualty loss). [IRC § 280A(c)(5)]

e. [13:293.11] **Optional home office deduction "safe harbor":** Taxpayers may claim a home office deduction simply by multiplying the square footage of that portion of their house used as a home office (not to exceed 300 square feet) by $5.00. This optional method results in a maximum deduction of $1,500, plus otherwise allowable itemized deductions for expenses such as home mortgage interest, property taxes and casualty losses. It is an alternative to the often complex and burdensome pre-2013 requirement of calculating, allocating and substantiating actual expenses. [See Rev.Proc. 2013-13, 2013-6 IRB 478; Megaard & Megaard, "When Should the New Safe Harbor Method for Deducting Home-Office Expenses be Elected?" (July 2013) 119 J. Tax'n 5]

3. [13:294] **Vacation Home Deductions:** Taxpayers frequently rent out a home that they also use for vacations. For tax purposes, it is necessary to *prorate* business deductions (depreciation, repairs, insurance, etc.) between *personal* and *rental* use. Also, if the property is "used as a residence," the business deductions are limited to the income generated by the property (¶ *13:294.8*). [See IRC § 280A(c)(3) & (5), (d) & (e)] (For a detailed treatment of the deduction, see Truskowski, "Tax Consequences of Renting Out a Second Home May Turn on How Often the Taxpayer Makes Use of It" (July 2004) 101 J. of Taxation 26.)

Of course, qualified residence interest on a second home, real property tax and casualty losses remain deductible in full. [IRC § 280A(b) & (e)(2)]

Comment: Because the 2017 Tax Cuts and Jobs Act limited the deductibility of state and local taxes (as well as interest) on the amount of deductible qualified mortgage interest, the tax case for a vacation home that is also rented out is not as strong as it used to be for many taxpayers. (See Cox, "Fractional Ownership of a Vacation Home under the Tax Cuts and Jobs Act" (March 2022) J. of Tax'n 3.)

a. [13:294.1] **"Used as a residence":** A dwelling is "used as a residence" if it is used for *personal purposes* by any of its owners or their relatives, or by any person who fails to pay a fair rental, for more than 14 days per year *or* more than 10% of the days it was rented at a fair rental, whichever figure is greater. [IRC § 280A(d)(1) & (2); see *Razavi v. Commissioner* (6th Cir. 1996) 74 F3d 125, 127-128 (discussing "fair rental" standard)—"fair rental" requires comparison to other rentals of comparable properties; *DiDonato v. Commissioner*, TC Memo 2013-11—self-serving testimony regarding fair rental value deemed insufficient given property's condition; compare *Lucero v. Commissioner*, TC Memo 2020-136—days spent primarily repairing and maintaining dwelling do not count toward personal use limit, even if other individuals are doing different activities on property]

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(1) Examples

• [13:294.2] Bob lived in his ski condo seven days last year. He rented it (at a fair rental) to nonfamily members for 40 days. Since he did not use it for the greater of 14 days or 10% of the rental days, he did not use it "as a residence."

• [13:294.3] Alice and Sally own a beach house as tenants in common. During the taxable year, Alice used the house one day, Sally eight days, and Sally's daughter six days. It was rented to others for 85 days. Since personal use for 15 days exceeds the greater of 14 or 8.5 (10% of 85), the house was "used as a residence."

(2) [13:294.4] **Exceptions:** If the dwelling is rented for at least one year, the taxpayer's personal use before or after the rental period is ignored. Similarly, if the dwelling is sold at the end of the rental period, personal use before the rental period is disregarded. [IRC § 280A(d)(4)]

Also, a dwelling is *not* "used as a residence" if rented at a fair rental to a relative of the owner as the occupant's principal residence. [See IRC § 280A(d)(3)]

b. [13:294.5] **Proration:** If the dwelling was used at all for personal purposes (*whether or not* it was "used as a residence," ¶ 13:294.1 ff.), the various expenses (other than qualified residence interest, property tax or casualty loss) must be *prorated*. Only the portion allocable to *rental use* is deductible. [IRC § 280A(e)]

Examples

• [13:294.6] In the example at ¶ *13:294.2*, 40/47 of the business items (depreciation, etc.) are deductible by Bob; 7/47 are allocable to personal use and are not deductible.

• [13:294.7] In the example at ¶ *13:294.3*, 85/100 of the expenses on Alice's and Sally's beach house are deductible; but, in their case, there is an additional limitation (*see* ¶ *13:294.8 ff.*).

c. [13:294.8] **Limitation on amount where property "used as a residence":** The expenses prorated to rental use are deductible only in part if the dwelling was "used as a residence" (¶ *13:294.1*). In that case, the owners cannot deduct more than the gross rental income less a prorated share of the qualified residence interest and taxes. [IRC § 280A(c)(5)]

(1) Examples

• [13:294.9] Referring again to the example at ¶ *13:294.2*, the IRC § 280A(c)(5) limitation does not apply to Bob because his ski condo was not "used as a residence."

• [13:294.10] On the other hand, in the example at ¶ *13:294.3*, the IRC § 280A(c)(5) limitation on amount *does apply* to Sally and Alice (the beach house has been "used as a residence").

Assume Alice's share of the qualified residence interest and taxes for the year is $1,200 and 85/100 of her share of the business costs (such as depreciation, repairs and/or insurance) is $2,000. Her share of the gross rentals is $2,800. Alice can deduct all of the qualified residence interest and taxes. But she can deduct only $1,600 of the remaining expenses ($2,800 less $1,200). [IRC § 280A(c)(5)]

(2) [13:294.11] **Application of passive loss/at-risk limitations:** Even if the taxpayer can get past the ceiling on deductible business costs (¶ 13:294.8 ff.), those costs may be nondeductible under the passive loss rules (¶ *13:240 ff.*) or the at-risk rules (¶ *13:230 ff.*). However, IRC § 280A takes *precedence* over those rules … because even at the time the vacation house is sold, the disallowed costs still cannot be deducted (whereas, under the passive loss and at-risk rules, the deduction of disallowed costs is merely deferred until the property is sold; ¶ *13:235, 13:247*).

d. [13:294.12] **Disqualifying limited rental use:** No rental use deductions are allowed on a dwelling rented fewer than 15 days during the year; and the income from the rental is not included in gross income. [IRC § 280A(g); see *Lucero v. Commissioner*, TC Memo 2020-136—days spent primarily repairing and maintaining property do not count toward maximum days limit]

[13:295 - 13:299] ***Reserved.***

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Chapter 13. Real Property Purchase and Sale Tax Concerns

Part III. Disposition of Real Property

A. Pertinent Tax Issues

[13:300] Several important tax issues arise in connection with the disposition of real property, including:

• Was the gain or loss realized? (*¶ 13:301 ff.*)

• Was the gain or loss recognized? (*¶ 13:303 ff.*)

• What was the amount realized? (*¶ 13:395 ff.*)

• Was the gain or loss capital or ordinary? (*¶ 13:415 ff.*)

• When is the gain or loss recognized for tax purposes? (*¶ 13:465 ff.*)

• Withholding and reporting on sales of property (*¶ 13:520 ff.*)

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Cal. Prac. Guide Real Prop. Trans. Ch. 13(III)-B

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 13. Real Property
Purchase and Sale Tax Concerns

Part III. Disposition of Real Property

B. Realization of Gain or Loss

1. [13:301] General Rule of "Realization"
2. [13:302] Exchanges
    a. [13:302.1] Exchange of mortgages
    b. [13:302.2] Partition

1. [13:301] **General Rule of "Realization":** Although it is an open question whether realization is necessary under the Constitution for gain or loss to be recognized for tax purposes, it is at least sufficient to trigger income tax consequences. [See *Moore v. United States* (2024) 602 US _, _, _, 144 S.Ct. 1680, 1688-1689, 1696 & fn. 3]

Gain or loss is "realized" on the "sale or other disposition" of property. [Treas.Reg. § 1.1001-1(a)]

Normally, therefore, any sale, exchange or other disposition is sufficient to trigger "realization." For example, realization occurs when property is transferred to discharge a claim against the taxpayer, even though the amount of the claim is not ascertainable. There must, however, be a bona fide disposition of property to realize a loss. [*United States v. Davis* (1962) 370 US 65, 68-71, 82 S.Ct. 1190, 1192-1193—gain realized on H's transfer of property in discharge of W's inchoate marital property claim against him (case overruled by IRC § 1041 with respect to transfers incident to divorce, ¶ *13:385*); see *Sage v. Commissioner* (2020) 154 TC 270, 283-284—taxpayer could not claim losses on real estate transfers from his wholly owned companies to liquidating trusts (taxpayer's companies were "grantors" of trusts and, therefore, remained owners of transferred property for tax purposes)]

2. [13:302] **Exchanges:** Gain or loss is realized on an exchange of property "for other property differing materially either in kind or in extent." [Treas.Reg. § 1.1001-1(a)]

a. [13:302.1] **Exchange of mortgages:** The exchange of a package of mortgages for a different package of mortgages of equal value is the occasion for realization of loss. While the mortgages given up and received may have been similar, they are on different properties and therefore embody legally distinct entitlements. [*Cottage Sav. Ass'n v. Commissioner* (1991) 499 US 554, 566, 111 S.Ct. 1503, 1511]

b. [13:302.2] **Partition:** A partition of a single co-owned property, or of several contiguous properties, so that each of the co-owners now owns part of the property outright, is *not* a realization. [Priv.Ltr.Rul. 9633028]

However, where co-owners each own part of *separate* properties, and partition their interests so that each owns one of the properties outright, the exchange *is* a realization. But in that situation, the realized gain or loss would not be recognized under IRC § 1031 (assuming both properties fall within § 1031; *see* ¶ *13:304 ff.* re like-kind exchanges). [Rev.Rul. 73-476, 1973-2 CB 301; Rev.Rul. 79-44, 1979-1 CB 265]

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Cal. Prac. Guide Real Prop. Trans. Ch. 13(III)-C

California Practice Guide: Real Property Transactions | September 2024 Update
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Chapter 13. Real Property Purchase and Sale Tax Concerns

Part III. Disposition of Real Property

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1. [13:303] **General Rule of "Recognition":** Generally, gain or loss is "recognized" whenever it is realized (¶ *13:301 ff.*). [IRC § 1001(c)]

As developed at ¶ *13:303.5 ff.*, the general rule of recognition is subject to numerous Code provisions requiring or permitting nonrecognition of gain or loss. However, nonrecognition occurs only by virtue of a Code section specifically so providing. [See IRC § 1001(c)—"Except as otherwise provided in this subtitle …"]

[13:303.1 - 13:303.4] ***Reserved.***

2. [13:303.5] **Personal Losses Not Deductible:** No deduction (not even a capital loss) is allowed for loss on the sale of assets held for personal use. [IRC § 165(c)]

Thus, even though gain on the sale of a personal residence is taxable (unless it qualifies for exclusion, ¶ *13:345 ff.*), loss on the sale of a personal residence presently is not deductible.

a. [13:303.6] **Exception—certain casualty losses:** Casualty losses over $100 are deductible if they exceed 10% of adjusted gross income. [IRC § 165(c)(3), (h)]

(1) [13:303.6a] **"Casualty loss" defined:** Generally, a deductible casualty loss to real property must arise from a sudden, unexpected or unusual physical event that damages the property, such as fire or earthquake. A temporary decline in value arising out of market fluctuations will not suffice. [*Caan v. United States* (CD CA 1999) 83 AFTR2d 99-1640—O.J. Simpson neighbor could not deduct loss in property value owing to "buyer resistance" resulting from Simpson criminal trial; see Riordan & Nichols, "Casualty Losses on Real Estate: Does 'Buyer Resistance' Create a Deduction?" (2000) 28 J. Real Est. Tax 36]

(2) [13:303.6b] **Amount deductible; evidence:** A casualty loss deduction is ordinarily measured by the decline in value of the property owing to the casualty *or* the adjusted basis of the property, *whichever is less*. [Treas.Reg. § 1.165-7(b)]

While appraisals are generally preferred, the cost of repairs to the property is often accepted as evidence of the decline in value. [Treas.Reg. § 1.165-7(a)(2)]

b. Compare—house converted to rental property

(1) [13:303.7] **Ordinary loss deduction for loss occurring after conversion:** If a personal residence is, prior to its sale, *rented* or otherwise appropriated to "*income-producing purposes*" and is used for such purposes up to the time of its sale, a loss sustained on the property's sale is deductible as ordinary loss (the loss is ordinary rather than capital because the house is a trade or business asset; see IRC § 1231(a)(2), *discussed at*¶ *13:442 ff.*). The basis for determining loss is the house's original basis or its value at the date of conversion, whichever is less. [Treas.Reg. § 1.165-9; see also Raby & Raby, "Deducting a Loss on Sale of a Personal Residence"(June 24, 2002) 95 Tax Notes 1945; and Raby, "Ordinary Loss on Sale of Residence" (April 24, 1995) 67 Tax Notes 535]

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• [13:303.8] **Example:** T bought a house for $400,000. When the house was worth $320,000, T tried unsuccessfully to sell it. Finally, T moved out and rented the house. He ultimately sold it for $305,000. T can deduct $15,000 as ordinary loss. The $80,000 loss that occurred while the house was held for personal use is *not* deductible.

(2) [13:303.9] **Depreciation, etc.:** Once the house is converted to rental use and "held for the production of income," the taxpayer can also deduct depreciation and other costs, subject to the passive loss rule limitations (*¶ 13:240 ff.*). [See IRC §§ 167(a)(2), 212(1)] The basis for purposes of computing depreciation is the value at the date of conversion or the original basis of the residence, whichever is less. [Treas.Reg. § 1.167(g)-1]

(a) [13:303.10] **"Held for production of income" requirement:** To qualify for the depreciation deduction (*¶ 13:303.9*), the house must be "held for the production of income." On this point, the Ninth Circuit has adopted the Tax Court's "nonexhaustive" list of factors to be considered:

• The length of time the house was occupied as a residence before going on the market;

• Whether the taxpayer permanently abandoned all personal use of the property;

• The character of the property (recreational or otherwise);

• Offers to rent; and

• Offers to sell. [*Bolaris v. Commissioner* (9th Cir. 1985) 776 F2d 1428, 1432-1433—several factors supported conclusion taxpayers possessed requisite "profit motive" to properly claim rental expense deductions]
However, "the use made of the property and the owner's intent in respect to the future use of [sic] disposition of the property are *generally* controlling." [*Horrmann v. Commissioner* (1951) 17 TC 903, 907 (emphasis added)]

[13:303.11 - 13:303.14] *Reserved.*

(3) [13:303.15] **Establishing whether "conversion" occurred; effect of mere offers to rent:** If a property is rented out before it is sold, the conversion from personal residence to rental property is self-evident. On the other hand, if the property is simply held out for rent and not actually rented, it becomes more difficult to establish that a conversion actually occurred. This is so even if the property is no longer occupied as a residence. Thus, courts examine whether the efforts to rent were serious. [See *Redisch v. Commissioner*, TC Memo 2015-95 (denying both ordinary loss and depreciation deduction for taxpayers' secondary residence where efforts to rent appeared "minimal"); compare *Horrmann v. Commissioner* (1951) 17 TC 903, 907-910 (permitting depreciation deduction, but not ordinary loss deduction, where inherited property merely offered for rent); and see *Cowles v. Commissioner,* TC Memo 1970-198 (criticizing *Horrmann*, supra, for distinguishing between depreciation and ordinary loss deductions re mere offers to rent but "unwilling to chart a new course")]

3. [13:304] **Like-Kind Exchanges (IRC § 1031):** Gain or loss is *not recognized* upon the exchange of real property of *like kind*. Both the property surrendered and the property received must be held for *productive use in a trade or business* or *for investment,* not for personal purposes or for sale. [IRC § 1031(a)(1), (2); see Foster, "A Checklist for Like-Kind Real Estate Exchanges" (2015) 42 J. Real Est. Tax. 126]

a. [13:305] **Real property:** For purposes of IRC § 1031, all real property—improved and unimproved—is considered of like kind, as long as they are held for use in a trade or business or for investment. [Treas.Reg. § 1.1031(a)-1(a), (c)]

➪ [13:305.1] ***PRACTICE POINTER:*** As a result, IRC § 1031 is of great importance in real estate investing:
It allows taxpayers with profitable real estate investments to swap them for other real estate without paying tax. Indeed, if this process can be repeated until the taxpayer dies, the gain will never be taxed.

(1) [13:305.2] **"Real property" defined:** Under the regulations, "real property" means "land and improvements to land, unsevered natural products of land, and water and air space superjacent to land." [Treas.Reg. § 1.1031(a)-3(a)(1)]

(a) [13:305.3] **"Improvements to land" defined:** The term "improvements to land" means "inherently permanent structures and the structural components of inherently permanent structures." [Treas.Reg. § 1.1031(a)-3(a)(2)]

1) [13:305.4] **"Inherently permanent structures":** "Inherently permanent structures" means buildings and other structures that are (i) "permanently affixed to real property," and (ii) "will ordinarily remain affixed for an indefinite

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period of time." A structure is permanently affixed "if it is reasonably expected to last indefinitely based on all the facts and circumstances." [Treas.Reg. § 1.1031(a)-3(a)(2)(ii) (listing examples of "buildings" and "other inherently permanent structures," including parking facilities, permanently affixed fences, and oil and gas pipelines)]

The following five-factor test applies to determine if a structure not specifically listed in Treas.Reg. § 1.1031(a)-3(a)(2)(ii) qualifies as an inherently permanent structure (Treas.Reg. § 1.1031(a)-3(a)(2)(ii)(C)):

— Manner in which the structure is affixed;

— Whether the structure is designed to be removed or remain in place;

— Damage that removal of the structure would cause to the structure itself or real property;

— Any circumstances suggesting the expected affixation period is not indefinite; *and*

— Time and expense required to move the structure.

2) [13:305.5] **"Structural components":** The term "structural components of inherently permanent structures" means any "distinct asset" that is a "constituent part of, and integrated into, an inherently permanent structure." [Treas.Reg. § 1.1031(a)-3(a)(2)(iii); see Treas.Reg. § 1.1031(a)-3(a)(4) (defining "distinct asset")]

If interconnected assets work together to serve an inherently permanent structure (e.g., systems that provide a building with electricity, heat, or water), the assets are analyzed together as one distinct asset that may be a structural component. [Treas.Reg. § 1.1031(a)-3(a)(2)(iii)]

A structural component may qualify as real property only if the taxpayer holds its interest in the structural component together with a real property interest in the space in the inherently permanent structure served by the structural component. [Treas.Reg. § 1.1031(a)-3(a)(2)(iii)]

(b) [13:305.6] **Intangible assets included:** An interest in real property includes fee ownership, co-ownership, a leasehold, an option to acquire real property, an easement, stock in a cooperative housing corporation, shares in a mutual ditch, reservoir, or irrigation company (see IRC § 501(c)(12)(A)), and land development rights. Similar interests qualify as real property "if the intangible asset derives its value from real property or an interest in real property and is inseparable from that real property or interest in real property." [Treas.Reg. § 1.1031(a)-3(a)(5)(i); see also Cunningham & Weller, "Intangible Interests in Real Property Under IRC 1031" (2nd Quarter 2023) Real Estate Tax'n 45]

1) [13:305.7] **Compare—intangible assets excluded:** The following intangible assets are not real property under the regulations: (i) types of stock not described in Treas.Reg. § 1.1031(a)-3(a)(5), bonds, or notes; (ii) other securities or evidences of indebtedness or interest; (iii) interests in a partnership (other than an interest in a partnership that has in effect a valid election under IRC § 761(a) to be excluded from application of all of subchapter K); (iv) certificates of trust or beneficial interests; and (v) choses in action. [Treas.Reg. § 1.1031(a)-3(a)(5)(i)]

2) [13:305.8] **Licenses and permits:** Real property generally includes a "license, permit, or other similar right that is solely for the use, enjoyment, or occupation of land or an inherently permanent structure and that is in the nature of a leasehold, easement, or other similar right," but not "a license or permit to engage in or operate a business on real property." [Treas.Reg. § 1.1031(a)-3(a)(5)(ii)]

(c) [13:305.9] **Effect of state/local law:** If the property is considered real property under state and local law on the date it is transferred, it is considered real property for purposes of IRC § 1031. [Treas.Reg. § 1.1031(a)-3(a)(6); see also Charin, "Like-Kind Exchanges of Real Property: New Final Regs.," The Tax Adviser (4/1/21), available at *thetaxadviser.com*; Parillo, "IRS Attorney Anticipates Flexibility in Like-Kind Regs Test," 172 Tax Notes 823 (Aug. 2, 2021) (suggesting if property is treated as real property under at least one state or local level it will likely be treated as real property under Section 1031)]

(2) [13:306] **Example:** T holds Blackacre, a piece of raw land, for investment. She exchanges it for White Arms, an apartment house that she will actively manage. T does not recognize gain or loss on Blackacre because the exchange is of property of a like kind covered by IRC § 1031.

(3) [13:307] **Personal use real estate:** Real estate held for *personal use* (e.g., a vacation home) is *not* held for use in a trade or business or for investment, even if the taxpayer expects it to appreciate in value. [*Moore v. Commissioner*, TC Memo 2007-134]

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(a) [13:307.1] **Compare—limited personal use rental property; replacement property:** The IRS will not challenge whether a dwelling unit is held for productive use in a trade or business under IRC § 1031 if (i) the relinquished unit is rented for a fair rental rate during each of the two 12-month periods immediately preceding the exchange; and (ii) the taxpayer's personal use of the dwelling does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the unit was rented at a fair rental rate. [Rev.Proc. 2008-16, 2008-10 CB 547]

Replacement property must meet the same standards during the two 12-month periods following the exchange (Rev.Proc. 2008-16, 2008-10 CB 547). Merely designating replacement property as rental property and attempting to rent it out may not be sufficient. [See *Goolsby v. Commissioner,* TC Memo 2010-64—taxpayers who attempted to rent out replacement property for two months before giving up and moving in did not show requisite investment intent; *Adams v. Commissioner*, TC Memo 2013-7—although fair rental rate requirement applies to replacement property rented out to relatives, courts may consider other factors in establishing fair rent such as whether relative bore rehabilitation costs (¶ 13:156 ff., 13:316.1); see also Chief Counsel Advice 201025049—renting out some replacement property while sale is pending is insufficient]

The above requirements parallel those used in determining whether the costs of holding the property are currently deductible. [IRC § 280A; *¶ 13:294 ff.*]

[13:307.2 - 13:307.4] ***Reserved.***

(4) [13:307.5] **Easements:** A perpetual easement right considered an interest in real property under state law is treated as of like-kind with any other real property interest. [Rev.Rul. 55-749, 1955-2 CB 295 (perpetual water rights exchanged for fee interest in land); Priv.Ltr.Rul. 200203042 (permanent conservation easement exchanged for fee interest in land similarly burdened)]

(5) [13:308] **Leases:** A lease having *30 or more* years to run is treated as of like-kind with a fee in real estate. The 30-year requirement is strictly enforced. [Treas.Reg. § 1.1031(a)-1(c); *VIP's Indus. Inc. v. Commissioner*, TC Memo 2013-157—like-kind status denied for leasehold interest with only 21 years and 4 months remaining; see also Leitner & Stein, "Tax Aspects of Modern Sale-Leasebacks of Real Property" (2022) 176 Tax Notes 1691, 1695]

However, a sale of property for its value, coupled with a leaseback of the property for a term over 30 years, is a sale—not an "exchange" under IRC § 1031; consequently, the seller can recognize loss. [*Jordan Marsh Co. v. Commissioner* (2nd Cir. 1959) 269 F2d 453, 456-457] Indeed, a sale-leaseback has to actually transfer the benefits and burdens of ownership to the taxpayer to qualify as an exchange. [See *Exelon Corp. v. Commissioner* (7th Cir. 2018) 906 F3d 513, 523-528—series of sale-leasebacks deemed disguised loans ineligible for IRC § 1031 exchange treatment because they were structured so "seller" was likely to exercise lease cancellation options]

(a) [13:308.1] **Property *subject to leases:*** The fact that real property is *subject to* a lease, even a long-term lease (e.g., 99 years), does not disqualify it from being treated as like-kind property, and any rent received under the lease is not treated as "boot" (*¶ 13:317*). [*Koch v. Commissioner* (1978) 71 TC 54, 63; *Peabody Natural Resources Co. v. Commissioner* (2006) 126 TC 261, 279—exchange of gold mine for coal mine burdened with contracts for supplying coal to utility qualified as IRC § 1031 exchange]

(6) [13:309] **Tenancy in common interests:** Under IRC § 1031, an undivided tenancy in common interest in real property is treated as of like-kind with a fee interest. [See generally, Cuff, "Section 1031 Exchanges Involving Tenancies-in-Common" (2002) 29 J. Real Est. Tax 53; Cuff, "Selecting and Describing TICs as Replacement Property" (2006) 34 J. Real Est. Tax 32]

Exchanging a fee interest for a tenancy in common interest can be useful to a taxpayer who has not yet selected a replacement property under the time limits for a deferred exchange (*see¶ 13:332*). Certain "promoters" facilitate § 1031 exchanges by offering cotenancy interests in rental property that can be exchanged later for the replacement property.

(a) [13:309.1] **Compare—partnership interests:**Section 1031 does *not* apply to an exchange involving a "cotenancy" interest that is in fact classified for tax purposes as a *partnership* interest (*see¶ 13:259.1 ff.*). Therefore, taxpayers participating in such an exchange should attempt to comply with IRS guidelines regarding the tax treatment of an "undivided fractional interest" (i.e., a tenancy in common) in rental real property to ensure that the cotenancy will qualify for IRC § 1031 treatment (see Rev.Proc. 2002-22, 2002-1 CB 733; *and¶ 13:259.4*). [See also Lipton, "The 'State of the

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Art' in Like-Kind Exchanges, 2012" (2012) 116 J. of Tax. 246, 273-275; Borden, "Open Tenancies in Common" (2009) 39 Seton Hall L.Rev.]

(7) [13:309.2] **Development rights:** Under state law, development rights in real property may be transferred separately from the property itself. The IRS has ruled that those development rights are of like-kind to real property for IRC § 1031 purposes. Thus, a taxpayer may swap one of its real properties for development rights, and then use those rights to develop another one of its properties. [Priv.Ltr.Rul. 200901020; Priv.Ltr.Rul. 200805012]

[13:309.3 - 13:309.4] ***Reserved.***

(8) [13:309.5] **Limited liability company interests?** Where a taxpayer proposed to exchange an interest in real property for an interest in a single-member limited liability company, the IRS held that the acquisition of the LLC could be treated as the acquisition of IRC § 1031 like-kind replacement property to the extent that the LLC's property at the time of the exchange consists of qualifying like-kind property; any other property held by the LLC would be taxable as "boot" (¶ *13:317*). [Rev.Rul. 99-6, 1999-1 CB 432; Priv.Ltr.Rul. 200118023]

(9) [13:310] **Exceptions—property not subject to § 1031 treatment:** IRC § 1031 is inapplicable to many types of property, thus making exchanges of such property taxable events. The exceptions include:

- [13:311] *Property held primarily for sale.* [IRC § 1031(a)(2); *Neal T. Baker Enterprises, Inc. v. Commissioner*, TC Memo 1998-302]

  Thus, "dealers" cannot take advantage of IRC § 1031 with respect to property held for sale to customers. [*Neal T. Baker Enterprises, Inc. v. Commissioner*, TC Memo 1998-302—IRC § 1031 treatment not available where taxpayer sold 14 subdivided lots before exchanging remaining 38 lots; *and see* ¶ *13:422 ff.* for discussion of dealer property]

  Cross-refer: For a discussion of *Baker*, supra, see Cuff, "Tax Free Real Estate Transactions" (1999) 26 J. Real Est. Tax 304.

- [13:312] *Foreign real property*. [IRC § 1031(h)]

[13:313 - 13:315.4] ***Reserved.***

(10) [13:315.5] **Compare—improvements:** Sometimes surrendered real property is exchanged into replacement property on which improvements are partially constructed or will be constructed in the future. *Contracts to construct* improvements in the future are *not* like-kind to real property for IRC § 1031 purposes. On the other hand, improvements *under construction* on the replacement property will qualify as like-kind real property to the extent those improvements are classified as real estate under state law on the date the replacement property is received. [See Treas.Reg. § 1.1031(k)-1(e)]

(a) [13:315.6] **Comment:** A "reverse deferred exchange" (¶ *13:339.5 ff.*) could be used to qualify an exchange involving replacement property on which improvements will be constructed in the future as tax-free. For instance, the replacement property may be acquired by an independent party who then constructs the improvements. The replacement property, including the newly-constructed improvements, is then exchanged for the surrendered property.

However, exchanging parties using the "parking arrangement" form of a reverse exchange (¶ *13:339.8 ff.*) may find it difficult meeting the 180-day requirement (¶ *13:339.15*) because of potential construction delays.

[13:315.7 - 13:315.9] ***Reserved.***

(11) [13:315.10] **Compare—assignment of right to receive future income generated by property:** If the exchange involves a transfer of the right to receive future income generated by the property (e.g., an assignment of the right to receive oil lease income), it is *not* a like-kind exchange; the property received is not "substantially a continuation of the old investment still unliquidated" (*see* ¶ *13:316*). [*Commissioner v. P. G. Lake, Inc.* (1958) 356 US 260, 267-268, 78 S.Ct. 691, 695-696]

b. [13:316] **"Held" for productive use or investment requirement:** The relinquished property in a IRC § 1031 exchange must be "held" for productive use or investment. The replacement property must also be held as such. [IRC § 1031(a)(1)]

The rationale behind this rule is that "the taxpayer's economic situation after the transfer is fundamentally the same as it was before the transfer: his money is still tied up in investment in the same kind of property." [*Magneson v. Commissioner*

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(9th Cir. 1985) 753 F2d 1490, 1494-1495—taxpayers exchanged property for like-kind property which they continued to hold for investment, albeit in different form of ownership]

(1) [13:316.1] **Taxpayer's intention re replacement property:** The taxpayer must establish that their primary intention is to hold the replacement property for productive use or investment. [See *Adams v. Commissioner,* TC Memo 2013-7—replacement property rented to taxpayer's son for below market price still qualified as "like kind" because rent was deemed "fair" given substantial renovation work son did to make property livable; *Goolsby v. Commissioner*, TC Memo 2010-64—replacement property disqualified as "like kind" where taxpayer moved in shortly after exchange and made only feeble attempt to rent]

(2) [13:316.2] **Length of time "held" not dispositive:** There is no bright line rule for determining how long the relinquished or replacement property must be held in order to qualify for a IRC § 1031 exchange. The taxpayer's *intent* to hold the property for productive use or investment is dispositive, rather than the amount of time the property is held. [See Priv.Ltr.Rul. 8429039—where replacement property held for 2 years, exchange qualified for § 1031 treatment; *Reesink v. Commissioner*, TC Memo-2012-118—where replacement property held for 8 months before being converted to personal residence, exchange qualified for § 1031 treatment (taxpayer's unsuccessful attempts to rent replacement property and change in personal financial circumstances justified removing property from rental market); see also generally, Fogel, "How Long Must Like-Kind Exchange Properties be Held?" (Sept. 25, 2006) 112 Tax Notes 1133]

(3) [13:316.3] **Compare—property acquired for purpose of sale or exchange:** If the taxpayer acquired the relinquished property with the intention of selling or exchanging it (rather than holding it for productive use or investment), the exchange does *not* qualify under IRC § 1031. [See *Black v. Commissioner* (1960) 35 TC 90, 95; Rev.Rul. 75-291, 1975-2 CB 332; Rev.Rul. 77-297, 1977-2 CB 304; Rev.Rul. 84-121, 1984-2 CB 168]

Put another way, for an exchange to qualify under § 1031, the taxpayer need not have an intent to keep the relinquished property *indefinitely prior to* forming the intent to exchange it for the replacement property. Rather, if the taxpayer owns property that they do not intend to dispose of by sale or exchange or to use for personal pursuits, it is held for productive use in trade or business or for investment within the meaning of § 1031. [*Bolker v. Commissioner* (9th Cir. 1985) 760 F2d 1039, 1045—where taxpayer received property in tax-free corporate liquidation and then exchanged it for like-kind property several months later, exchange qualified under § 1031 because liquidation planned before taxpayer formed intent to swap properties]

(a) [13:316.4] **Effect of holding property as investment in different form:** Where immediately after a like-kind exchange, the taxpayer does not dispose of the property but continues to own it, albeit in a different *form*, the exchange still qualifies for IRC § 1031 tax-free treatment. [See *Magneson v. Commissioner* (9th Cir. 1985) 753 F2d 1490, 1494-1496—exchange of property for like-kind property, followed by prearranged contribution of replacement property to partnership, qualified under § 1031 because taxpayers intended to and continued to hold replacement property (contribution to partnership was change in form of ownership of replacement property rather than relinquishment of property); *Maloney v. Commissioner* (1989) 93 TC 89, 95-99—same where corporation exchanged property for like-kind property and then distributed replacement property to taxpayers, who were controlling shareholders of corporation, as part of liquidation of corporation; see also Lipton, "The 'State of the Art' in Like-Kind Exchanges, 2012" (2012) 116 J. of Tax. 246, 276-282]

1) [13:316.5] **Compare—California's application of step-transaction doctrine:** Traditionally, California's tax authorities (i.e., the Franchise Tax Board and Office of Tax Appeals) have applied aggressively the step-transaction doctrine to recharacterize immediate drop downs of replacement property as exchanges of real property for partnership interests, making them ineligible for IRC § 1031 treatment. [See *Matter of the Consol. Appeals of S. Kwon et al.,* OTA Case Nos. 18011810-13 (April 14, 2021)—Office of Tax Appeals determined partnership's (*not* individual taxpayers') receipt of property meant holding period requirement was violated in swap and drop transaction]

By the same token, the Office of Tax Appeals has followed federal law on swaps and drops where the facts were appropriate. [See *Matter of Sharon Mitchell*, 2018 OTA 210 (citing *Magneson*, supra, with approval)—FTB determination re swap and drop transaction that last minute change in ownership violated holding period requirement overturned]

(4) [13:316.6] **Mixed-use property:** For purposes of the IRC § 1031 "held-for" requirement, taxpayers may not bifurcate a single asset so that it can be considered one personal use property and one business use property. [See ILM 201605017—private plane used for both personal and business reasons had to be treated as one or the other]

Although the IRS has not specified how much business use is necessary to make a mixed-use asset qualify, it has indicated that less than 50% is insufficient. [See ILM 201605017; Davis, "IRS Punted on Like-Kind Exchange Deferral Percentage" (May 16, 2016) 151 Tax Notes 904]

(5) [13:316.7] **Profit not required:** Property held for productive use in a trade or business need not generated profits to qualify for IRC § 1031 treatment. [See ILM 201601011—property leased to related entity at rate that does not generate profit still satisfies "held-for" test if entity cannot own it outright and property is otherwise productively used]

(6) [13:316.8] **Conversion of residential property before exchange:** The property relinquished in a IRC § 1031 exchange must have been held for productive use in a trade or business or for investment. As a result, residential property ordinarily is not eligible for nonrecognition treatment upon a like-kind exchange. If, however, the property was converted to rental use before the exchange, it may satisfy the "held" requirement. [See IRC § 1031(a)(1)]

(a) [13:316.8a] **Eligibility for IRC § 121 exclusion:** Because of prior residential use, a property transfer may qualify for both nonrecognition under IRC § 1031 (¶ 13:316.8) *and* for an exclusion under IRC § 121 (¶ 13:345 ff.). [See Priv.Ltr.Rul. 201944006—taxpayers who satisfy all § 1031 nonrecognition requirements may apply IRC § 121 up to maximum amount and also apply § 1031 to amount of gain that exceeds § 121 maximum]

c. [13:317] **Treatment where property received not solely of like kind—gain on "boot":** Where the taxpayer receives both property of like kind *and* "other property or money" (commonly referred to as "boot"), loss is not recognized. [IRC § 1031(c)] However, realized gain is recognized to the extent of the value of the boot. [IRC § 1031(b)]

(1) [13:317.1] **Example:** Bob owns Blackacre, worth $1,000. His basis for Blackacre is $400. He exchanges it for Whiteacre, worth $900. In addition, Bob receives $100 cash. Bob's realized gain is $600, but his recognized gain is only $100.

(*Compare:* If Bob's basis for Blackacre were $980, his realized and recognized gain would be only $20, even though he received $100 of boot.)

(2) Mortgages on surrendered property as "boot"

(a) [13:318] **General rule:** Where surrendered property is subject to a mortgage, the party acquiring the property commonly assumes or takes subject to that mortgage. To the party surrendering the encumbered property, the debt taken over by the acquiring party is treated the same as cash. Thus it is treated as boot received. [Treas.Reg. §§ 1.1031(b)-1(c), 1.1031(d)-2 ex. (1)]

(b) [13:318.1] **Netting of mortgages:** However, if there is a mortgage on *both* the property surrendered *and* the property acquired, the two mortgages are netted against each other. [Treas.Reg. § 1.1031(b)-1(c)]

• If the taxpayer takes on more debt than they gave up, the taxpayer is not treated as receiving any boot. Instead the two mortgages cancel out and the taxpayer is treated as if they paid cash equal to the excess of the mortgage acquired over the mortgage surrendered. [Treas.Reg. § 1.1031(d)-2 ex. (2)]

• But if the taxpayer gives up more debt than they take on, the difference is treated as cash received. [Treas.Reg. § 1.1031(d)-2 ex. (2)]

Cross-refer: For detailed discussion of the various scenarios relating to mortgage netting, see Cuff, "Liabilities in Section 1031 Exchanges" (2000) 27 J. Real Est. Tax 119.

1) [13:318.2] **Netting, boot received:** Alice's basis for Blackacre is $400. Blackacre is worth $1,000 and is subject to a $300 trust deed. Thus, Alice's equity is $700.

Alice swaps Blackacre for Whiteacre. Whiteacre is worth $800 and is subject to a $160 trust deed, yielding $640 in equity. To equalize the deal, Alice receives $60 in cash. Alice therefore receives a total of $200 in boot in this transaction—the $140 difference in the debts plus the $60 cash. Alice's realized gain was $600, but her recognized gain is $200.

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2) [13:318.3] **Netting, boot paid:** Alice's basis for Blackacre is $400; Blackacre is worth $1,000 but is subject to a $300 trust deed (equity of $700). Alice swaps Blackacre for Whiteacre (owned by Wanda). Whiteacre is worth $1,600 and is subject to a trust deed of $500 (equity of $1,100). Alice also pays $400 to equalize the exchange (thus, both parties pay $1,100). Alice's realized gain is $600 but she recognizes no gain. Although Wanda took over Alice's $300 debt, Alice took on new debt of $500. The two debts are netted and Alice is treated as having paid $200 in cash on the exchange of debt plus an additional $400 in cash.

3) [13:318.4] **Netting plus cash received:** Again, assume Alice's basis for Blackacre is $400 and it is worth $1,000 but is subject to a $300 trust deed (equity of $700). Alice exchanges it for Greenacre, owned by George. Greenacre is worth $800 and is subject to a debt of $720 (equity of $80). Thus, George pays Alice $620 in cash. In this situation, the two debts are first netted; Alice is treated as having paid $420 cash because she took on debt of $720 and gave up debt of $300. However, Alice is still treated as having received $620 cash, because the Regulations do not allow netting of the mortgages to reduce the actual cash received on the deal. As a result, Alice recognizes her entire $600 realized gain because she has received $620 in boot. [Treas.Reg. § 1.1031(d)-2 ex. (2)(b)]

4) [13:318.5] **Netting plus cash paid:** In the example at *¶ 13:318.4*, assume George's basis for Greenacre was $50. George had a realized gain of $750. When the two mortgages are netted, George is treated as having received cash of $420 (i.e., he gave up debt of $720 and acquired debt of only $300). However, the $620 cash *paid* by George reduces this sum. George is treated as having received no boot and instead is treated as having paid $200 in cash. [Treas.Reg. § 1.1031(d)-2 ex. (2)(c)]

(3) [13:319] **Costs of exchange reducing boot:** In some circumstances, the IRS has ruled that boot received can be reduced by the taxpayer's costs incurred in making the exchange. [Rev.Rul. 72-456, 1972-2 CB 468 (brokerage costs offset cash received); see Levine & Schneider, "Netting Boot Received Against Expenses Paid in a Section 1031 Exchange" (1990) 18 J. of Real Est. Tax 14]

[13:320] ***Reserved.***

(4) [13:321] **Tax deferral under installment method:** If boot received in a IRC § 1031 exchange is in the form of a deferred payment obligation, the installment method can be used to defer tax until the obligation is paid. [IRC § 453(f)(6); Prop.Regs. § 1.453-1(f)]

Cross-refer: The installment method is discussed at *¶ 13:466 ff.*

➪ [13:321.1] ***PRACTICE POINTER:*** Sellers in a tax-free exchange involving encumbered property may want to receive cash in the deal but not have to recognize it as taxable boot. One way to accomplish this is to refinance the property either before or after the exchange and receive the refinanced loan proceeds tax-free. However, caution should be taken to make sure that the refinancing is *completely separate* from the exchange. Otherwise, the IRS should assert that the refinancing proceeds are actually taxable boot.

d. [13:322] **Basis of property received:** The basis of property received in a IRC § 1031 exchange is the same as the basis of the property exchanged, decreased by the amount of any money the taxpayer receives and increased by any gain (or decreased by any loss) recognized by the taxpayer on the exchange. [IRC § 1031(d); Rev.Rul. 92-95]

Note again that the taxpayer is treated as paying cash if the mortgage on the property received is greater than on the property surrendered; conversely, the taxpayer is treated as receiving cash if the mortgage on the property surrendered is greater than on the property received. [See Treas.Reg. § 1.1031(d)-2, examples]

(1) [13:323] **Noncash boot:** Noncash boot received in a IRC § 1031 exchange is given a basis equal to its value. [IRC § 1031(d)]

(2) Examples

• [13:324] Blackacre is worth $1,000. Bob's basis for Blackacre is $400. Bob exchanges Blackacre for Whiteacre, worth $900. Bob also receives $100 in cash. The basis of Whiteacre is $400: old basis ($400), plus gain recognized ($100), less cash received ($100). However, if the basis of Blackacre had been $980, the basis of Whiteacre would be $900: old basis ($980), plus gain recognized ($20), less cash received ($100).

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• [13:325] In the preceding example, Willy owned Whiteacre, which was worth $900. Willy's basis for Whiteacre was $820. Willy did not receive any boot on the exchange, but he paid $100 in boot. Willy does not recognize gain. His basis for Blackacre is $920: old basis ($820) plus cash paid ($100).

• [13:326] Bob trades Blackacre, worth $1,000, for Whiteacre, worth $900. Bob's old basis for Blackacre was $400. Instead of $100 cash, Bob receives GM stock worth $100. Bob recognizes $100 gain. His basis for Whiteacre is $400 and his basis for the GM stock is $100.

e. [13:327] **Multi-party exchanges:** It is often necessary to involve a third party to facilitate a IRC § 1031 exchange. This is permissible so long as the taxpayer makes an exchange.

(1) Examples

• [13:328] Bob owns Blackacre, which he would like to exchange for Whiteacre, owned by Willy. However, Willy wants to sell for cash. Tom wants to buy Blackacre for cash. In this situation, Tom could purchase Whiteacre for cash; then Tom could exchange Whiteacre for Blackacre. Since Bob never receives cash—only Whiteacre in exchange for Blackacre —he qualifies under IRC § 1031 and recognizes no gain.

• [13:329] The problem in the example at ¶ 13:328 could also have been solved if Bob and Willy exchanged Blackacre for Whiteacre; then Willy sold Blackacre to Tom for cash.

(2) [13:330] **Four parties:** As a practical matter, it is often necessary to involve a fourth party in such exchanges to serve as facilitator.

• [13:331] **Example:** Again assume Bob owns Blackacre, which he would like to exchange for Whiteacre, owned by Willy; Willy wants to sell for cash and Tom wants to buy Blackacre for cash. Assume further that Fred is the fourth party.

Using cash supplied by Tom, Fred purchases Whiteacre from Willy; Fred exchanges Whiteacre for Blackacre with Bob; then Fred transfers Blackacre to Tom. Fred can achieve all of this with only a single escrow.

(For an excellent treatment of the many variations on the multi-party exchange scenario, see Wasserman, "Mr. Mogul's Perpetual Search for Tax Deferral: Techniques and Questions Involving Section 1031—Like-Kind Exchanges in a World of Changing Tax Alternatives" (1987) 65 Taxes 975.)

f. [13:332] **Deferred exchanges:** Exchanges deferred for brief periods will qualify for IRC § 1031 treatment. [IRC § 1031(a)(3), codifying but limiting *Starker v. United States* (9th Cir. 1979) 602 F2d 1341, 1354-1355]

(For a detailed discussion of deferred exchanges, see Lipton, "The 'State of the Art' in Like-Kind Exchanges, 2012" (2012) 116 J. of Tax. 246, 249. For a basic discussion of a straightforward deferred exchange with practical tips, see Cuff, "Structuring a Simple Forward Real Estate Exchange" (2007) 34 J. Real Est. Tax 77.)

The following three conditions apply (IRC § 1031(a)(3)):

• The taxpayer must *identify* the replacement property *within 45 days* after transferring the old property. [IRC § 1031(a)(3)(A)]

• The taxpayer actually must *receive* the replacement property *on or before 180 days* after transferring the old property *or on or before the due date for the tax return* for the year in which the transfer occurred (including extensions)—*whichever date comes sooner*. [IRC § 1031(a)(3)(B); Brady, "Planning Tax-Deferred Exchanges Around the Year-End" (Jan. 11, 2016) 150 Tax Notes 241]

If the taxpayer fails to apply for a tax return filing extension (although one would automatically have been granted), replacement property acquired after the return due date is disqualified. [*Christensen v. Commissioner*, TC Memo 1996-254, aff'd (9th Cir. 1998) 142 F3d 442— old property transferred to facilitator on 12/22/88, but replacement property not acquired until 4/25/89—after 4/17/89 due date for 1988 return]

• The replacement property must be "substantially the same property as identified." [See Treas.Reg. § 1.1031(k)-1(d)]

➪ [13:332.1] ***PRACTICE POINTER:*** The 45- and 180-day periods begin running only when the taxpayer transfers title to, or the benefits and burdens of ownership of, the old property to the buyer, whichever occurs first (*see*¶ *13:46 ff.*). Thus, where the taxpayer anticipates needing more time to identify and receive the replacement property, the taxpayer may wish to delay the date when escrow closes on the sale of the old property. However, if the buyer is eager to gain possession of

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the property, such a delay may be unacceptable. Under these circumstances, in order to accommodate both parties' desires, rather than sell the property outright to the buyer, the taxpayer could grant the buyer an option to purchase (*see¶ 13:50*) and simultaneously lease the property to the buyer. To avoid having this arrangement being considered an immediate sale, market rates for the option grant and the lease should be used. [See generally, Copple, "What if the Seller Needs More Time?" (2007) 34 J. Real Est. Tax. 69, 71-76]

(1) [13:333] **Identification requirement:** Within the 45-day period (¶ 13:332 ff.), the replacement property must be identified in a written document signed by the taxpayer and delivered to the person obligated to transfer the replacement property to the taxpayer (or to any other person involved in the exchange). The document must unambiguously identify the replacement property. [Treas.Reg. § 1.1031(k)-1(c); see *Smith v. Commissioner*, TC Memo 1997-109, aff'd (4th Cir. 1997) 129 F3d 1260—T failed to formally identify replacement property within 45 days even though he had already focused on that property]

(a) [13:334] **Identification of multiple properties:** The taxpayer can identify up to three properties without regard to their market value or any number of properties if their aggregate market value does not exceed 200% of the value of the relinquished properties. Identifications can be revoked. [Treas.Reg. § 1.1031(k)-1(c)]

If properties originally identified as replacement property are determined to be ineligible, it may be possible to substitute other properly identified properties acquired within the statutory time periods. [TAM 201437012]

(2) [13:335] **Security arrangements—"safe harbors":** A taxpayer who transfers property as part of a deferred exchange is properly concerned that the return promise to convey property in the future be adequately secured. Similarly, the taxpayer may be entitled to receive cash if no suitable replacement property is identified or purchased; yet, the taxpayer must avoid receiving or constructively receiving money if replacement property is actually acquired. [Treas.Reg. § 1.1031(k)-1(f)]

The Regulations provide for a number of "safe harbors" whereby the promise to convey property or cash in the future can be secured without disqualifying the exchange:

(a) [13:336] **Security:** The return promise can be secured by a mortgage or other security interest in property, a standby letter of credit, or a third party guaranty. [Treas.Reg. § 1.1031(k)-1(g)(2)]

(b) [13:337] **Qualified escrow or qualified trust; express limitations:** The cash obtained from selling the taxpayer's property can be held in an escrow or trust if the escrow holder or trustee is not the taxpayer or a "disqualified person." A "disqualified person" is someone who is the taxpayer's agent (or who has been an agent within the preceding two years) or a family member or related entity. The escrow or trust must *expressly limit* the taxpayer's rights to obtain the cash or borrow against any cash held in the escrow or trust. [Treas.Reg. § 1.1031(k)-1(g)(3), (6) & (k); see also Wagner, "Ruling Paves the Way for Professionals to Operate Section 1031 Exchange Intermediaries" (Dec. 2003) 99 J. Tax. 349; Cuff, "Issues in Cashing Out of an Exchange"(2000) 28 J. Real Est. Tax 68; Cuff, "High Anxiety and the Effect of a Premature Disbursement of Exchange Balances on Deferred Exchanges" (1995) 23 J. Real Est. Tax 31]

Having in place *express limitations* on the taxpayer's right to receive, pledge, borrow or otherwise access funds held in an escrow account may satisfy the requirements for a qualified escrow when there is an accidental transfer of funds. [See *Morton v. United States* (Fed.Cl. 2011) 98 Fed.Cl. 596—escrow agent's accidental transfer of funds to taxpayer's S corporation did not invalidate like-kind exchange where express limitations on taxpayer's right to access said funds were in place and taxpayer immediately returned funds to escrow account; compare *Crandall v. Commissioner*, TC Summ.Opn. 2011-14—absence of express limitations on taxpayer's right to access escrow funds fatal to like-kind exchange even though taxpayer did not actually receive any proceeds]

(c) [13:338] **Qualified intermediary (QI):** A QI cannot be the taxpayer or a "disqualified person" (¶ *13:337*). [See *Blangiardo v. Commissioner,* TC Memo 2014-110—exchange ruled taxable because qualified intermediary was taxpayer's son; Lipton et al., "The 'State of the Art' in Like-Kind Exchanges - 2015" (Jan. 2016) 124 J. Tax. 5, 11]

Moreover, the taxpayer must be unable to obtain cash or borrow against cash held by the QI (as explained at ¶ *13:337*). A QI enters into a written agreement with the taxpayer to acquire the old property, dispose of the old property, acquire the new property, and transfer the new property to the taxpayer.

"Direct deeding" is permitted—i.e., the taxpayer may deed the property to the purchaser and the seller of the replacement property can deed it to the taxpayer. Thus, the QI can stay out of the chain of title. [Treas.Reg. § 1.1031(k)-1(g)(4); see Cuff, "Working with Deferred Exchange Accommodators" (Jan. 1991) 13 L.A. Lwyr. 13; Dukes, "Direct Deeding May Avoid Intermediary's Environmental Exposure" (1993) 79 Tax. 210]

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1) [13:338.1] **Example:** On May 17, pursuant to a written agreement, Bob deeds Blackacre to Ira. Ira is unrelated to Bob and has not acted as his agent (except insofar as Ira serves as a QI in this transaction). Ira sells Blackacre to Tom for cash and holds the cash in an escrow account. On or before July 1, Bob identifies Whiteacre, owned by Willy, as his replacement property. On or before November 13, Ira uses Tom's cash to buy Whiteacre. Willy conveys Whiteacre to Ira and Ira conveys it to Bob. The written agreement between Bob and Ira sufficiently limited Bob's ability to obtain cash held by Ira or borrow against it. Ira is a QI, and Bob's deferred exchange of Blackacre for Whiteacre qualifies under IRC § 1031. [Treas.Reg. § 1.1031(k)-1(g)(8) ex. 3]

The transaction would also be eligible for § 1031 treatment if Bob deeded Blackacre directly to Tom and Willy deeded Whiteacre directly to Bob. [Treas.Reg. § 1.1031(k)-1(g)(4)]

➪ [13:338.2] ***PRACTICE POINTER:*** To protect against the QI mismanaging funds, the exchanging parties should investigate the QI's financial viability and creditworthiness before turning funds over to the QI. [See Sikora, "Deferred Exchanges—Selecting A QI and Document the Transaction With It" (2007) 107 J. of Tax 297]

In addition, either of the "safe harbor" security arrangements described at ¶ 13:335 ff. can be used in conjunction with the QI. For instance, the parties could require the QI to secure the QI's obligations (*see*¶ *13:336*) or to hold the exchange funds in an escrow or trust (*see*¶ *13:337*).

2) [13:338.3] **Default by QI:** One risk associated with the deferred exchange procedure is that the QI may go bankrupt and thus be unable to complete the transaction within the statutory time periods. As a result, the IRS has ruled the taxpayer need not recognize immediate gain, but will recognize it in the year the taxpayer receives a payment attributable to the relinquished property. [Rev.Proc. 2010-14, 2010-12 IRB 456; see Lipton & Weller, "IRS Provides Limited Relief for Section 1031 Exchanges that Fail Due to Default by a QI" (2010) 113 J. of Tax. 5]

[13:339] ***Reserved.***

(3) [13:339.1] **Use of installment method:** The installment method can be used in the case of a deferred exchange that straddles several tax years or where the taxpayer receives a deferred payment note in a transaction that employed a qualified intermediary. [Treas.Reg. § 1.1031(k)-1(j)(2); see *Smalley v. Commissioner* (2001) 116 TC 450—taxpayer had bona fide intent to enter into deferred sale, so installment method applies; *Christensen v. Commissioner*, TC Memo 1996-254, aff'd (9th Cir. 1998) 142 F3d 442—deferred exchange not meeting IRC § 1031(a)(3) time requirements (¶ *13:332*) qualifies for installment method; see also Cuff, "Combining Installment Sales & Exchanges Under the Final 453/1031 Regulations" (1994) 22 J. Real Est. Tax. 15]

• [13:339.2] **Example:** Pursuant to a qualified IRC § 1031 deferred exchange, P transfers Blackacre, subject to a $100,000 liability, in Year 1, and receives Whiteacre, subject to a $60,000 liability, in Year 2. P's $40,000 decrease in liability is treated as boot (*see*¶ *13:318.1*) and taxable in Year 1 (the year P surrendered the old property) and *not* in Year 2 (the year P acquired the replacement property). [See Rev.Rul. 2003-56, 2003-1 CB 985 (discussing tax treatment of partnership's liabilities resulting from deferred exchange); Lipton, "Multi-Year Deferred Like-Kind Exchanges by Partnerships" (August 2003) 98 J. of Tax. 69]

Cross-refer: For a discussion of the installment method, *see*¶ *13:466 ff.*

[13:339.3 - 13:339.4] ***Reserved.***

(4) [13:339.5] **Compare—reverse deferred exchanges:** Rather than deferring the acquisition of replacement property for a brief period of time (a typical *Starker* exchange scenario, ¶ *13:332*), a taxpayer may want to acquire replacement property *before* transferring the old property.

A "reverse exchange" occurs when the taxpayer *first acquires* the replacement property, *then disposes* of the old property.

(a) [13:339.6] **Generally nonqualified § 1031 exchanges:** Generally, reverse deferred exchanges do *not* qualify for nonrecognition under IRC § 1031(a)(3) or the regulations thereunder. [*DeCleene v. Commissioner* (2000) 115 TC 457; TAM 200039005—reverse exchange using third party accommodator did not qualify for IRC § 1031 nonrecognition; but see Priv.Ltr.Rul. 9814019, as modified by Priv.Ltr.Rul. 9823045—reverse exchange transaction between two parties, where conveyance of new easement to taxpayer to be followed by relinquishment of old easement to second party *qualified* as like-kind exchange]

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1) [13:339.7] **Example:** TP owned Property Old and wished to exchange it for Property New. B wanted to acquire Old. TP first purchased New for cash, then deeded New to B. B improved New with TP's funds. TP swapped with B, giving up Old and receiving New. The Tax Court held this was an attempted reverse deferred exchange without a third party intermediary and therefore did not qualify as a IRC § 1031 exchange under the safe harbor provision (¶ *13:338*). TP had never, in substance, disposed of New; the "parking transaction" (¶ *13:339.8*) with B was disregarded and, as a result, there was no exchange. The transaction boiled down to TP buying New for cash, then selling Old to B for cash. [*DeCleene v. Commissioner*, supra (preceding eff. date of Rev.Proc. 2000-37, ¶ *13:339.8*)]

(b) [13:339.8] **"Parking" exception—QEAA transactions:** The IRS has provided a "safe harbor"— known as a "qualified exchange accommodation arrangement" (QEAA)—by which such transactions can qualify under IRC § 1031. QEAA transactions will not be challenged by the IRS. [Rev.Proc. 2000-37, 2000-2 CB 308; see Lipton, "The 'State of the Art' in Like-Kind Exchanges, 2012" (2012) 116 J. of Tax. 246, 250-253; Levine, "Long-Awaited IRS Guidance on 'Parking Arrangements' Facilitates Like-Kind Exchanges" (2001) 28 J. Real Est. Tax. 91; Cuff, "Foot Faults, Pratfalls, and Landmines for Parking Transactions Under Section 1031" (2002) 29 J. Real Est. Tax. 106; Cuff, "The Strange State of the Law on Exchange Accommodation Titleholders" (2003) 30 Real Est. Tax. 52]

It is unclear whether California tax authorities will follow Rev.Proc. 2000-37.

1) [13:339.9] **General description of QEAA:** A QEAA generally works as follows:

• The replacement property is located by the taxpayer/owner of the old property (TP); the replacement property is acquired by a third party (the "exchange accommodation titleholder" or EAT) with funds loaned to EAT by TP. This is sometimes referred to as a "parking transaction."

• TP locates a buyer (B) for the old property.

• TP transfers the old property to EAT in exchange for the replacement property.

• EAT transfers the old property to B.

[13:339.10] ***Reserved.***

2) Rev.Proc. 2000-37 requirements for QEAA transactions

• [13:339.11] EAT must hold all the "qualified indicia of ownership" of the property, including legal title. EAT must not be a "disqualified person" (¶ *13:337*) and must be an individual or entity that is subject to income tax. [Rev.Proc. 2000-37, § 4.02(1)]

• [13:339.12] When EAT acquires the property, "it is the taxpayer's bona fide intent" that the property represent either replacement property or relinquished property in an exchange that is *intended* to qualify for IRC § 1031 nonrecognition. [Rev.Proc. 2000-37, § 4.02(2)]

• [13:339.13] No later than five business days after EAT acquires the replacement property, TP and EAT must enter into a written agreement (the "QEAA Agreement") providing that (i) the property is held to facilitate a IRC § 1031 exchange in compliance with Rev.Proc. 2000-37, and (ii) EAT agrees to report the transaction as provided in Rev.Proc. 2000-37 and to be treated as the beneficial owner of the property for all income tax purposes. [Rev.Proc. 2000-37, § 4.02(3); see Rev.Proc. 2000-37§ 4.03 (setting forth various provisions that can be included in a QEAA agreement)]

The IRS has ruled that a statement in a QEAA Agreement that EAT is acting as the agent for TP "for all purposes other than federal income tax purposes" does not invalidate the QEAA Agreement or the QEAA. [Priv.Ltr.Rul. 200148042; but see Cuff, supra, 30 Real Est. Tax. at 57]

• [13:339.14] No later than 45 days after EAT acquires the replacement property, TP must "identify" one or more relinquished properties in a manner consistent with the usual deferred exchange rules (¶ *13:333 ff.*). [Rev.Proc. 2000-37, § 4.02(4)]

• [13:339.15] No later than 180 days after EAT acquires the replacement property, that property is transferred to the taxpayer (either directly or indirectly through a qualified intermediary, ¶ *13:338*) as replacement property (in

exchange for the old property), *or* to a person who is not the taxpayer or a disqualified person as relinquished property. [Rev.Proc. 2000-37, § 4.02(5)]

• [13:339.16] The "combined time period that the relinquished property and the replacement property are held in a QEAA does not exceed 180 days" (the "QEAA period"). [Rev.Proc. 2000-37, § 4.02(6)]

• [13:339.16a] TP cannot have owned the replacement property within the 180-day period ending on the date of transfer of ownership of the replacement property to EAT. [Rev.Proc. 2004-51, 2004-33 IRB 294; see also Alton, Borden & Lederman, "Rev.Proc. 2004-51: The IRS Strikes Back" (Feb. 2005) 83 Taxes 17]

a) [13:339.17] **Nonexclusive criteria:** Rev.Proc. 2000-37 states that no inference should be drawn that reverse deferred exchanges not meeting the precise terms of the Rev. Proc. cannot qualify for nonrecognition. Indeed, in a subsequent private ruling, the IRS approved such a transaction. [Priv.Ltr.Rul. 200011025; see also *Estate of Bartell v. Commissioner* (2016) 147 TC 140 (approving accommodation party with unrelated party where arrangement not within Rev. Proc. "safe harbor")]

Nevertheless, as a matter of caution, practitioners should strive to follow Rev.Proc. 2000-37 in all respects, especially since the IRS has announced its nonacquiescence in *Bartell.* [See AOD 2017-06; Banoff & Lipton, "Living with *Bartell* Uncertainty" (Nov. 2017) 127 J. Tax'n 238]

b) [13:339.17a] **Using one intermediary for related parties:** The IRS has approved the use of a single intermediary by related parties in a reverse deferred exchange. [See Priv.Ltr.Rul. 201242003—IRC § 1031 applied to defer gain in transaction where taxpayer and related party entered into separate QEAAs for parking same property held by single EAT; Lipton et al., "The 'State of the Art' in Like-Kind Exchanges - 2015" (Jan. 2016) 124 J. Tax. 5, 13-14]

c) [13:339.17b] **"Parking" transactions involving land leased from exchanging taxpayer's relative:** The IRS has approved a transaction in which a person related to the taxpayer transferred a leasehold interest in land to an accommodation party who made improvements to the land before transferring the leasehold and the improvements to the taxpayer in exchange for other real estate. [Priv.Ltr.Rul. 201408019]

3) [13:339.18] **Permissible involvement with replacement property:** During the QEAA period (¶ *13:339.16*), TP (the taxpayer) can be involved with the replacement property by, for example, leasing it from EAT, or managing or supervising improvements thereto, and still qualify for the QEAA exception. [Rev.Proc. 2000-37, § 4.03(4) & (5)]

➪ [13:339.19] ***PRACTICE POINTER:*** A strategy for a seller who is fast approaching the 45-day deadline (¶ *13:339.14*) without having yet identified the replacement property is to delay the closing date for the sale of the relinquished property. This can be done by including a provision in the relinquished property's sale agreement to extend the closing date, or by the buyer first leasing the relinquished property from the seller and then purchasing the property at a later date.

g. [13:340] **Special limitations on "related party" exchanges:** IRC § 1031 does not apply to an exchange with a "related party" if, within two years after the date of the last transfer, either the related party conveys the old property or the taxpayer conveys the new property. [IRC § 1031(f), (g); see generally, Alton, Borden, & Lederman, "Related-Party Like-Kind Exchanges" (Apr. 30, 2007) 115 Tax Notes 467]

For this purpose "related party" includes the taxpayer's spouse, lineal ancestors and descendants, siblings, and numerous related entities. [IRC § 1031(f)(3), incorporating IRC §§ 267(b) & 707(b)(1)]

The "related party" provision applies "to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection." [IRC § 1031(f)(4)]

(1) Examples

• [13:341] Bob exchanges Blackacre for Whiteacre, owned by Willy. Willy is Bob's brother. Within two years, Willy sells Blackacre for cash. This sale *disqualifies* the original exchange. Bob must recognize gain or loss on the original exchange, but he recognizes it as of the date on which Willy disposed of Blackacre. [IRC § 1031(f)(1)]

• [13:341.1] Bob transfers Blackacre to QI, a qualified intermediary (*see* ¶ *13:338*). QI sells Blackacre to Mary for cash, and one week later uses the cash to purchase Whiteacre from Willy, Bob's brother. QI then transfers Whiteacre to Bob. The result is the same as in the example at ¶ *13:341*: The IRC § 1031 nonrecognition provisions do not apply because the transaction is in substance an attempt to avoid the "related party" exclusion. [IRC § 1031(f)(4); *Teruya Bros., Ltd. v. Commissioner* (9th Cir. 2009) 580 F3d 1038, 1045-1048—T who used QI to sell low-basis property to unrelated taxpayer

and acquired new property from related party recognized IRC § 1031(f)(4) gain because transaction was structured to avoid related party rules; *Ocmulgee Fields, Inc. v. Commissioner* (2009) 132 TC 105, 106, aff'd (11th Cir. 2010) 613 F3d 1360, 1368-1373 (same); see also *North Central Rental & Leasing, LLC ex rel. Butler v. United States* (D ND 2013) 112 AFTR2d 2013-7045—T's use of related party to acquire replacement property violated related party rules even though replacement property was acquired in anticipation of exchange; Alton, Borden & Lederman, "Are Related Party Acquisitions in Anticipation of Exchange Technically and Theoretically Invalid?" (2014) 120 J. Tax'n 52; and Lipton, "The 'State of the Art' in Like-Kind Exchanges, 2012" (2012) 116 J. Tax. 246, 253-262]

(2) [13:342] **Exceptions for certain dispositions:**IRC § 1031(f) does not apply to certain dispositions. [IRC § 1031(f)(2)] The excepted (disregarded) dispositions are:

• A disposition after the earlier of the death of the taxpayer or the related party. [IRC § 1031(f)(2)(A)]

• A disposition in an involuntary conversion, such as a condemnation or casualty. [IRC § 1031(f)(2)(B)]

• A disposition with respect to which it is established that neither the exchange nor the disposition had as one of its principal purposes the avoidance of federal income tax. [IRC § 1031(f)(2)(C); see also Priv.Ltr.Rul. 201216007—taxpayer established series of dispositions to related parties were not motivated by tax avoidance because no material cashing out by any related party occurred within two years of each respective transfer; Priv.Ltr.Rul. 201834010—disposition of two properties received and subsequently transferred by taxpayer's two wholly-owned LLCs disregarded since both dispositions were part of nonrecognition transactions in which no cash was received and were completed within two years of original receipt]

h. [13:343] **Like-kind exchange of property sold as personal residence within five years of acquisition:***See discussion at¶ 13:347.35*.

i. [13:344] **Like-kind exchange of nonresident-owned California property for out-of-state property:** According to the California Franchise Tax Board, when an out-of-state resident swaps California property for out-of-state property in an IRC § 1031 exchange and the out-of-state property is later sold in a taxable transaction, any unrecognized gain on the property is subject to California income tax. [FTB Pub. 1100, "Taxation of Nonresidents and Individuals Who Change Residency" (revised 5/2020) (downloadable at *www.ftb.ca.gov*); see also Weller & Marques, "State Income Tax Conformity with Section 1031" (2007) 34 J. Real Est. Tax 4, 8-9]

• [13:344.1] T, a Texas resident, exchanges California Property A for like-kind Property B located in Texas, resulting in a $15,000 gain. Subsequently, T sells Property B in a nondeferred transaction for a $20,000 gain. At that time, the unrecognized $15,000 gain on Property A, originating in California, is subject to California tax. [FTB Pub. 1100, supra, ex. 17]

• [13:344.2] Similarly, if T, a Nevada resident, exchanges Nevada business Property C for California business Property D, resulting in a $10,000 gain, and then sells Property D in a nondeferred transaction for a recognized gain of $50,000, the recognized $50,000 gain is taxable by California because the gain originated in California. [FTB Pub. 1100, supra, ex. 18]

(1) [13:344.3] **Annual reporting requirement:** Effective January 1, 2014, all residents and nonresidents who exchange California property for out-of-state replacement property under IRC § 1031 must file an information return with the Franchise Tax Board in the year of the exchange and in each subsequent year until the deferred gain or loss from the exchange is recognized. [Rev. & Tax.C. §§ 18032, 24953]

4. [13:344.4] **Opportunity Zones (IRC § 1400Z-1 et seq.):** To encourage investment in economically distressed communities, gains from property sales that are reinvested within 180 days in "Qualified Opportunity Funds" (¶ 13:344.5) are, at the election of the taxpayer, deferred until the earlier of the date the investments are sold or exchanged and December 31, 2026. [See IRC § 1400Z-2(a), (b); Sheppard, "Opportunity Zones: Tax Benefits, Criticisms, and Early IRS Enforcement" (2nd Quarter 2023) Real Estate Tax'n 4; Berman & Weller, "Opportunity Zone Investments: The New Emerald City of Tax Law" (2019) J. Tax'n 6; Griffith & Morris, "Opportunity Zone Benefits: Nuts and Bolts; and Loose or Missing Screws" (2019) 97 Taxes 47; compare Treas.Reg. § 1.1400Z2(a)-1(c)(8)(iii)(B)—if partnership does not elect to defer all of its eligible gain, partner may elect to start its own 180-day period on last day of partnership taxable year or due date for partnership's tax return].

Elections must be made by filing Forms 8949 and 8997 for individuals, and Form 8996 for the funds as part of the taxpayer's annual return. The IRS, however, has granted permission for late elections. [See Sheppard, "Opportunity Zones, Late Elections, and new Enforcement and Oversight Actions" (Nov. 2022) J. Tax'n 3]

a. [13:344.5] **"Qualified Opportunity Funds":** A Qualified Opportunity Fund is any investment vehicle organized as a corporation or partnership that holds at least 90% of its assets in "Qualified Opportunity Zone Property" (¶ 13:344.6). The Fund's status is determined by the average of the percentage of assets it holds on (i) the last day of the first six months of the fund's taxable year, and (ii) the last day of the fund's taxable year. [IRC § 1400Z-2(d)(1); Treas.Reg. § 1.1400Z2(d)-1(c)(1)]

b. [13:344.6] **"Qualified Opportunity Zone Property":** Qualified Opportunity Zone Property means:

- "Qualified Opportunity Zone Business Property" (¶ 13:344.7) located in a "Qualified Opportunity Zone" (¶ 13:344.9); *or*

- Stock or partnership interests acquired *after 12/31/17* in a corporation or partnership that qualifies as a "Qualified Opportunity Zone Business," *or* a business entity in which substantially all of its assets constitute Qualified Opportunity Zone Business Property. [IRC § 1400Z-2(d)(2); see also Treas.Reg. § 1.1400Z2(d)-2(d)(3)(i), (d)(4)(ii)—"substantially all" requirement is satisfied if, during at least 90% of period, 70% of entity's property is used in qualified opportunity zone]

c. [13:344.7] **"Qualified Opportunity Zone Business Property":** Qualified Opportunity Zone Business Property is tangible property acquired *after 12/31/17* and used by a Qualified Opportunity Fund's trade or business in the Qualified Opportunity Zone (¶ 13:344.9). It may be property originally used *or* "substantially improved" (¶ 13:344.8) by the Qualified Opportunity Fund (¶ 13:344.5). [IRC § 1400Z-2(d)(2)(D)]

(1) [13:344.8] **"Substantial improvement":** Although "substantial improvement" is measured by an increase in the basis from when a property was originally acquired, if land is purchased with a building that is subsequently substantially improved, the original use requirement is ignored for purposes of the land. [See Rev.Rul. 2018-29, 2018-45 IRB 765]

d. [13:344.9] **"Qualified Opportunity Zone":** A Qualified Opportunity Zone is a population census tract in a low income community (¶ 13:344.10) that is designated as a Qualified Opportunity Zone by the Governor or chief executive of the State in which it is located. [IRC § 1400Z-1(a), (b)]

(1) [13:344.10] **Low income community:** To qualify as low income, a community's poverty rate must be at least 20%. Alternatively, a community located within a metropolitan area qualifies as low income if its median family income does not exceed 80% of the greater of statewide median family income or the metropolitan median family income. And a community located outside a metropolitan area qualifies as low income if the median family income does not exceed 80% of the statewide median family income. [IRC §§ 1400Z-1(c)(1), 45D(e)(1)]

A tract that does not qualify as low income (above) still may be part of a Qualified Opportunity Zone if it is contiguous with a low income community and its median family income does not exceed 125% of the median family income for the low income community. [IRC § 1400Z-1(e)]

e. [13:344.11] **Special exemptions:** The gain from any sale or exchange of an investment held by a Qualified Opportunity Fund (¶ 13:344.5) for designated amounts of time is *exempt, not* merely deferred. But only investment of the gain, *not* recovery of the capital, is eligible for the basis step-ups and exemptions (¶ 13:344.12 ff.). [See IRC § 1400Z-2(e)(1)(B)]

(1) [13:344.12] **Five years:** The basis of any *investment* held for at least five years must be increased by an amount equal to 10% of the amount of gain deferred. [IRC § 1400Z-2(b)(2)(B)(iii)]

(2) [13:344.13] **Seven years:** In addition to the adjustment made for an investment held for five years (¶ 13:344.12), the basis for that same investment if it is held for at least seven years must be increased by an amount equal to 5% of the amount of gain deferred. Thus, the total amount exempted for an investment held for seven years is 15%. [IRC § 1400Z-2(b)(2)(B)(iv)]

(3) [13:344.14] **Ten years:** The basis for any investment held by a taxpayer for at least ten years, and for which the taxpayer makes an election, must be equal to the fair market value of the investment on the date it is sold or exchanged. [IRC § 1400Z-2(c)]

5. [13:345] **Sales of Personal Residence—IRC § 121 Exclusion:** Gain on the sale or exchange of a *principal residence* is excluded up to $250,000 for a single person, and up to $500,000 for a husband and wife filing a joint return in the year of sale. The $500,000 exclusion also applies to the sale by a surviving spouse within two years of the deceased spouse's death, provided the $500,000 ceiling would have applied to a sale prior to death. [IRC § 121(a), (b)]

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Cross-refer: A detailed explanation of IRC § 121 is set forth in IRS Publication 523, "Selling Your Home." It is available on the Internet (see *www.irs.gov*).

Loss compared: Loss is never recognized on the sale of personal assets, including residences. [IRC § 165(c)]

a. [13:345.1] **Effective date of $250,000/$500,000 exclusion:** The IRC § 121 $250,000/$500,000 exclusion applies to a sale or exchange of a principal residence *after May 6, 1997*. Sales prior to that date may be eligible for rollover of gain under now-repealed IRC § 1034 (¶ *13:349 ff.*) or exclusion of gain up to $125,000 under the former version of § 121 (¶ *13:365 ff.*).

b. [13:345.2] **Consequences of § 121, contrasted with prior law:** Suppose H & W bought their residence in 1970 for $200,000. Last year, they sold it for $1,600,000. This year, they buy another residence for $2,000,000. Under IRC § 121, they can exclude $500,000 of their $1,400,000 gain, but the remaining $900,000 is taxable in the year of the sale as a capital gain. The fact that they purchased another house is irrelevant. Under prior law (repealed IRC § 1034), the entire gain would have been rolled over. Thus, for expensive houses, present tax law is far less favorable to taxpayers than prior law.

➪ [13:345.3] ***PRACTICE POINTER:*** Consequently, taxpayers who wish to move from a highly appreciated residence should consider *renting* rather than selling it. If it is possible to hold the property until the taxpayer's death, the basis will be stepped up to fair market value and the capital gain tax will be avoided (*see*¶ *13:23*).

c. [13:346] **General conditions for § 121 exclusion:** To qualify for IRC § 121 gain exclusion, the taxpayer must satisfy *each* of *three separate two-year requirements:*

• *Ownership* of the property for at least *two* of the five years preceding the date of the sale;

• *Use* of the property as a *principal residence* for at least *two* of the five years preceding the date of the sale; *and*

• The taxpayer cannot have made any *other sale* to which § 121 applied during the *two-year* period ending on the date of the sale. [IRC § 121(a), (b)(3)(A)]

(1) [13:346.1] **Establishing two-year ownership and use:** The two-year ownership and use requirements can be satisfied by the taxpayer's ownership and use for 24 full months *or* 730 days in the five-year period ending on the date of sale. [Treas.Reg. § 1.121-1(c)(1)]

(a) [13:346.2] **Concurrent periods *not required:*** The periods counted for satisfying the two-year ownership and use requirements do *not* have to be concurrent. [Treas.Reg. § 1.121-1(c)(1)]

1) [13:346.2a] **Example:** T lived in a rented townhouse from 1993 to 1997. He bought the townhouse on January 1, 1998. On February 1, 1998, he moved into his daughter's home. On March 1, 2000, while still living in his daughter's home, T sold the townhouse. T qualifies for a IRC § 121 exclusion because as of the date of sale he had both owned and used the townhouse as a principal residence for at least two of the preceding five years, even though those periods did not coincide. [Treas.Reg. § 1.121-1(c)(4), ex. 3]

(b) [13:346.3] **"Use" requires actual occupancy:** The use requirement is satisfied only if the taxpayer *actually "occupies"* the house for two years. [Treas.Reg. § 1.121-1(c)(2)(i)]

Thus, if a taxpayer moves out of the house while attempting to sell it, and this period of sale extends beyond three years, IRC § 121 will not apply to the ultimate sale.

(c) [13:346.4] **Effect of temporary absences:** Short temporary absences from the residence, such as for vacation or other seasonal absence (even though accompanied by a rental of the residence) are counted as periods of use for the two-year use requirement. [Treas.Reg. § 1.121-1(c)(2)(i)]

• [13:346.4a] **Examples:** A two-month summer vacation is considered a short temporary absence, while a professor's one-year sabbatical leave is *not*. [Treas.Reg. § 1.121-1(c)(4), ex. 4, 5]

(d) [13:346.4b] **Effect of "out-of-residence" care:** A taxpayer may become physically or mentally incapable of self-care and move out of their house into a licensed care facility (such as a nursing home). So long as the taxpayer owns and uses the house as their principal residence for *at least one year* during the five-year period preceding the sale of the house, the time spent in the facility can be added to the time of actual use of the house to satisfy the two-year use requirement. [Treas.Reg. § 1.121-1(c)(2)(ii)]

[13:346.4c - 13:346.4f] *Reserved.*

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(2) [13:346.4g] **Reductions for “nonqualified use”:** The amount of gain on the sale of a principal residence that qualifies for the IRC § 121 exclusion must be reduced by the amount of gain allocated to periods of *nonqualified use* that occur on or after January 1, 2009. [IRC § 121(b)(4) (second of two enacted with same paragraph number)]

(a) [13:346.4h] **Calculating reduction:** The allocation is determined by a fraction. The numerator is the aggregate periods of nonqualified use while the taxpayer owned the property and the denominator is the period the taxpayer owned the property. [IRC § 121(b)(4) (second of two enacted with same paragraph number)]

(b) [13:346.4i] **Meaning of “nonqualified use”:** The term “nonqualified use” means any period of time occurring on or after January 1, 2009, “during which the property is not used as the principal residence of the taxpayer or the taxpayer's spouse or former spouse.” [IRC § 121(b)(4)(C)(i)]

Presumably, the rules relating to temporary absences (*¶ 13:346.4*) apply in this instance so that temporary absences do not count as nonqualified use. On the other hand, it is unclear how the various rules under the “facts and circumstances” test (*¶ 13:346.11*) are to be integrated into the “nonqualifying” use test.

(c) [13:346.4j] **Exceptions:** The term “nonqualified” use does not apply to:

• Any portion of the five-year period ending on the date of sale that falls after the last date the property is used as the principal residence of the taxpayer or their spouse (or former spouse);

• A period of temporary absence (not to exceed an aggregate period of two years) due to change of employment, health conditions or such other unforeseen circumstances as are specified by the Secretary; and

• An absence due to “qualified official extended duty” in the armed services. [IRC § 121(b)(4)(C)]

(For a similar provision relating to temporary absences that cause taxpayers to fail to satisfy the IRC § 121 ownership/use requirements, *see¶ 13:346.5 ff.*)

(d) [13:346.4k] **Coordination with depreciation provision:** The provision for “nonqualified use” must be coordinated with the provision relating to recapture of depreciation on the property (*¶ 13:347.18*). [See IRC § 121(b)(4)(D) (second of two enacted with same paragraph number)]

(e) [13:346.4*l*] **Example:** T, a single taxpayer and law professor, bought a house in 2008 and sold it in 2012. She owned it for 48 months (1,440 days). During 2010, the house was vacant for 360 days because T was on a sabbatical leave in Argentina. She used the house as a principal residence for 1,080 days prior to sale. Her gain on sale was $280,000. Although T meets both the use and ownership tests of IRC § 121, she must reduce the amount of her gain qualifying for the exclusion by a fraction of 25% (360/1440). Thus, she is permitted to exclude only $210,000 of gain (75% of the total). The remaining $70,000 of gain is taxable as a long term capital gain (at the rate of 15%). [See Emily White example in IRS Publication 523, “Selling Your Home”]

(3) [13:346.5] **Hardship exception to two-year rules:** In certain hardship cases, the two-year rules (*¶ 13:346*) are relaxed. If the hardship rule applies, the taxpayer's gain is excluded, but the maximum exclusion figure is *reduced* (*¶ 13:346.7*). [IRC § 121(c)]

(a) Eligible hardships

1) [13:346.6] **Change in employment or health:** Taxpayers fall within the IRC § 121(c) hardship exception if the sale or exchange occurs because of a *change in place of employment or health*. [Treas.Reg. § 1.121-3(b), (c), (d)]

A “change in place of employment” requires the new job to be at least *50 miles* farther from the sold house than the old job was. [Treas.Reg. § 1.121-3(c)(2)(ii)] “Employment” includes beginning work with a new employer, continuing work with the same employer, or beginning or continuing self-employment. [Treas.Reg. § 1.121-3(c)(3)]

A “change in health” requires a physician's recommendation. [Treas.Reg. § 1.121-3(d)(2)]

2) [13:346.6a] **“Unforeseen circumstances”:** The hardship exception also applies when a sale or exchange occurs because of other *unforeseen circumstances*. [Treas.Reg. § 1.121-3(e)]

An “unforeseen circumstances” sale is one where the primary reason for the sale is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence. It does *not* apply to a sale that occurs because of the taxpayer's preference “for a different residence or an improvement in financial circumstances.” [Treas.Reg. § 1.121-3(e)(1)]

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The following events are considered "safe harbors," meaning they *always* qualify as "unforeseen circumstances" *so long as* they occur during the period of the taxpayer's ownership and use of the property as a principal residence:

• Involuntary conversions of the residence;

• Natural or man-made disasters, or acts of war or terrorism resulting in damage to the residence;

• Death;

• Cessation of employment resulting in eligibility for unemployment compensation;

• Change in employment status that results in the taxpayer's inability to pay housing costs and reasonable basic household expenses;

• Divorce or legal separation;

• Multiple births resulting from the same pregnancy;

• Other events or situations designated by the Commissioner as unforeseen circumstances in "published guidance of general applicability," or identified in rulings issued by the Commissioner to specific taxpayers. [Treas.Reg. § 1.121-3(e)(2)-(3); see Priv.Ltr.Rul. 201628002—single child's birth deemed unforeseen circumstance]

a) [13:346.6b] **Failure to satisfy disclosure obligations?** According to a private letter ruling, a taxpayer's sale of their residence caused by the previous owner's failure to satisfy a state-mandated disclosure obligation during the prior purchase and sale transaction (*see*¶ *4:354 ff.*) may constitute an "unforeseen circumstance." [See Priv.Ltr.Rul. 200702032—where taxpayer sold residence and sued previous owner for failing to disclose airport noise problem as required by state law, proceeds of lawsuit settlement treated as proceeds from sale and fell under "unforeseen circumstances" rule]

(b) [13:346.6c] **"Qualified individuals":** The events giving rise to the hardships described at ¶ 13:346.6 ff. must occur to a "qualified individual," defined as the taxpayer, the taxpayer's spouse, a co-owner of the residence, a person whose principal place of abode is the residence, or a close relative. [Treas.Reg. § 1.121-3(f)]

For purposes of the "change in health" exception (¶ *13:346.6*) only, in addition to those persons identified above, a "qualified individual" may include a close relative as described in IRC § 152(a)(1)-(8), or a descendant of the taxpayer's grandparent. [Treas.Reg. § 1.121-3(f)]

(c) [13:346.7] **Adjusted exclusion formula:** If the hardship rule applies, a *proportional* exclusion is available based on a fraction of the maximum exclusion available ($250,000 or $500,000). [Treas.Reg. § 1.121-3(g)(1)]

The numerator in the fraction is the shortest of the period of ownership, period of use, or period of time since the previous sale, and the denominator is either 24 months or 730 days (depending on whether the numerator was measured in months or days, ¶ *13:346.1*).

• [13:346.8] **Example:** A, who is single, owns her residence for only 12 months before she sells it because of a change in her place of employment. She realizes a gain of $400,000. A does not qualify for the normal ($250,000) IRC § 121 exclusion because she owned and used the house for only one year; but she is eligible for the hardship exclusion. The fraction is 12 over 24. Since the maximum normal exclusion would be $250,000, A's hardship exclusion is $125,000 ($250,000 x 12/24). The remaining $275,000 gain is taxable. [Treas.Reg. § 1.121-3(g)(2), ex. 1]

[13:346.9] ***Reserved.***

(4) [13:346.10] **"Principal residence":** The property must have been used as the taxpayer's *principal residence* for at least two of the five years preceding the sale (¶ *13:346*).

(a) [13:346.10a] **Demolished home:** If an old house is demolished and a new one is rebuilt on the same land, the taxpayer must live in the new house for two of the five years preceding the sale. The time spent living in the old house does not count. [*Gates v. Commissioner* (2010) 135 TC 1, 4-14]

1) [13:346.10b] **Comment:** In *Gates,* supra, the new house was much larger than the old house and their "footprints" did not coincide (i.e., the perimeter of the old house's foundation did not correspond to the perimeter of the new house's foundation). Moreover, since the taxpayers never lived in the new house, they could not meet the IRC § 121 "use" test.

2) [13:346.10c] **Demolition vs. remodel:** Under *Gates*, supra, there is a major distinction between extensively remodeling a house *versus* demolishing it and rebuilding a new one on the property. It is unclear whether a new house that utilizes the foundations of the old one (or one wall from the old house), but otherwise is rebuilt from the ground up, would be treated as a remodel or a demolition.

(b) [13:346.11] **"Facts and circumstances" test:** Whether property is used by the taxpayer as their principal residence depends on "all the facts and circumstances." [Treas.Reg. § 1.121-1(b)(2)]

1) [13:346.12] **"Majority" use generally determinative:** If a taxpayer alternates between different residences, the property used by the taxpayer a *majority of the time during the year* will *ordinarily* be considered their principal residence. [Treas.Reg. § 1.121-1(b)(2); *Guinan v. United States* (D AZ 2003) 2003-1 USTC ¶ 50475—"time spent in a residence is a major factor, if not the most important factor"; *see*¶ *13:346.14*]

The fact that the taxpayer used one residence on more days in *total* during the *five-year* period preceding the sale is *irrelevant* "because [Treas.Reg. § 1.121-1(b)(2)] refers to the time spent in a residence during a *single* tax year." [*Guinan v. United States*, supra (emphasis added)—taxpayers who alternated between 3 residences only established that they spent more time in purported principal residence during first year of 5-year period]

2) [13:346.13] **Other relevant factors:** Other factors relevant to the principal residence determination include, but are not limited to:

- The taxpayer's place of employment;
- The principal place of abode of the taxpayer's family members;
- The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration;
- The taxpayer's mailing address for bills and correspondence;
- The location of the taxpayer's banks; and
- The location of religious organizations and recreational clubs with which the taxpayer is affiliated. [Treas.Reg. § 1.121-1(b)(2)]

(c) Examples

1) Exclusive use of different residences during separate periods *within same year*

- [13:346.14] T owns two residences, one in New York and one in Florida. During each of years 1 to 5, T lives in the New York residence for 7 months and the Florida residence for 5 months. Absent "facts and circumstances" indicating otherwise, the New York residence is T's principal residence. As a result, T would be eligible for the IRC § 121 exclusion from the sale of the New York residence, but not the Florida residence. [Treas.Reg. § 1.121-1(b)(4), ex. 1]
- [13:346.15] H and W owned two residences, one in Hagerstown, Maryland, and one in Berlin, Maryland. W spent most of her time at the Berlin residence. For business reasons, H often stayed during the week at Hagerstown but spent the weekends at Berlin.

  The Tax Court made a detailed examination of the facts and determined Berlin was the principal residence for W for 4 of the 5 years preceding its sale, and for H for 2 of the 5 years preceding the sale. Thus, H and W qualified for a $500,000 exclusion on the sale of the Berlin residence. This was so even though they maintained voting registrations, drivers' licenses, etc. in Hagerstown, where they lived before purchasing Berlin. [*Farah v. Commissioner*, TC Memo 2007-369]

• [13:346.16] T owned three residences, one in Wisconsin, another in Georgia, and the other in Arizona. T resided in the Wisconsin home during the warmer months and at the other homes during the rest of the year. T sought to establish the Wisconsin house as the principal residence. A majority of the relevant "facts and circumstances" (¶ *13:346.13*) did *not* favor *any* one of the residences as being the principal residence, while other important factors definitely pointed to the Wisconsin house as *not* being the principal residence. [*Guinan v. United States* (D AZ 2003) 2003-1 USTC ¶ 50475]

2) [13:346.17] **Exclusive use of different residences during separate periods *extending over several years:*** T owns houses in California and Nevada. In years 1 and 2, T lives exclusively in the California house. In years 3, 4 and 5, T lives only in the Nevada house. At the end of year 5, either house would be considered a principal residence since T met the ownership and use requirements as to both. [Treas.Reg. § 1.121-1(b)(4), ex. 2]

3) [13:346.18] ***Nonexclusive* use of different residences *during same period:*** T works in Oregon where he lives five days a week in a rented apartment. He spends the weekends in the house he owns in California. He regards California as his principal residence: He gets mail there, votes there, and his car is registered there. He sells the California house at a $350,000 gain. Under the "facts and circumstances" test, the California house could be considered T's "principal residence," even though he spends a majority of the time during the year in Oregon (*see*¶ *13:346.12*).

[13:346.19 - 13:346.24] *Reserved.*

d. [13:346.25] **Application to married couples filing joint return:** A husband and wife who file a *joint return* for the taxable year of the sale or exchange may qualify for the IRC § 121 exclusion as follows:

(1) [13:346.26] **Qualification for maximum $500,000 exclusion:** To qualify for the maximum $500,000 exclusion, *either* spouse can be the owner (they do not have to own the property jointly) but *both spouses* must meet the two-year use requirement and the "only-once-every-two-years" limitation (¶ *13:346*). [IRC § 121(b)(2); Treas.Reg. § 1.121-2(a)(3)(i)]

(2) [13:346.27] **Maximum exclusion where $500,000 exclusion requirements not met:** Where a married couple cannot meet the requirements described at ¶ 13:346.26, the maximum exclusion will be the *sum of each spouse's limitation amount determined on a separate basis, as if they had not been married.* For this purpose, each spouse is treated as owning the property during the period that *either* spouse owned the property. [Treas.Reg. § 1.121-2(a)(3)(ii)]

(a) [13:346.28] **Example—sale of separate residences:** H and W marry in year X and file a joint return. During that year, H and W each sell a residence that they owned separately before marriage. H and W each satisfy the ownership and use requirements for the houses they owned separately, but not for the house that the other owned. H realizes a gain of $300,000 on his house and W realizes a gain of $200,000 on her house.

On the joint return, each spouse is entitled to nonrecognition of gain under IRC § 121: H can exclude $250,000 of the sale price on his house (but must recognize the other $50,000 of gain). W can exclude the entire $200,000 gain on her house. [Treas.Reg. § 1.121-2(a)(4), ex. 3]

(b) [13:346.29] **Example—one spouse fails to satisfy use requirement:** H and W are married and sell their residence at a gain of $400,000. W, but not H, satisfies the use requirements for the house. They file a joint return. They can exclude $250,000 of the gain. This is the sum of each spouse's limitation amount determined on a separate basis: W has a limitation amount of $250,000 and H has a limitation amount of $0. W may not use H's unused exclusion to exclude gain in excess of her exclusion amount. [Treas.Reg. § 1.121-2(a)(4), ex. 4]

(3) [13:346.30] **Compare—separate returns:** If taxpayers jointly own a home but file *separate returns*, *each taxpayer* is entitled to exclude up to $250,000 of gain attributable to that taxpayer's interest in the property so long as the IRC § 121 requirements are otherwise met. [Treas.Reg. § 1.121-2(a)(2)]

• [13:346.31] **Example:** A and B (unmarried) jointly own a house as tenants in common or joint tenants, and live there together. After owning and using the house as their principal residence, they sell it for a $256,000 gain. A and B can each exclude $128,000 on their separate tax returns. [Treas.Reg. § 1.121-2(a)(4), ex. 1]

(4) [13:346.32] **Compare—surviving spouse:** A surviving spouse may qualify for the $500,000 exclusion amount (rather than the $250,000 allotted single persons) provided their residence is sold no later than two years after the deceased spouse's death, assuming the $500,000 exclusion requirements (¶ *13:346.26*) were met immediately prior to the death. [See IRC § 121(b)(4) (first of two enacted with same paragraph number)]

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e. Special marital dissolution rules

(1) [13:347] **Marital property divisions:** If a spouse or former spouse receives a residence in a marital property division described in IRC § 1041 (*see*¶ *13:385 ff.*), the period that the spouse or former spouse owns the property *includes* the period that the *transferor* owned the property. [IRC § 121(d)(3)(A)]

• [13:347a] **Example:** H owned Encino Home as his separate property. He purchased it for $100,000 before marrying W. H and W lived in Encino since 1980. When H and W divorced in 1998, H transferred Encino Home to W as part of a division of property. Under IRC § 1041, H did not recognize gain on this transfer; W's basis for the home remains $100,000 (*see*¶ *13:385 ff.*). W sold the house six months after receiving it for $1,000,000. W's realized gain is $900,000 but she can exclude $250,000 because she is treated as having owned Encino Home since 1980.

(2) [13:347b] **"Out spouse" rule:** Frequently, in marital dissolution situations, one spouse (the "in spouse") is given exclusive possession of the home for a period of time but it continues to be owned by both spouses. Later, the house is sold and the proceeds are divided between the "in spouse" and the "out spouse." For purposes of the IRC § 121 exclusion, the out spouse is treated as using the property as the out-spouse's principal residence during any period of ownership that the in spouse is granted use of the property under a divorce or separation agreement. [IRC § 121(d)(3)(B)] This provision corrects a serious problem under former IRC §§ 1034 and 121 (*see*¶ *13:359*).

• [13:347c] **Example:** When H and W divorce in 1996, their marital settlement agreement provides that W will continue to reside in the family home for five years until H and W's child reaches age 16, at which time the house will be sold and the proceeds divided equally. The house is sold in 2001 at a $700,000 gain. Pursuant to IRC § 121(d)(3)(B), H (the out spouse) satisfies the two-year use requirement; both H and W can exclude $250,000 of their $350,000 gain on the sale.

f. [13:347.1] **Election out of § 121:** A taxpayer may *elect out* of IRC § 121 by filing a return that includes in income the entire gain from sale of the principal residence in the taxable year. [IRC § 121(f); Treas.Reg. § 1.121-4(g)] It is permissible to *amend* a tax return (within the three-year limitations period) to elect out of § 121 even though the return as filed took advantage of the exclusion. [Treas.Reg. § 1.121-4(g)]

A taxpayer may wish to elect out of § 121 because the gain on the sale of a principal residence is relatively small and the taxpayer wants to keep the § 121 benefit available for a subsequent sale within two years after that sale. [See IRC § 121(b)(3)(A)—§ 121 benefit not available if previously applied to earlier sale during two-year period ending on sale date (¶ *13:346*)]

• [13:347.2] **Example:** W wants to sell a house in year 1 that she owned before marriage at a small gain. H and W contemplate that in year 2 H will sell a house he owned before marriage at a large gain. (Assume W meets the IRC § 121 ownership and use requirements because she lived for two years with H in his house prior to marriage.)

If W claims nonrecognition under § 121 for sale of her house in year 1, H cannot claim the maximum $500,000 exclusion for sale of his house in year 2 (¶ *13:346.26*). But if W elects out of § 121 in year 1, the full exclusion should be available for the sale of H's house in year 2.

[13:347.3 - 13:347.4] ***Reserved.***

g. [13:347.5] **Deceased spouse's ownership and use:** If an unmarried surviving spouse sells a residence that was owned and used by the deceased spouse, the surviving spouse's use and ownership will include the period of time the deceased spouse owned and used the property before death. [See IRC § 121(d)(2)]

(1) [13:347.6] **Example:** H bought a house in 1985 and used it as his principal residence until his death in 2000. Early in 2000, H and W were married and W moved into H's house. H died and W inherited the house and sold it in 2001 at a gain of $180,000 after having lived in it only one year. (Note that W's basis for H's house was stepped up to its value on the date of H's death; thus, the $180,000 appreciation occurred after H's death.) W can exclude the entire gain since she is permitted to treat H's ownership and use of the house as her own. [Treas.Reg. § 1.121-4(a); see Dilley & Callihan, "Planning Ideas for Sale of a Residence" (Aug. 24, 1998) 80 Tax Notes 949, 954-955]

(2) [13:347.7] **Sales within two years of death:** A surviving spouse qualifies for the full $500,000 exclusion if the sale occurs within two years of the date of the deceased spouse's death, provided the requirements for the maximum exclusion are met. [IRC § 121(b)(4)]

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Section 121(b)(4) applies regardless of whether the surviving spouse files a joint return for the sale year. (Whether the surviving spouse can file jointly for two years after the death of the deceased spouse depends on the surviving spouse maintaining a household that includes a dependent; see IRC § 2(a).)

➪ [13:347.8] ***PRACTICE POINTER:*** Call this point to the attention of a surviving spouse who owns a home that has appreciated in value. If the house was held as community property, both halves receive a stepped up basis (¶ *13:25*); and the appreciation occurring before the first spouse's death escapes taxation. But if the house was not held as community property and is to be sold in any event, the $500,000 (rather than $250,000) exclusion amount applies if the house is sold no later than two years after the death of the first spouse.

h. [13:347.9] **Application to joint owners filing separate returns:***See discussion at¶ 13:346.30 ff.*

[13:347.10 - 13:347.13] ***Reserved.***

i. [13:347.14] **Effect of depreciating residence:** Normally the owner of a house cannot claim depreciation deductions since the house is used for personal rather than business purposes (see IRC § 167(a); ¶ *13:292*). However, if the owner uses part of the house exclusively for business purposes, that portion can be depreciated under certain circumstances (¶ *13:293 ff.*).

In addition, if the taxpayer moves out of the house and rents it, the house can be depreciated during the period it is rented. However, the depreciation deductions on the house must be recaptured and cannot be excluded under IRC § 121 at the time the house is sold.

(1) [13:347.15] **Residential and business portions in *same dwelling unit:*** When a personal residence consists of a single "dwelling unit," part of which is used for business (such as a home office or for rental), the entire gain on the sale of the unit qualifies for nonrecognition under IRC § 121. [Treas.Reg. § 1.121-1(e)(1) & (4), ex. 4, 5 & 6]

However, if the portion used for business was *subject to a depreciation allowance* taken after May 6, 1997, an amount equal to the depreciation allowance does *not* qualify for nonrecognition under § 121. Instead that amount will be taxed at the rate of 25% (the rate applicable to depreciable realty under IRC § 1250) as opposed to the normal 15% long-term capital gain rate (Treas.Reg. § 1.121-1(d)). The amount recaptured is equal to the post-May 6, 1997 depreciation *or the realized gain,* whichever is less.

• [13:347.15a] **Example:** Attorney T owns a house that constitutes a single dwelling unit. She uses a portion of the house as an office and claims depreciation deductions of $2,000. After three years, T sells the house for a $13,000 gain. She must recognize $2,000 of the gain as "unrecaptured" depreciation, but may exclude the remaining $11,000 because she is not required to allocate gain to a business use of the dwelling unit. [Treas.Reg. § 1.121-1(e)(4), ex. 5]

Compare: If T sold the house for a $4,000 loss, there would be no depreciation recaptured since the recapture is limited to the amount of the realized gain on sale, if any.

(2) [13:347.16] **Rental property:** If a house was used for rental purposes and was subject to depreciation deductions taken after May 6, 1997, the same rule applies—i.e., the amount of the depreciation or the realized gain, whichever is less, is not excluded under IRC § 121. Instead, it is taxable at the rate of 25%. [IRC §§ 1(h)(1)(D) & 121(d)(6); Treas.Reg. § 1.121-1(d)]

(a) [13:347.16a] **Example:** T bought a house in 1998 that he rented to tenants until 2008. T claimed $14,000 in depreciation deductions for the years 1998 to 2008. In 2008, T moved into the house and lived there for two full years before selling it at a $40,000 gain. T has $14,000 in depreciation recapture that is taxed at the rate of 25%. The remainder of the $26,000 gain qualifies for exclusion under IRC § 121. [Treas.Reg. § 1.121-1(d)(2) ex.]

Compare: If the period of nonqualified use had occurred on or after January 1, 2009, the gain would be allocated between the periods of qualified and nonqualified use (¶ *13:346.4g*). The portion allocable to nonqualified use would be taxable as capital gain (15% tax rate) and would not qualify for exclusion under § 121.

(3) [13:347.17] **Business portion not within dwelling unit:** By contrast, when portions of a personal residence *separate* from the "dwelling unit" are used for business purposes (e.g., detached barn or basement apartment), the gain allocable to those portions does *not* qualify for IRC § 121 nonrecognition. [Treas.Reg. § 1.121-1(e)(1) & (4), ex. 1, 2 & 3; see also Hood, "Gain on the Sale of a Principal Residence: The Basics and Beyond"(Sept. 2008) 86 Taxes 17, 23-24, for detailed example of separate structure depreciation]

➪ [13:347.17a] ***PRACTICE POINTER:*** When a house that has appreciated in value will be sold for a *gain*, the owner should consider converting any portion of the house separate from the "dwelling unit" used for business purposes back to residential use at least two years before selling. By doing so, the owner will satisfy the IRC § 121 personal use requirement.

On the other hand, when the house has depreciated in value and will be sold for a *loss*, the owner should consider a different strategy. Loss resulting from the sale of real estate held for use in a trade or business is deductible (¶ *13:445*), while loss on the sale of property used as a personal residence is not (¶ *13:303.5*). By using the portion of the residence that is separate from the "dwelling unit" for business purposes during at least three of the five years preceding the sale, the owner should be able to deduct the loss allocable to the separate "business" portion of the house as an ordinary business loss.

(4) [13:347.18] **Nonqualified use and depreciation:** As pointed out at ¶ *13:347.16a*, if a principal residence was subject to "nonqualified use" on or after January 1, 2009, a portion of the gain on sale of the residence does not qualify for the IRC § 121 exclusion. If the property was subject to depreciation, the depreciation recapture is computed first and taxed at the rate of 25%. The remaining gain is subject to allocation between qualified and nonqualified use. [IRC § 121(b)(4)(D) (second of two enacted with same paragraph number)]

• [13:347.18a] **Example:** T, a single taxpayer and a law professor, bought a house in 2008 and sold it in 2012. She owned it for 48 months (1,440 days). During 2010, the house was vacant for 360 days because T was on a sabbatical leave in Argentina. She rented the house during her sabbatical and claimed $10,000 of depreciation on the house. She used the house as a principal residence for 1,080 days prior to sale. Her gain on sale was $280,000. T first must recapture $10,000 of her gain (the depreciation taken after May 6, 1997). This portion is taxed at the rate of 25%. [IRC § 1(h)(1)(D)]

Although T meets both the use and ownership tests of IRC § 121, she must further reduce the amount of her gain qualifying for the exclusion by a fraction of 25% (360/1440) because she had a period of nonqualified use after January 1, 2009. Thus, T is permitted to exclude only $210,000 of gain (75% of the total). The remaining $70,000 of gain is taxable as a long term capital gain (at the rate of 15%). [IRC § 1(h)(1)(C); see IRS Publication 523, "Selling Your Home," Emily White example, involving reductions both for depreciation and for nonqualified use]

(5) [13:347.19] **Sale satisfying requirements for § 121 and § 1031 nonrecognition of gain:** When a property used for business purposes (such as rental) was previously used as a residence during two of the preceding five years, and is exchanged for another like-kind business property, IRC §§ 121 (¶ *13:345 ff.*) and 1031 (¶ *13:304 ff.*) *both* apply. Specifically, § 121 must be applied first to any gain realized from the exchange, and then IRC § 1031 is applied to any amount of the gain that is not excluded under § 121.

For example, gain may be recognized despite § 121 because of a post-May 6, 1997 depreciation allowance (¶ *13:347.15*) or because it exceeds the $250,000/$500,000 ceilings (¶ *13:345*). If the property is disposed of in an exchange for another business property, those gains qualify for nonrecognition under § 1031. [Rev. Proc. 2005-14, 2005-1 CB 528; see also Siegel, "New Procedure on Taxation of Dual-Use Property Governs Interaction of Sections 121 and 1031" (2005) 102 J. of Tax. 282]

j. Homes held by trusts or entities

(1) [13:347.20] **Trusts:** A house owned by a *grantor trust* (i.e., a trust *not* treated for tax purposes as a separate taxpayer under IRC §§ 671-679) will be treated as if owned by the taxpayer(s)/grantor(s) of the trust for purposes of the IRC § 121 two-year ownership requirement. [Treas.Reg. § 1.121-1(c)(3)(i)]

For example, if a house is owned by a revocable or "living" trust and used by the taxpayer/grantor of the trust as a principal residence for two years, the sale of the house would qualify for the § 121 exclusion.

On the other hand, a house owned by a trust that is *taxed as a separate entity* will not be considered as owned by the taxpayer who is the owner or beneficiary of the trust; and the sale of the house will not qualify the taxpayer for § 121 gain exclusion.

(2) [13:347.21] **Single-owner entities:** A house owned by a *single-owner* entity (e.g., a one-member limited liability company) that elects for tax purposes to be disregarded as a separate taxpayer under Treas.Reg. § 301.7701-3(a), will be treated as if owned by that single member for purposes of the two-year ownership requirement. [Treas.Reg. § 1.121-1(c)(3)(ii)]

(3) [13:347.22] **Partnerships:**Treas.Reg. § 1.121-1(c)(3)(ii) (¶ 13:347.21) only applies to a single-owner entity electing to be disregarded as a separate taxpayer. Presumably, therefore, a house owned by a *partnership* will *not* be treated as owned by any one of the individual partners for IRC § 121 purposes.

[13:347.23 - 13:347.24] ***Reserved.***

k. [13:347.25] **Application to cooperatives:**IRC § 121 applies to the sale of stock in a housing cooperative. The requirement that the taxpayer own the residence for two years applies to the stock of the co-op; the two-year use requirement applies to the co-op house or apartment occupied by the taxpayer. [IRC § 121(d)(4); Treas.Reg. § 1.121-1(b)(1)]

l. [13:347.26] **Application to involuntary conversions:** If a principal residence is destroyed by a casualty or condemned, the receipt of insurance or condemnation proceeds is treated as a sale for purposes of IRC § 121. [IRS CCA 200734021—destroyed residence treated as sold for § 121 purposes]

In addition, if the casualty or condemnation gain exceeds $250,000 or $500,000, and if the taxpayer reinvests in another home, the excess gain qualifies for exclusion under IRC § 1033 (*see*¶ *13:375 ff.*). The amount realized from the involuntary conversion for IRC § 1033 purposes is reduced by the amount of gain excluded under § 121. [IRC § 121(d)(5); Prop.Regs. § 1.121-4(d); and see Lai & Thomas, “Tax Consequences of an Involuntary Conversion of a Principal Residence”(2008) 86 Taxes 33]

m. Application to sale or exchange of partial interests

(1) [13:347.27] **Partial interests other than remainder interests:** Subject to the rules regarding remainder interests (¶ *13:347.29*), a taxpayer may apply the IRC § 121 exclusion to gain from the sale or exchange of an interest in the taxpayer's principal residence that is *less than the taxpayer's entire interest* so long as the interest sold or exchanged includes an interest in the “dwelling unit.” However, all such sales or exchanges are aggregated, and only the first $250,000/$500,000 of gain on all the sales or exchanges can be excluded. [Treas.Reg. § 1.121-4(e)(1)]

• [13:347.28] **Example:** T owns a house used as a principal residence. In year 1, B moves in and T sells B a 50% interest in the house for a $136,000 gain. T properly excludes this gain under IRC § 121. In year 2, T sells B his remaining 50% interest in the house for a $138,000 gain, only $114,000 of which is excludable ($250,000 less the $136,000 previously-excluded gain). [Treas.Reg. § 1.121-4(e)(3)]

(2) [13:347.29] **Remainder interests:** A different rule applies to the sale or exchange of a remainder interest in a principal residence. Gain from the sale or exchange of a remainder interest to a *related party* (as defined in IRC §§ 267(b) or 707(b)) will *not* qualify for IRC § 121 exclusion. [Treas.Reg. § 1.121-4(e)(2)(ii)(B)]

On the other hand, a taxpayer may elect to apply the § 121 exclusion to gain from the sale or exchange of a remainder interest in the taxpayer's principal residence to an *unrelated* party; but, in that event, the taxpayer cannot exclude gain from the sale or exchange of *any other interest* in the residence that is sold or exchanged *separately*. [IRC § 121(d)(8); Treas.Reg. § 1.121-4(e)(2)(ii)(A)]

(a) [13:347.30] **How election made:** An election to exclude gain from the sale or exchange of a reminder interest to an unrelated party is made by filing a tax return for the year of the sale or exchange that does *not* include the gain in the taxpayer's gross income. This election may be made *or revoked* at any time before expiration of the three-year period running from the last date for filing a return for the taxable year in which the sale or exchange occurred. [Treas.Reg. § 1.121-4(e)(2)(iii)]

n. [13:347.31] **Application to sale of adjacent vacant land:** Under certain circumstances, the sale or exchange of vacant land adjacent to a taxpayer's principal residence may be considered a sale or exchange of the principal residence. [See Reichert, “Sale or Exchange of Principal Residence”(April 2003) 81 Taxes 49, 50-52]

(1) [13:347.32] **Qualifying conditions:** The sale of vacant land adjacent to a taxpayer's principal residence may be considered a sale or exchange of the taxpayer's principal residence for purposes of applying IRC § 121 when *all* of the following conditions are met:

• The vacant land is adjacent to land containing the “dwelling unit” of the principal residence;

• The taxpayer owned and used the vacant land as part of their principal residence;

• The taxpayer sells or exchanges the dwelling unit in a § 121 qualified sale or exchange within two years before or two years after the vacant land's sale or exchange; *and*

• The § 121 requirements have otherwise been met with respect to the vacant land. [Treas.Reg. § 1.121-1(b)(3)(i)]

(2) [13:347.33] **Maximum limitation amount:** For purposes of applying the maximum amount excludable under IRC § 121, the sale or exchange of the dwelling unit and the vacant land are treated as *one* sale or exchange. Therefore, only one maximum limitation amount ($250,000/$500,000) applies to the *combined* sales or exchanges of the vacant land and the dwelling unit. [Treas.Reg. § 1.121-1(b)(3)(ii), (4), ex. 3, 4]

o. [13:347.34] **Application to bankruptcy trustee's sale of principal residence:** IRC § 121 applies to the sale of an *individual* debtor's principal residence by a Chapter 7 or 11 bankruptcy trustee. [Treas.Reg. § 1.1398-3]

p. [13:347.35] **Application to property acquired in like-kind exchange as personal residence and sold within five years:** When a taxpayer acquires a house in a IRC § 1031 like-kind exchange (¶ *13:304 ff.*), uses it for their personal residence, and then sells it for a gain within five years of its acquisition, the gain is not excludable. This is the case even if the taxpayer used it as a principal residence for two of the five years (*see* ¶ *13:356*). [IRC § 121(d)(10)]

q. [13:347.36] **Application to settlement proceeds:** A taxpayer may sell a principal residence and then sue the person who sold them the property for failure to disclose various defects therein. The taxpayer's receipt of proceeds in settlement of the litigation is treated as additional gain on the sale of the residence and qualifies for nonrecognition treatment under IRC § 121. [See Priv.Ltr.Rul. 200702032]

r. [13:347.37] **Reporting home sales/gain on tax return:** If the gain on sale of a home is *wholly excludable* under IRC § 121, the transaction should *not be reported* on the seller's tax return. On the other hand, if the gain *exceeds the maximum* § 121 excludable gain, only the *excess* gain should be reported. [IRS Form 1040, Schedule D Instructions]

➪ [13:347.38] ***PRACTICE POINTER:*** Notwithstanding ¶ 13:347.37, if the taxpayer/seller receives a Form 1099-S from the escrow or title company, they probably should report the gain on Schedule D and then offset it by claiming a loss of the same amount, explaining that the gain is excludable under IRC § 121.

6. [13:348] **Sales of Personal Residence—Rollover/Exclusion Under Prior Law (pre-May 7, 1997 Sales):** With regard to nonrecognition or exclusion of gain on the sale or exchange of a principal residence, *prior law* applies if the sale or exchange occurred *before May 7, 1997*. Two different Code sections provided for nonrecognition of gain on such sales:

• [13:348.1] **Former IRC § 1034 rollover:** IRC § 1034 was called "rollover"—i.e., gain was not recognized if a new residence was purchased within two years before to two years after the sale of the old (*see* ¶ *13:349 ff.*).

➪ [13:348.2] ***PRACTICE POINTER—CONTINUING IMPORTANCE:*** IRC § 1034 remains important because a vast number of houses were purchased in rollover transactions. This affects the basis of the house (purchase price less unrecognized gain; *see* ¶ *13:351*). The taxpayer must know the basis of the house in order to apply the current IRC § 121 exclusion for sales of houses occurring after May 6, 1997.

• [13:348.3] **Former IRC § 121 one-time exclusion:** Before its amendment in 1997 (¶ *13:345 ff.*), IRC § 121 provided for a one-time exclusion (nonrecognition) of up to $125,000 gain if the seller was 55 years of age or older (*see* ¶ *13:365 ff.*).

a. [13:349] **Section 1034 rollover:** Rollover applied if a taxpayer sold a principal residence before May 7, 1997 and purchases or constructs another principal residence within a period of two years before to two years after the sale of the old residence. The taxpayer must actually occupy the new dwelling within the two-year period. [IRC § 1034(a)]

(1) [13:349.1] **Gain recognized only to extent price of old residence exceeds price of new:** If the purchase price of the new residence is equal to or greater than the "adjusted sales price" of the old, gain on the sale of the old house is not recognized. [IRC § 1034(a)]

On the other hand, if the purchase price of the new residence is *less* than the "adjusted sales price" of the old, gain is recognized to the extent of the difference. [IRC § 1034(a)]

• [13:350] **Example:** The basis of House A is $100,000. T sells it for $400,000 in 1996. Within two years, T buys House B for $330,000. Both houses are T's principal residence. Of the total $300,000 realized gain on the sale of House A, only $70,000 is recognized.

(Conversely, no gain would be recognized if House B were purchased for a price of at least $400,000.)

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(2) [13:351] **Basis of new house:** The basis of the new house is equal to its cost, *less any unrecognized gain* on the sale of the old house. [IRC § 1034(e)]

Thus, in the example at ¶ 13:350, the basis of House B is $100,000 (i.e., $330,000 less $230,000 of unrecognized gain on the sale of House A).

(3) [13:351.1] **Purchase requirement:** IRC § 1034 rollover requires that the old home be "sold" and the new home be "purchased." If either transaction is a gift or bequest, IRC § 1034 does not apply. [Treas.Reg. § 1.1034-1(c)(4)(i)]

For this purpose, note that any transfer *to or from a spouse* (or a former spouse incident to divorce) is treated as a gift, even if it is a cash purchase. [IRC § 1041, *discussed at* ¶ *13:385 ff.*]

• [13:351.2] **Example:** W is single and sold her home (Oak Street) for $300,000 in 1996. Her realized gain was $120,000. Within two years, she marries H and purchases a one-half interest in H's home (Elm Street) for $360,000. H has no realized gain because he had purchased Elm Street for $800,000 and it had declined in value to $720,000. Because of IRC § 1041, W's acquisition of one-half of Elm Street is considered a gift from H to W, not a purchase, even though W paid fair market value for it. Consequently, the $120,000 gain on W's sale of Oak Street is taxable and cannot be rolled over under IRC § 1034.

(The result would have been different had W purchased the interest in Elm Street *before* she married H, because § 1041 would not have applied to that purchase.)

[13:351.3 - 13:351.9] ***Reserved.***

(4) [13:351.10] **Identity of buyer:** IRC § 1034 did not prohibit a sale to related parties. [See Priv.Ltr.Rul. 9625035 (sale to closely-held corporation)]

(5) [13:352] **"Adjusted sales price":** For purposes of measuring the taxpayer's selling price for the old house, the sale price should be reduced by expenses for work performed on the old residence to assist in its sale ("adjusted sales price"). This rule applies to expenses for work performed within the 90-day period ending on the date on which the contract to sell the old residence is entered into and which are paid on or before 30 days after the date of sale of the old residence. [IRC § 1034(b)]

(6) [13:353] **Rollover procedure:** If the old house is sold in one year and the taxpayer intends to roll over the gain but has not purchased a new house by the end of the year, the taxpayer should file IRS Form 2119 with the return for the year of sale.

(a) [13:354] **Amended return:** In the event the taxpayer fails to purchase another residence within the rollover period, or if they purchase a new residence for a price lower than the sale price of the old, the taxpayer should file an amended return for the year of the sale that reports the gain.

(b) [13:355] **Statute of limitations on deficiency assessment:** The statute of limitations relating to assessment of a deficiency attributable to the gain in the year of sale shall not expire before the expiration of three years after the IRS is notified by the taxpayer about the purchase of the new residence or the taxpayer's failure to purchase a new residence. [IRC § 1034(j)]

IRS Form 2119 should be used to notify the Service.

(7) [13:356] **"Principal residence":** For the most part, case law has been generous to taxpayers in defining a "principal residence" for IRC § 1034 purposes.

Caveat: The continuing relevance of this authority under amended IRC § 121 is uncertain. For purposes of amended § 121, the issue normally will be whether the dwelling was "used by the taxpayer as the taxpayer's principal residence," rather than whether the dwelling qualifies as a "principal residence." Arguably, the test will require actual physical occupancy by the taxpayer for the requisite two-year period. (*See* ¶ *13:346 ff.*)

(a) [13:356.1] **Adjacent land may be included:** The acreage surrounding a home may be considered part of the taxpayer's principal residence if it is used for *personal purposes* such as "appreciating nature, living in open spaces, hiking, horseback riding, and enjoying unobstructed views of the countryside." [*Schlicher v. Commissioner*, TC Memo 1997-37 (decided under former IRC § 1034)]

(b) [13:357] **Absence for business reasons:** A home was deemed to remain the taxpayer's "principal residence" even though they were not living there at the time of sale if the taxpayer's absence was of a temporary nature required by the taxpayer's business or employment. [*Trisko v. Commissioner* (1957) 29 TC 515, 518-519; *Green v. Commissioner*, TC Memo 1992-439; Rev.Rul. 59-72, 1959-1 CB 5]

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(c) [13:358] **Temporary rentals:** Even more generously, a house was held to remain a principal residence even though the taxpayer moved out, continued trying to sell the house, and rented the house because market conditions precluded a sale. [*Bolaris v. Commissioner* (9th Cir. 1985) 776 F2d 1428, 1431, 1434—house remained principal residence *and* owner allowed to deduct loss on rental activity; *Green v. Commissioner*, supra; but see *Houlette v. Commissioner* (1967) 48 TC 350, 356-357—taxpayer who rented out dwelling deemed to abandon it as principal residence; see generally Bird, "Planning for the 'Temporary Rental' of a Principal Residence" (1993) 20 J. of Real Est. Tax 135]

(d) [13:359] **Compare—absence by marital breakup:** But prior law took a stricter approach with regard to a taxpayer's absence incident to a marital breakup. Once the taxpayer moved out, *permanently and with no intention to return,* pursuant to a divorce settlement that gave the other spouse exclusive occupancy and did not mandate that the house immediately be sold, the house could *no longer* qualify as the "principal residence" of the spouse who moved out and they could not take advantage of IRC § 1034 nonrecognition with respect to that property. [*Perry v. Commissioner* (9th Cir. 1996) 91 F3d 82, 86; *Young v. Commissioner*, TC Memo 1985-127; see also Hogoboom & King, *Cal. Prac. Guide: Family Law* (TRG), Ch. 10]

Thus, § 1034 rollover applies to the "in spouse" but *not* to the "out spouse." (Contrast this with the treatment under *amended IRC § 121*, where an out spouse in a marriage dissolution situation is allowed to take advantage of the in spouse's use of the residence and thus *can qualify* for the § 121 $250,000 gain exclusion; *see¶ 13:347 ff.*)

[13:360 - 13:361] ***Reserved.***

(e) [13:362] **Compare—business use:** To the extent part of a residence is used for *business purposes*, that part does *not* qualify for IRC § 1034 rollover. Gain attributable to the business premises (such as a home office) would be recognized, regardless of whether another house (with another office) is purchased. [Treas.Reg. § 1.1034-1(c)(3)(ii); *Schlicher v. Commissioner*, TC Memo 1997-37]

However, a home office is disqualified from rollover only if it meets the requirements for deductibility of expenses in the year of sale. [See Rev.Rul. 82-26, 1982-1 CB 114]

Cross-refer: Home office deductibility criteria (IRC § 280A(c)) are discussed at *¶ 13:293 ff.*

➪ [13:363] ***PRACTICE POINTER:*** Advise your clients to exercise great caution in claiming business deductions for part of a highly appreciated house. In many cases, the claim will itself be questionable—particularly a contention that the "business portion" is used "exclusively" for nonresidential purposes (*¶ 13:293*). And for taxpayers still eligible for IRC § 1034 rollover (pre-May 7, 1997 sales), the relatively small deductions available might well trigger recognition of a vastly greater amount of gain upon a sale of the house.

[13:364] ***Reserved.***

b. [13:365] **Former § 121 one-time exclusion:** For sales prior to May 7, 1997, up to $125,000 of gain ($62,500 in the case of a separate return by a married person) on the sale of a principal residence was not recognized if the taxpayer attained age 55 by the date of sale and so elected. [Former IRC § 121(a)(1), (b)(1)]

If the residence was held jointly or as community property and the spouses filed a joint return, only one spouse needed to be age 55. [Former IRC § 121(d)(1)]

(1) [13:366] **Three-of-five-year use limitation:** To qualify, the taxpayer must have used the property as a principal residence for a period of at least three years out of the five-year period ending on the date of sale. [Former IRC § 121(a)(2)] This means 36 full months or 1095 days during the five-year period. However, short temporary absences can be disregarded. [Treas.Reg. § 1.121-1(c)]

(2) [13:367] **Once-only election:** The election to take advantage of former IRC § 121 could be made only *once in a lifetime*. Also, the spouse of a married taxpayer had to join in the election, whether or not the spouse owned any portion of the residence. [Former IRC § 121(b)(2), (c)]

(a) [13:368] **Disqualification by spouse's prior election:** A IRC § 121 election could *not* be made if the taxpayer's spouse made a previous election— even before marrying the taxpayer. In effect, a spouse's § 121 election precluded the taxpayer from ever making such an election for a future sale. [Former IRC § 121(b)(2)]

(3) [13:369] **"Principal residence":** A § 121 election was available only if the taxpayer "owned and used" the property as their "principal residence." [Former § 121(a)]

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(a) [13:369.1] **Facts and circumstances test:** In determining whether a taxpayer "owned and used" property as a "principal residence" for three of the five years preceding its sale, courts have utilized the "facts and circumstances" test applied under IRC § 1034 (¶ *13:356 ff.*). [*Gummer v. United States* (Fed.Cl.1998) 40 Fed.Cl. 812, 819, 98-1 USTC ¶ 50401—applying Treas.Reg. § 1.121-3 (defining "principal residence" as having same meaning as under § 1034) and rejecting "strict physical occupancy" test urged by IRS]

(b) [13:369.2] **Comment:** Although amended IRC § 121 uses identical language ("owned and used as a principal residence"), it remains to be seen whether this more flexible "facts and circumstances" test will apply under the amended statute (*see*¶ *13:346.10 ff.*).

(4) [13:370] **Utilizing both former §§ 121 and 1034:** Where the respective conditions were met, it was possible to utilize both the IRC § 1034 rollover provision and the IRC § 121 one-time exclusion election. For § 1034 purposes, the sale price of the property was reduced by the amount of gain not recognized under § 121. [Former IRC § 121(d)(7)]

(a) [13:371] **Example:** T's basis for House A is $100,000 and he sells it in 1996 for $400,000 when he is age 55. He satisfies the IRC § 121 3-of-5-year rule and makes a § 121 election for nonrecognition of gain. T buys House B for $330,000 within two years of the sale of House A. Although his realized gain on House A is $300,000, the § 121 exclusion reduces the amount that would be recognized to only $175,000. By purchasing House B, even that gain is not recognized. The adjusted sales price of House A is deemed to be $275,000 ($400,000 less $125,000) and since he bought House B for more than $275,000, no gain on the sale of House A is recognized. The basis of House B is $155,000 ($330,000 less $175,000 of gain not recognized by reason of IRC § 1034).

(b) [13:371.1] **Proposition 13 advantages:** Also note that in this situation the taxpayer can retain the low property tax valuation of the transferred property (House A in the example at ¶ 13:371) by filing the appropriate claim. *See*¶ *13:91 ff.*

(5) [13:372] **Election procedure:** An election under former IRC § 121 could be made or revoked at any time within the limitations period for the year in which the sale occurred. The taxpayer made the election by attaching a signed statement, such as IRS Form 2119, to the tax return for the year of sale or an amended return. (Again, a married taxpayer's spouse had to join in the election or revocation.) [Former IRC § 121(c)]

[13:373 - 13:374] ***Reserved.***

7. [13:375] **Involuntary Conversions:** If property is subject to an "involuntary conversion" and replaced within the statutory period and the taxpayer so elects, gain on the involuntary conversion is not recognized. [IRC § 1033]

This provision only authorizes nonrecognition of gain; it does *not* apply to nonrecognition of loss.

a. [13:376] **"Involuntary conversion" defined:** An "involuntary conversion" for IRC § 1033 nonrecognition purposes means a destruction of the property through a casualty or theft and the recovery of money (from insurance or otherwise) resulting from such destruction; or condemnation of the property (or sale of the property under the threat of condemnation). [IRC § 1033(a)]

b. [13:377] **Replacement period:** The property must be replaced within a period of two years after the end of the first taxable year in which any part of the gain is realized. However, the IRS can grant extensions of this period. [IRC § 1033(a)(2)(B); *but see*¶ *13:380* (3-year period in certain cases)]

c. [13:378] **Similar property limitation:** Normally, the money received must be invested in property that is "similar or related in service or use." [IRC § 1033(a)(2)] This is a much stricter standard than the like-kind standard used under IRC § 1031 (¶ *13:305 ff.*). For example, unimproved and improved property are *not* treated as "similar or related in service or use." [Treas.Reg. § 1.1033(a)-2(c)(9)]

(1) [13:379] **Meaning of similarity:** For property used in a business *other than leasing*, the end use of the new property must be substantially similar to the end use of the old property. [*McCaffrey v. Commissioner* (3rd Cir. 1960) 275 F2d 27, 30-31—parking lot replaced by warehouse does not qualify]

However, for *leased property*, the lessees' use does not matter. Rather, what counts is the similarity of the *lessor's* position —for example, the similarity of the demand for management services and the relationship to tenants. [*Liant Record, Inc. v. Commissioner* (2nd Cir. 1962) 303 F2d 326, 328—replacement of office building into apartment houses qualifies; Rev.Rul. 71-41, 1971-1 CB 223—replacement of rented warehouse with rented gas station qualifies]

(2) [13:380] **Exception:** In the case of nondealer real property that is condemned (as distinguished from destruction in a casualty), property meeting the more generous IRC § 1031 "like-kind" test "shall be treated as property similar or related in service or use" for IRC § 1033 purposes. [IRC § 1033(g)(1)]

Moreover, in such cases, the replacement period is three years instead of the usual two. [IRC § 1033(g)(4)]

[13:380.1 - 13:380.4] ***Reserved.***

d. [13:380.5] **Special rule for Presidentially-declared disasters:** The involuntary conversion rules relating to a "principal residence" (as defined by IRC § 121, ¶ *13:345 ff.*) and its contents are liberalized in the case of Presidentially-declared disasters.

No gain is recognized by reason of the receipt of insurance proceeds for personal property that was not scheduled property for insurance purposes. The rest of the proceeds received for the residence or its contents are treated as received for the conversion of a single item of property, and any replacement property similar or related in service or use to the residence or the contents will qualify as replacement property under IRC § 1033. Moreover, the taxpayer has four years rather than the usual two years to replace the property. [IRC § 1033(h)]

(1) [13:380.6] **Section 121 exclusion also applicable:** The IRC § 121 exclusion rule also applies in this situation: Gain on the principal residence qualifies for the § 121 $250,000/$500,000 exclusion and any additional gain can be nonrecognized under IRC § 1033 if replacement occurs. [See IRC § 121(d)(5)]

e. [13:381] **Election procedure:** An IRC § 1033 election is made by not reporting the gain on the tax return for the year of sale; however, all relevant details of the conversion should be reported. [See Treas.Reg. § 1.1033(a)-2(c)(2); Priv.Ltr.Rul. 201240006]

If the requisite reinvestment does not occur, an amended return reporting the gain should be filed.

(1) [13:382] **Statute of limitations on deficiency assessment:** By making the election, the taxpayer extends the statute of limitations on assessing a deficiency attributable to the gain until three years after the Service is notified of the replacement or failure to replace the property. [IRC § 1033(a)(2)(C)]

[13:383 - 13:384] ***Reserved.***

8. [13:385] **Transfers to Spouses or Former Spouses Incident to Divorce:** Neither gain nor loss is recognized upon a transfer to a spouse or former spouse incident to divorce. [IRC § 1041(a)]

a. [13:386] **Treatment as gift:** Transfers covered by IRC § 1041 are treated as *gifts* … meaning the transferee takes over the transferor's adjusted basis, regardless of whether the property has appreciated or depreciated in the hands of the transferor and regardless of whether the transferee paid consideration for the property. [IRC § 1041(b); Treas.Reg. § 1.1041-1T, A11 (pointing out that these rules are different from those under IRC § 1015)]

b. [13:387] **Transfers covered:** A transfer is "incident to divorce" for IRC § 1041 purposes if it occurs within one year after cessation of the marriage. It is also incident to divorce if it occurs after one year following cessation of the marriage and "is related to the cessation of the marriage." [IRC § 1041(c)]

(1) [13:388] **Within six years after cessation of marriage:** Under the Regulations, a transfer that occurs more than one but less than six years after cessation of the marriage and is pursuant to a divorce or separation instrument is deemed related to the cessation of marriage. [Treas.Reg. § 1.1041-1T, A-7]

(2) [13:389] **Compare—more than six years after cessation of marriage:** On the other hand, a transfer more than six years after the marriage ends is presumed *not* to be related to cessation of the marriage; but this presumption can be rebutted by showing the transfer was made to effect the division of property owned by the former spouses at the time of cessation of the marriage. [Treas.Reg. § 1.1041-1T, A-7]

c. Exceptions

(1) [13:390] **Nonresident alien transferee spouse:** A transfer to a nonresident alien spouse is not covered by IRC § 1041. [IRC § 1041(d)]

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(2) [13:391] **Certain transfers to trust:** While IRC § 1041 normally covers transfers to trusts for the benefit of a spouse or former spouse, it is not applicable to a transfer in trust where the liabilities to which the property is subject exceed the basis of the property. [IRC § 1041(e)]

• [13:392] **Example:** The basis of Blackacre is $1,000 and it is subject to a liability of $1,400. Pursuant to marital dissolution, H transfers Blackacre to W. Gain is not recognized and W's basis is $1,000.

However, if Blackacre was transferred to a trust for W, H would recognize gain of $400 and the trust's basis would be $1400.

Cross-refer: For a comprehensive treatment of IRC § 1041 nonrecognition in connection with marital dissolution and marital property settlements, see Hogoboom & King, *Cal. Prac. Guide: Family Law* (TRG), Ch. 10.

9. [13:393] **Investment Surtax:** Effective January 1, 2013, there is a 3.8% surtax on net investment income for taxpayers earning $250,000 or more ($200,000 if single). This applies to sales of real estate, including principal residences, but only on gains in excess of the IRC § 121 exclusion. [See IRC § 1411]

(Answers to frequently asked questions regarding the net investment tax are available online at *www.irs.gov*.)

a. [13:393.1] **Rental real estate:** The surtax also specifically applies to “rents,” which are defined in the Preamble to the investment surtax as amounts paid or to be paid principally for the use of (or the right to use) tangible property. [See IRC § 1411(c)(1)(A)(i); Keator, “Rental Real Estate and the Net Investment Income Tax” (Aug. 2013) J. Tax'n 60]

b. [13:393.2] **“Ordinary course” exception:** The definition of net income specifically excludes income “derived in the ordinary course of a trade or business,” unless that trade or business is a IRC § 469 passive activity of the taxpayer. [IRC § 1411(c)(1)(A)(i)]

Some commentators have suggested that real estate professionals may be able to use this exception to avoid the net investment surtax. [See McBride, “Rental Real Estate Trade or Business—The NIIT and Beyond” (2015) J. Real. Est. Tax. 16; McBride, “Rental Real Estate Trade or Business—The NIIT and Beyond, Part II” (2016) J. Real. Est. Tax. 113; Keator, “Rental Real Estate and the Net Investment Income Tax” (Aug. 2013) J. Tax'n; Elias, “Obamacare: A New Tax Incentive for Real Estate Fund Managers?” (Oct. 28, 2013) Tax Notes at 403]

10. [13:394] **Charitable Contributions of Conservation Easements:** Donors may deduct contributions of qualified real property interests to qualified organizations that are used exclusively for conservation purposes. [IRC § 170(h)(1); see Gerzog, “Alms to the Rich: The Façade Easement Deduction” (2014) 34 Va. Tax Rev. 229]

To qualify, contributions must involve (a) preservation of land areas for the general public's outdoor recreation or education, (b) protection of a relatively natural habitat of fish, wildlife, plants or similar ecosystem, (c) preservation of open space for the general public's scenic enjoyment or one that yields a significant public benefit, as defined, or (d) preservation of an historically important land area or a certified historic structure. [IRC § 170(h)(4)(A), (B); see *Champions Retreat Golf Founders, LLC v. Commissioner* (11th Cir. 2020) 959 F3d 1033, 1037-1039—deduction allowed for conservation easement over property that included private golf course and undeveloped land due to presence of rare and declining bird, plant and wildlife species; *Atkinson v. Commissioner*, TC Memo 2015-236—deduction denied where easements granted on golf courses would continue to operate within gated communities on membership-only basis and would permit pesticides and cutting down of trees to maintain property; *Partita Partners LLC v. United States* (SD NY 2016) 216 F.Supp.3d 337—deduction denied for building in registered historic district because entire exterior not preserved]

The deduction must be claimed in the year the real property interest was recorded, not the year in which the real property interest was transferred. [See *Mecox Partners LP v. United States* (SD NY 2016) 117 AFTR2d 2016-593 (denying deduction for property donated in 2004 because deed not recorded until 11/05); *Zarlengo v. Commissioner*, TC Memo 2014-161 (denying deduction taken in 2004 for interest transferred in 9/04, but not recorded until 1/05); Agostino et al., “Reviving Disallowed Conservation Easement Deductions”(2015) 147 Tax Notes 449]

a. [13:394.1] **“Qualified real property interests”:** A qualified real property interest may be (i) the donor's *entire* interest other than a qualified mineral interest; (ii) a remainder interest; or (iii) a restriction (granted in perpetuity) on the use that may be made of real property. [IRC § 170(h)(2); see also *Harbor Lofts Assocs. v. Commissioner* (2018) 151 TC No. 3—historic buildings' long-term lessee who did not hold fee interest in property deemed incapable of granting perpetual

conservation restriction within IRC § 170(h)(2)(C)'s meaning (¶ 13:394.3); *61 York Acquisition, LLC v. Commissioner*, TC Memo 2013-266—no deduction for *portion* of historic building's façade donated as conservation easement]

b. [13:394.2] **"Qualified organizations":** Qualified organizations include (i) the State (or a political subdivision thereof); (ii) the Federal Government; and (iii) IRC § 501(c)(3) charitable organizations that are publicly supported, or organizations that support such charitable organizations. [IRC § 170(h)(3)]

c. "Exclusively for conservation purposes"

(1) [13:394.3] **In perpetuity requirement:** To satisfy the exclusive conservation purpose, the use must be protected in perpetuity. [IRC § 170(h)(2)(C), (5)(A); see *Belk v. Commissioner* (4th Cir. 2014) 774 F3d 221, 225-227—deduction denied where donor had right to substitute portions of golf course contributed to conservation easement for other property not previously subject to easement; *Carroll v. Commissioner* (2016) 146 TC 196 (per regs., contribution must vest donee with property right equal to proportionate value gift bears to "property as a whole")—deduction denied where T's gift only valued easement for purposes of determining donee's rights should easement be extinguished at its tax deduction amount; compare *Pine Mountain Preserve, LLLP v. Commissioner* (11th Cir. 2020) 978 F3d 1200, 1208-1209—easement granted in perpetuity over defined conservation area satisfies § 170(h)(2)(C), even if grantor reserves limited development rights and easement allows parties to amend its restrictions; see also McLaughlin, "Amendment Clauses in Easements: Ensuring Protection in Perpetuity"(2020) 168 Tax Notes 819]

(a) [13:394.4] **Mortgaged property:** Property subject to a mortgage having a prior claim to condemnation and insurance proceeds still may satisfy the exclusive use in perpetuity requirement. [*Kaufman v. Shulman* (1st Cir. 2012) 687 F3d 21, 25-27; compare *Minnick v. Commissioner* (9th Cir. 2015) 796 F3d 1156, 1159—no deduction permitted if mortgage not subordinated to conservation easement; *RP Golf v. Commissioner* (8th Cir. 2017) 860 F3d 1096, 1099-1100 (same); see also *901 S. Broadway Partnership, Ltd. v. Commissioner*, TC Memo 2021-132, on appeal to the 9th Cir., No. 22-70012 (2022 WL 1199727)—deduction denied due to lack of evidence indicating mortgage holder subordinated its rights to rights of easement's donee]

(b) [13:394.4a] **Extinguishment clauses:** A conservation easement may be terminated by judicial decree if it is impossible or impractical to use the contributed property for conservation purposes. Deeds typically contain "extinguishment clauses" to address the distribution of sales proceeds if a court terminates a conservation easement and the property is sold. To satisfy the "protected in perpetuity" requirement, the extinguishment clause must entitle the donee organization to a portion of the proceeds from a subsequent sale, exchange, or involuntary conversion of the property that is at least equal to the proportionate value of the perpetual conservation easement—i.e., generally the gross value without subtracting for improvements. [Treas.Reg. § 1.170A-14(g)(6); *Sells v. Commissioner*, TC Memo 2021-12—no deduction for conservation easement donation because under extinguishment clause value of improvements were subtracted from any condemnation award before calculating donee's percentage; *Carroll v. Commissioner* (2016) 146 TC 196 (per regs., contribution must vest donee with property right equal to proportionate value gift bears to "property as a whole")—deduction denied where T's gift only valued easement for purposes of determining donee's rights should easement be extinguished at its tax deduction amount; compare *Corning Place Ohio, LLC v. Commissioner*, TC Memo 2022-12 (IRS summary judgment motion denied)—distinguished from *Carroll* et al. because donee's rights were set at fair market value rather than deduction amount and no carveout was set for tenant improvements); see also Megaard & Megaard, "Taxpayers Must Strictly Comply with Extinguishment Proceeds Regulations when Making Charitable Contributions of Conservation Easements" (2016) 125 J. Tax'n 62]

Comment: Circuit courts have split as to the validity of Treas.Reg. § 1.170A-14(g)(6). [Compare *Oakbrook Land Holdings, LLC v. Commissioner* (6th Cir. 2022) 28 F4th 700, 718-722 (upholding tax court's interpretation in concluding Treasury's interpretation of § 1.170A-14(g)(6) was neither arbitrary nor capricious and therefore entitled to deference) with *Hewitt v. Commissioner* (11th Cir. 2021) 21 F4th 1336, 1339 (siding with taxpayer in finding § 1.170A-14(g)(6) invalid because Treasury failed to adhere to Administrative Procedure Act by not responding to "significant" comment re treatment of post-easement improvements during regulation's review process)]

In 2024, a majority of the Tax Court reversed its own ruling that was upheld on appeal in *Oakbrook Land Holdings* (supra) by concluding Treas.Reg. § 1.170A-14(g)(6)(ii) is invalid under the Administrative Procedure Act (APA). [See *Valley Park Ranch LLC v. Commissioner* (2024) 162 TC No. 6] Since the *Valley Park Ranch* ruling is appealable

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to the Tenth Circuit, neither the Sixth Circuit's ruling that the regulation is valid, nor the Eleventh Circuit's ruling that the regulation is invalid, will be binding.

To complicate matters, the Supreme Court's 2024 decision overturning the *Chevron* Doctrine could affect *any* appellate court decision. [See *Loper Bright Enterprises v. Raimondo* (2024) _ US _, _, 144 S.Ct. 2244, 2273—per APA, courts may not defer to agency's legal interpretation simply because statute is ambiguous (holding courts must exercise independent judgment in deciding whether agency acted within its statutory authority); Slowey & Cioffi, “IRS Rulemaking Authority on Shaky Ground with Chevron Overturned,” Bloomberg Law, July 1, 2024 (concluding regulations governing syndicated conservation easements are particularly susceptible to judicial review under *Loper*)]

➪ [13:394.4b] ***PRACTICE POINTER:*** To aid taxpayers in complying with the judicial pronouncements on extinguishment clauses, Congress directed the IRS to publish “safe harbor” language for these clauses. In response, the IRS provided the following approved language (Notice 2023-30, § 4.01, 2023-17 IRB 766):

> Pursuant to Notice 2023-30, Donor and Donee agree that, if a subsequent unexpected change in the conditions surrounding the property that is the subject of a donation of the perpetual conservation restriction renders impossible or impractical the continued use of the property for conservation purposes, the conservation purpose can nonetheless be treated as protected in perpetuity if (1) the restrictions are extinguished by judicial proceeding and (2) all of Donee's portion of the proceeds (as determined below) from a subsequent sale or exchange of the property are used by the Donee in a manner consistent with the conservation purposes of the original contribution.

> Determination of Proceeds. Donor and Donee agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in Donee, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction, at the time of the gift, bears to the fair market value of the property as a whole at that time. The proportionate value of Donee's property rights remains constant such that if a subsequent sale, exchange, or involuntary conversion of the subject property occurs, Donee is entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction.

It would be wise to reproduce the above language exactly if using an extinguishment clause in a deed. This is so even though Notice 2023-30 does provide a little flexibility, acknowledging that deeds sometimes use different terminology to describe donors as grantors, or use the terms easement or servitude instead of restriction. [Notice 2023-30, § 4.03]

(c) [13:394.4c] **Boundary Line Adjustment Clauses:** The IRS sometimes challenges deductions when easements contain provisions permitting taxpayers to change the boundary lines of contributed property after the contributions have already been completed. However, these types of clauses may be necessary because of a dispute regarding the location of a boundary line. Nonetheless, such clauses, if not properly worded, have the potential to be abused so as to circumvent the “in perpetuity” requirement. [See, e.g., *Balsam Mountain Investments, LLC v. Commissioner*, TC Memo 2015-43 (concluding easement agreement did not restrict grant in perpetuity and therefore did not constitute “qualified conservation contribution”)—deduction denied because easement reserved to T right to change conservation area's boundaries; compare *BC Ranch II, L.P. v. Commissioner* (5th Cir. 2017) 867 F3d 547, 551-554 (concluding easements' homesite adjustment provisions did not prevent easement grants from being deemed made “in perpetuity”)—deduction permitted where right to change boundaries was only within tracts subject to easement and without increase to acreage of any homesite parcels]

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➪ [13:394.4d] ***PRACTICE POINTER:*** As with extinguishment clauses (¶ 13:394.4b), Congress directed the IRS to publish “safe harbor” language for boundary line adjustment clauses. In response, the IRS provided the following approved language for such clauses (Notice 2023-30, § 4.02, 2023-17 IRB 766):

> Pursuant to Notice 2023-30, Donor and Donee agree that boundary line adjustments to the real property subject to the restrictions may be made only pursuant to a judicial proceeding to resolve a bona fide dispute regarding a boundary line's location.

It would be wise to reproduce the above language exactly if using a boundary line adjustment clause in a deed. This is so even though Notice 2023-30 does provide a little flexibility, acknowledging that deeds sometimes use different terminology to describe donors as grantors or use the terms easement or servitude instead of restriction. [Notice 2023-30, § 4.03]

(d) [13:394.4e] **Constructive approval or denial clauses:** Conservation easement deeds may include a clause stating certain uses of the land are only permitted with the easement holder's express approval. In some cases, there is a clause indicating a request for approval of a proposed use will be deemed approved if the easement holder fails to respond to the request within a certain time period. This automatic approval has been held to violate the perpetuity clause because it could allow the donor to make changes that are inconsistent with the conservation purpose. [See *Hoffman Properties II, LP v. Commissioner* (6th Cir. 2020) 956 F3d 832, 834-835]

On the other hand, if there is a clause indicating that a request for approval of a proposed use will be deemed denied if the easement holder does not respond to the request, the IRS has opined that such clauses are not inconsistent with the perpetuity clause. [ILM 202002011]

(2) [13:394.5] **Irrevocable requirement:** The donation cannot be revocable or conditionally revocable. [See *Graev v. Commissioner* (2013) 140 TC 377, 409; *Carpenter v. Commissioner,* TC Memo 2013-172; but see also *Kaufman v. Shulman* (1st Cir. 2012) 687 F3d 21, 26, fn. 3—deduction permitted where easement was extinguished by judicial proceeding rather than at parties' option]

(3) [13:394.6] **No quid pro quo arrangements:** The donation cannot be part of an arrangement by which the donor receives something in return for granting the conservation easement. [See *Triumph Mixed Use Investments III, LLC v. Commissioner,* TC Memo 2018-65—deduction denied where easement donation was conditioned on government granting T development rights; *Pollard v. Commissioner,* TC Memo 2013-38—deduction denied where 67 acres of donor's farm were contributed as part of quid pro quo arrangement that included approval of subdivision exemption request to build second home on another portion of donor's property; see also Lindstrom, “4 Tax Issues for Conservation Easement Transactions” (Aug. 31, 2015) 148 Tax Notes 953, 954-955]

(a) [13:394.6a] **Substantiation:** The donor should receive a contemporaneous written acknowledgement of the gift indicating whether the donee provided any goods or services in consideration, in whole or in part, for the donation, as well as a description and good faith estimate of the value of any goods or services received (IRC § 170(f)(8)). Some courts have held, however, that an easement deed constitutes contemporaneous written acknowledgment for these purposes. [See *Big River Development, L.P. v. Commissioner,* TC Memo 2017-166 (finding mention of $93,500 one-time donation fee in “historic preservation and conservation easement” deed to be sufficient good faith estimate of donee's legitimate monitoring services); *310 Retail, LLC v. Commissioner,* TC Memo 2017-164 (finding reference to “consideration of One Dollar ($1.00) … and other good and valuable consideration” in deed of easement to be mere “boilerplate language”)]

d. [13:394.7] **Valuation:** The charitable contribution amount equals the easement's fair market value at the time of the contribution, typically determined by using a “before and after” calculation of the value of the underlying property to which the easement is attached. The “before and after” calculation should also take into account any effect from zoning, conservation, or historic preservation laws that restrict the use of the property even without the presence of an easement. [See *Buckelew Farm LLC v. Commissioner*, TC Memo 2024-52 (characterizing valuation as “fantasy” because it relied upon unreasonable assumption re chances property would receive rezoning and development approval)] It is also possible for an easement to increase the value of the underlying property (e.g., when it preserves an unobstructed view of a lake or other natural feature). [Treas.Reg. § 1.170A-14(h)(3)(i); see also *Glade Creek Partners, LLC v. Commissioner* (11th Cir. 2022) 2022 WL

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3582113, *6 (not reported)—“before and after” valuation method deemed “standard method for determining the value of an easement”; Sheppard, “New Cases Bolster Special Valuation Methods for Conservation Easements”(2022) 177 Tax Notes 1107; *Kissling v. Commissioner*, TC Memo 2020-153 (reducing deduction amount because local laws limited taxpayer's activities on property); CCA 201334039]

(1) [13:394.7a] **Inventory issue:** The fair market value at donation must be reduced by the amount of gain that would not have been long-term gain if the taxpayer had sold the property, effectively reducing the deduction's value to the basis in the property. [See IRC § 170(e)(1)(A)]

The IRS has challenged some deductions on the ground the donated property was inventory in the taxpayer's hands and therefore was either sold in violation of the five-year disposition rule or excluded from the capital asset definition (IRC §§ 724(b), 1221(a)(1)). Moreover, in each case, the Tax Court sided with the IRS and characterized the property as inventory because the partner that contributed the property to the partnership originally held it as inventory and that characterization carried over to the partnership in the contribution. [See *Glade Creek Partners*, TC Memo 2023-82; *Mill Road 36 Henry, LLC v. Commissioner*, TC Memo 2023-129; *Oconee Landing Property LLC v. Commissioner*, TC Memo 2024-25; Hoard, Nelson & Young, “Taking Inventory of the IRS's Latest Attack on Qualified Conservation Easements” 181 Tax Notes 833]

(2) [13:394.7b] **Qualified appraisal:** The taxpayer must provide a “qualified appraisal” to substantiate the fair market value and it must specify the method for determining the valuation (Treas.Reg. § 1.170A-13(c)(3)(ii)). Some courts have accepted almost any appraisal as evidence for valuation purposes. [See *Scheidelman v. Commissioner* (2nd Cir. 2012) 682 F3d 189, 197 (noting “regulation requires only that the appraiser identify the valuation method ‘used’; it does not require that the method adopted be reliable”); *Elgin 78 LLC v. Commissioner*, No. 26892-21 (TC 2024) (accepting appraisal despite failing to (i) specifically discuss exclusion in property description, (ii) mention expected contribution date, and (iii) provide fair market value as of that date); *Friedberg v. Commissioner,* TC Memo 2013-224 (finding qualified appraisal requirement fulfilled if appraiser's analysis is present, even if Commissioner deems it “unconvincing,” “sloppy or inaccurate,” or “haphazardly applied”); *Emanouil v. Commissioner*, TC Memo 2020-120 (accepting qualified appraisal for charitable donation of real estate even though it did not include date, expected contribution date, or statement indicating it was prepared for income tax purposes); compare *Savannah Shoals LLC v. Commissioner*, TC Memo 2024-35 (rejecting even “qualified” appraisal where conclusions were inconsistent with facts of case)—appraisal failed to account for transfer occurring before donation and was inconsistent with comparable values in area; see also Downs & Englebrecht, “Scenic and Conservation Easement: Keys to a Successful Valuation Challenge,” (2d Quarter 2021) Real Est. Tax'n 4; McLaughlin, “Conservation Easements and the Valuation Conundrum” (2016) 19 Fla. Tax Rev. 225]

The appraisal also must include the cost basis of the land on which the easement has been granted. [See Treas.Reg. § 1.170A-13(c)(4)(ii)(E); *Brooks v. Commissioner*, TC Memo 2022-122—reporting cost basis over entire parcel, rather than smaller portion of property encumbered by easement, failed to comply with Reg. § 1.170A-13(c); *Oakhill Woods, LLC v. Commissioner*, TC Memo 2020-24—although cost basis information could be derived from other information supplied by taxpayer, appraisal did not satisfy regulatory reporting requirements because it did not explicitly disclose easement's cost basis]

Caution: In recent cases, the IRS has targeted inadequate appraisals when contesting charitable deductions for conservation easements. [See Jordan, “Appraisers as Collateral Damage in the Syndicated Conservation Easement War”(Nov. 7, 2022) 177 Tax Notes 837; Parillo, “Easement Appraisals Based on Lies and Fantasy, IRS says,” (June 6, 2022) 175 Tax Notes 1612; Sheppard, “Valuation, Highest and Best Use, and Easements: New IRS Attacks,” (May 16, 2022) 175 Tax Notes 1061]

The above targeting includes the criminal tax indictment of two appraisers, one of whom pled guilty and was sentenced to a year in prison. [See Richman, “Hammer Falls on Conservation Easement Criminal Defendants”(2024) 182 Tax Notes 560]

➪ [13:394.7c] ***PRACTICE POINTER:*** If a conservation easement is donated shortly after the property is sold, the sales price will likely substantially constrain the conservation easement's valuation. [See *TOT Property Holdings, LLC v. Commissioner* (11th Cir. 2021) 1 F4th 1354, 1368 & fn. 21—taxpayer's $6.9 million valuation of conservation easement deemed “dubious” where donation made two weeks after 98.99% of entity that owned underlying property sold for $1,039,200]

(3) [13:394.8] **Taxpayer's "good faith" investigation:** While the presence of a qualified appraisal is one element that satisfies the reasonable cause exception to an accuracy-related penalty, taxpayers also must make their own good faith investigation into an easement's value. [See *Kaufman v. Commissioner* (1st Cir. 2015) 784 F3d 56, 58-62 (upholding Tax Court's finding that taxpayers were liable for gross underpayment penalty (40%) because they ignored "warning signals" regarding appraisal)]

(a) [13:394.9] **Listed transactions:** Due to concerns regarding overvaluation of conservation easements, the IRS issued Notice 2017-10 which identifies certain syndicated conservation easement transactions and substantially similar transactions as listed transactions. Under Notice 2017-10, these transactions are supposed to be reported on the taxpayer's return. [See IRC § 6111; Notice 2017-10, 2017-4 IRB 544; Sheppard, "Conservation Easements and the Potential Reach of Notice 2017-10" (2019) 47 Real Estate Tax'n 10; Starkman, "Conservation Easements: The 21st Century Abusive Tax Shelter" (2018) 159 Tax Notes 1475; Hagen & Weller, "Recent Attacks by the IRS and the Tax Court on Façade Easement Contributions" (4th Quarter 2017) Real Estate Tax'n 28]

In several recent cases, however, courts struck down the IRS' syndicated conservation easements listing notice, finding that it failed to comply with the notice and comment requirements of the Administrative Procedure Act. [See *Green Rock, LLC v. Internal Revenue Service* (11th Cir. 2024) 104 F4th 220, 222; *GBX Associates, LLC v. United States* (ND OH 2022) (2022 WL 16923886, *18) (slip copy)—Notice 2017-10 deemed "unlawful" as to plaintiff only; *Green Valley Investors, LLC v. Commissioner* (2022) 159 TC No. 5—citing Sixth Circuit's ruling involving different IRS notice]

Other funds are also contesting the listing requirement. [See Parillo, "Limited Vacatur of Easement Notice Opens Floodgates, Funds Say," (Nov. 21, 2022) 177 Tax Notes 1177]

➪ [13:394.10] ***PRACTICE POINTER:*** Whether the above rulings (¶ 13:394.9) invalidate the listing requirement nationwide, or just for the individual litigants, is not yet clear. At present, however, it is advisable to continue proceeding with caution when undertaking one of the transactions identified on Notice 2017-10. After there were reports that the IRS counsel's office was under a directive to not settle cases involving syndicated conservation easements (see Stone, "Conservation Easement Settlements Appear to be Eradicated"(2023) 181 Tax Notes 1563). Indeed, the IRS has challenged some deductions on the ground the donated property was inventory in the taxpayer's hands and therefore either sold in violation of the five-year disposition rule or excluded from the capital asset definition. [IRC §§ 724(b), 1221(a)(1)] The IRS started a settlement initiative to clear a backlog of cases. [See Sheppard, "Conservation Easement Settlement Initiatives in 2020 and 2024" 182 Tax Notes 2355] That initiative, however, could end at any time.

(b) [13:394.11] **2.5 Times Rule:** In response to continuing concerns about overvaluation in syndicated conservation easement transactions, Congress passed the SECURE 2.0 Act in December 2022, which adopts a new standard for deductions in these transactions. Under this rule, a partnership's contribution is not treated as a qualified conservation contribution if it exceeds 2.5 times the sum of the partner's relevant bases in the partnership. (IRC § 170(h)(7)(A))."Relevant basis" is the portion of each partner's modified basis allocable to the property with respect to which the contribution was made. [IRC § 170(h)(7)(B); see also Treas.Reg. § 1.170A-14(k)-(*l*) (on computing modified basis)]

The 2.5 times rule does *not* apply to certain historic preservation easements, family limited partnerships, and contributions outside a three-year holding period. [See IRC § 170(h)(7)(C), (D), (E)]

If a deduction is disallowed because of the 2.5 Times Rule, the consequences are severe. The taxpayer is subject to a gross valuation misstatement penalty of 40 percent and may not invoke a reasonable cause defense such as relying upon a qualified professional. [IRC §§ 6662(b)(10), (h)(2)(D), 6664(c)(2)]

(c) [13:394.12] **Penalties:** The IRS has imposed "gross valuation misstatement" and "substantial valuation misstatement" penalties in an amount equal to 20-40% of the underpayment in cases involving overvaluations of conservation easements donated to charity. [See IRC § 6662; *Roth v. Commissioner* (10th Cir. 2019) 922 F3d 1126, 1128-1129 & fn. 1 (imposing gross valuation misstatement penalty for donation of easement for gravel mining, which was deemed worthless because land was more valuable for farming than gravel mining); *Belair Woods, LLC v. Commissioner* (2018) TC Memo 2018-159 (imposing gross valuation misstatement penalty when deduction was overvalued by 1,380% and failure to submit valuation appraisal was "conscious election not to supply the required

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information"); see also Ware, "Valuing Conservation Easements: An Empirical Analysis of Decided Cases"(July 22, 2019) 164 Tax Notes 495]

In addition to the above penalties, the IRS has increased its use of a 75% civil fraud penalty, asserting it in sixty-six syndicated easement cases in 2021 alone. [See IRC § 6663(a); Parillo, "Civil Fraud Penalty on the Line in Tax Court Easement Petitions"(Dec. 13, 2021) 175 Tax Notes 1587]

Comment: Notwithstanding the above, disclosing the taxpayer's cost basis in the donated property may negate the intent to conceal which is necessary for a fraud penalty (see *Mill Road 36 Henry, LLC v. Commissioner,* TC Memo 2023-129). On the other hand, doing so may not be enough on its own if there are other indicia of fraud. [*North Donald LA Property LLC v. Commissioner,* No. 24703-21 (TC 4/10/24)]

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Chapter 13. Real Property Purchase and Sale Tax Concerns

Part III. Disposition of Real Property

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7) [13:399.27] Compare—California law
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1. [13:395] **General Principles:** Where gain or loss is realized and recognized (¶ 13:301 ff.), the next step is to compute the taxpayer's "amount realized." If the amount realized exceeds adjusted basis, the taxpayer has a gain; if the amount realized is less than adjusted basis, the taxpayer has a loss.

a. [13:396] **"Amount realized":** The Code defines "amount realized" as "the sum of any money received plus the fair market value of the property (other than money) received." [IRC § 1001(b)] Selling expenses reduce amount realized. [Treas.Reg. § 1.263(a)-2(e)]

b. [13:397] **Exception—real estate taxes:** Real property taxes must be apportioned between the buyer and seller on a daily basis. [IRC § 164(d), *discussed at ¶ 13:201*] Where the sale price of property includes reimbursement for real property taxes paid by the seller, the amount realized does not include reimbursement of such taxes if the taxes are treated as imposed on the purchaser. Similarly, the purchaser does not include the amount of such reimbursement in the purchaser's basis for the property. [IRC § 1012]

In contrast, the seller's amount realized includes amounts representing real property taxes which are treated as imposed on the seller if the taxes are paid or to be paid by the purchaser, and the purchaser includes such amounts in basis. [IRC § 1001(b); Treas.Reg. § 1.1001-1(b)]

2. [13:398] **Property of Indeterminate Value:** Where the seller receives property of indeterminate value, the amount realized is established by the value of the property surrendered, since it is presumed the property surrendered and property received are equivalent in value. [*United States v. Davis* (1962) 370 US 65, 72, 82 S.Ct. 1190, 1194—taxpayer who transfers stocks to spouse in exchange for discharge of marital claims is presumed to have realized amount equal to value of stock]

3. [13:399] **Transfers of Property Subject to Debt and Cancellation of Debt Income; General Considerations:** The transfer of property subject to debt (whether in a voluntary conveyance or by foreclosure) generally triggers gain or loss because the taxpayer is treated as having realized the amount of the debt. However, the rules relating to recourse and nonrecourse debt are not identical (*¶ 13:400 ff.*; and see generally, Onsager & Becker, "The Federal Income Tax Consequences of Foreclosures and Repossessions" (1991) 18 J. Real Est. Tax 291; IRS Publication 4681, "Cancelled Debts, Foreclosures, Repossessions, and Abandonments"). Lenders are required to inform the IRS if they acquire an interest in property in full or partial satisfaction of the debt. [IRC § 6050J; *see ¶ 13:524*]

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It is necessary to distinguish the gain or loss resulting from the transfer of property subject to debt from cancellation of debt income. Both gain or loss *and* cancellation of debt income can arise from foreclosures, short sales, etc., but the tax rules relating to them are entirely different.

Cancellation of debt income normally is treated as ordinary income and therefore is fully taxable. Creditors are required to report this income to the IRS and send the debtor a Form 1099 reflecting the income. [IRC §§ 6041, 6050P] However, several exceptions exist, including the exclusion for qualified principal residence indebtedness (¶ *13:399.4 ff.*).

a. [13:399.1] **Cancellation of debt (COD) income:** In general, COD income occurs when a taxpayer's liabilities decline by more than the taxpayer's assets. For example, a taxpayer has $400 of COD income if the taxpayer's creditor reduces an outstanding $1,000 debt to $600 or if the taxpayer discharges a $1,000 debt by paying the creditor $600. [IRC § 61(a)(11)]

(For a comprehensive treatment of the rules relating to COD income, see Lipton, “Real Estate Debt Workouts in 2008—The Rules Have Changed” (2008) 108 J. of Tax 207, 214-223; Bittker & Lokken, “Federal Taxation of Income, Estates & Gifts,” Ch. 7 (3d ed. 1999 and current supp.).)

(1) [13:399.1a] **Government “incentive” payments under Homes Affordable Mortgage Program (HAMP):** HAMP is a government program intended to facilitate mortgage modifications. Distressed homeowners whose mortgages have been modified may receive federal assistance under this program in the form of incentive payments to their lenders that reduce their principal loan amount. These payments are tax-free to the borrowers under the nonstatutory “general welfare” rule (i.e., welfare payments do not constitute IRC § 61 income). [Rev.Rul. 2009-19, 2009-28 IRB 111; see also IRS Notice 2011-14, 2011-11 IRB 544—payments to homeowners under various federal/state programs through Treasury's “Hardest Hit Fund” are tax-free under “general welfare rule”]

(a) [13:399.1b] **National Mortgage Settlement payments:** In 2012, the federal government, 49 state attorneys general and the District of Columbia entered into settlement agreements with five bank mortgage servicers to provide compensation to borrowers who lost their homes to foreclosure in 2008-2011, under conditions indicating loan servicing or foreclosure abuse. The IRS has ruled that the settlement payments are intended to compensate the borrowers for the loss of their homes and therefore may be eligible for exclusion under IRC § 121 (¶ *13:345 ff.*). [Rev.Rul. 2014-2, 2014-2 IRB 255]

(2) [13:399.2] **Substitution of one debt instrument for another:** The substitution of one debt instrument for another (or a material modification of a debt instrument) can produce COD income if the principal amount is reduced or if the interest rate is reduced below the applicable federal rate. [IRC § 108(e)(10); Treas.Reg. § 1.1001-3; Lipton, “Real Estate Debt Workouts in 2008—The Rules Have Changed” (2008) 108 J. of Tax 207, 208-214; Barrance, “Financial Workouts and Partnerships—A Primer” (2001) 28 J. Real Est. Tax 141]

(3) [13:399.3] **COD income from reduction of nonrecourse debt:** A taxpayer probably has COD income where a creditor reduces an undersecured nonrecourse debt without taking back the property. [*Gershkowitz v. Commissioner* (1987) 88 TC 984, 1014; Rev.Rul. 91-31, 1991-1 CB 19; but see *Fulton Gold Corp. v. Commissioner* (1934) 31 BTA 519, 520 (reduction in basis rather than COD income); see also *2925 Briarpark, Ltd. v. Commissioner* (5th Cir. 1999) 163 F3d 313, 318 (per curiam)]

However, *exclusions* from COD income may be applicable in these cases. Indeed, there are exclusions that arise from the reduction of a purchase money debt, qualified real property business indebtedness or qualified principal residence indebtedness (QPRI). *See* ¶ *13:399.8 ff.*

(4) [13:399.4] **Exceptions to COD income:** COD income is *not recognized* or it can be *deferred* under a variety of statutory exceptions:

(a) [13:399.5] **Insolvency, bankruptcy, farm indebtedness exceptions:** COD income is not recognized when (i) the taxpayer is insolvent; (ii) discharge of the debt occurs in a Title 11 bankruptcy action; or (iii) the debt is “qualified farm indebtedness.” [IRC § 108(a)(1)(A)-(C), (d)(3), (e), (g); and see Rev.Rul. 92-53, 1992-2 CB 48—amount by which nonrecourse debt exceeds value of asset securing it is considered in determining insolvency when nonrecourse debt is reduced or forgiven, but not when other debts are reduced or forgiven]

1) [13:399.5a] **Reduction of tax attributes:** Where the insolvency, bankruptcy or farm exceptions apply, the taxpayer must reduce various tax attributes. The first attribute reduced is net operating loss, followed by general business credits, minimum tax credits, capital loss carryovers, basis of depreciable and nondepreciable property, passive activity loss and credit carryovers, and foreign tax credit carryforwards. [IRC § 108(b)]

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When the basis of property must be reduced, it occurs in the following order: real property used in business or for investment; personal property used in business or for investment; remaining property used in business or for investment; inventory and stock in trade, including dealer real property (*¶ 13:422 ff.*); and property not used in business or for investment. [Treas.Reg. § 1.1017-1(a)] Taxpayers can elect to reduce the basis of depreciable property and dealer real property instead of reducing other tax attributes first. [IRC § 108(b)(5)]

2) [13:399.6] **Application of insolvency exception to entities:** In the case of a *partnership*, insolvency is determined at the *partner* level. Thus, where a real estate partnership is insolvent, but the individual partners are not, the insolvency exception does *not* apply. [See IRC § 108(d)(6)]

In the case of an *S corporation*, insolvency is measured at the *corporate* level and the insolvency exception thus applies at the *corporate* level. [IRC § 108(d)(7)(A)]

➪ [13:399.7] ***PRACTICE POINTER:*** The difference in applying the insolvency exception to a partnership vs. an S corporation (¶ 13:399.6) may be something to consider in setting up your client's real estate venture.

(b) [13:399.8] **Exception for purchase price reduction:** No COD income is realized if a seller of property reduces a buyer's purchase money debt. The reduction is treated as a purchase price adjustment, meaning the buyer must *reduce basis* by the amount of the reduction. However, this rule does not apply if the debtor is insolvent or the reduction occurs in bankruptcy. [IRC § 108(e)(5); see *Preslar v. Commissioner* (10th Cir. 1999) 167 F3d 1323, 1331—applies only to direct agreements between buyer and seller and, therefore, settlement with FDIC (not original seller) cannot be treated as purchase price reduction; and Taggart, "Revenue Reconciliation Act of 1993—Real Estate Indebtedness" (1994) 23 Real Est. L.J. 48, 54-55]

1) [13:399.9] **Example:** B buys property from S for $100, paying $12 and borrowing $88 from S. Later, the debt is still $88 and the adjusted basis of the property is $85. The value has dropped to $80. B is solvent. S reduces the $88 debt to $80. Because of the purchase price reduction rule, B does not have $8 of COD income. The basis of the property is reduced to $77.

[13:399.10] ***Reserved.***

(c) [13:399.11] **Exclusion of qualified real property business indebtedness:** COD income does not include the discharge of qualified real property business indebtedness. This means recourse or nonrecourse debt incurred or assumed by the taxpayer in connection with real property used in a trade or business and secured by such property. The election applies only to depreciable real property; it does *not* apply to dealer real property held for sale to customers (¶ 13:422 ff.). [IRC §§ 108(a)(1)(D), (c) & 1017(b)(3)(F)(ii); Rev.Rul. 2016-15, 2016-26 IRB 1060; see Johnson & Harmon, "Clarifying Standards for Trade or Business Real Estate Debt"(Aug. 24, 2015) 148 Tax Notes 875; Taggart, supra, at 55-65]

1) [13:399.12] **"Qualification" of prevs. post-1993 debt:** If the debt was incurred or assumed after January 1, 1993, to be "qualified" it must be qualified acquisition indebtedness (i.e., incurred or assumed to acquire, construct, reconstruct or substantially improve the property). On the other hand, debt assumed or incurred *before* January 1, 1993 can be "qualified" even if it is not acquisition indebtedness. [IRC § 108(c)(3)]

2) [13:399.13] **Election required:** This exclusion provision applies only if the taxpayer so *elects* on the return for the taxable year in which the discharge occurs or at such other time as provided by regulations. (The taxpayer should file IRC Form 982 to claim the exclusion.) [IRC § 108(d)(9)]

If no election is filed, the COD income is taxable (unless it falls within some other exception).

3) [13:399.14] **Basis reduction:** If the taxpayer elects to exclude COD income arising from the discharge of qualified real property business indebtedness, the taxpayer must reduce the basis of the property with respect to which the debt was reduced by the amount of the excluded COD income. Moreover, the basis reduction must occur in the disposition year, rather than the following year. [IRC § 1017(b)(3)(F)(iii); Hussey, 156 TC No. 12 (2021)]

If there is insufficient basis in that property to absorb the entire reduction, the basis of all of the taxpayer's other depreciable property should be proportionately reduced. [IRC §§ 108(c)(1) & (2)(B), 1017]

4) [13:399.15] **Exceptions:** The § 108(a)(1)(D) exclusion for qualified business real property indebtedness does not apply to debt owed by a *C corporation*; nor does it apply to debt relief that occurs in a *bankruptcy proceeding* or if the taxpayer is *insolvent*. [IRC § 108(a)(1)(D) & (2)]

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Additionally, this exclusion apparently does not apply if the purchase price reduction rule applies (¶ *13:399.8 ff.*).

5) [13:399.16] **Value limit:** The amount excluded under this provision cannot exceed the excess of the outstanding principal amount of the discharged or reduced debt over the fair market value of the property (reducing that value by any other qualified business real property indebtedness secured by such property). [IRC § 108(c)(2)(A)]

6) [13:399.17] **Example:** T owns Black Arms, an apartment building, worth $700; this is the only real estate she owns. The property's basis is $1,200 and it is subject to a trust deed in favor of Bank for $1,000. This debt was incurred in year 1 when T purchased Black Arms. T is neither bankrupt nor insolvent.

In year 3, Bank reduces the debt to $700. The debt represents qualified real property business indebtedness. If T so elects, she can exclude $300 of COD income. And if she so elects, the basis for Black Arms is reduced by $300 to $900.

(d) [13:399.18] **Exclusion for qualified principal residence indebtedness (QPRI):** COD income does not include QPRI reductions (i.e., reductions in acquisition debt secured by a principal residence). These reductions reduce the basis of the principal residence (but not below zero). [IRC § 108(a)(1)(E), (h)]

The current exclusion applies for QPRI that was discharged *before January 1, 2026*. [IRC § 108(a)(1)(E)] The exclusion is claimed on IRC Form 982. For examples of QPRI, see IRS Pub. 4681 (available online at *www.irs.gov*).

1) [13:399.19] **Definitions:** For purposes of applying the IRC § 108 exclusion, "principal residence" is defined exactly as it is under the IRC § 121 exclusion for gain from sale of a personal residence (¶ *13:346.10*)—i.e., the property must have been used as the taxpayer's *principal residence* for at least two of the five years preceding the sale. [IRC § 108(h)(5)]

"Acquisition indebtedness" is defined as it is for IRC § 163 qualified residence interest purposes (¶ *13:177*)—i.e., the debt must be incurred to acquire, construct or substantially improve a qualified residence, and must be secured by that residence. Acquisition indebtedness also includes any debt secured by the residence resulting from the refinancing of debt (but only to the extent the debt resulting from refinancing does not exceed the amount of refinanced debt). [See IRC §§ 108(h)(2) & 163(h)(3)(B)]

(Note: The QPRI exclusion does *not* cover forgiveness of home equity loans, except those used to make substantial residential improvements.)

a) [13:399.20] **Monetary cap on acquisition indebtedness:** For purposes of the QPRI exclusion from COD income, acquisition indebtedness is capped at $2,000,000 ($1,000,000 for a married person filing separately). [IRC § 108(h)(2)] By contrast, these figures are $1,000,000 and $500,000 for purposes of deducting the loan interest. [IRC § 163(h)(3)(B)(ii)]

2) [13:399.21] **"Short sale":** A "short sale" occurs when the lender reduces the amount of debt encumbering property before it is sold. There are two ways to account for a short sale: One way is to separate the debt reduction from the sale of the property (¶ *13:409.3*), in which case the QPRI exclusion applies to the debt reduction (provided the taxpayer otherwise qualifies for QPRI treatment), or one of the other COD exclusions (¶ *13:399.5 ff.*) also might apply.

The second way to account for a short sale is to ignore the debt reduction and treat the seller as realizing the full amount of the unreduced debt as consideration for the sale of the property (¶ *13:409.4*). In this situation, particularly if the debt involved is nonrecourse (¶ *13:400 ff.*), there is no COD income and COD exclusions are inapplicable.

There appears to be some latitude for taxpayers to structure a short sale in either of the above ways, depending on which is more favorable taxwise (¶ *13:409.5*).

a) [13:399.21a] **Example:** T's principal residence (Oak Street) was purchased two years ago for $1,000,000. It is subject to a $900,000 nonrecourse purchase money lien in favor of Bank. The value of Oak Street declines to $600,000. Bank reduces the lien to $600,000. T sells the residence to X for $600,000 in a short sale. Assuming the debt reduction is treated as separate from the sale of Oak Street, T excludes the $300,000 of COD income because it qualifies for the QPRI exclusion. T reduces the basis of Oak Street by $300,000 to $700,000. T sustains a nondeductible personal loss of $100,000 upon the sale to X. [See IRS Pub. 4681 (applying the QPRI exclusion to a short sale)]

(Note: The IRS could choose to integrate the debt reduction and sale. Under this approach, the debt reduction is ignored and T has a $400,000 nondeductible personal loss.)

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3) [13:399.22] **Exclusion relates only to residence's value or taxpayer's financial condition:** The QPRI exception to COD income does *not* apply to a loan discharge on account of services performed for the lender or for any other reason not directly related to a *decline in the residence's value or the taxpayer's financial condition*. [IRC § 108(h)(3)]

4) [13:399.23] **Coordinating with other exceptions:** The QPRI exception does *not* apply if the debt is discharged in a Title 11 case (i.e., a bankruptcy action). And the insolvency exception (¶ *13:399.5*), if elected, is "in lieu of" the qualified principal residence exception. [IRC § 108(a)(2)(A),(C)]

5) [13:399.24] **Phaseout:** The amount of debt subject to the QPRI exclusion cannot exceed $2,000,000 ($1,000,000 for married persons filing separate returns). If only a portion of the discharged loan is QPRI, the COD exception "shall apply only to so much of the amount discharged as exceeds the amount of the loan (as determined immediately before such discharge) which is not qualified principal residence indebtedness." [IRC § 108(h)(2), (4)]

a) Examples

• [13:399.25] T, a single and solvent taxpayer, owns a principal residence purchased for $3,000,000. The residence is subject to a $2,500,000 lien in favor of Bank. The residence's value declines to $2,100,000, and Bank reduces its lien to $2,100,000.

In the above example, $500,000 of the loan is not QPRI because the $2,500,000 loan exceeded the $2,000,000 limit by $500,000. In addition, reduction of the loan was only $400,000. Since the amount discharged did not exceed the amount of the loan that was QPRI, the QPRI exception does not apply.

• [13:399.25a] Assume in the example at ¶ 13:399.25 that the loan is reduced from $2,500,000 to $1,800,000. Of the $700,000 in potential COD income, $200,000 qualifies for the QPRI exception, but $500,000 does not because the $700,000 reduction exceeded $500,000 by $200,000.

Of course, if T is insolvent, T may instead rely on the insolvency exception (¶ *13:399.5*).

6) [13:399.26] **Basis reduction and exclusion of ultimate gain:** In many cases, the QPRI provision will result in exclusion rather than deferral of income to a taxpayer who is able to hold onto their residence.

• [13:399.26a] **Example:** T's basis for her principal residence (Oak Street) is $1,000,000. It is now worth $600,000. It is subject to a $900,000 nonrecourse purchase money lien in favor of Bank. Bank reduces the loan to $600,000. T does not sell the house but continues to make payments on the loan. Because of the QPRI provision, the basis of Oak Street is reduced from $1,000,000 to $700,000. Several years later, price levels recover and T sells the house for $850,000. Because T meets the requirements for exclusion under IRC § 121 (¶ *13:345 ff.*), her gain of $150,000 on the sale is not recognized. Consequently, T's gain from COD is never taxed.

7) [13:399.27] **Compare—California law:** California's counterpart to the federal QPRI exclusion applies to debt forgiveness on a principal residence that occurs on or after January 1, 2013, and before January 1, 2014. The maximum amount that can be excluded is $500,000 ($250,000 on the return of a married person filing separately). For California purposes, the amount of debt subject to the QPRI exclusion cannot exceed $800,000 ($400,000 for married persons filing separately). [Rev. & Tax.C. § 17144.5]

b. [13:400] **Gain or loss on property transferred in discharge of nonrecourse debt:** Where property is subject to nonrecourse debt, a transferor realizes the full amount of the debt upon a sale or other disposition of the property *regardless of the value of the property*. [IRC § 7701(g); Treas.Reg. § 1.1001-2(b); *Commissioner v. Tufts* (1983) 461 US 300, 316, 103 S.Ct. 1826, 1836]

This result occurs even though the transfer is in the form of a mortgage foreclosure or other transfer to the creditor in discharge of the debt. If the lender is in the lending trade or business, it must report such transactions to the IRS. [IRC § 6050J; *see* ¶ *13:524*]

(1) [13:401] **Example:** T owns Blackacre, which is encumbered by a $1,000 trust deed. The creditor is C. The debt is nonrecourse. Blackacre is worth only $700. T's adjusted basis for Blackacre is $560. C forecloses (or takes back Blackacre in lieu of foreclosure). T has a gain of $440 on the foreclosure because the value of Blackacre is ignored and the full amount of the debt is the taxpayer's amount realized. Assuming Blackacre is a capital asset, the entire gain is capital gain. [*Commissioner v. Tufts* (1983) 461 US 300, 316, 103 S.Ct. 1826, 1836]

(2) [13:402] **Not COD income:** The gain occurring upon the property transfer in discharge of a nonrecourse debt is *not* COD income (¶ *13:399.1 ff.*). Reason: The debt is treated as if it were paid in full by transfer of the property in discharge of

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the debt as opposed to being canceled. Therefore, the exceptions to COD income (e.g., insolvency, bankruptcy, qualified real property business indebtedness and qualified personal residence indebtedness) do not apply.

(3) [13:403] **Consequences to creditor upon foreclosure:** Upon foreclosure, a lender who was not the original seller of the property is entitled to a bad debt deduction for the difference between the value of the property (which is presumed to be the bid price at the foreclosure sale) and the creditor's basis for the debt. [Treas.Reg. § 1.166-6—difference between debt and bid price is bad debt]

If the foreclosing lender was the original seller, gain or loss normally is not recognized upon repossession of the property, whether the debt was recourse or nonrecourse. [See IRC § 1038] One exception to this rule is if the seller originally excluded gain from recognition under the IRC § 121 principal residence exclusion and did not resell the property within one year following its reacquisition. [See *DeBough v. Commissioner* (8th Cir. 2015) 799 F3d 1210, 1211-1212 (construing relationship between § 1038 and § 121 in case of first impression)]

(For detailed discussion of foreclosure or repossession consequences to the creditor, see Onsager & Becker, "The Federal Income Tax Consequences of Foreclosures and Repossessions" (1991) 18 J. Real Est. Tax. 291, 303-313.)

c. [13:404] **Gain on property transferred in discharge of recourse debt:** The rule for transfer of property in discharge of a *recourse debt* is different: The amount realized on a foreclosure or other transfer of property to the creditor in discharge of the debt is the *fair market value of the property or the face amount of the debt, whichever is less.* [Treas.Reg. § 1.1001-2(a)(2) & (c) ex. 8; see Rev.Rul. 90-16, 1990-1 CB 12; *Frazier v. Commissioner* (1998) 111 TC 243, 245; and *Aizawa v. Commissioner* (1992) 99 TC 197, 200-201, aff'd (9th Cir. 1994) 29 F3d 630—proceeds from foreclosure sale (not amount of deficiency judgment) is "amount realized"]

If the value of the property is less than the amount of the recourse debt, the difference is COD income (¶ *13:399.1 ff.*).

• [13:404a] **Comment:** Apparently, the QPRI exception to COD income (¶ *13:399.18 ff.*) applies to the foreclosure of a recourse acquisition loan on a qualified personal residence. This situation will be relatively rare in California, however, because acquisition loans on personal residences usually are nonrecourse under the antideficiency rules (¶ *6:563 ff.*).

Nonetheless, if a principal residence is secured by a recourse loan, and the requirements for the QPRI exception are met, the homeowner-borrower should have no COD income on foreclosure. While the QPRI exception requires reduction of the basis of the property so that the taxpayer has a gain upon foreclosure, that gain normally is excludable under IRC § 121 (¶ *13:345 ff.*).

(1) [13:405] **Example:** In the example at ¶ *13:401,* assume the debt was a recourse debt and that C discharged the debt by foreclosing on the property. Assume further that the property was a vacation home and therefore did not qualify for QPRI treatment. T has a capital gain of $140 ($700 less $560) and COD income of $300.

Now assume the property qualifies for QPRI treatment because it is a personal residence, the acquisition debt is below $2,000,000 and the foreclosure occurs before the end of 2012. On these facts, T has no COD income; rather, the basis of the property must be reduced by $300 to $260. As a result, T has a capital gain of $440. However, that gain is *not* recognized because of the personal residence exclusion (¶ *13:345 ff.*). [IRC § 121]

(2) [13:405.1] **Foreclosure bid presumed fair market value:** Absent clear and convincing proof to the contrary, the sale price of property at a foreclosure sale is presumed to be its fair market value. [See *Community Bank v. Commissioner* (1982) 79 TC 789, 792, aff'd (9th Cir. 1987) 819 F2d 940]

However, courts are not "bound to blindly accept a transaction" and may look behind the foreclosure sale to determine the fair market value if the presumption is rebutted by clear and convincing proof. [*Frazier v. Commissioner* (1998) 111 TC 243, 245-246—presumption that lender's bid at foreclosure sale was fair market value rebutted by appraisal showing fair market value substantially less than bid and fact lender resold property for amount comparable to appraisal]

[13:406 - 13:408] ***Reserved.***

d. [13:409] **Short sales:** A "short sale" occurs when a lender agrees to reduce the debt on encumbered property; the owner (debtor) then sells the property for an amount equal to or slightly more than the reduced debt.

Example: T bought a home for $660,000, subject to a $500,000 nonrecourse debt owed to L. The value of the home has declined to about $420,000. L agrees to reduce the outstanding principal obligation to $420,000. T then sells the house to B for $423,000. T keeps $3,000; $420,000 is paid to L.

(1) [13:409.1] **Practical advantages:** A short sale avoids a default on the loan. It is also advantageous to the lender since it motivates the owner/debtor to keep the property in good repair in order to find a buyer (rather than neglecting and then walking away from the property).

(2) [13:409.2] **Tax treatment:** The short sale transaction could be taxed in one of two ways:

(a) [13:409.3] **COD income:** The debt reduction could give rise to COD income, which would be taxable as ordinary income unless it qualified for one of the exceptions to COD income (*¶ 13:399.4 ff.*). [See *Stevens v. Commissioner* (2008) TC Summ.Opn. 2008-61—imposing penalties on borrower for failure to report COD income in short sale]

In the example at *¶ 13:409*, assuming no exception applied, T would have ordinary income from COD of $80,000. Then T would have a nondeductible personal loss of $237,000 ($660,000 less $423,000) (*see ¶ 13:303.5*).

On the other hand, if an exception were applicable, T could avoid COD income. (The exceptions for insolvency, qualified personal residence indebtedness (QPRI) and qualified business real property indebtedness should be considered; *¶ 13:399.4 ff.*)

In particular, the QPRI exception is applicable (assuming the home is T's principal residence) because the $500,000 debt is acquisition debt and it is less than $2 million (*¶ 13:399.20 ff.*). As a result, T can avoid COD income. The basis of the home is reduced by $80,000 to $580,000, and T has a nondeductible loss of $157,000 ($580,000 less $423,000). [See IRS Pub. 4681 (available online at *www.irs.gov*) for an example of the application of the QPRI exception to short sales]

(b) [13:409.4] **Sale for unreduced loan amount:** Alternatively, the debt reduction could be ignored and the taxpayer treated as having sold the property for the amount of the unreduced loan (*see ¶ 13:400*) plus any cash received. In the example at ¶ 13:409, T would then have a $157,000 nondeductible personal loss.

➪ [13:409.5] ***PRACTICE POINTER:*** Taxpayers should choose whichever approach is better for them and attempt to structure the transaction accordingly. In many situations, the first method will be better (as where the debt qualifies for an exception to COD income); however, the transaction must be structured carefully and the taxpayer should document the *independence of the two steps* (the debt reduction and subsequent sale). [See Raby, “Bifurcation & Excess Debt” (Jan. 10, 1994) 62 Tax Notes 211; *Gershkowitz v. Commissioner* (1987) 88 TC 984, 1014—reduction of nonrecourse debt produces COD income where not integrated with subsequent sale of properties]

The IRS may disregard an attempt to structure the transaction to produce separate debt cancellation and sale transactions if it finds that the two transactions are “*closely intertwined*.” In that event, the transaction will be taxed under the second approach (*¶ 13:409.4*). [*2925 Briarpark, Ltd. v. Commissioner* (5th Cir. 1999) 163 F3d 313, 319 (per curiam) (debt reduction integrated with property sale)—debt cancellation ignored and entire difference between debt and basis of property is capital gain; Lipton, “*Briarpark* and the Unexpected Limits to Careful Tax Planning” (April 1999) 90 J. of Tax. 198]

e. [13:410] **Accrued interest:** Normally, when a loan is foreclosed or reduced by the creditor, both the principal and interest are in default. Discharge (forgiveness) of the accrued interest obligation may be a realizing event to the taxpayer:

(1) Cash method taxpayers

(a) [13:410.1] **COD income:** A debtor who uses the cash method of accounting is not permitted to deduct unpaid interest as it accrues (*¶ 13:167 ff.*). If the interest would have been deductible had it been paid (e.g., trade or business interest, investment interest, or qualified residence interest), and the unpaid accrued amount is forgiven as part of a debt reduction, there is *no* COD income. [IRC § 108(e)(2)—no COD income to extent payment of debt would have given rise to deduction]

On the other hand, if the interest when paid would *not* have been deductible, the forgiven accrued interest will be COD income to the debtor.

(b) Interest deduction

1) [13:410.2] **Nonrecourse debt:** Accrued interest that is canceled as part of a foreclosure of a nonrecourse debt likely will be treated as if it was paid. The amount of the debt (which is automatically treated as the taxpayer's amount realized, *¶ 13:400 ff.*) should also include accrued interest. As a result, the debtor/cash method taxpayer would have an interest deduction (if the item is deductible) and also additional capital gain equal to the amount of the interest

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deemed paid. [*Allan v. Commissioner* (1986) 86 TC 655, aff'd (8th Cir. 1988) 856 F2d 1169, 1174—taxpayer's amount realized on transfer in lieu of foreclosure of nonrecourse debt includes interest added to principal of loan]

2) [13:410.3] **Recourse debt:** If, however, the debt is a *recourse* debt and the amount of the principal obligation *exceeds* the value of the property, it is unlikely that any of the amount realized at the foreclosure would be allocated to interest. Consequently, nothing would be deductible. [See *Aizawa v. Commissioner* (1992) 99 TC 197, aff'd without opn. (9th Cir. 1995) 29 F3d 630; *and ¶ 13:404*; see also Note, "Determining Amount Realized on Foreclosure of a Recourse Mortgage: *Aizawa v. Commissioner*" (1993) 46 Tax Lwyr. 643, 644-646]

(2) [13:410.4] **Accrual method taxpayers:** A debtor who uses the accrual method of accounting is permitted to deduct the unpaid interest as it accrues even though it has not been paid (*¶ 13:167*). If the unpaid interest is forgiven as part of a debt reduction, the taxpayer probably has additional COD income but, in many cases, can use the exceptions to COD income to avoid immediate taxation (*¶ 13:399.4 ff.*). [See Taggart, "Revenue Reconciliation Act of 1993—Real Estate Indebtedness" (1994) 23 Real Est. L.J. 48, 64-65]

If the property is foreclosed, the taxpayer will probably be treated as having received an additional amount equal to the accrued interest and thus will be considered to have paid the interest and to have additional capital gain in the amount of the interest. [*Allan v. Commissioner* (8th Cir. 1988) 856 F2d 1169, 1171-1172 & fn. 4—taxpayer has capital gain, not ordinary income, on amount of accrued interest and real estate taxes when property transferred to creditor in lieu of foreclosure]

f. [13:411] **Partnership debt:** Upon a sale of a partnership interest, the seller realizes the amount of partnership liabilities previously allocated to the seller. [IRC § 752(b), (d); Treas.Reg. § 1.1001-2(c), ex. (3)]

[13:412 - 13:414] *Reserved.*

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Chapter 13. Real Property Purchase and Sale Tax Concerns

Part III. Disposition of Real Property

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1. [13:415] **Overview:** A gain on the disposition of property that is characterized as long-term capital gain is subject to preferential tax treatment—i.e., a lower tax rate (*¶ 13:416*).

However, capital losses have restricted deductibility: They can be deducted only to the extent of capital gains plus $3,000 per year (*¶ 13:418*).

In deciding whether capital gain or loss occurs, the following questions are relevant:

• How are capital gains and losses taxed? (*¶ 13:416 ff.*)

• Is the asset a capital asset or a IRC § 1231 asset? (*¶ 13:420 ff.*)

• Was there a “sale or exchange”? (*¶ 13:452 ff.*)

• What is the “holding period”? (*¶ 13:457 ff.*)

(For a further overview and discussion of capital gains and losses, see Cummings, “Reexamining Capital Gains for Real Estate”(2015) 147 Tax Notes 1409.)

2. Taxation of Capital Gains and Losses

a. Capital gains

(1) [13:416] **Rates:** There are three general tiers of capital gain rates. The top rate of 20% is on incomes exceeding $400,000 for single filers, and $450,000 for married joint filers (these thresholds are adjusted annually for inflation). Individuals in the 10% or 15% tax bracket have no capital gain tax. All others pay capital gain tax at the rate of 15%. [See IRC § 1(h)(1)]

(a) [13:417] **“Net capital gain”:** “Net capital gain” means the excess of the net long-term capital gain over the net short-term capital loss. [IRC § 1222(11)]

“Long-term” means more than one year (*see ¶ 13:457 ff.*).

[13:417.1 - 13:417.4] ***Reserved.***

(2) [13:417.5] **Sales of real estate:** Gain on depreciable real estate is recaptured to the extent of depreciation on the property. The tax on the recaptured portion of the gain is 25%. The tax on additional gain, if any, is 15%. [IRC § 1(h)(1)(E), (h)(6)]

• [13:417.6] P bought Factory in Year 1 for $1,000,000 and sold it in Year 4 for $960,000. P correctly claimed depreciation of $100,000 on Factory, so P's adjusted basis at the time of sale was $900,000. The long-term capital gain on the sale is $60,000. Because $60,000 was less than the depreciation previously taken on Factory, the entire gain is taxed at the rate of 25%.

• [13:417.7] Suppose instead that Factory was sold in Year 4 for $1,150,000. The gain is $250,000, of which $100,000 would be taxed at 25% and $150,000 at 15%.

b. Capital losses

(1) [13:418] **Restricted deductibility:** Deductibility of a capital loss (assuming a loss is otherwise recognized) is sharply restricted: Capital losses may only be deducted to the extent of capital gains plus $3,000 (or $1,500 in the case of a married individual filing a separate return). In the case of corporations, capital losses can be deducted only to the extent of capital gains. [IRC § 1211]

(2) [13:419] **Carryover:** *Individuals* can carry forward capital losses for an indefinite period, offsetting them in each future years against capital gains plus $3,000. *Corporations*, on the other hand, can carry capital losses back three years and forward five years. [IRC § 1212]

3. [13:420] **Capital Asset vs. § 1231 Asset:** To qualify for the favorable treatment of capital gains (and the unfavorable treatment of capital loss), an asset must be a “capital asset.” IRC § 1231 assets, by contrast, receive favorable treatment of *both* gains and losses (*¶ 13:442 ff.*).

a. [13:421] **“Capital asset”:** The term “capital asset” means any property held by the taxpayer *subject to certain specific exceptions*. [IRC § 1221] However, as explained at ¶ 13:424 ff., case law has broadened the exceptions.

(1) [13:422] **“Dealer property” not capital asset:** The most important exception to capital treatment is “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business”—often called “dealer property.” [IRC § 1221(1)]

(a) [13:423] **Significance:** Identifying dealer property is important for numerous reasons in addition to the question of capital gain or loss treatment. For example, dealer property does not qualify for IRC § 1031 like-kind exchange treatment (*¶ 13:304*) or for the installment method (*¶ 13:469*), and it cannot be depreciated. [IRC §§ 453(b)(2)(A), (*l*) & 1031(a)(2)(A)]

(b) [13:424] **Application:** IRC § 1221(1) distinguishes property held as an investment, where appreciation is attributable mostly to a rising market, from property held for sale by a dealer—a taxpayer who buys wholesale and adds value to the property in the course of selling it at retail.

In some cases, this Code Section is easy to apply, while in others it is more difficult. A taxpayer who occasionally sells a parcel of land or a building that was held for farming or rental qualifies for capital gain. A home builder who subdivides land, builds hundreds of homes, and sells them one at a time, is clearly a dealer. But there are innumerable situations that fall in between.

1) [13:425] **“Primarily”:** As used in IRC § 1221(1), the word “primarily” means “of first importance” or “principally.” [*Malat v. Riddell* (1966) 383 US 569, 572, 86 S.Ct. 1030, 1032]

If, for example, holding for rental or farming purposes was more important during the holding period (before taxpayer decided to sell the property) than holding for sale, the property is a capital asset.

2) [13:426] **“For sale to customers in ordinary course of trade or business”:** Application of this phrase depends on a multi-factor formula to determine whether the sale is in the “ordinary course” of business. Consequently, the results are rather unpredictable. [See, e.g., *Suburban Realty Co. v. United States* (5th Cir. 1980) 615 F2d 171; *Biedenharn Realty Co., Inc. v. United States* (5th Cir. 1976) 526 F2d 409; and generally, Sonnier, “How to Preserve Predevelopment Appreciation of Real Estate” (2014) 42 Real Est. Tax. 19; Hauser, “Dealer Status and the Condominium Conversion” (2007) 34 J. Real Est. Tax. 100; Swad, “Understanding Dealer Status on the Sale of Real Estate”(Oct. 2002) 80 Taxes 31]

The relevant factors are:

a) [13:427] **Frequency and substantiality of sales:** The higher the volume of sales, and the more frequently they occur, the more likely the taxpayer is a dealer. This is clearly the most important factor, since a regular flow of selling tends to establish the taxpayer is holding the property "primarily" for sale and that the sale is in the "ordinary course" of business. [*Suburban Realty Co. v. United States* (5th Cir. 1980) 615 F2d 171, 178; *Maddux Const. Co. v. Commissioner* (1970) 54 TC 1278; see also *Bennett v. Commissioner*, TC Memo 2012-193—single sale of unfinished house over 5-year period unlikely to be sufficient absent preexisting contract or some other evidence of sales activity]

b) [13:428] **Improvements:** If the taxpayer improved the property (e.g., by adding streets or sewers), the taxpayer is more likely to be a dealer. However, some improvement activity does not negate capital asset treatment, since it is obviously necessary to improve property to use it for farming or rental. [See *Maddux Const. Co. v. Commissioner*, supra]

c) [13:429] **Solicitation and advertising:** The more the taxpayer does (personally or through employees) to solicit sales, the more likely the taxpayer is a dealer. Use of independent contractors to solicit sales can also be attributed to the taxpayer, although less strongly than sales made through employees. [See *Maddux Const. Co. v. Commissioner*, supra]

d) [13:430] **Relation to taxpayer's other activities:** A taxpayer engaged in some other business who sells real estate as a "sideline" is less likely to be a dealer than one engaged full-time in land development. [See *Pool v. Commissioner,* TC Memo 2014-3—fact that taxpayer identified its principal business activity as "development," its principal product/service as "real estate" and filed affidavit identifying itself as developer that entered into buy-sell agreement for individual lots showed taxpayer bought land to develop and sell it]

e) [13:431] **Liquidating investments:** Some cases hold that a taxpayer who liquidates an investment by selling it off in small increments and not reinvesting the proceeds can still qualify for capital gain treatment. However, the better view is that liquidation produces capital gain only where the liquidation is caused by some externally-induced factor that makes the preexisting use of the property impracticable.

Thus, a taxpayer would be treated as a dealer where they made a voluntary switch from farming or rental to liquidating sales, but not where the switch was involuntary. [*Biedenharn Realty Co., Inc. v. United States* (5th Cir. 1976) 526 F2d 409, 422 (voluntary switch); *Gangi v. Commissioner*, TC Memo 1987-561—taxpayers who abandoned rental business and sold 26 condominiums not dealers because change in business resulted from their deteriorating relationship; but see *Boree v. Commissioner* (11th Cir. 2016) 837 F3d 1093, 1101-1103—property sold due to zoning change that made development prohibitively expensive *not* eligible for capital gain treatment because, among other things, taxpayer continued to engage in development activities until sale actually concluded]

f) [13:431.1] **Change in use of property:** A taxpayer who originally acquires property for resale purposes but then decides to hold it as an investment may not be a dealer. [*Maddux Const. Co. v. Commissioner* (1970) 54 TC 1278; compare *Allen v. United States* (ND CA 2014) 113 AFTR2d 2014-2262—taxpayers who purchased property for development and resale did not change their intent just because development was delayed due to financing issues; *Fargo v. Commissioner*, TC Memo 2015-96—taxpayers who continued to spend significant sums on development after supposedly changing their use to investment denied capital gain treatment]

(c) [13:432] **Section 1237 capital gain treatment—real estate sellers:** Notwithstanding ¶ 13:422 ff., one narrowly-drafted Code provision allows capital gain to real estate sellers. [IRC § 1237]

1) [13:432.1] **Minimum five-year holding period; no substantial improvements:** IRC § 1237 requires that the property be held at least five years (unless it was inherited) and prohibits any substantial improvements that substantially enhance the value of the lot or parcel. [IRC § 1237(a)(2) & (3); see *English v. Commissioner*, TC Memo 1993-111—substantial improvements rendered § 1237 inapplicable; McKinley & Zilber, "When Subdividing Real Estate Might Result in a Capital Gain" (2016) 43 J. Real Est. Tax. 80]

An improvement is not substantial if it increases value by no more than 10%. And more substantial improvements are permitted if the property is held at least 10 years (water, sewer, drainage or roads.) [See IRC § 1237(b)(3); Treas.Reg. § 1.1237-1(c)(3)]

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2) [13:432.2] **No other property for sale:** Further, IRC § 1237 applies only if the taxpayer holds no other real property for sale to customers in the ordinary course of business. [IRC § 1237(a)(1)]

3) [13:432.3] **Partial allocation to ordinary income:** If more than five parcels are sold from the same tract, 5% of the selling price is ordinary income (starting with the sixth parcel). [IRC § 1237(b)(1)]

(d) [13:432.4] **Land sale to corporation:** A taxpayer owning undeveloped land might sell it to a corporation for its present value; then, the corporation could subdivide the land, build houses on it, and sell the houses individually. Arguably, since the *taxpayer* is *not* a dealer, the taxpayer's gain on the sale of the land to the corporation (the difference between the undeveloped value of the property and the taxpayer's basis) is treated as a capital gain. On the other hand, because the *corporation* is a dealer, its gain from the sale of the homes (the income received from sale of the homes less the costs paid to purchase the land) is treated as ordinary income.

However, the gain from the sale of property by an individual to a corporation of which the individual owns more than 50% of the outstanding stock is treated as ordinary income if the property in the hands of the corporation is depreciable. [IRC § 1239(a), (b)(1), (c)(1)(A)]

Accordingly, because the property became depreciable once the corporation improved it with homes, for the taxpayer's gain from the land sale to be treated as capital gain, the taxpayer cannot own more than 50% of the corporation's outstanding stock. On the other hand, if the corporation buys the land from the taxpayer, subdivides it and sells the subdivided parcels without improving them, the property in the hands of the corporation is *not* depreciable, and the taxpayer *can* own more than 50% of the corporate stock without jeopardizing the capital gain treatment of the land sale. (The above analysis could apply equally to a taxpayer who owns multi-family rental property and sells it to a corporation that then converts it to condominiums for sale.)

• [13:432.5] **Comment:** Where the taxpayer sells property to a corporation of which the taxpayer owns stock, the IRS can be expected to challenge the taxpayer's claimed capital gain treatment of the sale on the ground that the corporation is merely the taxpayer's agent. However, taxpayers have successfully refuted such challenges by keeping meticulous records showing that they did *not* act in the name of or on account of the corporation, did not have authority to bind the corporation, and all contracts relating to development of the property were in the name of the corporation only. [See *Bramblett v. Commissioner* (5th Cir. 1992) 960 F2d 526, 534; *Glasgow Village Develop. Corp. v. Commissioner* (1961) 36 TC 691, 702; *Gordy v. Commissioner* (1961) 36 TC 855, 859-860; and see generally, Raby & Raby, "Capital Gain and the Real Estate Developer" (Nov. 10, 1997) 77 Tax Notes 717]

(2) [13:433] **Case law exclusions:** Numerous cases have found particular property interests ineligible for capital asset treatment even though they are not specifically listed in IRC § 1221. In these cases, the courts often refer to the consideration received as a "substitute for ordinary income" (although this is obviously inexact—i.e., the sale price of any asset is really the present value of all the income the property is expected to produce). [*United States v. Dresser Industries, Inc.* (5th Cir. 1963) 324 F2d 56, 58-59]

• [13:434] **Comment:** There is a close match between assignment of income cases and capital gain cases: If a donor could not transfer the income from an item by giving it away, the same item is not a capital asset if the owner sells it. [See generally, Bittker & Lokken, "Federal Taxation of Income, Estates & Gifts" p. 51-46 to 51-77 (2d ed. 1989 and current supp.)]

(a) [13:435] **Carveouts:** Where the taxpayer retains income-producing property and receives an amount that is the economic equivalent of rent, the amount is treated as ordinary income. Such transactions are often referred to as "carveouts."

1) [13:436] **Tenant's lease cancellation payments:** A payment made by a tenant to the lessor to terminate its lease is considered a substitute for rent (ordinary income to the lessor) and not capital gain from a sale of the lease. [*Hort v. Commissioner* (1941) 313 US 28, 32-33, 61 S.Ct. 757, 759; *compare* ¶ *13:440*]

• [13:436.1] **Comment:** Arguably, under IRC § 1234A, income received by a lessor from a tenant to cancel a lease should be treated as capital gain, but the IRS has not yet stated its position on the issue. (*See* ¶ *13:283.1*; and Roche, "Lease Cancellation Payments Are Capital Gain? Yes! The TRA '97 Change to 1234A overturned *Hort*" (2005) 102 J. of Tax. 364.)

• [13:436.2] **Section 1231 property:** Even if a tenant's lease cancellation payment normally should be treated as capital gain under IRC § 1234A (¶ 13:436.1), that is only true if the underlying property is itself a capital asset.

[See *CRI-Leslie, LLC v. Commissioner* (11th Cir. 2018) 882 F3d 1026, 1028 (denying capital gain treatment for tenant's lease cancellation payment on property classified as IRC § 1231 asset rather than capital asset)]

(Section 1231 assets are discussed in detail at ¶ 13:442 ff.)

2) [13:437] **Compensation for government taking:** Similarly, compensation paid by the government for a temporary taking of the taxpayer's property is treated as rent (ordinary income), not the sale of a capital asset. [*Commissioner v. Gillette Motor Transport, Inc.* (1960) 364 US 130, 136, 80 S.Ct. 1497, 1501]

3) [13:438] **Sale of mineral deposit production payments:** The sale of production payments in mineral deposits is treated as the mere anticipation of ordinary income (but the sale of a royalty interest would produce capital gain). [*Commissioner v. P.G. Lake, Inc.* (1958) 356 US 260, 265-266, 78 S.Ct. 691, 694-695]

(b) [13:439] **Sale of entire interest:** In contrast, a sale of the taxpayer's entire interest in property (or a fraction of the entire interest) will generally produce capital gain.

For example:

• [13:440] A tenant's sale of its lease to the landlord produces capital gain to the tenant. [*Commissioner v. Ferrer* (2nd Cir. 1962) 304 F2d 125, 130-133; see IRC § 1241]

• [13:441] And a sale by a life tenant of their entire life estate produces capital gain … although, under present law, the life tenant is denied any basis if they received the life estate by gift or bequest and the remainder is not sold at the same time. [IRC § 1001(e); *McAllister v. Commissioner* (2nd Cir. 1946) 157 F2d 235, 236]

b. [13:442] **Section 1231 assets:** Section 1231 assets (¶ 13:443) receive extremely favorable tax treatment: If all IRC § 1231 transactions together produce a net gain, all transactions are capital. But if they produce a net loss, all transactions are ordinary rather than capital. [IRC § 1231(a)(1) & (2); see IRC § 1221(2)—excluding such assets from capital asset treatment (but this is a conduit to § 1231, which gives taxpayers better than capital asset treatment)]

Thus, if there were only one § 1231 transaction that produced a $100,000 loss, and the taxpayer had no capital gains, the loss would be currently deductible; conversely, if it were a capital loss, it would be deductible only to the extent of $3,000 (with the balance carried forward; *¶ 13:418 ff.*).

(1) [13:443] **"Section 1231 assets" defined:** IRC § 1231 assets are depreciable personal property used in a trade or business or any real property (depreciable or not) used in the trade or business. In each case, the asset must be held more than one year. [IRC § 1231(b)]

(a) [13:444] **Not dealer property:** However, "dealer property" (*¶ 13:422*) is excluded from IRC § 1231 treatment. [IRC § 1231(b)(1)]

(b) [13:445] **Trade or business requirement:** Real estate qualifies for favorable IRC § 1231 treatment only if held for use in a trade or business. [IRC § 1231(b), ¶ 13:443] If held simply for the production of income, it would be a capital asset, not a § 1231 asset. (*See ¶ 13:303.10* for discussion of property "held for the production of income.")

1) [13:446] **Rental property:** Real estate rental property qualifies as a trade or business "if the taxpayer-lessor engages in regular and continuous activity in relation to [renting] the property." [*Keefe v. Commissioner* (2nd Cir. 2020) 966 F3d 107, 113 (internal quotes omitted); see also *Fackler v. Commissioner* (6th Cir. 1943) 133 F2d 509, 511-512; *Curphey v. Commissioner* (1980) 73 TC 766, 774—rental of single unit can qualify as trade or business]

Relevant factors include whether the taxpayer (or their agent) performs maintenance and repairs; employs labor to manage property or provide tenant services; purchases materials; collects rent; and pays expenses. The taxpayer's efforts to rent the property also are considered. [See *Keefe v. Commissioner*, supra, 966 F3d at 113-116—taxpayers who only had a "few causal conversations" with prospective tenants, and instead tried to sell their property, did not use property in trade or business]

[13:447 - 13:447.3] *Reserved.*

(c) [13:447.4] **Residence also used for business:** Taxpayers who use their homes for personal *and* rental purposes are required to prorate any applicable business deductions between the two uses of the property (*see ¶ 13.294 ff.*). Similarly, when such property is sold, the sale price must be allocated between the portions of the property used for personal versus business reasons.

As such, any *gain* on the sale of the *personal* portion of the property is treated as capital gain, unless the property qualifies as a "principal residence" (*¶ 13:356*), in which event the gain may qualify for IRC § 121 nonrecognition;

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and any *loss* on the personal portion sale is *not* deductible (¶ *13:345 ff.*). On the other hand, gain *or* loss on the *rental* portion of the property is treated as a IRC § 1231 transaction. (For a discussion of the tax treatment of various sales of property used for personal and rental purposes, see Everett, Duncan & Lassar, "Assessing the Tax Consequences of a Sale of Rental Property with Varying Degrees of Personal Usage"(Oct. 2005) 83 Taxes 45.)

(d) [13:447.5] **Partnership interest:** IRC § 1231 does *not* apply to the sale of a partnership interest at a loss, even though the only partnership asset is a building used in a trade or business. Sale of a partnership interest normally produces capital gain or loss. [IRC § 741; *Baker v. Commissioner*, TC Memo 1997-442]

(2) [13:448] **Treatment of § 1231 transactions:** Under IRC § 1231, all gains and losses from sale or exchange of § 1231 assets are netted. [IRC § 1231(a)(1) & (2)]

(a) [13:449] **Involuntary conversions:** In addition, recognized gains or losses from involuntary conversion (i.e., casualties or condemnation) on all capital assets held more than one year and used in a trade or business or in a transaction entered into for profit are included in the equation, except that casualties are included only if losses on casualties exceed gains. [IRC § 1231(a)(3) & (4)(B)]

(Recall that gains from involuntary conversion are not recognized if appropriately reinvested under IRC § 1033; *see* ¶ *13:375 ff.*)

(b) [13:450] **Capital or ordinary:** If this netting process produces a gain, all transactions are long-term capital gains or losses. But if the netting produces a loss, all transactions are ordinary income or ordinary loss. [IRC § 1231(a)(1) & (2)]

(c) [13:450.1] **Depreciation recapture:** Normally, depreciation on real property is not recaptured as ordinary income when the property is sold (unlike personal property). [IRC § 1250 (depreciable real property); compare IRC § 1245 (depreciable personal property)] However, the Taxpayer Relief Act of 1997 introduced a form of depreciation recapture for real estate: To the extent of depreciation, capital gain is taxed at the rate of 25% rather than the usual 20%. [IRC § 1(h)(1) & (6)]

(For depreciation recapture rules relating to property purchased before 1987, see Maule, "Re-Use Gain Taxation Relief Keys: Unlock Section 1245(a)(5) Ordinary Income" (Nov. 10, 1997) 77 Tax Notes 721.)

Examples

• [13:450.2] TP purchases Mall, a IRC § 1231 real property asset, for $5,000,000 in 1987 and correctly claims straight-line depreciation of $2,000,000 between 1987 and 1999. Thus, Mall's adjusted basis is $3,000,000 in 1999. Mall is sold in 1999 for $3,500,000. This is TP's only IRC § 1231 transaction in 1999. TP's gain is $500,000. It is capital gain but is taxed at the rate of 25% rather than the normal 20%.

• [13:450.3] If instead, TP sold Mall in 1999 for $5,800,000, the gain would have been $2,800,000. Of that amount, $2,000,000 would be taxed at the rate of 25%; the remaining $800,000 would be taxed at the rate of 20%.

(d) [13:451] **Caution—losses followed by gains:** If in one year there are net IRC § 1231 losses (deducted as ordinary loss) and in any of the next five years there are net § 1231 gains, these gains are turned from capital gain to ordinary income to the extent of the losses. [IRC § 1231(c)]

4. [13:452] **Sale or Exchange Requirement:** A capital asset transaction can produce capital gain or loss only if characterized as a "sale or exchange." [IRC § 1222(1)-(4)] The phrase is a term of art and is narrower than "sale or other disposition." [See generally, Bittker & Lokken, "Federal Taxation of Income, Estates & Gifts" Ch. 52 (2d ed. 1989 and current supp.)]

Some of the sale or exchange issues significant to real estate investors include:

a. [13:453] **Leases:** Amounts received by a lessee to cancel a leasehold interest are considered received in exchange for the lease. [IRC § 1241]

b. [13:454] **Foreclosures:** The transfer of property by a debtor in connection with a foreclosure sale is treated as a sale or exchange of the property to the debtor. [*Helvering v. Hammel* (1941) 311 US 504, 512, 61 S.Ct. 368, 372]

c. [13:455] **Casualties:** A gain or loss resulting from casualty insurance compensation is *not* treated as a sale or exchange. [*Helvering v. William Flaccus Oak Leather Co.* (1941) 313 US 247, 251, 61 S.Ct. 878, 881] However, such transactions normally are treated as IRC § 1231 transactions (and thus give rise to capital gain or ordinary loss, depending on the results of § 1231 netting; *see* ¶ *13:448 ff.*).

d. [13:456] **Worthless and abandoned property:** A loss resulting from abandonment of property is an ordinary loss since there is no sale or exchange. [*Matz v. Commissioner*, TC Memo 1998-334] However, if the abandonment effectively returns

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the property to a lender, there is a sale or exchange because the transaction is akin to foreclosure. [See Bittker & Lokken, supra at ¶ 52.1.3; Harris, "Section 165(a): Losses on Troubled Real Estate" (1993) 71 Taxes 171; *Citron v. Commissioner* (1991) 97 TC 200, 213-217—ordinary loss on abandonment of partnership interest where partnership had no debt]

5. [13:457] **Minimum "Holding Period":** To be eligible for favorable capital gain treatment, the taxpayer, at a minimum, must have held the property for *more than one year*. [IRC § 1222(3)] Normally, the holding period is measured from the time the taxpayer is treated as being the owner of the property until they are no longer treated as the owner (*see ¶ 13:46 ff.* for discussion of acquisition and disposition dates).

a. [13:458] **Holding period carryover:** Ordinarily, under circumstances in which basis is carried over, the holding period is carried over as well. For example:

- [13:459] In the case of a IRC § 1031 (like-kind) exchange or IRC § 1033 nonrecognition after an involuntary conversion, the holding period of the new property includes the holding period of the old. [IRC § 1223(1)]
- [13:460] Similarly, in the case of a gift, the donee's holding period includes the donor's. [IRC § 1223(2)]
- [13:461] And, in the case of a tax-free transfer of property to a partnership or corporation, the entity's holding period includes that of the transferor. [IRC § 1223(2)]

b. [13:462] **Inherited property—one-year minimum deemed satisfied:** In the case of inherited property, the taxpayer is deemed to have held the property more than one year regardless of when it is sold. [IRC § 1223(11)]

c. [13:463] **Holding period for profit interests:** The required holding period for favorable capital gains treatment is *three years* for partnership interests that are transferred to the taxpayer in connection with substantial services performed by the taxpayer (or by any related person) in a trade or business that is (i) involved in raising capital; and (ii) either investing in or disposing of certain assets, including real estate held for rental or investment, or in developing those assets. [IRC § 1061(a), (c); see generally Rubin et al., "Real Estate Owners: Don't Get Carried Away by New Carried Interest Rule" (2018) 159 Tax Notes 45; Magette, "Carried Interest in a Tax Partnership: Reflection, Reaction, and Regs" (2018)]

[13:463 - 13:464] ***Reserved.***

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Cal. Prac. Guide Real Prop. Trans. Ch. 13(III)-F

California Practice Guide: Real Property Transactions | September 2024 Update
Dennis L. Greenwald and Steven A. Bank; Contributing Editor: Carol M. Clements

Chapter 13. Real Property Purchase and Sale Tax Concerns

Part III. Disposition of Real Property

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1. [13:465] **Methods of Accounting—In General:** Most individual taxpayers use the cash method of accounting, under which items of income are recognized when cash is received and items become deductible when cash is paid. Business taxpayers often use the accrual method of taxation, under which items of income are recognized when they are earned and items of income become deductible when the obligation to pay is incurred. But in no event are these items recognized or deducted any later than when they (or a portion thereof) are taken into account as revenue in the taxpayer's financial statement. [See IRC §§ 446(c), 451(a), (b)]

Normally, gain (but not loss) on the sale of property is recognized under the installment method of taxation, pursuant to which gain is recognized pro rata as cash payments are made by the buyer. [IRC § 453; *see ¶ 13:466 ff.*] However, the IRS can change a taxpayer's accounting method when necessary to clearly reflect income. [IRC § 446(b)]

2. Installment Method

a. [13:466] **When applicable:** Most sales of real property that result in recognized gain are taxed under the installment method. [IRC § 453] The installment method applies to a disposition of property where at least one payment is to be received after the taxable year in which the disposition occurs. [IRC § 453(b)]

(1) [13:467] **"Election-out" option:** When income is otherwise taxable under the installment method, the seller may avoid that method only by "electing out"—i.e., by reporting income on the tax return for the year of sale and following the appropriate instructions on the forms. [IRC § 453(d)]

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If the seller elects out of the installment method, the transaction is accounted for under the seller's normal accounting method (generally, cash or accrual).

(2) [13:468] **Compare—losses:** The installment method cannot be used if the seller has a loss rather than a gain. [Rev.Rul. 70-430, 1970-2 CB 51]

(3) [13:469] **Inapplicable to dealer property:** The installment method is not applicable to sales of "dealer property" (i.e., property held primarily for sale to customers in the ordinary course of business; *¶ 13:422 ff.*). Gain on such property is taxed under the cash or accrual method, depending on the method the seller uses. [IRC § 453(b)(2)(A) & (*l*)]

(a) [13:470] **Exceptions:** The installment method *can* be used in connection with a "dealer disposition" of (i) property used for farming, (ii) residential lots if neither the seller nor a related party made any improvements to the lots, or (iii) timeshares in residential real property. [IRC § 453(*l*)(2)]

However, in the case of residential lots and timeshares, a seller who uses the installment method must pay interest on any deferred tax. (See IRC § 453(*l*)(3) for details of computing interest.)

b. [13:471] **Installment method mechanics:** Under the installment method, the income recognized each year is equal to the same fraction of the payments received in that year as the "gross profit" bears to the "total contract price." [IRC § 453(c)]

For this purpose, the "gross profit" is equal to the sale price less basis. The "total contract price" is the total payments the buyer promised to make. [Treas.Reg. § 15A.453-1(b)(2)(iii)]

• [13:472] **Example:** S owns Blackacre, which is a capital asset or a IRC § 1231 asset. The basis of Blackacre in S' hands is $6,000. Blackacre is sold to B for $10,000. The purchase contract calls for interest on the unpaid balance at the rate of 10% (which is above the applicable federal rate).

In the year of sale, B pays $3,000 of principal and $400 of interest. S recognizes capital gain of $1,200 (i.e., $3,000 payment times $4,000/$10,000). The $400 of interest is ordinary income to S, because interest is taxed separately and is not involved in the installment method calculation, unless the imputed interest rules apply (*see ¶ 13:491 ff.*).

c. [13:473] **Treatment of debt to which property subject:** Any debt to which the property sold is subject is treated as part of the seller's amount realized and therefore determines the gross profit on the sale (*see ¶ 13:399*).

Ordinarily, however, the debt is not taken into account in the installment sale computation—either in measuring payments or total contract price. But there is an important exception: To the extent the debt exceeds basis of the property, it is treated as a payment in the year of sale and is included as part of the contract price. [Treas.Reg. § 15A.453-1(b)(2)(iii), (iv) & (3)(i)]

(1) Examples

• [13:474] Assume in the example at *¶ 13:472* (S' basis for Blackacre is $6,000 and it is sold for $10,000) that Blackacre was subject to $2,500 debt. Therefore, Buyer owes Seller only $7,500, of which $3,000 was paid in the year of sale. The gross profit remains $4,000 because the debt (whether Buyer assumed it or took subject to it) is part of the amount realized. However, the debt is not part of the total contract price or the payments received. Consequently, the total contract price is only $7,500. The income in the year of sale is $1,600 ($3,000 x $4,000/$7,500).

• [13:475] *Compare:* In the example set forth at ¶ 13:474, assume instead that S' basis was only $1,000. Since the $2,500 debt to which Blackacre was subject exceeds basis, the excess of $1,500 is treated as both a payment in the year of sale and as part of the total contract price. The gross profit and the total contract price are both $9,000. In the year of sale, S has capital gain of $4,500 (i.e., payments of $4,500 x $9,000/$9,000).

(2) [13:476] **Wraparound mortgages:** In a wraparound mortgage, the buyer does not assume or take subject to the existing debt but simply promises to pay the seller an amount that includes both the existing debt and the new purchase money debt. The Regulations treat a wraparound mortgage as if the buyer took subject to the existing mortgage. [Treas.Reg. § 15A.453-1(b)(3)(ii)] However, the courts have held this Regulation invalid and the IRS has acquiesced in this decision. [*Professional Equities, Inc. v. Commissioner* (1987) 89 TC 165, 181, acq. 1988-2 CB 1]

Evidently then, the wraparound mortgage technique can be used to avoid income under the installment method in the year of sale where the existing debt exceeds basis.

d. [13:477] **Interest on deferred tax liability:** In the case of certain large debts, a taxpayer using the installment method must pay interest to the Treasury on the deferred tax due. [IRC § 453A] The interest is potentially deductible if the taxpayer can surmount the various obstacles to the deduction of interest (*see ¶ 13:165 ff.*).

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(1) [13:478] **Installment sales affected:** The deferred interest rule applies only to installment sales for a price exceeding $150,000. Moreover, it applies only if the installment obligation is outstanding at the end of the year and the total of all such obligations which arose during and are outstanding at the end of the year exceed $5,000,000. [IRC § 453A(b)]

(a) [13:479] **Exceptions:** The deferred interest rule does *not* apply to personal use property, property used in farming, or certain timeshares and residential lots. [IRC § 453A(b)(3) & (4)]

(2) [13:480] **Interest calculation:** To calculate the interest on deferred tax, start by figuring the amount of deferred tax. This figure is that amount of gain not yet recognized times the maximum rate of income tax applicable to the taxpayer. The deferred tax figure is then multiplied by the "applicable percentage" of the deferred tax. The applicable percentage is the portion of the amount of the obligations arising in the taxable year in excess of $5,000,000 over the total of such obligations. Finally, the remaining figure is multiplied by the interest rate presently charged on tax underpayments. [IRC § 453A(c), referring to IRC § 6621(a)(2) for interest rate]

(3) [13:481] **Pledging:** As to installment obligations subject to the interest charge requirement (i.e., any obligation over $150,000 regardless of whether the $5,000,000 floor is met), if such obligations are pledged, the amount borrowed is treated as if it were collected from the installment debtor. [IRC § 453A(d)]

e. [13:482] **Payments received:** Since receipt of payment triggers recognition of income under the installment method (¶ *13:471*), it is important to know what constitutes payment. "Payment" includes actual or constructive receipt of money or property (other than the buyer's promise to pay). [Treas.Reg. § 15A.453-1(b)(3)(i)]

(1) [13:483] **Demand or readily-tradable instruments:** The seller is treated as receiving a payment if the evidence of debt received by the seller is in the form of an instrument that is payable on demand or is issued by a corporation or government entity and is readily tradable. [IRC § 453(f)(4); Treas.Reg. § 15A.453-1(e)]

(2) [13:484] **Security:** A seller does not receive payment simply because the buyer's promise to pay is secured by a mortgage or trust deed. Nor is payment received if the buyer's promise is secured by a third party guaranty or a standby letter of credit. A standby letter of credit is a nonnegotiable, nontransferable letter of credit issued by a bank or other financial institution which guarantees payment of the debt but cannot be drawn upon in the absence of default in payment on the underlying debt. [Treas.Reg. § 15A.453-1(b)(3)]

[13:484.1 - 13:484.4] ***Reserved.***

(3) [13:484.5] **Deferred exchange:** Many real property dispositions take the form of deferred exchanges intended to qualify for nonrecognition under IRC § 1031 (¶ *13:332 ff.*). If the transaction fails to qualify under § 1031, however, the installment method may still be available to defer taxation of the funds until they are actually paid over to the taxpayer. Receipt by the third-party qualified intermediary is not treated as constructive receipt of the proceeds by the taxpayer for purposes of IRC § 453. [See *Smalley v. Commissioner* (2001) 116 TC 450; *and* ¶ *13:339.1*]

f. [13:485] **Contingent payment obligations:** The installment method can be used even for contingent payment obligations as to which the gross profit and the total contract price cannot be ascertained in the year of sale. [IRC § 453(j)(2)] The Regulations provide the ground rules for applying the installment method to contingent payment obligations. [Treas.Reg. § 15A.453-1(c)]

(1) [13:486] **Maximum price stated:** If the amount of the sale price is contingent but is subject to a stated maximum, the installment method is applied as if the maximum price will in fact be paid. If the maximum is in fact not obtained, the gross profit ratio will then be recomputed. [Treas.Reg. § 15A.453-1(c)(2)]

(2) [13:487] **Fixed period:** If the amount of the sale price is contingent but the maximum period over which payments can be received is fixed, the taxpayer's basis is allocated equally to each taxable year in which payment might be received. However, no loss is permitted if the amount received in a given year is less than the basis allocated to that year. [Treas.Reg. § 15A.453-1(c)(3)]

(3) [13:488] **Neither maximum price nor fixed period:** If there is neither a maximum price nor a fixed period, and if it is determined that a sale has actually occurred (as opposed to a lease or some other arrangement), basis is recovered over an arbitrary period of 15 years (but taxpayers can try to persuade the IRS that a shorter period should be used). [Treas.Reg. § 15A.453-1(c)(4)]

g. [13:489] **Second dispositions:** If a taxpayer sells property to a related person ("first disposition") and the related person disposes of the property before paying the original seller all that is owed ("second disposition"), the amount realized in the

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second disposition is treated as received by the original seller. [IRC § 453(e)(1) & (f)(1) (definition of "related person"); see Harris, "Installment Sales of Real Estate: Second Disposition by Related Party Can Backfire on Seller" (2000) 27 J. Real Est. Tax 84]

However, in the case of real property, this provision does not apply if the second disposition is at least two years after the first disposition. [IRC § 453(e)(2)]

h. [13:490] **Dispositions of installment obligations:** If a seller deferred recognition of gain by using the installment method and disposes of the installment obligation before it is paid off, the deferred gain is recognized at the time of the disposition. If the obligation is disposed of other than by sale or exchange (i.e., disposition by gift), the transferor is treated as receiving the fair market value of the obligation. [IRC § 453B(a)]

However, this provision does not apply to a IRC § 1041 transfer to a spouse or former spouse incident to divorce (¶ *13:385*). [IRC § 453B(g)]

3. [13:491] **Imputed Interest:** Where the contract of sale fails to provide for interest on deferred payments at or above the applicable federal rate, interest must be imputed. This rule affects both the seller (who has imputed interest income) and the buyer (who has imputed interest payments that may be deductible). [IRC §§ 483, 1274; see generally, Bittker & Lokken, "Federal Taxation of Income, Estates & Gifts," Chs. 56, 57 (2d ed. 1989 and current supp.)]

a. [13:492] **Imputed interest Code provisions:** Two separate Code Sections are potentially applicable to such transactions:

(1) [13:493] **Section 1274:** Under IRC § 1274, the imputed interest rate is tied to the rates the federal government pays on its debt of varying maturity ("the applicable federal rate" or AFR). There is a short-term rate (for obligations up to three years), a mid-term rate (three-to-nine years), and a long-term rate (over nine years). These rates are announced periodically by the IRS. Unless an obligation calls for interest at least equal to the AFR, interest is ordinarily imputed at that rate. [IRC § 1274]

(a) [13:493.1] **Sale-leasebacks:** In the case of a sale and leaseback, the imputed interest rate is 110% of the AFR. [IRC § 1274(e)]

(b) [13:494] **Smaller transactions:** An interest rate of 9% is provided for certain sales of real property or used personal property (where the AFR is above 9%). A sale qualifies for the 9% rate if the sale price is less than $2,000,000. If the price is between $2,000,000 and $4,000,000, the applicable rate is a blend of the 9% rate and the AFR. [IRC § 1274A]

(2) [13:495] **Section 483:** Generally, IRC § 483 uses the AFR, but the method of accounting differs from the rule applicable under IRC §§ 1274 or 1274A. Section 483 is applicable to sales of farms (if the sale price does not exceed $1,000,000), sales of a principal residence, or any sale for less than $250,000 in principal and interest payments. [IRC § 1274(c)(4)]

b. [13:496] **Imputed interest computations:** Assume the AFR is 9%. Start with the sum of the principal payments due under the contract (the "stated principal" amount). Subtract the sum of the present values of the principal and interest payments called for by the contract. The present value is determined by using an actuarial table and by discounting the stream of payments at 9%. This figure is called the "imputed principal amount."

The imputed principal amount is included in the seller's income as the seller's amount realized (regardless of the actual fair market value of the note). If the seller uses the installment method, this figure is used to establish the gross profit and the total contract price. The imputed principal amount also will be the buyer's basis for the property.

Next, subtract the imputed principal amount from the stated principal amount. The difference is "original issue discount" (OID). The amount of OID must be included in the seller's income (in addition to the stated interest under the contract) and will be treated as an additional interest payment by the buyer (potentially deductible if all the requirements for deducting interest are met). [IRC §§ 1274(b), 483(a) & (b)]

(1) [13:497] **Example:** In Year 1, S sells Blackacre (a capital asset) for $1,000,000 to B. B will pay nothing down and will make payments of $200,000 per year for five years beginning in Year 2. B will pay interest on the unpaid balance at the rate of 5%, but the AFR is 9%.

The "stated principal" amount is $1,000,000. However, the present value of the payments of principal and interest due is only $820,000 (using a 9% discount rate compounded semi-annually). Thus, the imputed principal amount is $820,000. S' amount realized is $820,000 and B's basis for Blackacre is $820,000. The $180,000 difference is OID; it will be taxed as interest income to S over the life of the loan and will be deductible by B (assuming B meets the requirements for deductibility of interest). [IRC §§ 1274(b), 483(a) & (b)]

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(2) [13:498] **Special computation for "potentially abusive situations":** A different method of computation applies in the case of any "potentially abusive situation." [See IRC § 1274(b)(3)]

c. [13:499] **Timing:** Interest imputation *under IRC § 483* occurs as payments are made. Part of each principal payment will be treated as interest, rather than principal. Over the course of the contract, the entire amount of OID ($180,000 in the example set forth at ¶ 13:497) will be treated as interest payments from buyer to seller. [IRC § 483(a)]

IRC § 1274, on the other hand, uses an accrual method: Each year a portion of the OID is treated as interest regardless of whether any payments of principal are made. [IRC § 1272(a)]

d. [13:500] **Exceptions:** There are several exceptions to the imputed interest rules:

(1) [13:501] **Section 1041 transactions:** Interest is not imputed in connection with IRC § 1041 transfers between spouses or former spouses incident to divorce. [Treas.Reg. §§ 1.483-1(c)(2)(iii), 1.1274-1(b)(10)]

(2) [13:502] **Maximum $3,000 sale price:** IRC § 483 does not apply if the selling price (as determined at the time of the sale or exchange) does not exceed $3,000. [IRC § 483(d)(2)]

(3) [13:503] **Intrafamily real estate deals:** The imputed interest rate cannot exceed 7% in respect to land sales between family members (up to $500,000 per sale). [IRC § 483(e)]

(4) [13:504] **Personal use property:** If the buyer will use the property for personal rather than business or investment purposes, interest imputation applies only to the seller—*not* to the buyer (who thus is denied a deduction for imputed interest). [IRC § 1275(b)]

4. [13:505] **Accounting for Sales if Seller Elects Out of Installment Method:** If the seller elects out of the installment method (*¶ 13:467*) or does not qualify for it (*¶ 13:469*), gain should be reported under the taxpayer's normal method of accounting—either the cash or accrual method. Broadly, under the cash method, income is recognized when cash or a cash equivalent is received. Under the accrual method, income is recognized when earned (normally, at the time the sale is made).

a. [13:506] **Cash method—exceptions:** There are two important exceptions to the rule that income is recognized under the cash method only when cash is received:

(1) [13:507] **Constructive receipt:** Taxpayers cannot turn their backs on income. When a taxpayer has both the right and the power to receive an item of income, the item becomes taxable even though it is not in fact received—i.e., in this situation, the income is deemed "constructively received." [See *Reed v. Commissioner* (1st Cir. 1983) 723 F2d 138, 142; *Goldsmith v. United States* (Ct.Cl. 1978) 586 F2d 810, 815]

However, income is not constructively received where by contract it is not yet payable (even if the taxpayer was responsible for the decision to make the contract deferring the income). [See Treas.Reg. § 1.451-2]

(2) [13:508] **Equivalent of cash:** Cash method taxpayers recognize income when they receive "the equivalent of cash" even though they have not actually received cash. Sometimes this rule is referred to as the "economic benefit doctrine" (taxpayer receives income when taxpayer receives an "economic benefit"). [See *Goldsmith v. United States* (Ct.Cl. 1978) 586 F2d 810, 820; *Drysdale v. Commissioner* (6th Cir. 1960) 277 F2d 413, 418]

(a) [13:509] **Special rule for sales of property:** Under the Regulations, if a taxpayer elects out of (or is ineligible to use) the installment method, the fair market value of the buyer's promise to pay is treated as property and included at its fair market value, regardless of whether it is transferable. Thus, it is necessary to value and include in income *any* legally enforceable promise to pay, regardless of whether it is embodied in a formal note, whether it is secured by a mortgage or trust deed, or whether it can be readily sold on the market. Consequently, unsecured notes, executory land sale contracts, or even an oral promise to pay must be valued if enforceable under local law. [Treas.Reg. § 15A.453-1(d)(2); *Warren Jones Co. v. Commissioner* (9th Cir. 1975) 524 F2d 788, 793-794; but see also Craven, "'Money' and 'Property (Other Than Money)': An Exploration of 'Amount Realized' Under Section 1001(b)"(1992) 70 Taxes 912, 914-917 (questioning this result and validity of Regulation)]

(b) Valuation of promise to pay

1) [13:510] **Fixed obligations:** In the case of a fixed amount obligation, the seller must value the obligation. In no event will that value be considered to be less than the fair market value of the property surrendered and in no case will the sale be considered an "open transaction." [Treas.Reg. § 15A.453-1(d)(2)(ii)]

2) [13:511] **Contingent obligations:** In the case of a contingent payment obligation, if neither the obligation nor the underlying property is subject to valuation, an "open transaction" method can be used, pursuant to which the amounts received are applied first against basis with the excess being gain. [Treas.Reg. § 15A.453-1(d)(2)(iii)]

b. [13:512] **Accrual method:** A seller using the accrual method must accrue as income the entire amount payable under an installment obligation, regardless of the value of the obligation, unless the debt is of doubtful collectibility. [Treas.Reg. § 15A.453-1(d)(2)(ii); Rev.Rul. 79-292, 1979-2 CB 287; Craven, supra at 918-922]

(1) [13:513] **Application to land sale contract:** In the case of a land sale contract (under which the buyer takes possession but the seller retains title, ¶ *13:48*), an accrual basis seller must accrue as income the gain arising from such sale in the year when the right to receive the income becomes fixed—i.e., when the contract is executed and the buyer takes possession. [*Keith v. Commissioner* (2000) 115 TC 605, 616-619 (applying rule to "contract for deed" under Georgia law)]

5. [13:514] **Long-Term Contracts:** When a contract to perform services extends more than one year (as in the development and construction of real property), there are two methods of accounting for the expenses and reporting the gain, and one optional "safe harbor" method relating to common improvement costs (¶ *13:514.1 ff.*).

a. [13:514.1] **Complete contract method:** All income and most deductions associated with the contract are deferred until the year in which the contract is substantially completed. This occurs when 95% of the total allocable costs have been incurred or when the contract has been accepted as completed. [Treas.Reg. § 1.460-1(c)(3)(i)]

This method permits income to be deferred and some expenses not directly associated with the contract (e.g., marketing) to be taken currently. Thus, Congress has limited its availability to home construction contracts and any other construction contract entered into by a taxpayer who (i) expects the construction to be completed within two years and (ii) has gross receipts for the previous three years of not more than $25 million. [IRC §§ 460(e), 448(c)(i); *Shea Homes, Inc. v. Commissioner* (9th Cir. 2016) 834 F3d 1061, 1070 (permitting developer to classify completion as not only construction of single house, but also entire development); TAM 2016650014—complete contract method permitted for grading and soil compaction of pad area needed for house foundations; compare *Howard Hughes Co., L.L.C. v. Commissioner* (5th Cir. 2015) 805 F3d 175, 182-184—complete contract method denied where taxpayer did not incur any construction costs in conjunction with its common improvement costs; see also Friedline, "The Completed Contract Method and Master Planned Communities" (4th Quarter 2017) Real Estate Tax'n 17]

Caution: The IRS has announced it will *not* acquiesce in *Shea Homes, Inc.* [See AOD 2017-03, 2017 IRB 1072]

b. [13:514.2] **Percentage of completion method:** Unless the construction project qualifies for the complete contract method (¶ *13:514.1*), the taxpayer must report income each year in an amount that roughly corresponds to the percentage of the contract completed that year. This is done by comparing the costs incurred in the taxable year with the costs estimated for the entire contract. [IRC § 460]

The taxpayer may receive interest on overpayments, or be required to pay interest on underpayments, upon completion of the contract when the actual costs are known. [IRC § 460(b)(2)]

c. [13:514.3] **Common improvement costs:** For common improvement costs, which include improvements to real property that benefit two or more properties held for sale (e.g., streets, sidewalks, sewer lines, playgrounds, clubhouses, tennis courts, and swimming pools that developers are required by contract or law to provide and for which the costs are not recoverable through depreciation), developers may use an optional "safe harbor" method of accounting. It is referred to as the "Alternative Cost Method" and is used to determine the allocable share of the estimated costs of the common improvement costs that may be included in the basis of an individual real property unit held for sale. This may include costs not actually incurred by the end of the tax year but may not exceed the cumulative amount of common improvement costs for all tax years that have been incurred as of the end of the tax year. [See Rev.Proc. 2023-9, 2023-7 IRB 471; Seago & Orbach, "Home Construction Common Improvement Costs: The Matching Issue"(2023) 180 Tax Notes 709]

6. Abandonment Losses

a. [13:515] **Loss treatment, generally:** Where property used in business or for investment becomes worthless, its owner may seek a *loss deduction* equal to the property's adjusted basis. [IRC § 165(a), (c); Harris, "Section 165(a): Losses on Troubled Real Estate" (1993) 71 Taxes 171] (For a discussion of whether such loss is ordinary or capital, *see* ¶ *13:456*.)

(1) [13:515.1] **Compare—treatment upon transfer of encumbered property:** The tax treatment may be different if the property is conveyed to a lender (or to a taxing authority where real property taxes are delinquent): Here, the amount of discharged debt is considered an amount realized; and the taxpayer may have a *gain* on abandonment rather than a loss. [*Tufts v. Commissioner* (1983) 461 US 300, 317, 103 S.Ct. 1826, 1836; see *L & C Springs Assocs. v. Commissioner* (7th Cir. 1999) 188 F3d 866, 868]

Moreover, the “sale or exchange” requirement is met so that the loss may become a capital loss or a IRC § 1231 loss (*see* ¶ *13:418 ff., 13:448 ff.*). [*Freeland v. Commissioner* (1980) 74 TC 970, 979-981]

b. [13:516] **Timing of loss deduction:** Generally, a loss deduction must be evidenced by closed and completed transactions and fixed by identifiable events. [Treas.Reg. § 1.165-1(b), (c)]

(1) [13:516.1] **Land:** In the case of land, a loss deduction is allowed in the year the land becomes worthless, which may precede the year in which there is an overt act of abandonment or loss of title.

Worthlessness occurs in the year the taxpayer decides the property has become worthless if the property is objectively worthless in that year and the “identifiable event” test is met. [Treas.Reg. § 1.165-2(a); *Echols v. Commissioner* (5th Cir. 1991) 935 F2d 703, 707, rhng.den. (5th Cir. 1991) 950 F2d 209] However, some cases require an act of abandonment in this situation. [See *Corra Resources, Ltd. v. Commissioner* (7th Cir. 1991) 945 F2d 224, 226-227; *A.J. Industries, Inc. v. United States* (9th Cir. 1974) 503 F2d 660, 668]

(2) [13:516.2] **Buildings:** A loss deduction on abandoned (worthless) buildings requires an overt act of abandonment—i.e., the taxpayer's intent must “be irrevocably to discard the asset so that it will neither be used again by him nor retrieved by him for sale, exchange or other disposition.” [Treas.Reg. § 1.167(a)-8(a)(4)]

(3) [13:516.2a] **Mortgaged property:** Since abandonment of mortgaged property to the lender often generates income rather than loss (¶ *13:515.1*), the taxpayer may attempt to delay the year in which abandonment occurs. In this situation, no overt act is required and an abandonment can be found to have occurred based on all the facts and circumstances. [*L & C Springs Assocs. v. Commissioner* (7th Cir. 1999) 188 F3d 866, 870-871—test is whether for all practical purposes taxpayer will not retain the property]

(4) [13:516.3] **Partnership interest:** In the case of a partnership interest, a loss deduction is allowed in the year the taxpayer can establish either worthlessness or abandonment. [*Echols v. Commissioner* (5th Cir. 1991) 935 F2d 703, 707]

[13:517 - 13:519] ***Reserved.***

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Chapter 13. Real Property
Purchase and Sale Tax Concerns

Part III. Disposition of Real Property

G. Withholding and Reporting on Sale of Property

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1. Withholding Obligations

a. [13:520] **FIRPTA withholding:** Under the Foreign Investment in Real Property Tax Act (FIRPTA), a nonresident alien individual or corporation who sells real property located in the United States is subject to U.S. individual or corporate tax on the gain (even if the alien is not engaged in a U.S. trade or business). To facilitate enforcement of this requirement, as of February 17, 2016, the buyer of the property must withhold tax at the rate of 15% on the amount paid for the property (10% for pre-2/17/16 dispositions and personal residences valued above $300,000 and below $1 million), or such lesser amount as set forth in a certificate provided by the IRS. In certain circumstances, these provisions also apply to the sale of stock in a domestic corporation or in a partnership or trust that owns a U.S. real property interest, depending on whether foreign persons own 50% or more of the entity's fair market value. [IRC §§ 897, 1445(a); see also Treas.Reg. § 1.897-1(c) (applying a look-through approach for determining direct or indirect ownership); IRS Pub. 515 ("Withholding of Tax on Nonresident Aliens and Foreign Entities"), p. 46; Diosdi, "An Introduction to the Taxation of U.S. Real Estate Held by Foreign Investors" (2024) 140 J. Tax'n 7; Cohen, "A Complete History of Firpta Reform"(2018) 127 J. Tax'n 26]

However, there are numerous exceptions to the withholding requirements, including one covering the purchase of a residence for $300,000 or less (IRC § 1445(b)(5)). [IRC §§ 897, 1445; *see also* ¶ *4:510.1 ff.*]

b. [13:521] **California withholding:** Buyers of California real property interests for a price exceeding $100,000 generally must withhold and pay to the Franchise Tax Board 3 1/3% of the sale price. The tax must be withheld regardless of whether the proceeds will be distributed locally or out of state. [Rev. & Tax.C. § 18662(e)(1)-(2)(A), (3)(A); *but see* ¶ *13:521.8*]

Other withholding rates, specified as a percentage of the gain, may apply to sales of California real property by non-California partnerships and non-California "S" corporations (¶ *13:521.9*). [See Rev. & Tax.C. § 18662(e)(2)(B)]

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Escrow holders are required to give buyers written notice of the withholding requirements. [See generally, Rev. & Tax.C. § 18662(e)(3)(B); and Rev. & Tax.C. § 18668 (withholding liability to FTB; interest assessment for failure to withhold and pay to FTB)]

(1) [13:521.1] **Exempt sellers:** The following sellers are exempt from the California withholding requirements:

• Corporations and partnerships having a permanent place of business in California after the transfer of title (see Rev. & Tax.C. § 18662(e)(1)(A) & (B)); and

• Banks acting as trustees other than as trustees of deeds of trust (Rev. & Tax.C. § 18662(e)(3)(C)(ii)).

(2) [13:521.2] **Exempt sales conditions:** In addition, the withholding requirements do not apply when any of the following conditions exist:

• The sale price does *not* exceed $100,000 (Rev. & Tax.C. § 18662(e)(3)(A));

• The *escrow holder failed to give the transferee written notice* of the withholding obligations, unless the transferee was a qualified intermediary or accommodator in a deferred IRC § 1031 exchange (¶ *13:338*) (Rev. & Tax.C. § 18662(e)(3)(B));

• The transferee acquired the property by foreclosure or by deed in lieu of foreclosure (Rev. & Tax.C. § 18662(e)(3)(C)(i));

• The transferee relies in good faith on the transferor's *written certificate* (executed under penalty of perjury) that *either:*

— The property was *last used* as the transferor's *principal residence* within the meaning of IRC § 121;

— The property being conveyed is exchanged, or will be exchanged, for IRC § 1031 *like-kind* property (¶ *13:332 ff.*), but only to the extent of the gain not recognized under § 1031;

— The property has been "compulsorily or involuntarily converted" under IRC § 1033 (¶ *13:347.26*), and the transferor intends to acquire property similar to or related in service or use so as to be eligible for nonrecognition of any gain under IRC § 1033; or

— The transaction will *result in a net loss or gain* not required to be recognized for California income tax purposes (Rev. & Tax.C. § 18662(e)(3)(D)).

(3) [13:521.3] **Installment sales:** In the case of an "installment sale" within the meaning of IRC § 453(b), for California income tax purposes, the provisions of Rev. & Tax.C. § 18662(e) must be separately applied to each principal payment made under the installment sale agreement. [Rev. & Tax.C. § 18662(e)(3)(E)]

[13:521.4 - 13:521.6] ***Reserved.***

(4) [13:521.7] **Withholding mechanics:** Amounts withheld under Rev. & Tax.C. § 18662 must be reported and remitted to the FTB in the form and manner specified by the FTB. Notwithstanding the foregoing, funds withheld on individual transactions by real estate escrow persons may, at the option of the real estate escrow person, be remitted by the 20th day of the month following the close of escrow for the individual transaction or may be remitted on a monthly basis in combination with other transactions closed during that month. [Rev. & Tax.C. § 18662(e)(4)(A)]

(5) [13:521.8] **Alternative withholding amount pursuant to transferor election and certification:** Upon the transferor's election and written certification under penalty of perjury on a prescribed FTB form, rather than withholding the typical 3 1/3% amount (¶ *13:521*), the transferee may be required to withhold an amount not less than the gain required to be recognized by the taxpayer. [Rev. & Tax.C. § 18662(e)(2)(B), (C)]

(a) [13:521.9] **Non-California "S" corporations:** In the case of a sale by a non-California "S" corporation, the "S" corporation may elect the alternative withholding rate of 10.8% or 12.8%, as applicable, of the gain recognized by the "S" corporation instead of the default withholding rate of 3 1/3%. [Rev. & Tax.C. § 18662(e)(B)(ii)]

Cross-refer: For excellent guidance on the California real estate withholding requirements and applicable forms, see FTB Pub. 1016 (accessible online at *www.ftb.ca.gov*).

2. Reporting Requirements

a. [13:522] **"Real estate transaction" information return upon closing:** The escrow company or other person who closes a real estate transaction (designated by the Code as a "reporting person") must file an information return reporting the transaction to the IRS. IRS Form 1099 is used for such reporting. The form generally is required for any sale or exchange of realty, whether or not the transaction is taxable, but does not cover transfers by corporations or government units. In addition, the reporting person must furnish a written statement containing such return to the seller of the property. [See IRC § 6045(e); Treas.Reg. § 1.6045-4; Prescott & Teichner, "Information Reporting Requirements for Real Estate Transactions" (1992) 44 U.S.C. Tax Inst. Ch. 18]

(1) [13:522.1] **Exception for certain principal residences:** The reporting requirement does *not* apply to the sale or exchange of a residence for $250,000 or less ($500,000 or less in the case of a married couple) if the person otherwise responsible for reporting receives written assurance from the seller that (a) the residence is the seller's *principal residence* (as defined in IRC § 121, *see ¶ 13:345 ff.*), (b) no federally-subsidized mortgage assistance is involved, and (c) the full amount of the gain is excludable from gross income. [IRC § 6045(e)(5); Rev.Proc. 98-20, 1998-1 CB 549]

➪ [13:523] ***PRACTICE POINTER:*** IRC § 6045(e) and the Regulations designate one "reporting person" for each real estate transaction. Generally, the reporting person is the person responsible for closing the transaction; this could be the transferee's or transferor's *attorney*, in which event, the attorney (like any reporting person) could be subject to penalty assessments for failure to comply (IRC §§ 6721, 6722, 6723). [See IRC § 6045(e)(2); Treas.Reg. § 1.6045-4(e)(1), (3)]

Under the standards adopted by the Regulations, it is not always easy to decipher who, in a particular real estate transaction, is required to act as a reporting person. However, the parties can resolve this problem by *appointing* a reporting person in a written "*designation agreement*" executed at or before the closing and signed by the designated person. The designated person must be someone who is "responsible for closing the transaction"; the transferee's or transferor's attorney; the disbursing title or escrow company that is "most significant" in terms of gross proceeds to be disbursed; or, the mortgage lender. Such appointment is expressly permitted by the Regulations and will supersede the criteria otherwise used to identify the reporting person. [See Treas.Reg. § 1.6045-4(e)(5)]

b. [13:524] **Lender's information return upon foreclosure:** A lender who forecloses on property must file an information return with the IRS on the foreclosure transaction. Lenders also must file an information return if they know that property in which they have a security interest has been abandoned. [IRC § 6050J] Thus, gains arising under *Tufts* (*¶ 13:400 ff.*) will be drawn to the IRS' attention.

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