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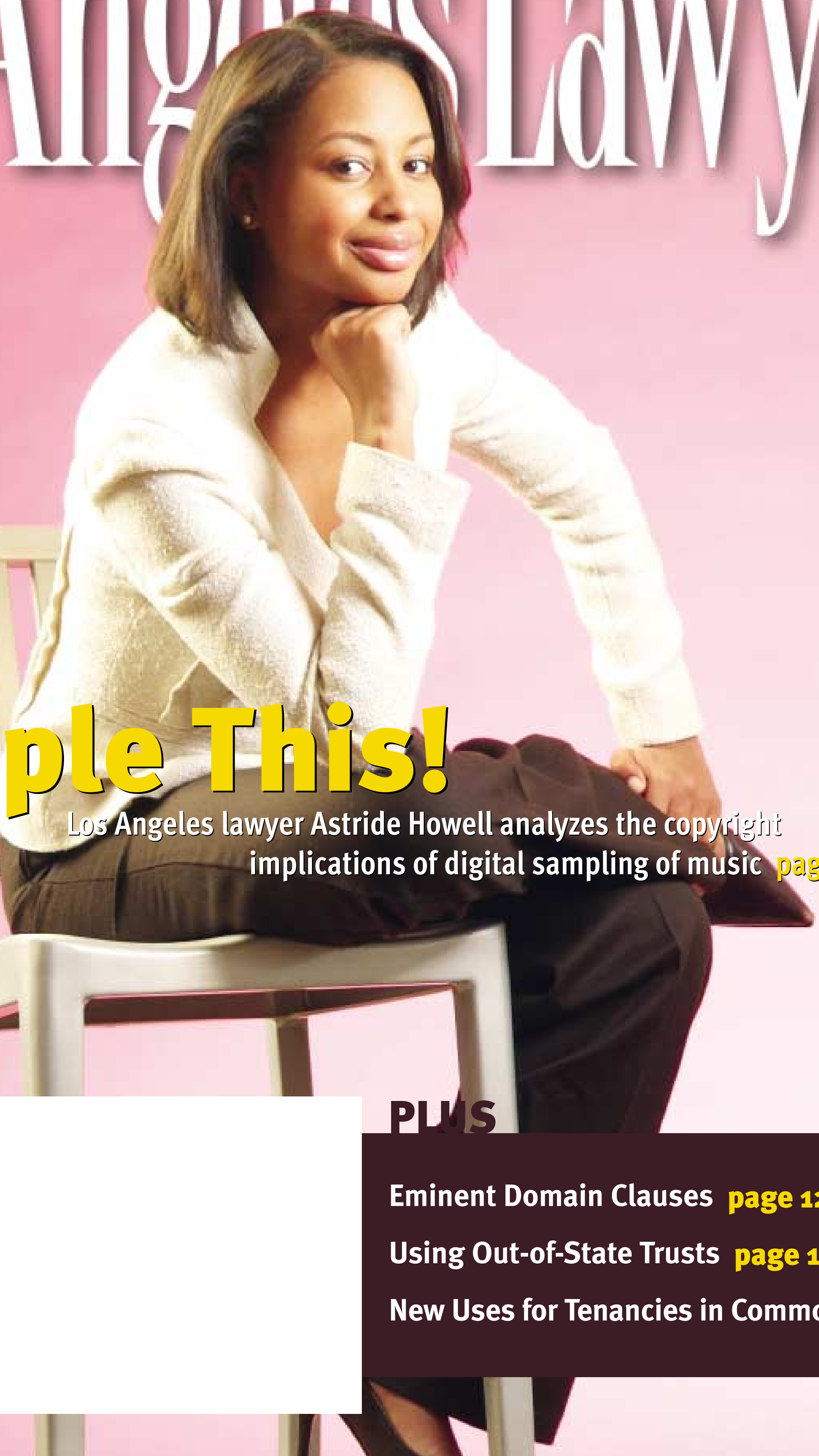

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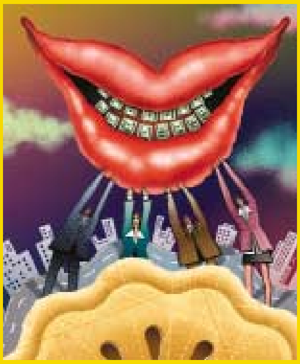

FEATURES

Los Angeles Lawyer

The magazine of The Los Angeles County Bar Association

DEPARTMENTS

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Los Angeles Lawyer

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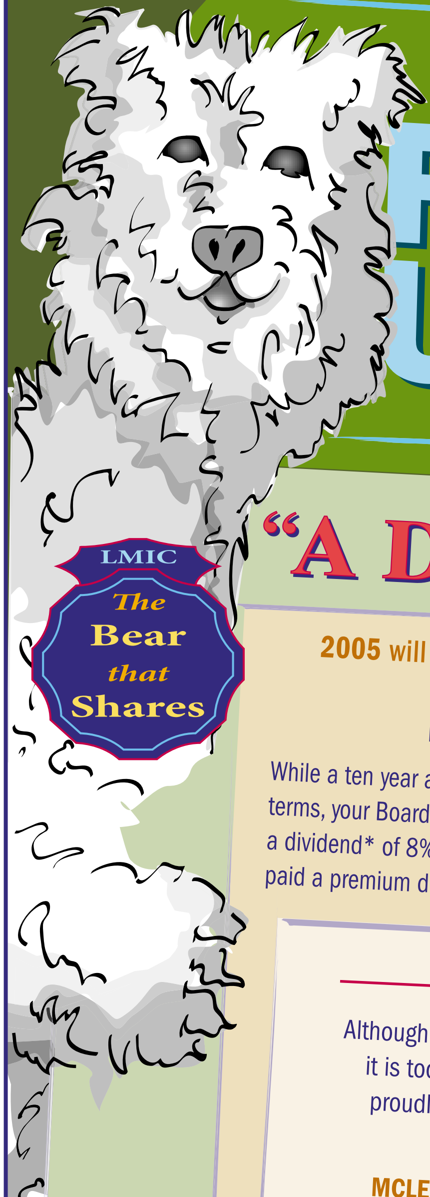

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From the Chair

BY R. J. COMER

My wife declared, "I reject the institutionalization of what ultimately comes down to just being a good person." I stopped laying cheese over a corn tortilla and realized, that's it! After weeks of wringing my hands and spirit on what makes an effective mentor, and working it over with her for hours one Sunday afternoon, my big law firm refugee spouse finally cut to the heart of the matter. Law firms and other legal organizations with formal mentor programs are either willfully or ignorantly blind to the simple fact that not every senior lawyer is equipped with the requisite qualities for effective mentoring: human empathy and a genuine desire to help others.

Matt Fragner, in last month's *Los Angeles Lawyer*, eloquently argued for CLE credit as an incentive for senior counsel to take up the mantle of mentorship despite the ever-increasing mobility of lawyers and their ever-decreasing organizational loyalty. Eva Petko Esber, in the Spring 2005 edition of *Litigation*, argued that technological advances have interfered with traditional mentoring. She provided advice for overcoming this interference. In the upcoming *Survival Guide for New Attorneys* from the Los Angeles County Bar Association, there is advice on how mentees can make the most of a relationship with a mentor. Obviously, we lawyers think mentoring is important. We seem to agree that much advice is needed to improve mentoring in our profession. Yet we seem content to remain practical in our advice because perhaps it is too radical to charge ourselves with the less practical responsibility of simply being good to one another.

Going to the source, the term "mentor" comes from a character in *The Odyssey* by the same name. Mentor was the goddess Athena in the guise of an old man who was entrusted by Ulysses with the care and education of his son, Telemachus, while Ulysses was away at the Trojan War. With Mentor at his side, Telemachus grew from a naïve boy to a capable man.

Thus, the calling of a mentor is a divine calling, a calling beyond the gnashing teeth of the mundane. A mentor is not impaired by technology. A mentor is not discouraged by the statistical probability that a younger lawyer may lateral to another firm. A mentor empathizes with the confusion and uncertainty of new lawyers and genuinely desires to help young lawyers develop skills, poise, confidence, and wisdom. A mentor takes up this mantle regardless of whether a formal mentoring program exists.

Managing shareholders and executive directors and elected city attorneys may roll their eyes, thinking of countless senior counsel in their organizations who exemplify the polar opposite of this mentoring ideal. To them I ask: "Should we limit ourselves to the best of the least among us?" I hope not. Instead, we should spend less time institutionalizing mentor programs and more time personalizing them.

Last month, I suggested that leaders are shapers of meaning. Shape the meaning of your mentoring program by identifying empathy and service as the meaning of your mentor program. Aggressively confront resistance and ignorance. Eliminate senior counsel from your mentoring program who cannot fulfill this ideal, and reward those mentors who do. Rewards in a law firm may be lower billable hours requirements for those allowed by firm leadership to serve as mentors. Rewards in civil service may be commendations and additional points toward promotion. Ask junior counsel to submit anonymous evaluations of senior counsel.

The sweet truth of humanity is that mentors will always arise even when there is a dearth of incentives. Take a moment and reflect upon those that inspired and instructed us, those that challenged and consoled us. Is there really such a person as a "self-made success" in our profession? ■

R. J. Comer is a partner at Allen Matkins Leck Gamble & Mallory LLP, where he specializes in land use law and municipal advocacy. He is the chair of the 2005-06 *Los Angeles Lawyer* Editorial Board.

BY WENDY L. WILCOX AND CHRISTOPHER J. WEBER

Dodging the Pitfalls of Qualifying an Expert

MOST LAWYERS FIND IT NECESSARY to search through advertisements to find an expert who can prove a client's case. It is incumbent, however, upon counsel to be aware of the pitfalls when selecting an expert and take precautionary steps.

Toxic tort and product liability cases are illustrative. Expert testimony is typically required as a matter of law when the ultimate issue is not within common knowledge. Such is the case in most toxic tort and product liability actions because the causation element of the claims asserted in these actions involve complicated chemical, mechanical, and other specialized knowledge.

The expert and his or her opinion are subject to attack from the moment they are disclosed pursuant to Code of Civil Procedure Section 2034, and they may be attacked in more than one instance. Indeed, there are various vehicles such as motions in limine, motions for summary judgment, and the 402 hearing that opposing counsel can use to prevent a plaintiff from introducing his or her expert and the expert's opinion at trial. The motion for summary judgment typically seeks to adjudicate the issue of causation soon after the expert's opinion is disclosed, whereas the motion in limine and the 402 hearing are brought at the eve of trial and seek to preclude the expert's opinion as lacking the proper foundation. Therefore, counsel must determine that the expert and his or her opinion are qualified at a very early stage, and ensure the expert's opinion remains consistent throughout his or her retention to avoid disqualification in the event of multiple attacks on foundational matters.

At a very early stage, ensure the expert's opinion remains consistent to avoid disqualification in the event of multiple attacks on foundational matters.

Determining whether an expert is qualified typically entails examining his or her curriculum vitae. Reliance upon one's own impression of the qualifications presented is usually sufficient. That is, common sense dictates that a Harvard graduate of a particular study might be more qualified to opine on a subject than one with mere experience in that study. However, take care to ensure the expert's cited credentials have a basis in reality. In a recent and much publicized toxic mold case, the plaintiff's expert was critically impeached when opposing counsel elicited testimony as to the falsity of several credentials set forth by the expert at trial.[1] Counsel should not hesitate to inquire as to the authenticity of the items listed in the expert's curriculum vitae and perhaps undertake efforts to independently verify them. Opposing counsel certainly will.

Once an expert is selected, counsel should pay special attention to the matters the expert relies upon in formulating his or her opinion. Evidence Code Section 801 provides that an expert's opinion must be based on matters reasonably relied upon by experts in forming opinions on the particular subject. Thus, even though an expert may be qualified to testify on a given subject, if his or her opinion is premised upon an unreliable source, the expert may be precluded from providing that opinion at trial. Therefore, when an expert relies upon material that is speculative, remote, or conjectural, the resulting opinion is deemed to lack evidentiary value.

In one case, the plaintiffs' expert sought to testify that the plaintiffs suffered physical injuries after they were allegedly exposed to certain chemical compounds found in the defendants' facility.[2] The expert relied upon epidemiological studies indicating increased instances of lung cancer in individuals exposed to these chemicals. However, as the defense pointed out, the individuals in the underlying study were exposed to over 130 chemicals, while only five of those chemicals were present at the defendants' facility. The court held that the underlying study did not provide a reasonable basis for the proffered opinion because it did not specifically indicate that exposure to the five chemicals at issue caused cancer. The plaintiffs' expert was not allowed to give his opinion as to causation, and judgment was entered for the defendants.

When a case runs afoul because an expert or the opinion is disqualified, all attention focuses on the handling attorney. The fact that an expert's incompetence is at issue will not serve as a shield, as it is the attorney's duty and responsibility to hire competent experts and to protect against the expert's vulnerabilities. Failure to monitor the expert and the expert's opinion could subject counsel to litigation on the other side of the table as public policy supports an equitable indemnity action by the expert against counsel for allowing the expert to provide inconsistent opinions.[3]

Competent selection and utilization of experts requires counsel to exercise diligence, thoroughness, and a healthy amount of skepticism as to the expert's touted skills. Awareness of the traps experts often fall prey to, and careful preparation to avoid them, will vastly increase the chances of your expert offering his or her opinion at trial. ■

[1] Daniel Fisher, "Dr. Mold," *available at* http://www.forbes.com.

[2] Lockheed Litigation Cases, 115 Cal. App. 4th 558, 564 (2004).

[3] *See* Forensis Group, Inc. v. Frantz, Townsend, & Foldenauer, et al., 130 Cal. App. 4th 14, 37-39, 2005 WL 1356925 (2005).

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BY GLENN L. BLOCK AND ROBERT T. FLICK

Condemnation Clauses in Real Estate Agreements

CERTAIN CLIENT INSTRUCTIONS should alert counsel to consider taking a different tack. Real estate practitioners must be particularly wary when they hear, "Don't nit pick the document, just make the deal." Or, "Forget about the condemnation provision—this property will never be taken." Wise counsel know that in every real property transaction, it is worthwhile to pause, concentrate, and get everything right when it comes to the issue of eminent domain.

As California's population continues growing and the competition for the use of its real estate becomes keener, cities and other governmental agencies are reaching more frequently for their eminent domain tool. They are doing so as a means to expand their educational infrastructure,[1] upgrade their economic base through the addition of new retail stores or other projects that generate high revenue and jobs, and mitigate ever-growing transportation woes. The U.S. Supreme Court's recent decision in *Kelo* v. *New London*[2] constitutes icing on the condemnor's cake and raises the specter of condemnation in virtually all real estate transactions.

While often overlooked, typical condemnation provisions in real estate transactional documents can have unexpected and unintended consequences if an eminent domain proceeding affects the subject property. A real estate agreement cannot prevent a condemnation from occurring, but a little attention paid to the condemnation provisions can provide greater certainty, help to assure desired outcomes, and manage the parties' expectations in the event of an eminent domain action.

All private property in California is subject to the power of eminent domain—the government's right to acquire, or take, private property for public use.[3] The power can be exercised by all governmental entities—including cities, counties, school districts, redevelopment agencies, and transportation agencies—and is very difficult to repel. Although it is possible to attack successfully a decision to take private property, most challenges merely delay the inevitable. Compensation usually is the focus for a party whose property is condemned, and a well-drafted condemnation clause can ensure that the party is compensated to the extent required by law for the taken property.

The taking entity must pay "just compensation" for the condemned real property, including all interests in the property and improvements to it.[4] A business operated on the property also may be compensated for loss of business goodwill and is entitled to relocation benefits.[5] The property owner in a condemnation action must be "put in as good position pecuniarily as he would have occupied if his property had not been taken."[6] Just compensation typically is computed on the basis of the fair market value of the property that is being taken.[7] Fair market value, in turn, is defined as the highest price the property would bring in the open market based on the property's "highest and best use."[8]

Although the obligation to pay just compensation in a condemnation action is controlled by California's Eminent Domain Law,[9] a party's entitlement to compensation will be affected by the provisions of a condemnation clause in a real estate agreement.[10] Depending on the nature of the agreement, a condemnation provision may:

RICHARD EWING

- Allocate compensation between or among the parties to the agreement.
- Maximize the amount of compensation payable.
- Specify which parties are allowed to participate in the compensation process.
- Provide assurances—usually in the form of representations and warranties—regarding the threatened or actual existence of an eminent domain proceeding.

Provisions for Common Contracts

A variety of clauses may achieve these objectives. Different approaches may be needed for each of the most common contracts involving real property—leases, purchase and sale contracts, options to purchase, deeds of trust, easements, and covenants, conditions, and restrictions (CC&Rs).

Leases. Landlords and tenants have separate and distinct interests in real property. In a condemnation action, however, the potential exists for the intermingling of these interests. Practitioners should draft lease condemnation clauses to ensure that the interests of landlords and tenants are separately compensable and that the condemnation award flows to the intended party or parties.

A lease condemnation clause should address:

- The allocation between landlord and tenant of compensation for "improvements pertaining to the realty." The Eminent Domain Law uses this term and deems these improvements to be compensable.
- The allocation between landlord and tenant of compensation for

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any leasehold bonus value.

• The rights and obligations of the parties in the event of a partial taking.

• The allocation between landlord and tenant of compensation for any purchase option that may be contained in the lease.

When the entirety of the property subject to a lease is condemned, the lease terminates, and the tenant's obligation to pay rent ceases.[11] Nevertheless, the tenant's entitlement to compensation in the condemnation action survives and is not affected by the lease termination.[12] The condemnation clause, if one is present, generally will control the rights of the parties to compensation in the condemnation action.[13] In the absence of a condemnation clause, entitlement to compensation may be determined by examination of other lease provisions, such as those for alteration or termination. Unfortunately for the tenant, however, there is a good chance that a tenant will not be compensated for improvements it owns unless the condemnation clause properly provides for compensation for them. In particular, the issues of compensation for improvements and for leasehold bonus value must be addressed specifically in the condemnation provision to avoid unexpected and undesired results for either the landlord or the tenant.

"Improvements pertaining to the realty" is a statutory term of art defined as items installed by any method for use on the real property that cannot be removed without substantial economic loss or causing substantial damage to the property.[14] These items may include buildings, structures, machinery, equipment, furnishings, and fixtures. Improvements pertaining to the realty are compensable notwithstanding the fact that the tenant under the lease may have the right or obligation to remove them upon expiration of the lease.[15] Also, while these items may be considered personal property in the contract between the landlord and the tenant, for purposes of the condemnation proceeding they are compensable as part of the realty.[16]

"Improvements pertaining to the realty" may be a meaningful term of art to those who litigate eminent domain but not to those who negotiate leases. In lease condemnation clauses, these improvements generally are referenced by terms that are common in the real estate industry, such as "tenant improvements" or "trade fixtures." These real estate terms are not mentioned in the Eminent Domain Law, so issues related to whether tenant improvements or trade fixtures are compensable, and who is entitled to compensation, are litigated frequently. These differences in terms are more than semantics. They can have surprising outcomes that can be avoided by simply referring to tenant improvements and trade fixtures in the condemnation clause of the lease as improvements pertaining to the realty and clearly stating which party is entitled to compensation.

Also compensable in a condemnation action is the loss of the right to possess the premises for the rent provided for in the lease during the remaining unexpired term of the lease, including any option terms (whether or not the options have been exercised at the time of commencement of the condemnation action). The value of the lease possessory right often is referred to as the leasehold bonus value and is apportioned from the compensation for the fee interest in the property.[17] A leasehold bonus value claim typically is not negotiated in advance by the parties, but it may entitle the tenant to a significant share of the compensation for the fee and thus lead to an unexpected and severe result. Fortunately for the landlord, a tenant may waive its right to compensation for leasehold bonus value, and many condemnation clauses include such a waiver.

The appropriateness of a tenant waiver of leasehold bonus value depends on the nature of the lease. For example, it is not uncommon for long-term ground leases to be subject to a significant leasehold bonus value claim, because the market lease rates often increase over time at a rate that exceeds the rent amounts scheduled in the lease, resulting in the tenant having the right to possess the premises at below market rents. The leasehold bonus value claim in the context of a ground lease may amount to 50 percent, or more, of the compensation awarded for the fee title to the real estate. Given the tenant's long-term use and possessory expectations, as well as the fact that ground leases usually delegate to the tenant many of the risks of ownership, the tenant's receipt of some or all of this compensation is not necessarily unfair or unwarranted. In shorter commercial leases (5 or 10 years), however, the leasehold bonus value claim—which may still amount to several hundred thousand dollars depending on the scheduled lease rate and the length of the remaining unexpired term—is less likely to be an appropriate part of the tenant's expectation. The landlord typically asserts that the landlord, not the tenant, is in the business of owning the property and taking the risks and reaping the rewards associated with that ownership. Accordingly, the landlord should receive all compensation paid for any taking of fee title to the property whether arising from increases in market rents or otherwise.

These issues can be addressed as part of a lease's condemnation clause with the following language:

> Any award for the taking or damaging of all or any part of the Premises under the power of eminent domain, or any payment made under the threat of the exercise of such power, shall be the property of Landlord, except that Tenant shall be entitled to compensation separately awarded to it, if any, for improvements pertaining to the realty owned by Tenant, loss of business goodwill and relocation benefits.

The foregoing clause effects a waiver by the tenant of its leasehold bonus value claim, but preserves the tenant's entitlement to compensation for its improvements pertaining to the realty.

When only a portion of the property subject to a lease is condemned, it may be appropriate for the lease to be terminated or for the terms of the lease to be modified. Examples of partial takings include the loss of spaces in a parking lot, or the taking of portions of a building or part of an industrial yard, each of which may or may not prevent the tenant from using the premises for the tenant's intended purposes. If the lease does not address termination upon a partial taking, the Eminent Domain Law leaves the issue up to the judge,[18] specifying that the lease terminates if the court determines "that an essential part of the property…is taken or that the remainder…is no longer suitable for the purposes of the lease."[19]

The court in a partial taking action may not find in a particular case that an essential part of the property has been taken or that the remainder is no longer suitable for the intended purposes, or the court may make such a finding in a situation in which the landlord or the tenant would prefer that the lease remain in effect, with modifications. Therefore, the possibility of a partial taking should be addressed in the condemnation clause during the negotiation of the lease agreement, when the parties are able to negotiate the circumstances under which a termination, partial termination, or modification of the lease would be appropriate. As alternatives to termination, the condemnation clause may provide the landlord the opportunity to restore, repair, or reconstruct any improvements or otherwise mitigate the impact of the taking to preserve the tenancy and identify specific circumstances or events that would justify the termination of the lease, even if the statutory partial taking termination standard is not met. A well-drafted condemnation provision that addresses partial termination should include a waiver of the parties' statutory right to terminate the lease if the parties want a different standard to apply.

Purchase and sale contracts. For a typical commercial real estate purchase and sale contract, in which the entire time period from execution of the agreement to closing typically does not exceed 90 days, condemnation is primarily a buyer's due diligence concern. Although there is no centralized clearing-

house for information regarding potential eminent domain proceedings, there are several steps that practitioners can take on behalf of their buyer (or tenant) clients to gain access to all the available pertinent information:

• Conduct a review of the preliminary title report to determine if the property is within a redevelopment area. Title reports may or may not show this information. Indeed, title companies may take the position that filed descriptions of redevelopment areas are not part of the public record they are required to search, disclose, and insure. Thus counsel should consider the preliminary report to be only one of the available resources.

• Round up the usual suspects. Contact local agencies that may be likely condemnors, such as counties, cities, school districts, water districts, Caltrans, and local redevelopment agencies. Inquire about proposed projects, including parks, schools, public facilities, and street and highway expansions or improvements. It may not be practical to contact every conceivable agency, but cities, counties, redevelopment agencies, and school districts are among the most common condemning authorities and should be contacted in each instance. Common sense and a property-specific diligence plan will help determine the appropriate scope of due diligence.

• Ask the seller to represent and warrant in the purchase and sale agreement whether the seller has been contacted by any governmental agency or other entity regarding the possible acquisition of all or a portion of the property, and whether any governmental agencies or other entities have requested or conducted environmental investigations or appraisal inspections. Governmental bodies generally conduct environmental investigations and appraisal inspections in advance of making a condemnation offer.

The condemnation clause in a purchase and sale contract also should address which party bears the risk of loss—and which party is entitled to the condemnation award if the property is condemned before the transaction is completed. In the absence of a relevant contractual provision, the party who bears the risk of loss at the time the condemning authority may take possession of the property generally is entitled to the owner's portion of the award.[20] If neither legal title nor possession has been transferred to the purchaser by the time the condemning authority may take possession, the seller receives the award; if the purchaser has either title or possession at that time, the purchaser receives the award.[21] The statutory scheme may appear fair at first blush, but it may create an undesirable result for many reasons. The seller and purchaser may agree that the purchaser can enter the property early to make repairs, begin planning, or even commence a work of improvement. If a full or partial condemnation occurred, it would be unexpected and unfair for the purchaser to receive the condemnation proceeds simply by virtue of having an early possession right. Additionally, the parties may desire that payments for partial takings be handled contrary to the statutory protocol, such as by allowing the purchaser to continue with the transaction and receive an assignment of, or credit for, proceeds payable to the seller.

Finally, a condemnation clause in a purchase and sale agreement should provide that the property conveyed includes all actions, causes of action, and all rights to insurance and condemnation proceeds pertaining to the property. This makes certain that the purchaser may participate in and receive any award from a condemnation proceeding, even one that may have commenced before the closing of the purchaser's acquisition.

Options to purchase. The owner of an unexercised option to purchase real property or improvements possesses a compensable property right in a condemnation action. In the absence of a clause in the option agreement to the contrary, the measure of damages to the optionee is the excess, if any, of the condemnation compensation above the option purchase price.[22] Once again, many option agreements fail to address the possibility of condemnation, and a landowner might be surprised to find a portion of the compensation flowing to the optionee—a situation that could have been prevented by including the optionee's waiver of compensation in the agreement.

Deeds of trust and financing agreements. The condemnation clause in a deed of trust or other financing agreement should address how the outstanding obligation is to be satisfied, including interest and attorney's fees, in the event that all or a portion of the collateral is taken by eminent domain. The lienholder generally has a priority interest in the condemnation award to the same extent as it would have a priority interest in the proceeds of a typical sale. Under California law, however, the lender is not entitled to enforce a prepayment penalty provision in a condemnation action.[23]

The lender should become a party to the action, whether or not it is named or served, as a "person" who claims an interest in the condemned property.[24] An adequately collateralized loan usually can be satisfied from the initial deposit of probable compensation that the condemning authority places with the court in order to obtain possession.[25] The lienholder can seek an order in the condemnation proceeding authorizing distribution of the proceeds that are necessary to satisfy the lien.[26] Often, the borrower's attorney will facilitate satisfaction of these obligations from the deposit to minimize the accrual of interest and to avoid, or at least minimize, the borrower's obligation for the lienholder's attorney's fees. When the borrower is cooperative, the distribution can be accomplished by a stipulated order. The loan documents should include the right of the lienholder to have condemnation proceeds paid to the lienholder, because this will be a necessary allegation to obtain an order.

If the deposit is insufficient to satisfy the outstanding balance or if there are other disputes, the matter may be resolved in a judicial apportionment of the final condemnation award.[27] In unusual circumstances, when a loan is significantly undercollateralized and the borrower walks away from the property, the lienholder actually may choose to be the one to defend the action (in the borrower's name or otherwise) to seek greater compensation and maximize recovery on its loan. The Eminent Domain Law does not specifically provide this right, so the lender can protect itself by including this right in the deed of trust or financing agreement.

For partial takings in which a significant portion of the property is condemned, impairment of security may also be an issue. Under the Eminent Domain Law, a lienholder is entitled to share in the condemnation award for a partial taking "only to the extent determined by the court to be necessary to prevent an impairment of the security."[28] This statute applies even if a condemnation clause provides otherwise.[29] The lien will remain on the property not taken. The Eminent Domain Law also addresses the allocation of an award for a partial taking among senior and junior lienholders.[30]

Rather than attempting to deal with the issue of allocation for a partial taking, the deed of trust or financing agreement—or the subordination and intercreditor agreement if there are multiple loans secured by the same property—may be better served by focusing on the use of funds and the effect of the taking on the contractual relationship. Specifically, the parties may prefer to apply the condemnation award for a partial taking to the repair, restoration, or reconstruction of the property and improvements. Alternatively, if the taking exceeds a certain percentage or dollar value, the parties may choose to have the proceeds used to pay down the loan and have the lending relationship terminate.

Easements and CC&Rs. Condemnation clauses are often conspicuously absent from easement agreements or agreements establishing CC&Rs. Easements or CC&Rs should address compensation for the different interests and the rights and obligations of the parties in the event of a taking. In the absence of an agreement to the contrary, if the servient tenement is acquired, or the dominant tenement's interest is otherwise extinguished or damaged, just compensation will be determined as the diminution in the value of the dominant tenement measured before and after the taking.[31]

The characterization of a condemnation provision as boilerplate tends to diminish the attention that parties should be willing to devote to it as they negotiate their real estate agreements. A condemnation clause can materially affect the rights of the parties. By crafting carefully tailored condemnation provisions, practitioners can help their clients avoid unpleasant surprises and unintended consequences from an eminent domain proceeding involving the subject property. ■

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[1] For example, the Los Angeles Unified School District has a plan that calls for the development of a $14 billion campus building program to be completed by 2012, with eminent domain as one of the contemplated acquisition tools. *See, e.g.*, Cara Mia DiMassa, *An Education in Expansion*, L.A. Times, Nov. 23, 2004, at A1.

[2] Kelo v. New London, 125 S. Ct. 2655 (2005). In a 5-4 decision, the U.S. Supreme Court ruled that the taking of property by the government from one private party to give to another private party constitutes a "public use" so long as it is done with the hope of creating jobs, increasing tax revenue, or otherwise providing economic stimulation. Justice O'Connor, writing for the dissent, sees the decision as an abandonment of the public use restriction on the government's eminent domain power, leaving open the possibility that any property may be taken by the government: "Nothing is to prevent the State from replacing any Motel 6 with a Ritz-Carlton, any home with a shopping mall, or any farm with a factory."

[3] U.S. Const. amend. IV; Cal. Const. art. 1, §19.

[4] Code Civ. Proc. §§1263.010, 1263.205.

[5] Code Civ. Proc. §1263.510; Gov't Code §§7262 *et seq.* Generally the rights of a business to compensation for loss of business goodwill and relocation benefits are not directly affected by a condemnation clause.

[6] United States v. Miller, 317 U.S. 369, 373 (1943).

[7] Code Civ. Proc. §1263.310.

[8] Code Civ. Proc. §1263.320. In certain limited situations, such as property owned by nonprofit organizations and special use property, valuation is computed based on the replacement cost of the taken property. Code Civ. Proc. §1263.321.

[9] Code Civ. Proc. §§1230.010 *et seq.*

[10] *See* Code Civ. Proc. §1265.160; Dix Box Co. v. Stone, 244 Cal. App. 2d 69 (1966) (lease provided that tenant would not share in condemnation award notwithstanding that statutory sharing might have been available); City of Beverly Hills v. Albright, 184 Cal. App. 2d 562 (1960) (lease provision by which tenant divested itself of right to fixtures operated to bar tenant from compensation when the fixtures were taken).

[11] Code Civ. Proc. §1265.110.

[12] Code Civ. Proc. §1265.150.

[13] Code Civ. Proc. §1265.160. *See also* City of Vista v. Fielder, 13 Cal. 4th 612, 618 (1996) ("[I]f the lease does not provide to the contrary, the rules in question [Eminent Domain Law] apply.").

[14] Code Civ. Proc. §1263.205. *See also* County of San Diego v. Cabrillo Lanes, Inc., 10 Cal. App. 4th 576 (1992) (providing judicial interpretation of §1263.205).

[15] Code Civ. Proc. §1263.210.

[16] Concrete Serv. Co. v. California *ex rel.* Dep't of Pub. Works, 274 Cal. App. 2d 142 (1969).

[17] Code Civ. Proc. §§1260.220, 1265.150. At trial, the jury will first determine the amount of compensation to be paid by the condemnor for the taking of the real property. Once the amount of compensation is determined, in the same proceeding the jury will "determine the respective rights of the defendants in and to the amount of compensation awarded and shall apportion the award accordingly." Code Civ. Proc. §1260.220(b).

[18] Code Civ. Proc. §§1265.120, 1265.130.

[19] Code Civ. Proc. §1265.130.

[20] Redevelopment Agency v. Maynard, 244 Cal. App. 2d 260, 265 (1966). *See generally* Civ. Code §1662 (Uniform Vendor and Purchaser Risk Act).

[21] Brick v. Cazaux, 9 Cal. 2d 549 (1937); County of Santa Clara v. Curtner, 245 Cal. App. 2d 730 (1966).

[22] County of San Diego v. Miller, 13 Cal. 3d 684 (1975).

[23] Code Civ. Proc. §1265.250.

[24] Code Civ. Proc. §§1250.230, 1250.320.

[25] The condemnor must make a deposit of probable compensation, in the amount of its highest appraisal, in order to secure prejudgment possession of the property. Code Civ. Proc. §§1255.010, 1255.410.

[26] Code Civ. Proc. §1255.210.

[27] Code Civ. Proc. §1265.220.

[28] Code Civ. Proc. §1265.225(a).

[29] Code Civ. Proc. §1265.225(b) & Law Revision Commission cmt. (providing that the lienholder and the borrower may agree "after commencement of the proceeding" to apportion the condemnation proceeds without regard to impairment of security).

[30] Code Civ. Proc. §1265.230.

[31] Redevelopment Agency v. Tobriner, 153 Cal. App. 3d 367, 372 (1984).

BY EDWARD J. MCCAFFERY, ALAN T. YOSHITAKE, AND KEITH A. DAVIDSON

The Advantages of Creating Out-of-State Trusts

WHILE CALIFORNIA IS A DESIRABLE place to live, it is not necessarily the best choice as a venue in which an individual or family should establish a trust for personal financial management. Many other states offer significant advantages for those seeking to form a trust. Attorneys creating trusts for California residents should consider the benefits of having their clients create trusts that live in other states.

In the last few years, states have been increasing their influence over trust and estate planning issues. Under federal law, the Estate and Gift Tax Relief and Reconciliation Act of 2001 (EGTRA)[1] phases out the estate tax and ultimately repeals it in 2010—but only for that year. Beginning in 2011, the estate tax returns to its pre-EGTRA levels (that is, with an exemption level per decedent of $1 million). As a consequence, states have been scrambling to replace lost revenue sources by reinstating their own estate and inheritance taxes.[2]

At the same time—and largely at cross purposes—many states are trying to create attractive jurisdictions for trust planning. Just as Delaware has become a bastion of corporate law (with recent competition from Nevada and others), states such as Alaska, Illinois, New Jersey, South Dakota, and Delaware are positioning themselves as trust-friendly places. In order to do so, states have made some significant changes to their laws, including:

- The creation of favorable tax treatment on trust income.
- The repeal of the age-old rule against perpetuities, thereby allowing for the creation of "dynasty trusts."
- Amendments to the Uniform Principal and Income Act that permit "total return trusts" to provide better benefits for present and future beneficiaries.
- The addition of asset protection laws for self-settled trusts.

Best of all, a settlor—a person who creates a trust—need not physically move to a trust-friendly jurisdiction to take advantage of these potentially attractive laws. Rather, a settlor can send his or her trust to reside in a more accommodating jurisdiction without the settlor ever leaving home.

In general, California settlors can set up trusts in jurisdictions outside California, provided that they follow the other state's trust creation laws. For example, some states, such as Delaware and Alaska, require trusts to have resident trustees.[3] Choosing the right home for a settlor's trust can be complicated because it requires a careful consideration of the trust and tax laws that apply in each jurisdiction.

Income Tax Considerations

Trusts that retain some or all of their income can be subject to state income tax. Most states that impose so-called fiduciary income taxes on trusts do so when the settlor resides in that state or when trust assets are located within the state. This is true of New York, for example.[4] But in California, trusts are subject to California income tax if *either* the trustee *or* the vested beneficiary resides in California.[5] If the trust has two or more trustees and only one of them resides in California, then the trust income is taxed proportionately. For example, if there are two trustees and only one of them resides in California, then half the trust income would be subject to California income tax.[6] The same is true if the trust has two or more beneficiaries.[7]

California's taxation of trusts—based on the residence of the trustees and beneficiaries—applies to California trusts and out-of-state trusts. This often is not a problem in simple trusts, which typically distribute all their net income to their beneficiaries. Once the distribution is made, there is nothing left to tax. But in a more sophisticated planning vehicle, such as a dynasty trust, the trust often retains some or all of its income, thus making it potentially subject to state income tax. Creating a Delaware trust, for example, does not guarantee that the trust will escape California income taxes.

Trust-friendly jurisdictions have a host of local trust companies that compete for business as in-state trustees for out-of-state settlors

In the income tax realm, states have the power to tax their own residents.[8] A state can also tax nonresidents who derive income from assets located within that state.[9] A state cannot, however, tax nonresidents if there is no reasonable nexus between the taxpayer and the state.[10] If a California settlor creates a Delaware trust and all the trust property is located outside California, California may still have the power to tax accumulated trust income. This is because California defines a trust as "resident" within its jurisdiction if either the trustee or the beneficiary resides in California.[11] If a California settlor has out-of-state beneficiaries, however, the settlor can create a non-California trust that will escape the reach of California's income tax—assuming that the trustee also resides outside California. For dynasty trusts or their sub-shares, which are likely to retain income, a non-California trust is especially attractive.

Trust-friendly jurisdictions have a host of local trust companies that compete for business as in-state trustees for out-of-state settlors. This service allows a California settlor to create, for example, a Delaware or Alaska trust with a Delaware or Alaska trustee. As long as the beneficiaries also reside outside California, the trust need not pay California income tax and instead will probably be subject

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to the beneficial income tax laws of Delaware or Alaska.

Dynasty Trusts

An increasingly common reason to create out-of-state trusts is to avoid the application of the rule against perpetuities. Not only is the rule against perpetuities the bane of every first-year law student, it also, for centuries, has prevented trusts from lasting forever.[12] Some states—such as Delaware, Alaska, Illinois, New Jersey, and South Dakota—have repealed the rule, allowing for the creation of a trust that can potentially last in perpetuity. A trust that is not subject to the rule against perpetuities is commonly referred to as a dynasty trust. Other states, such as Wyoming and Florida, have modified the rule so that trusts may remain in existence for hundreds of years.

The rule against perpetuities originally was implemented to prevent a settlor from forever controlling and restraining the free alienation of property. The rule ensured that the power of the "hand beyond the grave" was curtailed.[13] A settlor might want to implement long-lasting control over his or her property for many reasons, the most common being the desire to prevent younger generations from squandering the family fortune. Settlors want to impose their financial values on their hard-earned assets to ensure that those assets are preserved, protected, and prudently invested for all the generations that follow.

A dynasty trust provides settlors with the vehicle they need to preserve their assets, according to their desires, essentially for eternity, because the time that the trust would be in effect is unlimited. The essential element of a dynasty trust is its ability to last in perpetuity and thus create extraordinary opportunities for the transfer of wealth and the avoidance of transfer taxes.

Unfortunately, settlors may not create a dynasty trust under California law, which retains a version of the rule against perpetuities. In California, a nonvested property interest must vest or terminate, according to the venerable rule, within 21 years of a "life in being" or within 90 years after the creation of the trust.[14] This time frame certainly is not dynastic and clearly pales in comparison to hundreds of years or even forever.

With proper planning under another state's laws, settlors can use dynasty trusts to grow wealth from generation to generation free of the estate tax and the generation-skipping transfer tax (GST).[15] A transfer from a settlor to the settlor's grandchild is subject to the GST, which is the same high rate as the estate tax and is required in addition to the estate tax.[16] But since every taxpayer has a $1.5 million exclusion from the GST,[17] a settlor can create a dynasty trust, fund the trust with his or her $1.5 million GST exclusion amount ($3 million for a married couple) and allow the trust to appreciate free of all transfer taxes, including the GST tax, for generations to come.

For married couples, a dynasty trust typically begins with a bypass trust that allows $1.5 million (the estate and GST tax exclusion in 2005) to be preserved, free of all transfer taxes, upon the first spouse's death. Upon the second spouse's death, another $1.5 million passes free of all transfer taxes, thereby providing $3 million tax free to fund dynasty trusts for the settlors' children. This type of plan potentially can save the settlors and their descendants millions of dollars that would otherwise be paid as wealth transfer taxes.

The longevity of the trust, however, may lead to new problems and issues. When a trust has been in existence for a few hundred years, it could potentially have hundreds of beneficiaries. Administering such a large trust would be a monumental task. And as the trust corpus grows, so, too, can the desire to litigate over the growing pot of gold—especially when the warring factions are distant relatives who may have never met before the litigation. Dynasty trusts have the significant potential of bringing extended families together in new and possibly destructive ways if the trust and its future growth are not carefully planned.

To prevent a disastrous future marked by litigation among beneficiaries, the settlor must form a trust that will have a certain degree of flexibility so that the trustee can deal adequately with problems that cannot be anticipated at the time of the trust's creation. For example, the trust should allow the trustee to create new subtrusts for different branches of a family so that each branch could have essentially its own trust with its own smaller pot of gold.

Dynasty trusts also can pit one generation against another if an older generation is entitled to income while a younger generation receives principal. The income beneficiaries would want to maximize trust income, and the principal beneficiaries would want to maximize asset appreciation. The trustee must balance these interests—unless the trust is located in a total return trust jurisdiction. This problem is further compounded by the presence of multiple generations and multiple branches of the settlor's family as a result of the longevity of the dynasty trust.

Total Return Trusts

Dynasty trusts can be a powerful planning tool, preserving the settlor's intent in perpetuity and saving millions in GST and estate taxes. But their creation must be carefully

planned to minimize the potential for conflict among future generations. One means to avoid the problems that may arise from a dynasty trust and to address other thorny issues with other trusts—especially in an environment marked by low interest rates—is a total return trust. Like dynasty trusts, however, total return trusts are not available under California law.

A total return trust gives a trustee investment flexibility to maximize the returns of split-interests trusts. A split-interests trust is a trust in which one beneficiary (such as a spouse) is entitled to a present interest or income while another beneficiary (such as a child) is entitled to a future interest or principal. The most common example of a split-interests trust is a life estate left to a surviving spouse with the remainder to the decedent's children. A split-interests trust may lead to tension when, for example, an income beneficiary with a narrow self-interest wants the trustee to invest the entire trust corpus in income-producing assets while the principal beneficiary wants aggressive growth assets.

The Uniform Principal and Income Act[18] arose in large part to mediate such potential conflicts. Under the act, a trustee is charged with balancing competing interests so that no beneficiary suffers a disadvantage compared to the other beneficiary.[19] Unfortunately, a trustee who tries to please both beneficiaries may end up pleasing neither. For example, during times of low interest rates, a trustee may decide to invest partly in income-producing assets and partly in appreciating assets, thereby failing to fulfill entirely the goals of each party. The trustee may choose to invest the assets according to distribution concerns rather than the best investment strategy.

Certain states, however, have addressed these dilemmas regarding total return trusts through amendments to the Uniform Principal and Income Act.[20] The amendments allow a trustee of a total return trust to invest in a prudent way to maximize the total return of the trust, regardless of whether the underlying investments yield income in a traditional accounting sense.[21] The income beneficiary is paid a set percent, usually between 3 to 5 percent of the trust's fair market value.[22]

Especially in times of low yields, the use of total return trusts can increase returns for both the income and the remainder beneficiaries. It can ally both of these interests by allowing the trustee to invest in a more logical fashion for the benefit of both sides. Unfortunately, a California settlor cannot get this benefit if the trust is located in California, because California uses the traditional, unamended Uniform Principal and Income Act, which requires a trustee to balance the interests of the income and remainder beneficiaries for a result that may be equally disadvantageous to both.

Asset Protection

Trust-friendly jurisdictions also offer asset protection for self-settled trusts. In California, as with most states, a settlor can create a trust for children, grandchildren, or other beneficiaries and protect the assets from the beneficiaries' creditors by using spendthrift clauses, discretionary trust provisions, and nonassignability clauses. The settlor, however, cannot protect his or her own assets from creditors by creating a trust to hold the settlor's own assets.[23] These self-settled trusts generally are subject to the claims of creditors.

Jurisdictions such as Delaware, Alaska, Nevada, Rhode Island, and Utah have, however, implemented asset protection for self-settled trusts.[24] By creating a Delaware trust with a Delaware trustee, a settlor may protect the assets in his or her trust from the settlor's own creditors.[25] This protection is achieved by operation of Delaware law that was created specifically to protect self-settled trusts from creditors. Most of the laws providing asset protection for self-settled trusts have not yet been tested in the courts, however, and thus their long-term viability is uncertain. If they survive judicial scrutiny, these asset protection laws will be far more useful and beneficial than more recognized asset protection strategies, such as moving to Florida or setting up off-shore trusts in the Cayman Islands, Channel Islands, or Bermuda. The fact that a trust is created not just for asset protection but for other benefits, such as those provided by a dynasty trust and a total return trust, can only help make the case for the legal efficacy of the trust.

Asset protection for self-settled trusts—along with dynasty trusts, total return trusts, and favorable trust income tax laws—will certainly earn any jurisdiction the right to call itself trust-friendly, if not creditor-friendly. A skillful practitioner can accomplish the creation of a beneficial out-of-state trust for a client without the practitioner or the client needing to travel beyond the confines of the client's home state. Practitioners need to advise their clients of all relevant trust possibilities so that the clients can determine where their trusts should reside. ■

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[1] The Estate and Gift Tax Relief and Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in scattered sections of 26 U.S.C.).
[2] To date, California has not implemented its own estate or inheritance tax.
[3] ALASKA STAT. §06.26.010; 12 DEL. CODE ANN. tit. 12, §§3501–3510.
[4] N.Y. TAX LAW §605(b)(3).
[5] REV. & TAX. CODE §17742.
[6] REV. & TAX. CODE §17743.
[7] REV. & TAX. CODE §17744.
[8] Haavik v. Alaska Packers' Ass'n, 263 U.S. 510, 514 (1924).
[9] *See* James B. Ellis, *Forum Shopping for Your Trust's Tax Law*, USC TAX INSTITUTE, MAJOR TAX PLANNING, vol. 53, ch. 16, at 16-1 (Jan. 2001).
[10] *See* Haavik, 263 U.S. at 515.
[11] REV. & TAX. CODE §17742.
[12] PROB. CODE §21205 (California's Rule against Perpetuities).
[13] *See* W. Barton Leach, *Perpetuities in a Nutshell*, 51 HARV. L. REV. 638 (1938).
[14] PROB. CODE §21205.
[15] The GST is imposed on transfers to a person who is two or more generational levels below the settlor. I.R.C. §§2601, 2611, 2613.
[16] I.R.C. §§2621, 2622, 2623.
[17] I.R.C. §2631. The GST exemption amount will increase to $2.5 million in 2006 through 2008 and then increase to $3 million in 2009.
[18] PROB. CODE §§16320 *et seq.* (codification of California's Uniform Principal and Income Act).
[19] PROB. CODE §§16335, 16336.
[20] *See* Paul S. Lee, *Implementing Total Return Trusts*, 55 MAJOR TAX PLANNING ch. 16 (2003).
[21] *Id.*
[22] *Id.*
[23] PROB. CODE §18200.
[24] The Qualified Dispositions in Trust Act, 12 DEL. CODE ANN. tit. 12, §§3570–3576 (2004); the Alaska Trust Act, ALASKA STAT. §§13.12.205(2), 13.36.035, 13.36.310, 13.36.390, 34.40.010, 34.40.110 (2004); NEV. REV. STAT. §166.040 (2004); the Qualified Dispositions in Trust Act, R.I. GEN. LAWS §§18-9.2 *et seq.*; UTAH CODE ANN. §25-6-14(1)(a).
[25] 12 DEL. CODE ANN. tit. 12, §§3570–3576 (2004).

by ASTRIDE HOWELL

A Ninth Circuit decision seems to be in harmony with the Sixth Circuit's bright-line rule on what constitutes infringement in digital sampling

SAMPLE THIS!

TUNING INTO A LOCAL CAR COMMERCIAL or perusing the latest *Billboard* chart, one cannot escape the influence and prevalence of digital sampling. Sampling is everywhere. It is in Kanye West's debut "Through the Wire," as Chaka Khan's voice from her 1984 hit song "Through the Fire" rises from an accelerated hook. Fat Boy Slim's "Praise You," like many hits containing samples, was licensed to sell a bevy of products, including Nike shoes, and it is based on a vocal and piano sample from Camille Yarbrough's original song "Take Yo' Praise." Fat Boy Slim, whose real name is Norman Cook, admits that in his approach to sampling, "I'm trying to chop it up so much that whoever played it originally isn't going to recognize it."[1] Cook's take is most likely shared by most musicians, as they try to maintain their creativity within the limits they believe are placed on them by copyright law. Too often artists deal with infringement risks by creating legal mythologies that allow them to believe that sampling is a harmless creative effort or by adopting a mantra of innocent until proven guilty.

The controversy surrounding digital sampling and the legal rules of thumb generated in response reveal that there is quite a bit of misunderstanding among musicians about copyright law and sampling. Indeed, many musicians are operating under the incorrect perception that they have nothing to worry about if they sample less than 30 seconds of another song.[2] In reality, sampling just a few notes may be enough to give rise to a copyright infringement claim.

Digital sampling is the process of making a copy of an existing sound recording and using any portion of the existing recoding in a new sound recording.[3] Similar to remixing, digital sampling involves taking any guitar sound, drum sound, voice, or other element from a recording to make a perfect digital duplication that is played on a keyboard, edited, and reused in another recording.

The Zeus of copyright mythology, the "30-second rule," most likely emerged from the common confusion regarding the different rights that are held in one song. A single song—whether it is heard on the radio, an iPod, or a CD player—contains segmented rights. The song contains a copyright for 1) a musical composition and 2) a sound recording.[4]

A "musical composition" includes the words, if any, and the music associated with a song. The musical composition is owned by the songwriter or, by assignment, a music publisher. A "sound record-

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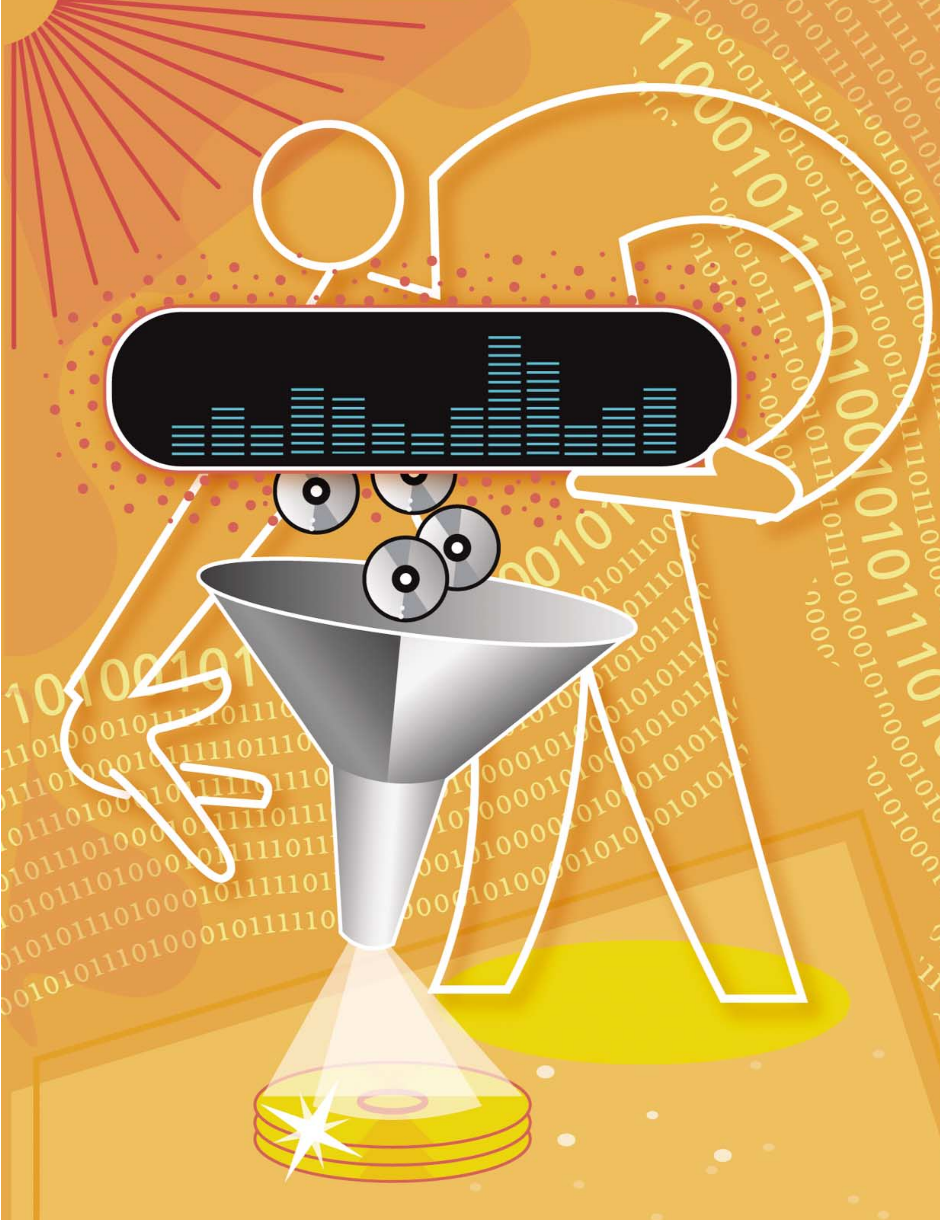


ing" is an actual recorded rendition of a song or musical composition. It results from the fixation (that is, a recording) of a series of musical, spoken, or other sounds. There can be different sound recordings of the same musical composition. In the music industry, the sound recording copyright typically is owned by the record label that represents the artist.

As a result of these rights, an artist seeking to utilize a sample from a song generally must obtain permission from the copyright holder in the form of a license. A master license is granted by the owner of the copyright for the sound recording. A synchronization license is granted for the use of the musical composition by the publisher of the song. Although the Copyright Act has a provision for compulsory licenses to allow for retention of a license without the express permission from the copyright owner, it does not apply to samples because "[a song's] melody or fundamental character may not be changed and [the provision is] applicable only for the re-release and manufacturing of 'phonorecords' once a song is publicly distributed."[5] Therefore, those seeking licenses must comply with the usage fees required by publishers and recording companies.[6]

Legal Challenges

Disputes arise when artists digitally sample existing recordings without obtaining complete license rights or any rights at all. Once digital sampling became a common practice in the recording industry, artists began challenging the unauthorized use of portions of their original works in new recordings.

In order to establish infringement, a plaintiff must prove ownership of the copyright and copying by the defendant.[7] Generally, it is difficult, if not impossible, to elicit direct evidence of copying. Accordingly, plaintiffs may instead establish copying indirectly by proving that the the defendant had access to the plaintiff's work and that the two works are substantially similar.[8] In the case of digital sampling, however, the test for copyright infringement varies based on whether it is the sound recording or musical composition that is infringed. In the case of sound recordings, an actual copy of a sound recording must be made in order to constitute infringement.[9] For musical compositions, infringement is determined based on the more traditional test of the substantial similarity between the original work and its alleged copy.

Even when a plaintiff can show that it owns a valid copyright and that its copyright has been infringed, there is a defense available to defendants when the degree of copying is so minimal as to be considered trivial. This so-called de minimis defense often is invoked in digital sampling cases in which the amount of sampled material is usually small and sometimes barely recognizable.

Although hip hop music has been using samples since its origins in the late 1970s, legal challenges to digital sampling first emerged in the early 1990s. One of the early district court cases testing the practice was *Grand Upright* v. *Warner Bros. Records Inc.*, which involved a popular song, "Alone Again," recorded by Biz Markie, a hip hop artist. Biz Markie sampled the chorus of Gilbert O'Sullivan's recording of "Alone Again" and used it as an element of his new song without obtaining a license to use the sample. Grand Upright, which owned the rights to the O'Sullivan recording, sued Biz Markie's record publisher, Warner Bros., for copyright infringement. The trial court ruled that Biz Markie's use of the sample without permission constituted copyright infringement and sent a biblical message to digital samplers: "Thou shall not steal."[10]

The *Grand Upright* court's pronouncement that sampling is akin to theft, coupled with a reluctance by copyright holders to incur litigation costs, has resulted in a variety of judicial pronouncements regarding the legality of digital sampling. Although courts had indicated that sampling constituted infringement prior to *Grand Upright*, none had developed a bright-line rule. Instead, courts have taken myriad approaches in analyzing whether the sampling of a minimal amount of an original work is actionable infringement.

A Bright-Line Rule for Sound Recordings

To sample a sound recording, the sampler must take a copy of a portion of the original work and apply it to a new work. Thus it is unlikely that there could ever really be a question of whether the original work was actually copied. By necessity, some portion of the original work must be copied to be sampled in the new work. Thus, the inquiry in most sampling cases brought by holders of copyrights in sound recordings is whether the use of the sample is sufficient to be deemed infringing.

The Sixth Circuit recently addressed digital sampling of sound recordings and, in the process, adopted a very clear bright-line rule of what constitutes infringement. In *Bridgeport Music, Inc.* v. *Dimension Films*, the defendants sampled only a small portion of the plaintiff's original sound recording.[11] *Bridgeport Music* centers on the NWA song "100 Miles and Runnin," which samples a three-note guitar riff from "Get Off Your Ass and Jam" by 1970s funkmaster George Clinton and Funkadelic. In the two-second sample, the guitar pitch has been lowered and the copied piece "looped" and extended to 16 beats. The sample appears five times in the new song. NWA's song was included in the 1998 movie *I Got the Hook Up*, starring hip hop impresario Master P and produced by No Limit Films, his movie company. No Limit Films asserted that copyright law did not protect the sample. Bridgeport Music and Westbound Records, which claimed to own the copyrights for the Funkadelic song, appealed the lower court's summary judgment in favor of No Limit Films.

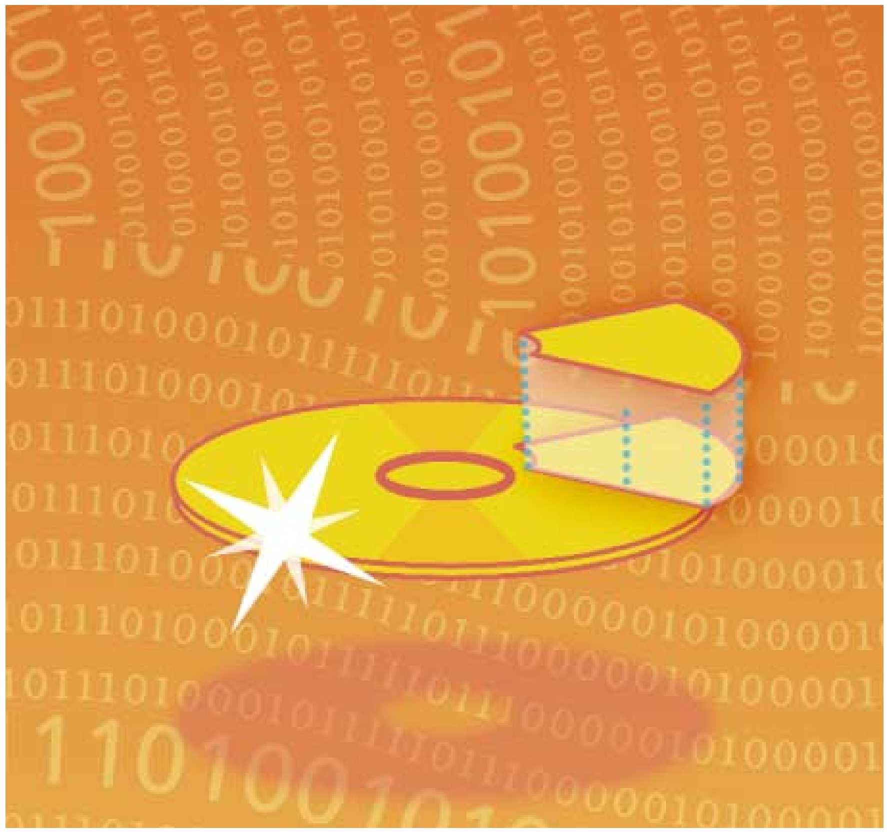
The district court had granted summary judgment to defendant Dimension Films on the grounds that the unlicensed digital sample used in the film soundtrack did not "rise to the level of a legally cognizable appropriation" of the plaintiff's sound recording.[12] On appeal, however, the Sixth Circuit reversed. The Sixth Circuit acknowledged that the music industry could benefit from a rule that "brings clarity to the digital sampling of copyrighted sound recordings."[13] In an attempt to enunciate such a rule, the court followed a legislative analysis of the Copyright Act. The court noted that 17 USC Section 114(b) establishes the right to prepare a derivative work in which the actual sounds fixed in the recorded sound are rearranged or remixed or altered, and thus it does not matter how much a digital sampler alters the actual sounds or whether the ordinary lay observer can recognize the song or the artist's performance of it. The similarity of a digital sampling to the original is immaterial "when the defendant has not disputed that it digitally sampled a copyrighted sound recording."[14] Similarly, the quantity of the sample is irrelevant, because even a small amount is clearly of value.[15] This ruling essentially precludes application of the substantial similarity test and the de minimis defense for sound recordings.[16]

The court, however, made clear that the analysis of a claim of infringement of a musical composition is not the same analysis applied for the alleged infringement of a sound recording. By explicitly distinguishing between a copyright in a musical composition and a sound recording, the court moved toward the bright-line rule that previous courts had failed to establish.

Nevertheless, it is unclear whether the Ninth Circuit will adopt the bright-line rule adopted by the Sixth Circuit in *Bridegeport*. However, the Ninth Circuit did reach a similar result in an earlier case involving sampling. In *United States* v. *Taxe*, the government obtained criminal convictions against the defendants for using 8-track recordings and modified tape equipment to re-record music. In the re-recording, the defendants modified the frequencies and added new synthesized sounds to create new works. The Ninth Circuit held that even re-recording a sound recording at different frequencies is still a copy and constitutes infringement, extending copyright protection to digital duplication of a sound recording.[17] In upholding the convictions, the Ninth Circuit noted that even though owners of sound recordings do not have the vested right to produce derivative works, they do have the right to protect the reproduction of their recordings.[18] This would seem to support the Sixth Circuit's conclusion that a copy is a copy, regardless of how substantial the taking.

Traditional Test for Musical Compositions

Because musical compositions are not subject to the same statutory proscriptions as sound recordings, courts have applied a more traditional test in determining whether they are infringed. In *Baxte*r v. *MCA*,[19] composer Leslie Baxter alleged that John Williams had copied his work in creating the theme for the movie *E.T.: The Extra-Terrestrial*. After listening to the two musical works, the district court granted summary judgment for the defendants. The Ninth Circuit reversed and remanded. Focusing on a qualitative approach for determining the substantial similarity of a musical composition, the Ninth Circuit held that the appropriate test in determining whether copyright infringement exists is whether “the ordinary lay hearer” comparing the two works could recognize the allegedly infringing sample as originating from the copyrighted work. The court held that reasonable minds could differ on whether the two works sounded substantially similar.



The Ninth Circuit also rejected the defendants' argument that if copying existed, it consisted of nothing more than a six-note sequence. While a small use of sound or de minimis use of a song is often used as a defense to copyright infringement, in digital sampling cases, unlike other copyright cases, courts have been reluctant to accept the defense. If they did so, alleged infringers would have the ability to use a small portion of sound because it would not be considered an infringement of a copyright holder's rights.[20] Thus, the Ninth Circuit ruled that even if the sample is “relatively small in proportion to the entire work, if qualitatively important, the finder of fact may properly find substantial similarity.”[21]

A recent round of digital sampling cases highlights the use of the de minimis defense. The most notable is the Ninth Circuit's decision on digital sampling in *Newton* v. *Diamond*.[22] Plaintiff James W. Newton brought a claim against the multiplatinum group the Beastie Boys for their use of the musical composition “Choir.” Newton had recorded the song and in 1981 assigned the copyright of the sound recording to ECM Records. The Beastie Boys obtained a license from ECM to digitally sample the sound recording of “Choir” in their work “Pass the Mic” but failed to obtain clearance and/or a license for the musical composition. Therefore, their defenses to copyright infringement were limited because they only obtained clearance for use of the sound recording. They argued that the elements of the composition had not been appropriated. Rather, the elements of “Choir” used in “Pass the Mic” were not separately copyrightable from the composition “Choir” as a whole. The “Pass the Mic” sample consisted of a six-second segment of a flute playing three notes. Plaintiff Newton offered that the performance containing the sample featured an overblow and a sequence of the note C that was used in “Choir.” The defendants replied that Newton's flute playing technique was unoriginal in its performance and further established that the overblow technique was in existence prior to the performance and publication of “Choir.”

The Ninth Circuit found that the attack to the Beastie Boys' composition as a whole was improper and that the elements of “Choir” were not separately copyrightable. The court indicated that even if the three notes performed were copyrightable, there would be no infringement because the “Pass the Mic” sample was neither qualitatively nor quantitatively substantially similar to “Choir.” Thus, use of the sample was de minimis.[23] The *Newton* decision was predicated on the musical composition itself and, more particularly, the sheet music publication of the composition rather than the sound recording embodying the composition.

The *Newton* ruling has been met with criticism that it created a back door for samplers seeking to use works of more established classic artists when the only means to protect the original performances of a composition would be to copyright each segmented piece of a song or recording. On the other hand, *Newton*, together with *Baxter,* hints that potentially even a small sample, such as Michael Jackson's recurring coo in “Billie Jean,” could be considered substantially similar. The *Newton* decision suggests that if a sample contains a few notes that are not recognizable without the original recording and if a license for the recording is obtained, a license for the musical composition is unnecessary. It should be noted that the court did recognize situations in which three notes would be deemed original and qualitatively distinctive, such as sequences with accompanying lyrics, sequences at the heart of a composition, sequences and lyrics that are repetitive, and sequences that are based on both the written composition and sound recording.[24]

Nevertheless, both *Newton* and *Bridgeport Music* represent a move away from the history of analyzing infringement by qualitative means under the *Baxter* ruling. The decisions established that there can be no de minimis uses or defenses to the unauthorized use of a sound recording. Thus, the heralded standard of *Grand Upright* remains: Sampling is not acceptable without authorization from the appropriate copyright holder, and samplers are warned to get a license or do not sample.

Bridgeport Music focuses the review of digital sampling of a sound recording to an issue of "whether [or not] the defendant re-recorded sound from the original." This standard makes the prosecution of unauthorized sampling much easier for copyright holders. The door therefore is open for copyright holders to bring an action for copyright infringement based only on the knowledge that sampling of their recordings has occurred.

Collectively the *Bridgeport Music* and *Newton* decisions now provide two concise rules for the digital sampling of the two core interests held in a song. For musical compositions, the sample must be so short or insignificant that the average listener would not recognize the original composition from which the sample was taken. For sound recordings, irrespective of whether the sampled recording can be recognized in the new recording, samplers must secure a license from the owner of the original recording or not sample at all.

Evolution and Future of Digital Sampling

The process of digital sampling continues to evolve. The use of existing sounds in new recorded songs is being accomplished through more novel technological methods. The current sampling trend of beat mashing occurs when two or more records are mixed together to create a completely new track. Though originally performed live using turntables and DJ mixers, beat mashing has reached a new level as a result of recent advances in sequencing software. In 2004, the headline-grabbing *Grey Album* from DJ Dangermouse offered a full-length mash of the Beatles *White Album* and Jay-Z's *Black Album*. The resulting work was never sold commercially but instead was made available though peer-to-peer networks. Dangermouse voices what most musicians and producers feel when faced with the strictures of copyright law: "Mashing is so easy. It takes years to learn how to play the guitar and write your own songs. It takes a few weeks of practice with a turntable to make people dance and smile. It takes a few hours to crank out something good with some software. So with such a low barrier to entry, everyone jumps in and starts immediately being creative. I don't understand why that is illegal."

The response to the *Grey Album* has been strong. The Jay-Z Construction Set, a tool kit with all the necessary software and raw material to create a new remix of Jay-Z's *Black Album*, was released. Audi, the German auto maker, launched a campaign to market its TT model sports car by sponsoring a contest to find the best mash-up of any track on David Bowie's *Reality* CD and a track from any of the rocker's other classics. In what is perhaps a throwback to the *Grey Album*, WEA recently released "Numb/Encore," a live mash-up of Jay-Z's song "Encore" and Linkin Park's song "Numb." Mashing awareness rose to new heights with the Recording Academy's recent nod to mashing as an art form at its 47th annual Grammy awards ceremony. Franz Ferdinand, Black Eyed Peas, Gwen Stefani, and Maroon 5 opened the show by performing simultaneously and thus overlaying their hits to create a unique sound.

From an intellectual property perspective, mashing clearly uses both the sound and composition rights in the copyright of a song, and a license would be required for each song that is part of a mash. Although proven artists have made mashing successful in today's music market, the risk of liability is extremely high for amateur DJs and bedroom producers.

The most prudent practice for any musician seeking to sample an original work is to follow the standard industry practice of obtaining clearances for the copyright for the sound recording and the musical composition before using the sample. The cost of obtaining clearances and the waiting time for receiving a response can be burdensome because multiple parties may hold the copyright to different elements of a work. In seeking clearances, it may be necessary to contact the recording company, the owner of the song, and its performers. Samplers may start first with administrative rights agencies, such as ASCAP and BMI, to seek the origins of the composition and track their way through the chain of title for the owners of the associated copyrights.

Independent record labels usually wait until an album is prepared for distribution before obtaining clearances. Major recording labels also will delay in obtaining clearances and will provide indemnification to artists and their production companies to subsidize their infringement concerns. Although music publishers and record labels routinely license use of their songs for sampling, they do require that each use be approved before a song containing a sample is released. The marketplace has responded by creating sample clearance companies that represent record companies, artists, and production companies that control the rights to sound recordings and musical compositions. These companies provide one-stop shopping for the licensing needs of samplers.[25]

While recent developments in case law have clarified the practical application of copyright law to digital sampling, they must be viewed against the backdrop of the binds they place on artistic creativity. The costs associated with obtaining the necessary licenses may curb the types of songs that will be sampled and used for new works. The creation of a robust marketplace for licenses ultimately may have a positive effect on new forms of music containing samples, but it is still possible that samplers will eventually choose only those works that are easy to obtain and cost effective for use in their final musical masterpieces. ■

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[1] FUTURE MUSIC MAGAZINE, Issue 106, May 1999, *as reprinted at* http://www.vintagesynth.org/index2.html.
[2] The law does not quantify fair use. The 30-second rule has become an arbitrary guideline used by academia. *See* UCLA Office of Instructional Development, *at* http://www.oid.ucla.edu/fnmc/fairuse.htm.
[3] Jarvis v. A&M Records, 827 F. Supp. 282, 294 (D. N.J. 1993) (citing Judith Greenberg Finnell, *How a Musicologist Views Digital Sampling Issues*, N.Y. L.J., May 22, 1992, at 5 n.3).
[4] 17 U.S.C. §106(4) provides that a holder of a copyright in a musical work has the exclusive right to perform the work publicly. However, §102(a) excludes sound recordings from this right except for those recordings that are in digital form—a provision that exists as a result of the Digital Performance Right in Sound Recording Act of 1995. The §106(4) public performance right in a musical composition requires anyone publicly performing the composition, including a radio DJ and a cover band, to obtain permission from the copyright holder.
[5] U.S. Copyright Circular 73: Compulsory License for Making and Distributing Phonorecords, "May a New Arrangement of the Copyrighted Musical Work Be Made for the Recording?"; *see also* 17 U.S.C. §115.
[6] The Copyright Act contains compulsory licensing provisions governing the making and distribution of phonorecords of nondramatic musical works that are often used for cover and remake versions of songs. Under 17 U.S.C. §115, once phonorecords of a musical work have been publicly distributed in the United States with the copyright owner's consent, anyone else may, under certain circumstances and subject to limited conditions, obtain a compulsory license to make and distribute phonorecords of the work without express permission from the copyright owner. *See* U.S. Copyright Circular 73: Compulsory License for Making and Distributing Phonorecords.
[7] Feist Publ'n, Inc., v. Rural Tel. Serv. Co., 499 U.S. 340 (1991).
[8] Howard v. Stercni, 974 F. 2d 1272 (11th Cir. 1992); *see also* Playboy Enters., Inc. v. Frena, 839 F. Supp 1552 (M.D. Fla. 1993).
[9] 17 U.S.C. §§106, 114 (1982).
[10] Grand Upright Music Ltd. v. Warner Bros. Records Inc., 780 F. Supp. 182 (S.D. N.Y 1991). The case was referred to the attorney general's office for possible criminal liability. Biz Markie did request a license from Gilbert O'Sullivan for use of the original composition, but while the request was pending the song was released by the record company.
[11] Bridgeport Music, Inc. v. Dimension Films, 401 F. 3d 647 (6th Cir. 2004), *affirmed and amended after rehearing*, 410 F. 3d 792 (6th Cir. June 3, 2005).
[12] Bridgeport Music, Inc. v. Dimension Films, 230 F. Supp. 2d 830, 842 (M.D. Tenn. 2002).
[13] Bridgeport Music, Inc., 401 F. 3d 647.
[14] *Id.* at 654.
[15] *Id.* at 658.
[16] *Id.* at 657 n.8 (citing Susan J. Latham, *Newton* v. *Diamond. Measuring the Legitimacy of Unauthorized Composition Sampling—A Clue Illustrated and Obscured*, 26 HASTING COMM. & ENTER L.J. 119, 125 (2004)).
[17] United States v. Taxe, 540 F. 2d 961, 964 (9th Cir. 1976).
[18] *Id.* at 965 n.2.
[19] Baxter v. MCA, 812 F. 2d 421 (9th Cir. 1987).
[20] *But see* Williams v. Broadus, 60 U.S.P.Q. 2d 1051 (S.D. N.Y. 2001). The court ruled that the two sampled measures that appear in the opening of the song "Hard to Handle" are not a substantial portion of the original work. Thus the plaintiff's use of the original work was de minimis and did not violate the copyrights of the original work. *See also* Jean v. Bug Music, Inc., 2002 U.S. Dist. LEXIS 3176 (S.D. N.Y. Feb. 27, 2002).
[21] Baxter, 812 F. 2d at 425.
[22] Newton v. Diamond, 349 F. 2d 591 (9th Cir. 2003), *amended,* 388 F. 3d 1189 (9th Cir. 2004), *cert. denied*, 125 S. Ct. 2905 (June 13, 2005).
[23] *Id.* at 592.
[24] *Newton* catalogued the cases that found qualitative distinctions for sequences containing less than six notes. *Id.*, 388 F. 3d at 1249-50. However, unusual words or sounds are necessarily more distinctive than a few generic notes of music. *See* NIMMER ON COPYRIGHT §2.05. The illustrations of the *Newton* court are consistent with *Grand Upright*'s findings. Grand Upright Music Ltd. v. Warner Bros. Records Inc., 780 F. Supp. 182 (S.D. N.Y 1991).
[25] By working with independent artists who retain their rights to sound recordings and musical compositions, clearance companies such as Blue Buddha Entertainment and Sugaroo are breaking new ground and providing convenience and savings for samplers seeking licenses.

MCLE ARTICLE AND SELF-ASSESSMENT TEST

By reading this article and answering the accompanying test questions, you can earn one MCLE legal ethics credit. To apply for credit, please follow the instructions on the test answer sheet on page 33.

by **Kyle Kveton**

Advice AND Counsel

The question of whether a lawyer has given legal or nonlegal advice is highly fact-specific

Years ago, when a law firm described itself as "full service," it meant that the firm could handle a variety of legal matters for a client, from transactional to tax to litigation. These days "full service" can mean something very different. Many law firms now offer client services that go far beyond traditional nuts and bolts legal advice to include such matters as advice on strategic business planning or public relations and crisis management. Providing these types of "nonlegal" advice raises a number of risk management and professional negligence issues.

Diversification of services is not entirely new. For example, law firms have long encouraged their members to serve on the boards of directors of corporate clients. As one study noted, there are many legitimate reasons for a firm, through its attorneys handling the representation of the client, to involve itself with the client's business affairs: The involvement 1) strengthens the firm's ties to the client, 2) keeps the firm better informed of the client's business affairs, 3) improves the credibility of the attorneys with their client, 4) results in additional prestige for the attorneys and the firm, and 5) assists the attorneys in developing contacts other than the client, which may result in additional business for the firm.[1] Offering nontraditional client services simply is another way to meet those objectives.

No good intention goes unpunished, however. There will inevitably be circumstances in which either the client or a third party

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claims it was harmed as a result of nonlegal advice. Malpractice lawsuits arising out of that advice raise several important questions that may affect dramatically the rights of a lawyer and a client:

• Does it matter whether a lawyer's advice is considered to be legal advice, business advice, or a hybrid? Stated differently, when can a lawyer be sued, if at all, for providing a client with nonlegal advice?
• If the advice in question cannot be classified as "legal advice," does the advice qualify as a privileged communication between the law firm and the client?
• Does the nature of the advice affect the standard of care or potential defenses?
• Can the law firm be liable to third parties?
• Will a firm's legal malpractice policy provide coverage for nonlegal advice?

The answers often are not simple, and there are few bright-line rules that can be applied. Some general principles, however, may provide some guidance.

Determining the Type of Advice

A useful starting point in the analysis involves determining whether or not the advice under scrutiny constitutes legal advice, either in whole or in part. The answer to this question is important because it provides the foundation for the subsequent layers of analysis on professional negligence, privilege, standard of care, liability to third parties, and coverage.

Traditionally, legal advice has been defined as advice or counsel given to a client by a lawyer who has been consulted for the purpose of providing that advice or counsel in his professional capacity.[2] If the services were of a type that could be undertaken by someone who is not a lawyer, those services traditionally have been defined as being outside the scope of legal advice.[3]

In some instances, these definitions can be easily applied. If a client asks a lawyer for information on when a statute of limitations for a breach of contract claim runs, the advice given by the lawyer clearly falls within the scope of legal advice. Other scenarios are more complex. For example, a situation may occur in which an attorney's opinion is sought regarding the wisdom of locating a business in a particular neighborhood. If the attorney is offering advice as to whether a business location is desirable because of neighborhood demographics and the local economy, that advice does not fall cleanly within the definition of legal advice. More often, however, a lawyer's advice in this situation is sought not only on the question of whether the demographics are desirable but whether the proposed use complies with local zoning ordinances. Communications covering legal and nonlegal topics are commonly referred to as dual purpose communications. In this example, the lawyer gives advice not only for the purpose of furthering the attorney-client relationship by providing information about compliance with local regulations but also to further a business purpose by providing information about demographics. The question of whether a dual purpose communication constitutes legal advice requires an examination of whether the dominant purpose of the communication was the furtherance of the attorney-client relationship or something else. The question ultimately is one of fact.[4]

In 1995, a New York district judge eloquently described how difficult it can be to determine whether an attorney's communications constituted primarily business advice or legal advice. In *Note Funding Corporation* v. *Bobian Investment Company*, NV,[5] the court was faced with motions to compel production of documents constituting communications between a law firm and a business client. To overcome the shield of the attorney-client privilege, the plaintiff seeking production argued that many of the communications concerned nonlegal business analysis and negotiation, even though the corporation's attorneys were participants in the communications. The court noted:

> Assessment of this argument requires the court to tread an occasionally blurry line. In pursuing large and complex financial transactions, commercial entities often seek the assistance of attorneys who are well equipped both by training and by experience to assess the risks and advantages in alternative business strategies. When providing this assistance, counsel are not limited to offering their client purely abstract advice as to the rules of law that may apply to their situation. Of necessity, counsel will often be required to assess specific tactics in putting together transactions or shaping the terms of commercial agreements, and their evaluation of alternative approaches may well take into account not only the potential impact of applicable legal norms, but also the commercial needs of their client and the financial benefits or risks of these alternative strategies.
>
> The fact that an attorney's advice encompasses commercial as well as legal considerations does not vitiate the privilege. If the attorney's advice is sought, at least in part, because of his legal expertise and the advice rests "predominantly" on his assessments of the requirements imposed, or the opportunities offered, by applicable rules of law, he is performing the function of a lawyer.[6] [Citations omitted.]

This rule, although couched in terms of privilege analysis, affects professional negligence and legal malpractice issues as well.

At the outset, both attorney and client should consider carefully what advice is being sought, and for what purpose the advice is being given—and both should revisit the issue during the course of the representation. This is important not only for determining whether or not the advice constitutes legal advice but also because California courts have imposed obligations on attorneys to volunteer legal opinions when necessary to further the client's objectives.[7] Making sure that the lawyer and the client fully understand the scope of the requested advice before the advice is given may minimize disagreements between the attorney and the client later on and will ensure that the client's expectations are considered properly.

The Lawyer as Defendant

Despite a lawyer's best efforts, it is always possible that a particular piece of advice will not result in a favorable outcome for the client, and the client may sue the lawyer. The initial determination of whether the advice was legal advice or business advice can have substantial ramifications for the lawyer defendant.

First, there is the question of whether the lawsuit is truly a legal malpractice lawsuit. A lawyer may be subject to liability for legal malpractice when the lawyer's negligent advice, investigation, or conduct relating to the client's affairs results in the loss of a meritorious claim or right.[8] An action for legal malpractice requires proof of 1) the duty of an attorney to use the skill, prudence, and diligence that members of the profession commonly possess, 2) a breach of that duty, 3) a causal connection between the breach and the resulting injury, and 4) actual loss or damage. The first element—the attorney's duty—presupposes that the advice provided by the lawyer is legal advice, and the attorney's conduct is measured by comparison to other lawyers practicing within the same community.[9]

Traditional definitions of "legal malpractice" generally encompass claims arising from the provision of legal services: "The test to distinguish malpractice from other wrongs is whether the claim primarily concerns the quality of legal services."[10] As a stark example of the distinction between legal malpractice and other attorney misconduct, "actual fraud by an attorney would not be legal malpractice since such conduct is not unique to the legal profession, nor does it necessarily concern the quality of professional services any more than does dishonesty by a lay person."[11]

The court in *Wasmann* v. *Seidenberg* offers another distinction between conduct consti-

MCLE Test No. 140

The Los Angeles County Bar Association certifies that this activity has been approved for Minimum Continuing Legal Education legal ethics credit by the State Bar of California in the amount of 1 hour.

1. Legal advice traditionally is defined as advice given to a client by a lawyer.
True.
False.

2. In *Holm* v. *Superior Court*, the California Supreme Court set forth the dominant-purpose test for characterizing advice.
True.
False.

3. Even in the context of providing business advice, a lawyer may be obligated to volunteer legal opinions if the situation so warrants.
True.
False.

4. Any failure on the part of a lawyer to perform competently constitutes legal malpractice.
True.
False.

5. Medical malpractice cases can provide useful frameworks for analysis of claims of legal malpractice.
True.
False.

6. The burden of proof and the evidence necessary to meet that burden may differ for claims of ordinary negligence and claims of legal malpractice.
True.
False.

7. Expert testimony usually is needed to establish a breach of the standard of care in legal malpractice cases.
True.
False.

8. The defense of qualified, or judgmental, immunity is available in legal malpractice cases.
True.
False.

9. Whether an attorney's conduct is alleged to constitute ordinary negligence or professional malpractice may affect which statute of limitations applies.
True.
False.

10. Communications between an attorney and a client are invariably protected from disclosure by the attorney-client privilege.
True.
False.

11. Only the client can assert or maintain the attorney-client privilege.
True.
False.

12. Even communications that may have legal significance are not always protected from disclosure by the attorney-client privilege.
True.
False.

13. The dominant-purpose test is applicable to determining the existence of, and the extent of, the attorney-client privilege.
True.
False.

14. California recognizes a statutory privilege for attorney work product.
True.
False.

15. Any research done by an attorney will be protected from disclosure by the attorney work product doctrine.
True.
False.

16. "Professional services" is a consistently defined term in legal malpractice policies.
True.
False.

17. Some legal malpractice policies will cover acts or omissions by lawyers for services performed by lawyers even if the services could have been performed by nonlawyers.
True.
False.

18. In most situations, an attorney's advice to a client to breach an agreement with a third party is not actionable.
True.
False.

19. An insurer may reserve its rights to recover attorney's fees and costs expended in defending against noncovered claims even if it agreed to provide a defense.
True.
False.

20. Courts have allowed allegations of ordinary negligence to be asserted against attorneys if the allegedly negligent act was not a "legal service."
True.
False.

MCLE Answer Sheet #140

ADVICE AND COUNSEL

Name ______________________

Law Firm/Organization ______________________

Address ______________________

City ______________________

State/Zip ______________________

E-mail ______________________

Phone ______________________

State Bar # ______________________

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   MCLE Test
   P.O. Box 55020
   Los Angeles, CA 90055

Make checks payable to Los Angeles Lawyer.

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ANSWERS

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

1.	☐ True	☐ False
2.	☐ True	☐ False
3.	☐ True	☐ False
4.	☐ True	☐ False
5.	☐ True	☐ False
6.	☐ True	☐ False
7.	☐ True	☐ False
8.	☐ True	☐ False
9.	☐ True	☐ False
10.	☐ True	☐ False
11.	☐ True	☐ False
12.	☐ True	☐ False
13.	☐ True	☐ False
14.	☐ True	☐ False
15.	☐ True	☐ False
16.	☐ True	☐ False
17.	☐ True	☐ False
18.	☐ True	☐ False
19.	☐ True	☐ False
20.	☐ True	☐ False

tuting ordinary negligence and conduct constituting legal malpractice.[12] The *Wasmann* case centered on the expected consummation of a settlement agreement. In order to achieve that result, an attorney was supposed to hold a deed of trust until his client paid $70,000 to her former husband. Without the lawyer's knowledge or permission, however, the client obtained the deed from the lawyer's office and recorded it without making the settlement payment. The ex-husband sued the ex-wife's lawyer for allowing the ex-wife to get the deed of trust without having first made the settlement payment.

The ex-husband brought claims against the attorney for legal malpractice and constructive fraud. The trial court sustained a demurrer to all causes of action. The court of appeal reversed, holding that a cause of action for ordinary negligence was appropriate, but a malpractice claim was not:

> These allegations of negligence, however, are not the stuff of which legal malpractice claims are made. An attorney's failure to prevent a client's unauthorized seizure and recordation of a document held in escrow is not negligent lawyering: "The situation required no professional 'skill, prudence and diligence.'" It simply called for the exercise of ordinary care.[13] [Citation omitted.]

California courts often rely on medical malpractice cases to assist in the analysis of claims of professional negligence against attorneys. The determination of whether a claim constitutes ordinary negligence or professional malpractice and the appropriate standard of care to be applied is no exception. *Wasmann* relied in part on a hospital injury case, *Gopaul* v. *Herrick Memorial Hospital*.[14] In *Flowers* v. *Torrance Memorial Hospital Medical Center*,[15] a hospital case that overruled *Gopaul*, a patient brought a professional negligence action against a hospital and a nurse for injuries sustained in a fall from a gurney allegedly caused by the nurse's failure to put up a guardrail. The trial court granted summary judgment. The court of appeal reversed, agreeing that while the defendants had negated any claim of professional negligence, the pleadings were broad enough to encompass a theory of ordinary negligence since a placement of a guardrail did not implicate professional services requiring specialized knowledge or skill.

Nevertheless, the California Supreme Court reversed the appellate court and, in doing so, it more carefully explained the practical effect of distinguishing between ordinary and professional negligence. The supreme court identified two different issues that are directly affected by the distinction. First, the characterization of the claim might determine which statute of limitation applies.[16] Second, the characterization would impact the burden of proof and the evidence needed to meet that burden. The standard for professional negligence is whether the defendant exercised the knowledge, skill, and care ordinarily possessed and employed by members of the profession in good standing.[17]

The determination of whether a case is one of ordinary or professional negligence may also affect the need for expert proof. In *Flowers*, the supreme court noted that "on numerous occasions" it had "articulated the general rule applicable in negligence cases arising out of the rendering of professional services." The court quoted the rule as it was set forth in the court's previous decisions:

> "The standard of care against which the acts…are to be measured is a matter peculiarly within the knowledge of experts; it presents the basic issue in a malpractice action and can only be proved by their testimony…, unless the conduct required by their particular circumstances is within the common knowledge of the layman."[18]

This language regarding the standard of care and the need for expert testimony has been cited with approval in legal malpractice cases. Indeed, the supreme court did so in *Flatt* v. *Superior Court*.[19]

Whether a claim is characterized as ordinary or professional negligence will not only directly affect the type of proof necessary to substantiate the claim but also determine what defenses are available. For example, in providing legal advice, the lawyer is not held to a standard of professional perfection, and in cases involving disputed issues of law or legal strategy, the lawyer can assert a defense of qualified, or judgmental, immunity, should the advice turn out to be incorrect.[20] But this type of immunity may not be available in a claim for something other than legal malpractice, in which ordinary negligence principles would apply. The Civil Jury Instructions adopted by the Judicial Council of California offer no professional perfection or qualified immunity instructions for ordinary negligence cases similar to those available in cases involving professional negligence.[21]

The applicable statute of limitations may differ as well. Under Code of Civil Procedure Section 340.6, a plaintiff must file an action against an attorney for a wrongful act or omission (other than actual fraud) arising in the performance of professional services within one year after the plaintiff discovers, or should have discovered through reasonable diligence, the facts constituting the wrongful act or omission.[22] If the claim is not one for negligence in the rendering of professional services—that is, a claim regarding legal advice—the plaintiff may have a different period in which to commence suit. In cases involving other types of professional malpractice, longer statutes of limitation apply. For example, an action against an accountant for malprac-

Whether a claim is characterized as ordinary or professional negligence will not only directly affect the type of proof necessary to substantiate the claim but also determine what defenses are available.

tice is governed by a two-year statute of limitations.[23]

The Attorney-Client Privilege and Work Product Doctrine

The diversification of legal services into the realm of nonlegal advice also raises issues of confidentiality and privilege. Nonlegal communications between a litigant and a person who just happens to be a lawyer may be critical to the outcome of the litigation, but it may be in the interest of one of the parties to the litigation to use the attorney-client privilege as a shield. Consider the case of a plaintiff who is suing his stockbroker for bad portfolio advice. If the plaintiff had previously received the exact same advice from his lawyer, thus calling into question whether the plaintiff really relied on the stockbroker's advice, the plaintiff may seek to hide behind the attorney-client privilege to prevent disclosure of this information.

Evidence Code Section 952 defines a confidential communication between the client and the lawyer as:

> Information transmitted between a client and his or her lawyer in the course of that relationship and in confidence by a means which, so far as the client is aware, discloses the information to no third persons other than those who are present to further the interests of the client in the consultation or those to whom disclosure is reasonably necessary for the transmission of the information or the accomplishment of the purpose for which the lawyer is consulted, and includes a legal opinion formed and the advice given by the lawyer in the course of that relationship.

The privilege attaches to those communications in which the client consults the attorney in the attorney's professional capacity. The privilege is held by the client or other persons who are statutorily defined as holding the privilege.[24] The lawyer is obligated to preserve the confidences of the client "at his own peril."[25]

But the privilege does not cover every communication between lawyer and client. It is not enough that an attorney may have been a participant in the communication. A client cannot create a privilege for information or communications if they were, by definition, nonconfidential. The test for determining the applicability of the privilege involves an analysis of the dominant purpose of the communications. Therefore, communications that reflect "pure" or "predominantly" business advice between the lawyer and the client may not remain confidential.[26]

Thus, for parties who seek to shield information, such as the plaintiff who does not want to disclose prior communications with the lawyer in the suit involving the stockbroker, the analysis begins with determining what type of advice—legal or nonlegal—is predominant in those communications. The analysis is fact-driven and can be complex. It can also provide seemingly contradictory results. For example, in *Montebello Rose Company* v. *Agricultural Labor Relations Board*, this issue regarding legal or nonlegal advice arose in a situation involving labor negotiations that were being conducted by an attorney. The communications in question dealt with the progress of those negotiations and negotiating strategy. The court of appeal found no privilege because labor negotiations can be conducted by a nonattorney, and the client had not demonstrated that the dominant purpose of the communications was to secure or render legal advice. The court rejected the contention that, because some of the communications involved strategy decisions that may have "legal significance" with regard to future unfair labor practice claims, the dominant purpose of the communications was legal.[27]

The court also cited another policy reason for declining to allow the universal application of the attorney-client privilege to every communication between attorney and client. If all such communications were deemed privileged, organizations able to hire attorneys to negotiate on their behalf would have an advantage because their communications regarding the negotiations would be automatically protected. Conversely, if an organization could not afford to hire a lawyer, the identical types of communications would not be protected from disclosure. That result would be inherently unfair.

Nevertheless, in a wrongful death case, a trial court ordered a hospital to turn over confidential occurrence reports. The hospital had resisted producing the reports, claiming they were protected by the attorney-client privilege and the attorney work product doctrine and were privileged under Evidence Code Section 1157 as hospital peer reviews. The trial court initially determined that the reports were not privileged as peer review materials or as attorney work product. After allowing for further briefing and arguing, the court ruled that the reports did not fall under the attorney-client privilege either. The court found that the primary purpose of the reports and communications was loss prevention, since the reports contained mostly "observational" information and not "opinion" information. The hospital sought review by writ, and the court of appeal reversed, finding that the facts demonstrated that the reports were intended to be transmitted to an attorney in the course of the attorney-client relationship under circumstances in which the hospital expected confidentiality, and the reports would be used by lawyers for the purpose of providing legal advice, such as defending against lawsuits.[28] Under the dominant-purpose test, the communications were considered privileged.

Likewise, a determination that work done by the attorney was not for the predominant purpose of providing legal advice can have an adverse impact on a claim of work product protection. The protection afforded to attorney work product is codified in Code of Civil Procedure Section 2018.[29] The policy behind the creation of the work product doctrine is one of protecting the attorney's legal research, impressions, conclusions, or opinions from discovery by nonclients. The doctrine is not limited to writings created by a lawyer in a litigated matter or in anticipation of a lawsuit. It applies to writings created by the lawyer while acting in a nonlitigation capacity as well.[30]

A necessary component of work product protection, however, is that the writings must reflect an attorney's impressions, conclusions, opinions, or legal research. In order for the writings to be protected, they must reflect, in whole or in predominant part, legal advice as opposed to business (or nonlegal) advice. If a court finds that the predominant purpose of the writings was to transmit advice or information of a nonlegal nature, the work product doctrine may not apply, since the writings do not reflect the attorney's evaluation or interpretation of the law or its impact on the relevant facts under scrutiny.[31] Thus, work product protection may not extend to business strategy or public relations plans that could have been prepared by nonlawyers.

So will the defendant stockbroker be permitted to learn about the lawyer's identical portfolio advice to the plaintiff client? The answer will undoubtedly depend on a more detailed factual analysis. If the advice was given over beers at a baseball game, the attorney-client privilege probably would not apply. But if the advice was provided in the context of estate planning services for which the client paid legal fees, it may be protected and not subject to disclosure.

Insurance Coverage

Whether or not a firm is providing legal advice may also affect whether a lawsuit is covered under a firm's legal malpractice policy. Typically, coverage for professional liability is extended (assuming all other policy conditions are met) for claims arising out of professional services rendered by the insured or persons acting within the scope of their employment by the insured. "Professional services" is often a defined term under malpractice policies. One typical policy defines "professional services" as "all services rendered or which should have been rendered for others by the Insured in the Insured's capacity as a lawyer, notary, administrator of an estate, executor, guardian, trustee or in any similar fiduciary capacity in the conduct of the firm's business."[32]

Another policy defines "professional services" with some amplification:

> [W]hen the Insured renders or fails to render services as an administrator, conservator, receiver, executor, guardian, trustee or in any similar fiduciary capacity, the Insured's acts and omissions in such capacities shall be deemed for the purpose of this section to be the performance of professional services for others in the Insured's capacity as a lawyer, provided that this coverage shall not apply to any losses sustained by the Insured as the beneficiary or distributee of any trust or estate....Services performed by the Insured in a lawyer-client relationship on behalf of one or more clients shall be deemed for the purpose of this section to be the performance of professional services for others in the Insured's capacity as a lawyer, although such services could be performed wholly or in part by non-lawyers.[33]

Depending on the applicable policy language, broader coverage may be afforded for nonlegal advice. Under some policies, if the services do not predominantly involve the provision of legal advice but rather involve business or strategic advice, the malpractice carrier may have a credible defense to coverage, because the complained of acts do not fall within the definition of professional services contained within the insuring agreement. Other policies offer broader language that may result in coverage for services that could be performed by nonlawyers, as long as the services were provided in the context of a lawyer-client relationship.[34]

Even if the carrier does not initially deny coverage when there is a question as to whether the advice was legal advice, business advice, or a hybrid, the carrier may elect to reserve its right to 1) withdraw a defense, 2) not indemnify against any eventual judgment if the damages sought are not covered, or 3) seek reimbursement for defense costs incurred for claims that were not potentially covered under the policy.[35] Carefully defining the attorney's role and the client's expectations at the outset can help reduce the risk of uncertainty regarding coverage.

Liability to Nonclients

A lawyer providing legal advice to a client often is entitled to protection from suits by nonclients. Attorneys ordinarily have no duty to protect the interests of an adverse party or a party with whom the client is dealing with at arm's length. Such adverse parties generally are not the intended beneficiaries of the attorney's services, and to impose a duty on the attorney to protect the interests of a third party could adversely affect the attorney's duty of undivided loyalty to the client. For these reasons, courts have been reluctant to allow third parties to sue lawyers, even when the lawyer's advice encouraged the client to breach a contract with a third party.[36]

However, if a lawyer is not providing legal advice, the policy concerns of protecting the duty of undivided loyalty and the attorney-client relationship are not present. Therefore, the attorney may not only find that his or her communications and written work are discoverable. The attorney also could be named as a defendant in, for example, a suit alleging interference with economic advantage or inducing breach of contract if the client relied on the attorney's business advice and in so doing harmed a third party. The lawyer may also be in hot water if the work performed by the lawyer was not within the parameters of legal services. Under those circumstances, courts have permitted nonclients to assert claims against lawyers for ordinary negligence.[37] Carefully defining and reevaluating the role of counsel can reduce the risk of potential exposure to nonclients.

There are a number of valid reasons why law firms can and will continue to provide nontraditional advice and consultation to clients. Counsel should, however, bear in mind the implications, both to the client and the firm, in providing those services. An understanding of the risks is fundamental to protecting the interests of clients and attorneys. ■

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1 Robert P. Cummins & Megyn M. Kelly, *The Conflicting Roles of Lawyer as Director*, 23 LITIGATION 48 (1996); James H. Cheek III & Howard H. Lamar III, *Lawyers as Directors of Clients: Conflicts of Interest Potential Liability and Other Pitfalls*, 712 PRACTICING LAW INSTITUTE 461 (1990). The American Bar Association issued a task force report on the issues presented when an attorney serves on a client's board of directors. John F.X. Piloso & Earl H. Warren, *The Lawyer-Director: Implications for Independence*, 1998 ABA SECTION ON LITIGATION TASK FORCE REPORT ON THE INDEPENDENT LAWYER.

2 EVID. CODE §§950-952.

3 Montebello Rose Co. v. Agricultural Labor Relations Bd., 119 Cal. App. 3d 1 (1981).

4 Holm v. Superior Court, 42 Cal. 2d 500, 507 (1954).

5 Note Funding Corp. v. Bobian Inv. Co., NV, 93 Civ. 7427, 1995 U.S. Dist. LEXIS 16605 (S.D. N.Y. Nov. 9, 1995).

6 *Id.* at *6-*7. The court analyzed the question of privileged communications under New York Civil Practice Law and Rules §4503. That section closely parallels Evidence Code §952.

7 *See, e.g.*, Nichols v. Keller, 15 Cal. App. 4th 1672 (1993) *and* ABA MODEL RULES OF PROF'L CONDUCT R. 2.1. The ABA Model Rules have not been adopted in

California, but they may be looked upon for guidance to the extent they do not conflict with California public policy. *See* State Bar of California, Formal Op. 1983-71.

[8] Stanley v. Richmond, 35 Cal. App. 4th 1070, 1092 (1995).

[9] JUDICIAL COUNCIL, CIVIL JURY INSTRUCTIONS (CACI) 600, 601.

[10] 1 RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE §1.1, at 3 (2005 ed.) (hereinafter MALLEN & SMITH).

[11] *Id.* at 4; Davis v. Parker, 58 F. 3d 183, 188 (1995) (quoting MALLEN & SMITH, *id.*).

[12] Wasmann v. Seidenberg, 202 Cal. App. 3d 752 (1988).

[13] *Id.* at 757.

[14] Gopaul v. Herrick Memorial Hosp., 38 Cal. App. 3d 1002 (1974), *overruled by* Flowers v. Torrance Memorial Hosp. Med. Ctr., 8 Cal. 4th 992 (1994).

[15] Flowers, 8 Cal. 4th 992.

[16] *Id.* at 998-99.

[17] *Id.* at 997-98. This standard is consistent with CACI 600.

[18] *Id.* at 1001 (quoting Sinz v. Owens, 33 Cal. 2d 749, 753 (1949) (a medical malpractice case)).

[19] Flatt v. Superior Court, 9 Cal. 4th 275, 293 (1994).

[20] CACI 602, 603; Village Nurseries v. Greenbaum, 101 Cal. App. 4th 26, 36-37 (2002).

[21] *Compare* CACI 401 *with* CACI 602, 603.

[22] The statute also provides that in no event shall the time for commencement of legal action exceed four years, except that the period may be tolled during the period when any of four statutorily enumerated conditions exist. CODE CIV. PROC. §340.6(a)(1)-(4).

[23] CODE CIV. PROC. §339(1); Apple Valley Unified Sch. Dist. v. Vavrinek, Trine, Day & Co., LLP, 98 Cal. App. 4th 934, 942 (2002).

[24] EVID. CODE §§953, 954.

[25] RULES OF PROF'L CONDUCT R. 3-100; BUS. & PROF. CODE §6068(e).

[26] San Francisco Unified Sch. Dist. v. Superior Court (Conner), 55 Cal. 2d 451, 456 (1961).

[27] Montebello Rose Co. v. Agriculture Labor Relations Bd., 119 Cal. App. 3d 1, 31-32 (1981).

[28] Scripps Health v. Superior Court of San Diego (Reynolds), 109 Cal. App. 4th 529, 532-35 (2003).

[29] Attorney work product protection is technically not a privilege in California, since all privileges are statutorily defined in Evidence Code §§900 *et seq*. Work product protection is more appropriately referred to as a doctrine. Kizer v. Sulnick, 202 Cal. App. 3d 431, 436 (1988).

[30] County of Los Angeles v. Superior Court (Axelrad), 82 Cal. App. 4th 819, 833 (2000). *Cf.* FED. R. CIV. P. 26(b)(3) (Work product protection ordinarily applies to "documents and tangible things prepared in anticipation of litigation or for trial.").

[31] Watt Indus. v. Superior Court, 115 Cal. App. 3d 802, 805 (1981). *Watt* was decided under former Code of Civil Procedure §2016(b). The court also noted that in cases in which legal and nonlegal work were "inextricably intertwined, the privilege will be sustained." *Id.* at 805 n.1.

[32] Transamerica Ins. Co. v. Hill Sayble, 193 Cal. App. 3d 1562, 1566 (1987).

[33] *Id.* at 1566.

[34] *See* RONALD E. MALLEN, LEGAL MALPRACTICE: THE LAW OFFICE GUIDE TO PURCHASING LEGAL MALPRACTICE INSURANCE (2005 ed.). This guide contains charts comparing various policy features—including insurance agreement language, deductibles, exclusions, and notice provisions.

[35] Buss v. Superior Court, 16 Cal. 4th 35 (1997).

[36] Schick v. Bach, 193 Cal. App. 3d 1321 (1987).

[37] Wasmann v. Seidenberg, 202 Cal. App. 3d 752 (1988).

by Ken Swenson and Mary L. Dickson

Common GROUND

The recent trend toward financing tenancies in common poses substantial challenges to lenders

When the Puente Hills Mall in the City of Industry, California, sold for $148 million in 2003, the biggest surprise was not the price for the 1.2 million square foot mall but the nature of the buyer. In conjunction with a Southern California-based real estate investment and management firm, more than 30 private investors joined the buying pool as tenants in common, a form of real property ownership that until recently was used more by default than design. Once shunned by investors, this method of holding title to real property has found new life in the otherwise mundane rules of like-kind property exchanges, commonly known as Section 1031 exchanges. (This common name references the section of the Internal Revenue Code that permits tax-deferred exchanges.[1])

Of equal interest to those in the business of real estate, however, was that a commercial lender risked $92 million of loan funds to finance the purchase by this collection of tenants in common.[2] In fact, lenders should take notice of this growing trend. Some reports suggest that the number of firms that sponsor tenancy in common transactions has grown to nearly 100, and the size and quality of tenancy in common transactions now includes Class A office and high-end retail properties.[3]

Until recently, a survey of real estate bankers and lawyers would likely have reached the conclusion that no lender in its right mind would make a loan—particularly such a substantial loan—to a tenancy in common group. Conventional thinking and black letter law pointed to the principal tenet of this form of ownership—that a tenant in common holds a separate but undivided interest in real property—as evidence that loans to tenancies in common were too risky. A "separate but undivided" interest means that each tenant in common has a separate interest that may be sold, financed, willed, or otherwise encumbered or transferred without the consent or even knowledge of the other tenants in common. It also means that each tenant in common has an undivided right to use or possess the whole of the property. The principle of separate but undivided is difficult both conceptually and in practice, and resolving disputes among tenants in common often requires court action, such as partition or

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ouster, which can effectively tie up the property for years.

With these difficulties in mind, the problems of loaning money to a tenancy in common ownership group are readily apparent. A lender would need to have the signature of each tenant in common to the loan documents, or the lender would only be able to foreclose on the interests actually pledged and could find itself a tenant in common with others. The free transferability of tenancy in common interests would have to be controlled or the lender would soon lose track of who actually owns the property and what ability any of them have to repay the loan. Some effort also must be made to control bankruptcy risks posed by individual tenants in common filing separate actions, especially one after another in a manner that would effectively thwart any collection or foreclosure attempt. Disputes among the tenants in common would need a forum for resolution that did not tie up the property itself. With these issues, combined with a plethora of simple and readily available alternative forms of property ownership (such as partnerships, limited partnerships, limited liability companies, and real estate investment trusts or REITs), tenancies in common were disfavored by real estate lenders and their borrowers until only recently.

Revenue Procedure 2002-22

What would cause the real estate development and finance industries to take a fresh look at tenancies in common? As is often the case, the answer lies in a confluence of events. Soaring real estate values have priced many individuals out of the single ownership or small partnership market for commercial real estate. Ownership pools, on the other hand, provide investors opportunities to participate in real estate acquisitions that would not otherwise be attainable. This expands the stock of available real estate investments for individuals. Of course, such ownership pools are already available in the form of real estate investment trusts, limited partnerships, and other vehicles, so this factor alone, while important, does not explain the interest in tenancies in common.

The decisive factor that made tenancy in common ownership deals more attractive was Internal Revenue Service Revenue Procedure 2002-22, which suggests that interests in tenancies in common may be exchanged under the Internal Revenue Code Section 1031 exchange rules for real estate that is not held in joint ownership.[4] Investors have for years enjoyed the benefits of tax-deferred Section 1031 exchanges, but the exchange rules—which permit exchanges of real or personal property for other property of a like kind—do not permit title to real property to be exchanged for interests in legal entities that own real property.[5] In other words, an acre in Azusa cannot be exchanged for a percentage of Pacoima Plaza partnership, even though the Pacoima Plaza partnership owns real estate and the values of the Azusa interest and the Pacoima interest may be identical.

Revenue Procedure 2002-22 opens the door to a form of group ownership—tenancies in common—that can be exchanged either for tenancy in common interests in other real estate or directly for fee ownership of real estate. In theory, this opens up potentially vast markets of exchange alternatives for individual investors. The investor not only gets the benefit of participating in a substantial project but also can defer the gain on both the initial exchange into the project and on any subsequent exchange out of the project.

Exchangeable Tenancy in Common Interests

The revenue procedure sets forth 15 criteria as a minimum standard to be considered for tax-deferred exchange treatment.[6] These criteria are important for the promoters and investors of tenancy in common projects and are equally important for lenders providing credit risk and legal review of tenancy in common loan proposals. While lenders and their counsel are advised to be familiar with all 15 criteria, several are noteworthy because they form the essential framework of an exchangeable tenancy in common:

• Coowners must retain the right to approve: the hiring of any property manager and the terms of any new, renewed, or extended management contract; the sale or other disposition of the real property; any lease or release of all or a portion of the property; and the creation or modification of any lien on the real property. Approval of these matters by coowners must be unanimous.[7]

• Coowners must retain the rights to transfer, partition, or encumber their interest in the property. However, the revenue procedure provides certain qualifications that limit these rights.[8]

• Revenue from a sale of the property, after payment of any blanket liens, must be distributed to coowners.[9]

• Coowners must share in all revenues from and expenses of the property in proportion to their ownership interest. Coowners, sponsors (those who put the group together), and managers may not loan money to other coowners for expenses unless the loan is recourse to the borrowing coowner and is for a period not exceeding 31 days.[10]

• Coowners may not undertake activities with respect to the property other than those customarily performed in connection with the maintenance and repair of rental real property.[11]

• Leasing arrangements must be based on rents that reflect the fair market value for the use of the property; this is important for projects utilizing a master lease structure.[12]

• Amounts paid to a sponsor must reflect the fair market value of the coownership interests sold or acquired and may not be based on income or profits derived from the property.[13]

Failure to follow these criteria would not necessarily be fatal to obtaining a favorable tax ruling, but adhering to these criteria is expected to provide a safe harbor to members of a tenancy in common group seeking to exchange their interests for real property and, as a consequence, to lenders seeking to finance the tenancy in common group. These rules differ in some material ways from standard REIT, partnership, or LLC terms, so care and thought must be given to reviewing tenancy in common formation documents as a precursor to providing debt financing.

Tenancy in Common Formation

Determining the form of, and creating the documentation for, tenancy in common ownership has been something of a growth industry for many lawyers, accountants, and real estate professionals. The requirements of the revenue procedure do not in all cases compare neatly with the traditional allocation of rights, powers, and obligations between general partners and limited partners, REIT managers and REIT investors, or limited liability company managing members and general members. However, the revenue procedure criteria establish the framework within which the tenancy in common group formation and documentation must operate, and so the typical tenancy in common operating structures represent a not-so-subtle attempt to retain as many control and revenue-generating features as possible from traditional ownership structures and graft them onto the minimally necessary base of revenue procedure criteria.

From the perspective of the professional real estate manager, developer, and investor, tenancy in common groups are a way to raise equity capital. Thus, such groups generally are put together by a promoter—a person or group of people who are full-time real estate professionals with a resume of owned, managed, and developed projects. The promoter will identify an acquisition property and may actually enter into a purchase contract and commence diligence at the same time it offers tenancy in common interests to private investors via private placement offering materials. If the requisite number of investors is reached (a number determined by the promoter and specified in the offering materials but not exceeding 35, per the revenue procedure),[14] then the purchase contract is assigned to the tenancy in common group.

The promoter and its affiliated entities wear many hats in this process. Typically, the promoter forms a special purpose entity that acts as one of the coowners in the tenancy in common. The number of interests sold depends in large part on the promoter's individual goals—such as raising a small amount of additional capital versus fully divesting itself of ownership and seeking only the fee income that derives from the promoter's other roles.

The promoter also may act as transaction adviser to investors and may manage the tenancy in common affairs. Entities affiliated with the promoter also may serve as the property manager, the leasing agent, the broker on a sale of the property, and the loan broker. Many tenancy in common arrangements involve a promoter-affiliated entity actually leasing the entirety of the property from the tenants in common and then managing and subleasing the property as a master tenant. In each case in which the promoter or a promoter-affiliated entity acts in a different capacity with respect to the property, the promoter or its affiliate charges a fee.

The most important document in this ownership structure is the tenancy in common (TIC) agreement. This document defines the rights and obligations among the tenants in common and includes most of the provisions that may create or defeat compliance with the criteria of Revenue Procedure 2002-22. Even though the tenancy in common is not (and may not be under tax law) an organized group that holds itself out as a single entity, it is important to have a well-drafted TIC agreement that serves many of the purposes that a partnership agreement or limited liability company operating agreement would serve. For these reasons, lenders must include the TIC agreement in their underwriting and legal review.

The Lender Watch List

Tenancy in common arrangements still rely on debt financing for the bulk of acquisition or development capital. Therefore, in order for tenancies in common to work, they must be financeable. This means lenders must have some certainty that the expected sources of repayment (property operations, equity growth, individual obligors or guarantors) will be continuously available, and that possession of the collateral (rents, accounts, and property), if necessary, will not unexpectedly be hindered.

The issues to be addressed by lenders should echo familiar themes. The foregoing discussions of the law of tenancies in common, the revenue procedure, and the structure of tenancy in common groups have already shaped to a large degree the analysis of lender review by identifying the areas of primary concern. In fact, the areas of concern to promoters, investors, and managers generally are also of concern to lenders, although their views of satisfactory resolution may differ.

Every loan is different; the guidance here can only be generic. Moreover, the issues raised here are in addition to, and not in lieu of, normal lending credit and legal issues, such as the quality and value of the collateral and the borrower, and the normal and customary loan covenants and lender protections. Special issues are nevertheless presented by loaning to a tenancy in common group. Most of these special issues are addressed in the TIC agreement, although some arise in other contexts.

When financing a tenancy in common group, lenders should pay special attention to at the least the following issues.

Nature and identity of coowners. The nature of the tenancy in common as a form of property ownership means that a loan to a tenancy in common group is really a loan to every individual in that group, each of whom is (or should be under the loan documents) jointly and severally liable for repayment. This has numerous ramifications.

First, every coowner should sign every document. This differs from other forms of property ownership. A coowner is permitted under the revenue procedure to give a power of attorney to another coowner to sign documents, but lenders are advised not to rely on powers of attorney for such important obligations as loan agreements, promissory notes, and pledges of real property collateral. Also, any document that contains representations and warranties should not be signed by power of attorney, or it becomes difficult to allocate liability for breach of the representations and warranties.

Second, lenders will probably want each coowner to be a single purpose, bankruptcy remote entity, such as a single-member limited liability company.[15] The use of special purpose entities by the tenants in common is designed to minimize the impact of the bankruptcy of a single coowner.

Third, lenders must consider whether their loans to tenancy in common members will be recourse or nonrecourse. Even if they are nonrecourse, the customary carve-out guaranties for so-called bad boy acts,[16] or springing guaranties,[17] are recommended. Similarly, for recourse loans, lenders must consider whether personal guaranties will be required and from which owners.

Fourth, because each coowner is pledging its interest in the underlying property to secure the obligations of every other coowner, each coowner should give waivers of the suretyship protections under California law.[18]

Finally, the customer identification requirements passed as part of the USA PATRIOT Act[19] will apply to each individual coowner, since each coowner is a separate borrower and since maintaining vigilance with respect to all the coowner borrowers supports the antiterrorism and anti-money laundering goals of that act.

Leasing requirements. One of the most unrealistic requirements of the revenue procedure is that all tenants in common approve all leases. A long term, single tenant building may be the easiest scenario for a tenancy in common group, but even single tenant leases may require amendments or adjustments after they are signed. Will it be possible to obtain the agreement and the signature of each tenant in common to such an amendment?

On the other hand, properties with mul-

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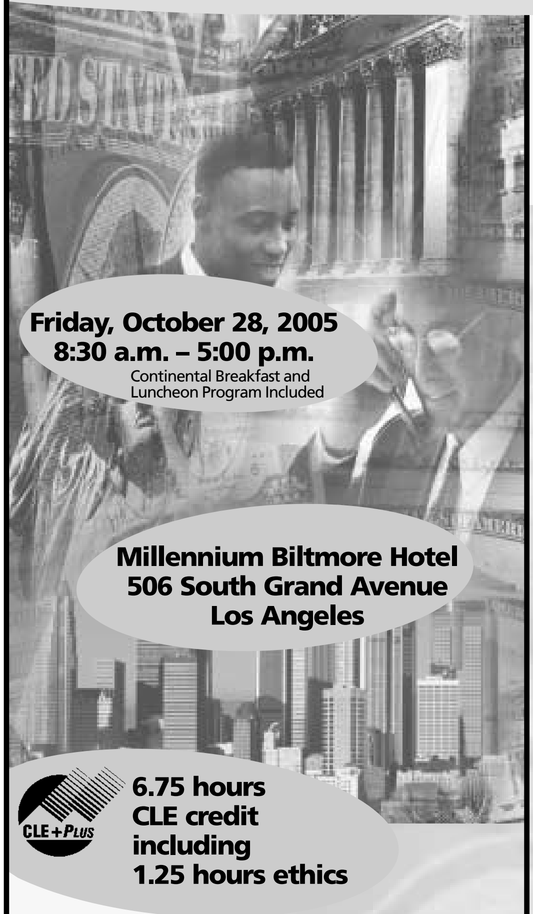

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tiple tenant spaces—including office, retail, and multifamily properties—are often leased by professional property managers who have been delegated the authority to sign tenants using a form lease. However, not every tenant is willing to sign the standard form lease, and owners need to address departures from the form.

One way to address the problem of unanimity is by using the master lease structure, which separates the ownership from the day-to-day leasing activities. The terms of the master lease are fixed at the time of the investment and, with luck, no changes will be necessary during its term. This also puts the risk (and benefit) of market rent fluctuations on the master lessee and flattens the risk curve for the tenants in common and the lender. Many lenders are familiar with the master lease structure and are comfortable with it so long as the master lease is subordinated to the lender's deed of trust and the master tenant gives to the lender a leasehold mortgage or an assignment of the property leases and rents.

Another way to address the unanimity problem is through the inclusion of buy-out provisions in the TIC agreement.

Partition and ouster. Under the laws of most states, including California, a tenant in common may end the tenancy in common by bringing an action for partition—that is, using judicial process to divide the otherwise indivisible right to possess and occupy the property by forcing a sale of the property and distribution of the proceeds.[20] Unless one coowner or a third party purchases all coownership interests, partition is the only method to end a tenancy in common. Of course, it merely ends the relationship by eliminating the underlying property, so it is something of a draconian measure. Obviously, a lender who has financed a tenancy in common does not want the loan transaction unwound because one or more coowners become dissatisfied and seek partition. For this reason, lenders providing financing to a tenancy in common group should require that the TIC agreement include a waiver of the right to partition. Waiver of partition appears to be permissible under California law.[21] Lenders should not rely on clauses in the TIC agreement that purport to create a "deemed" waiver in the event a lender were to require waiver as a condition to financing. Also, as with any other waiver in California, the waiver should be unambiguous as to the right being waived.

Ouster occurs when a coowner is excluded from possession by one or more other coowners who are in possession.[22] The coowner who has been ousted may bring an action to eject the dispossessing owners, or for damages, either one of which could adversely affect the function of a tenancy in common group. The California statutes specifically provide that ouster "does not apply to the extent the [co-owner] out of possession is not entitled to possession," and further refers to the supremacy of any "written instrument that indicates the possessory rights or remedies" of coowners.[23] A lender providing financing to tenants in common should require that the TIC agreement provide that none of the coowners has a right to possession of the underlying property, and that each waives its right to claim an ouster.

Transfer of interests. The appeal of tenancy in common groups to private investors is the ability to freely exchange their interests. Here, the interests of lenders and investors diverge widely. Lenders will review the credit risk of a loan to a tenancy in common group in part by determining the creditworthiness of the individual investors. This is true even though the loan may be nonrecourse; while lenders may not be able to recover directly from individual borrowers, lenders look for assurance that individual borrowers at least have the ability to make necessary payments and deficit contributions.

As a result, a lender will not, and should not, permit transfer of tenancy in common interests without the lender's review and approval of the proposed transferee, the terms of the transfer, an assumption by the transferee of the loan obligations, and an amendment to the TIC agreement adding the transferee. Fortunately for lenders, even though the revenue procedure requires that coowners maintain free transferability of their interests, the revenue procedure also states that "restrictions on the right to transfer…that are required by a lender and that are consistent with customary commercial lending practices are not prohibited."[24]

Involuntary transfers and transfers by operation of law, such as transfers by will or transfers as part of marital dissolution, create a practical issue for lenders. Current lending practice is that each such transfer is a default, and lenders reserve the ability to permit exceptions in the loan documents or to waive the default on a case-by-case basis. Lenders may find this a hard sell to sophisticated promoters arranging loans for tenancy in common groups made up largely of wealthy individual investors who will be concerned with the conduct of their individual affairs and that an entire investment could be lost as a result of an inadvertent, "no-fault" transfer. Also, too many waivers during the loan term could lead to modification of the loan terms unless the lender takes care to provide appropriate nonwaiver letters in each instance.

One solution is that coowners may each have a right of first refusal to purchase the interest of a transferring coowner, although this may be difficult to implement when the transfer is for estate planning purposes, is pursuant to a will, or part of a marital dissolution. There is not a right or wrong answer on this issue, and the solution will depend to a large degree on the strengths of relationship, collateral, and the market for the loan product in question.

Management decisions. As with leasing, the revenue procedure requires that certain other important decisions affecting the property require unanimous approval of the coowners, including hiring a manager, selling or disposing of the property, and the creation or modification of a lien on the whole of the property.[25] Most day-to-day operational decisions respecting the property require the approval of only 50 percent of the coowners, and most of those decisions, like property management, may be delegated to a professional property manager approved unanimously by the coowners.[26]

For management of the issues and relationships affecting the tenancy in common group, the TIC agreement should designate a single coowner as the contact for the lender (and for other contract parties, such as the property manager) for such things as delivery of notices and other day-to-day questions. Lenders may insist that a promoter-affiliated entity retain at least 50 percent of the interest in a tenancy in common group, assuring that no deadlock will occur over lesser management issues. Unfortunately, the revenue procedure proscribes the use of global powers of attorney (meaning that decision-making authority cannot be broadly delegated), although powers of attorney may be given to allow execution of specific documents relative to decisions already made.[27] Thus, powers of attorney are not the answer to management deadlock, and lenders should watch for misuse of them.

For the more important property decisions, TIC agreements should take a page from partnerships and limited liability companies. Lenders should require TIC agreements to include provisions to break a deadlock, such as buy-sell options allowing the interests of holdout coowners to be purchased by other coowners. Lenders should pay close attention to the terms of such buyouts. They must be structured as "call" options rather than "put" options.[28] In other words, the TIC agreement should be drafted so that if an action requiring unanimous vote falls short, those voting against are deemed to have offered their interests to the coowners or promoter, rather than the other coowners or promoter having an option to require those voting against to sell their shares. Additionally, the sales price must be fair market value, meaning the fair market value of the total property multiplied by the selling coowner's percentage interest in the property.[29] This will require an appraisal of the total property, and a lender should consider requiring copies of the appraisal to be delivered concurrently to the lender.

Subordination. Lenders should think about subordination in three areas. First, the TIC agreement may be recorded, as is permitted under the revenue procedure,[30] and would generally be an interest in the collateral preceding the lenders' security interest. Therefore, lenders will need to require that the TIC agreement be subordinated to the lien of a deed of trust or mortgage to prevent the terms of the TIC agreement from being a cloud on title postforeclosure. Second, in a tenancy in common group, the promoter or coowners may loan funds to other coowners, either as part of an up front arrangement to pay transaction or other costs or to advance funds on behalf of a coowner who is not contributing its fair share. A lender should require that the TIC agreement provide that such loans are subordinate to the lender's loan, that such loans require the lender's consent, and that any lien that may attach to the lender's collateral as a result of the coowner borrower's failure to repay the loan will be junior to the lender's lien. A similar provision should appear in the loan documents. Third, if the tenancy in common structure includes a master lease, the master lease should be subordinated to the lender's lien on the fee.

Fees. Promoters of tenancy in common groups and the promoters' affiliates generally wear numerous hats and collect fees associated with each. While some of these fees are not equity returns that can rationally and easily be subordinated to the lender's repayment, they still constitute payments to insiders that should be watched and regulated. Lenders should be sure such payments are at arm's-length rates. In fact, a market rate requirement is built into the revenue procedure.[31]

Moreover, lenders may seek loan document provisions that prohibit or defer payment of such fees if the loan is not paid timely or if the property fails to maintain specified standards (loan-to-value, debt service coverage, occupancy percentage, average lease rate, and so on). After all, it makes no sense from the lender's perspective for the principal-promoter to be receiving a return if the lender is not being paid. This may be more appropriate for some fees than for others. For example, if a promoter-affiliated entity is the working property manager (that is, has not subcontracted the actual management responsibilities), then payment for those services may be fair, as such expenses would be incurred by a third party if the affiliated entity had not undertaken management. On the other hand, many TIC agreements or related documents provide that the promoter or an affiliated entity will receive a loan finder's fee in connection with a loan made by the lender, or will receive a fee associated with its management of the tenancy in common group (as opposed to the property itself). Subordination, deferral, or a set aside account for such fees may make sense. Likewise, any fees that are being paid to a promoter-affiliated entity for property management or for leasing or sale brokerage where the same services have been subcontracted to third parties should also be considered for subordination, deferral, or set aside.

Obligations of the promoter/manager. A lender's actual borrowers in a tenancy in common group are the coowners, not the promoter (except to the extent the promoter is also a coowner). Since the promoter holds the cards at the outset of the tenancy in common relationship—for example, drafting all the agreements the coowners will sign—it is possible that the coowners will be asked to indemnify the promoter or promoter-affiliated entities from certain losses the promoter or promoter-affiliated entities may suffer as a result of the overall transaction (investment losses, hazardous substance response costs, or litigation losses, for example). So long as this indemnity does not run to the benefit of a promoter-affiliated entity that is also a coowner—since coowners must share equally in profits, losses, and debt—nothing in the revenue procedure prevents such an indemnity.[32] However, the larger the indemnity obligation, the more it will hurt the ability of the coowners to satisfy that obligation and satisfy lenders' debt. Therefore, lenders should remove, limit, cap, condition, or subordinate such indemnity obligations.

Revenues. For a tenancy in common property ownership to qualify for tax-deferred exchange treatment, coowners may engage only in customary activities "performed in connection with the maintenance and repair of rental real property."[33] Lenders should review the activities that the tenancy in common group will be undertaking to avoid the transaction being disqualified for tax deferral on exchange, an action that could diminish repayment prospects by limiting the liquidity of the tenancy in common interests. There is no bright-line test for what activities the IRS will consider customary. For example, it probably is not customary for a mall owner to also operate one or more restaurants in the mall, even though that does happen from time to time. If the mall is to be owned by a tenancy in common group, the restaurant operations should be divested. However, it may be perfectly plausible that customary activities include operating a gift wrapping service, kiddie rides, holiday activities (Santa, Easter Bunny), or a carousel.

Bankruptcy. The last but far from the least of a lender's concerns in dealing with a tenancy in common group is bankruptcy. The automatic stay imposed upon creditors on the filing of a petition in bankruptcy court[34] will shield the filing coowner from the necessity of immediate performance under the TIC agreement or under the loan documents. If additional capital is required to sustain the property during this time, other coowners or the lender will need to make up the share of the filing coowner (although this should be done under the auspices of the bankruptcy court as a postpetition financing in order to gain some rights to repayment). If other coowners are unable to sustain the increased burden, they too may file for bankruptcy. Ultimately, a coowner in bankruptcy may seek to have the TIC agreement rejected as an executory contract.[35] Successful rejection would allow the filing coowner to invoke the rights of a tenant in common that had been waived in order to induce financing, such as partition. Moreover, attempts to prevent a bankruptcy filing or to require a filing coowner to sell to nonfiling coowners would not be enforceable.

The bankruptcy risks of tenancies in common is an area of contracts and law that will evolve as modern tenancy in common arrangements work through a full economic cycle and reach the bankruptcy courts, providing rulings that will produce refinements to TIC agreements and loan documents. For the short term, lenders should continue to look to single purpose, bankruptcy remote entities and to provisions that allow nonfiling tenants in common to purchase the interests of filing tenants in common. These methods will not prevent bankruptcy, but they are likely to make the bankruptcy easier and faster to manage (dismissal, conversion to liquidation, sale under the auspices of the court).

Limitations on Tenancies in Common

Tenancies in common are not the right choice for all real estate investors. The implementation of tenancies in common as a practical ownership vehicle and the reliability of the revenue procedure as a principal driver of renewed use of tenancies in common introduce at least four problems that ultimately may limit their popularity.

For one thing, the free exchangeability of tenancy in common interests is limited in reality by numerous factors, including the presently limited secondary market for tenancy in common interests, and the fact that most tenancy in common agreements often require that a selling or trading coowner first offer the interest to other coowners at market value.

Additionally, the revenue procedure is not a law or even an IRS ruling. Simply put, it is an invitation to taxpayers to request an IRS ruling on the taxability of a transaction or event, with the suggestion that if the transaction or event satisfies numerous criteria outlined in the revenue procedure, then the actual ruling may be favorable—but no promises are made.[36] Until an actual ruling is issued, promoters, investors, and financiers should tread with due caution. Most offering materials for tenancy in common interests highlight this risk.

Moreover, the safe harbor of the revenue procedure, to the extent it can be called that, is based on the same legal nature of tenancies in common that historically made them disfavored by real estate investors and lenders in the first place. The IRS notes in the revenue procedure that "[t]he central characteristic of a tenancy in common…is that each owner is deemed to own individually a physically undivided part of the entire parcel of property."[37] The revenue procedure takes every opportunity to give effect to this central theme. Thus, the very characteristic of tenancies in common that makes them appropriate for tax-deferred exchanges is what makes them a challenge for investment or financing.

Finally, failure to satisfy the revenue procedure's 15 criteria for deferred tax treatment could cause financial difficulties for individual owners that would lead them to default on their pro rata obligations, resulting in a risk of a domino effect. Failure to satisfy these criteria could also result in the tenancy in common group being treated as a partnership or other state law organization,[38] yet the group would not have complied with the organizational and tax rules governing such organizations and would therefore have state and federal compliance issues that could increase the risk of a loan default.

For the time being, tenancies in common and TIC agreements are the favorite innovation of the real estate investment and exchange world and are likely to stay respectably popular unless or until economic recession lowers real estate prices substantially or until adverse rulings eliminate their advantages. As the volume of transactions involving this form of ownership increases, so does the likelihood that a lender will be asked to loan to one. Lenders can and should combine the criteria of the revenue procedure with their traditional underwriting procedures and take advantage of these potentially good business and relationship opportunities. ■

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[1] I.R.C. §1031.

[2] *See, e.g., Puente Hills Mall Changes Hands in $148 Million Tenant in Common Deal,* RETAIL TRAFFIC MAG., May 15, 2003, *available at* http://www.retailtrafficmag.com.

[3] Jessica Roe, *Uncommon Growth,* COMMERCIAL PROPERTY NEWS, Oct. 16, 2003.

[4] REV. PROC. 2002-22, Mar. 19, 2002.

[5] I.R.C. §1031.

[6] REV. PROC. 2002-22 §§6.01-6.15. For a discussion of these criteria, *see* Robert A. Briskin, *Fair Exchanges,* LOS ANGELES LAWYER, Sept. 2003, at 50.

[7] REV. PROC. 2002-22 §6.05.

[8] *Id.* §6.06.

[9] *Id.* §6.07.

[10] *Id.* §6.08.

[11] *Id.* §6.11.

[12] *Id.* §6.13. The fair market rent requirement is particularly important for master lease structures.

[13] *Id.* §6.15.

[14] *Id.* §6.02.

[15] For a discussion of single-purpose (or special-purpose), bankruptcy remote entities, *see* David B. Stratton, *Special-purpose Entities and Authority to File Bankruptcy,* AM. BANKR. INST. J., Mar. 2004, at 36. *See also* Adam B. Weissburg & John Matthew Trott, *Special Purpose Bankruptcy Remote Entities,* LOS ANGELES LAWYER, Jan. 2004, at 12, available at http://www.lacba.org/Files/LAL/Vol26No10/1477.pdf. Such single member entities generally will be disregarded for tax purposes, so an individual need not file separate returns or obtain a separate taxpayer identification number for the limited liability company.

[16] Bad boy acts typically include, at a minimum, fraud, waste, misappropriation or misapplication of rents or profits, failure to turn over insurance or condemnation proceeds as required, failure to apply or account for security deposits or prepaid rents, violation of hazardous substance covenants, and bankruptcy or similar filings.

[17] A springing guaranty comes into effect only if the primary borrower files for bankruptcy protection.

[18] CIV. CODE §§2787 *et seq.*

[19] *See* 31 U.S.C. §5318(I) (identification and verification of account holders); 31 C.F.R. §103.121 (2005) (customer identification programs).

[20] CODE CIV. PROC. §§872.010 *et seq.*

[21] *Id.* §872.710(b). *See also* 5 HARRY D. MILLER & MARVIN STARR, CALIFORNIA REAL ESTATE §12:21, at 49 (2000) ("The right to partition can be waived by an express or implied agreement between the cotenants.") *and* citations therein.

[22] CIV. CODE §843.

[23] *Id.*

[24] REV. PROC. 2002-22 §6.06.

[25] REV. PROC. 2002-22 §6.05.

[26] *Id.*

[27] *Id.* §§6.05, 6.12.

[28] *Id.* §6.10.

[29] *Id.*

[30] *Id.* §6.04 (The coowners may enter into a limited coownership agreement that may run with the land.).

[31] *Id.* §6.12.

[32] *Id.* §§6.08, 6.09.

[33] *Id.* §6.11.

[34] 11 U.S.C. §362.

[35] 11 U.S.C. §365.

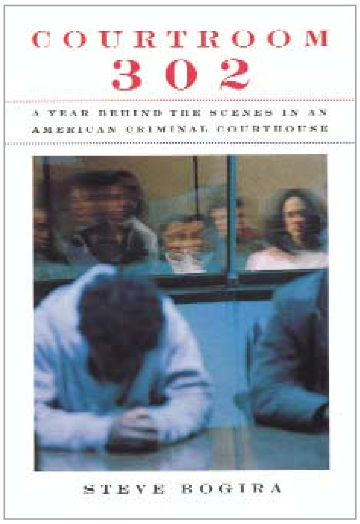
[36] "The guidelines set forth in this revenue procedure are not intended to be substantive rules and are not to be used for audit purposes." REV. PROC. 2002-22 §3.

[37] *Id.* §2 (citing 7 RICHARD R. POWELL, POWELL ON REAL PROPERTY §§50.01-50.07 (2000)).

[38] *See, e.g.,* Bergford v. Commissioner, 12 F. 3d 166 (9th Cir. 1993) (coownership interests in computer equipment subject to a lease constituted a partnership in which the coowners could not sell, lease, or encumber their interests or the underlying property and in which the manager participated in the profits and losses of the venture).

REVIEWED BY PAUL S. MARKS

Courtroom 302: A Year behind the Scenes in an American Criminal Courthouse



By Steve Bogira
Alfred A. Knopf, 2005
$16.50, 416 pages

The general public's healthy appetite for legal fiction is well known, with works by John Grisham, Scott Turow, and others regularly achieving best-seller status. In contrast, nonfiction courtroom dramas tend not to resonate with the American reading public, aside from occasional triumphs such as Jonathan Harr's *A Civil Action* and Alan Dershowitz's *Reversal of Fortune*. Recently, however, Chicago columnist Steve Bogira has set about to challenge this state of affairs with his outstanding inaugural work, *Courtroom 302: A Year behind the Scenes in an American Criminal Courthouse*. Bogira's eminently readable book proves that the truth is often more entertaining than fiction.

Bogira spent 1998 as a spectator in the courtroom of Judge Daniel Locallo, a criminal court judge in Cook County, Illinois. Locallo afforded the author broad access to the courtroom staff, the defendants, the lawyers, and anyone else who would talk to him. Early on, Bogira describes his mission in the following terms:

> Recent reporting about criminal justice has focused heavily on two important issues: the death penalty, and the conviction of defendants later proven innocent....This book intends to show more of what's typical about a courtroom. It is about how justice miscarries every day, by doing precisely what we ask it to do.

These words do not foreshadow a polemic. Bogira never even tells the reader precisely how he thinks justice miscarries, or just what it is that "we" are asking justice to do. Instead, his chronicle puts the reader in the courtroom and asks the reader to decide whether justice is being served. Bogira presents an unbiased, dispassionate accounting of the tales of human misery that unfolded before him. The vessel through which these real-life dramas flow is the author's engaging and entertaining prose, sprinkled with occasional dry humor that, for all its punch, never minimizes the humanity of the curious characters in *Courtroom 302*.

In its quest to show how justice miscarries, *Courtroom 302* explores three major themes: race, assembly-line justice, and the adversarial system's inability to achieve its goal of uncovering the truth. Bogira is particularly deft at handling the difficult issue of race. Initially, the basic framework is told in numbers. Cook County furnishes two-thirds of the prison inmates of Illinois—16,000 new prisoners per year. Eighty percent of these inmates are black, even though only 26 percent of Cook County's population is African American. Meanwhile, on the other side of the prison bars, 84 percent of the prosecution attorneys are white, as are 69 percent of the public defenders and 74 percent of the trial judges.

These numbers tell part of the story, but Bogira prefers to engage the reader with a combination of stark imagery and true crime reporting. Bogira's description of the typical courtroom scene, in which overworked white lawyers and judges quickly decide the fates of underrepresented black defendants, is at once compelling and thought-provoking. But it is the case of a white defendant, Frank Caruso Jr., that provides the central drama of *Courtroom 302*. *People* v. *Caruso* involved the beating of a black youngster who found himself in the wrong place—the largely white Chicago enclave of Bridgeport—at the wrong time. By the time of the Caruso trial, the reader has seen Locallo's penchant for handing out relatively lenient sentences to the masses of defendants pouring through his courtroom on their way to a quick and efficient dose of urban justice. Indeed, Locallo admitted to the author that he routinely gives probation to many defendants who would likely receive double-digit prison terms from other judges.

Yet the Caruso trial was different. It was a "heater," a case that grabs the public spotlight. Community activists, politicians, and newspaper editorials pushed for a quick conviction and a harsh sentence for what was universally viewed as a hate crime. The pundits even pointed to Locallo's upcoming retention election as a veiled threat for the judge to do the right thing. Judge Locallo was hardly immune to the publicity. After Caruso's verdict, the judge set a sentencing hearing on a short deadline, evidently so the case could be disposed of before Locallo's retention election. He then refused a request for a postponement that would have allowed defense lawyers to obtain a transcript for the sentencing hearing. Although such requests are usually granted, in this case a postponement would have put the sentencing after the retention election. Defense lawyers complained bitterly that Locallo was seeking to ensure his own election victory by giving Caruso a long prison sentence.

Sentencing Controversy

Ultimately, the sentence that was given raised questions about the impact of the pretrial publicity and Locallo's impending retention election. The controversy only grew when Caruso's codefendants were permitted to plead their charges down to probation. But here again, Bogira's watchful eye provides the reader with valuable new insights. After Caruso's sentence was announced in open court, the large number of Caruso family members who had sat through the trial caused a near riot in the courtroom, pounding on the protective glass separating the gallery from the court and raining obscene ges-

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tures and language down on Locallo and the prosecutors. Yet the judge and the courtroom deputies did virtually nothing to control the ruckus. This passive response from the authorities caused one of the prosecutors to comment that if an African American family had acted as Caruso's family had, the sheriffs "would have locked the whole group up."

A second major theme is the high-speed processing of criminal justice. Bogira shows how case dispositions, or "dispos," drive the agenda of the urban justice system. Dispos are to judges in Chicago what billable hours are to many attorneys: the primary measure of performance and productivity, and a sine qua non for advancement. Although depicting the vicissitudes of rapid-fire justice is nothing new, Bogira's treatment of the subject hooks the reader emotionally with superb storytelling and character development. Unfortunately, it is here that the author, for the only time, lets his personal feelings get the best of him. Bogira maintains that "Supreme Court justices have been more concerned with the backlog in the criminal courts, and the need to keep the line moving," than they have been in ensuring that the truly innocent are not convicted. This is at best an unfair characterization, and at worst an unsourced overgeneralization.

Trials and Truth

Bogira's third major theme is his examination of the system's built-in incentives to hide the truth from the jury. Astonishingly, the facts of virtually every case in *Courtroom 302* appear to have been misrepresented to the jury. We know this because of Bogira's dogged persistence, which enabled him to succeed where the system had failed in getting to the bottom of what really happened. The reader repeatedly marvels at the shortcomings in our system, and the ease with which the author has exposed them. On this score, Bogira's rendition of the murder of Chicago cab driver Jean François, or the two trials in *People* v. *Betts*, should be mandatory CLE for every trial lawyer who misses the forest for the trees in presenting cases to juries.

For all the systemic ills that are diagnosed in *Courtroom 302*, it may seem strange that the author proposes no solutions. But this is no shortcoming. Bogira undoubtedly appreciates that offering solutions would not only compromise his objectivity but also diminish the power of his work. To achieve solutions, society must first be aware of and concerned about the problems. Toward this end, Bogira has made a significant contribution through his unvarnished portrait of our criminal justice system. *Courtroom 302* should be required reading for anyone who has an interest in the system of justice under which Americans all live. ■

BY CAROLE LEVITT AND MARK ROSCH

Free Monitoring and E-Alerts to Keep a Step Ahead

BEING PROACTIVE RATHER THAN REACTIVE requires attorneys to stay a step ahead on the issues that affect their firm, profession, and clients (including current, past, and potential clients). Setting up online e-monitoring and e-alert services can be a secret weapon for the proactive attorney. Instead of trying to scan myriad news, legislative, regulatory, and docket sites, an attorney or firm can establish an e-monitoring service to keep track of an assortment of information. Some e-monitoring services require the user to go to a Web site to view new alerts, while others automatically send e-mail alerts. While there have been subscription-based e-monitoring and e-alert services for years, with the rise of the Internet, free services came into existence.

Federal legislation offers an example of how e-alerts can benefit the practice of law. The official federal legislative site, Thomas, does not have an e-monitoring or e-alert feature for pending legislation, but GovTrack does. (This site, www.govtrack.us, was developed by a graduate student at the University of Pennsylvania's Department of Linguistics.) At GovTrack, information from a variety of official sources—including Thomas (for bills and committee reports) and the U.S. Senate and House Web sites (for voting records)—is integrated into one database for ease of monitoring legislation and sending e-alerts. Thus, an immigration attorney who has clients claiming they would be tortured if returned to their country of origin may use GovTrack to research pending legislation on this topic. If a relevant bill is found, the attorney can request that GovTrack monitor it and send an e-alert when action is taken.

GovTrack is easy to use. For example, to find pending legislation on torture, click on the "Legislation" tab and either select "Search Legislation" from the drop-down menu and enter the word "torture" into the search box or click on the "Topic" tab, select "T" from the alphabetical list and then click on "torture." In both cases, 15 bills appear. If you are only interested in one bill, such as Senate Bill 654, click on it, and a screen will be displayed that shows the origin of the information, the status of the bill, and links to the full text of the bill. There is also a tab labeled "Monitor" that can be selected to monitor Senate Bill 654. (To end the monitoring, click "Stop Monitoring.") To monitor all bills under the topic "torture," use the topic search.

To receive an e-alert from GovTrack about Senate Bill 654, go to GovTrack's home page, scroll down to "Track," and then click on "Sign Up." Then enter an e-mail address and select a password. Then, back at the home page, click on "Your Settings," select "Your Monitors," and then select "General." From here, the user is able to select from a drop-down menu. One setting is "Send Me Daily Updates," and another is "Send Me Weekly Updates." Once a selection is made, click on "Update Settings." Do not choose "Activity on All Legislation," committee hearings, votes, or blog entries unless you really want e-alerts for all congressional bills.

If an attorney's practice involves federal regulatory law, subscribing to a free daily e-alert for the *Federal Register*'s table of contents is in order. Sign up by entering your name and e-mail address into the form found at http://listserv.access.gpo.gov and selecting "FEDREGTOC-L Federal Registers Table of Contents" from the drop-down menu. Unfortunately, there is no option to limit the alert to a specific agency's regulations. Each day subscribers receive a nicely formatted e-mail containing the table of contents of that day's *Federal Register*. Next to each entry are links to access the entry either as text or PDF.

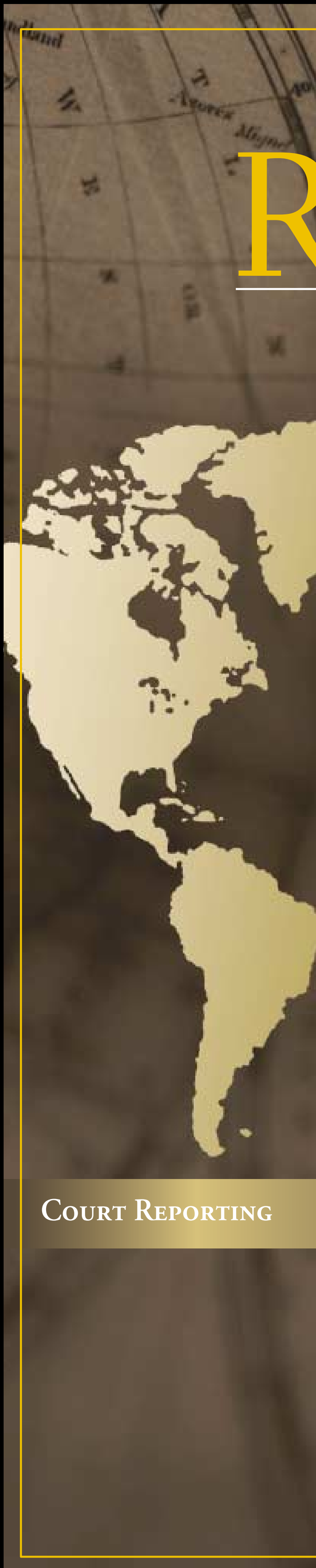
E-alerts can be a way for a busy attorney to stay ahead of the competition by keeping track of the news, legislation, regulations, and dockets that are important to his or her practice area.

An attorney monitoring a California state bill can take advantage of a free e-monitoring service by visiting the Assembly site (www.assembly.ca.gov) or the Senate site (www.sen.ca.gov) and clicking on "Legislation." Then, enter a bill number, key word, or author into the search box. After finding a relevant bill, link to it and click on "Subscribe" (located on the left side of the Senate page and at the bottom of the Assembly page). On the next screen, enter an e-mail address into the "Enter E-mail" box and click "Submit" on the Senate site and "OK" on the Assembly site. The Legislative Counsel site, LegInfo (www.leginfo.ca.gov/bilinfo.html) also offers this feature for Assembly and Senate bills.

An added feature at the Assembly site is the ability to send a comment via e-mail to the member of the Assembly who authored the bill. Click on the "Comment" tab located at the top of the screen (it is also located at the bottom) of any displayed Assembly bill. Although Assembly bills are also searchable at the LegInfo site, the "Comment" feature is not available there. The Senate site does not have this feature for Senate bills.

The California Court of Appeal's official site offers a free e-monitoring e-alert service of its docket. To search for the case to monitor, a user may for example visit http://appellatecases.courtinfo.ca.gov/search.cfm?dist=2. Once the case is selected, the user can request an e-alert by entering an e-mail address and the case number. The user then selects the case activities for which notification is to be

Carole Levitt and Mark Rosch are principals of Internet For Lawyers (www.netforlawyers.com) and coauthors of *The Lawyer's Guide to Fact Finding on the Internet*.



sent (for example, brief filed, calendar notice, disposition, record on appeal filed, and remittitur issued) and then clicks the "Register for Notification" button. Six months after a case is complete, e-alerts are deleted from the system. If a case is reinstated, re-registration is required. No alert is sent to notify a past user of this reinstatement.

The Los Angeles County Bar Association offers two free e-alerts to its members. The Daily EBriefs are daily summaries of appellate cases sent directly to LACBA members via e-mail. Case summaries are sorted by legal area and by court. Each summary also has a link to the full text of the decision. Members may subscribe at www.ebriefs.com. The Association also offers the Daily Case Filings Elert. This provides a complete listing of all cases filed in the Los Angeles Superior Court since the prior daily alert. In addition to listing the parties and subject matter, this daily report includes the plaintiff's counsel, the filing date, and a link to the case summary on the Association Web site. Members may subscribe to the Daily Case Filings Elert at www.lacba.org/elert.

Yahoo and Google

For those who want access to a broad amount of information, the e-monitor and e-alert features at Yahoo and Google are the answer. To set up a Google e-alert, visit www.google.com/alerts and enter your key words (for example, client names, company names, competitor names, words describing an industry, and so on.) into the first box. Then choose the type of alert (Web, news, or both) and how often the alert should be e-mailed (daily, weekly, or as they occur). Next, enter a recipient e-mail address.

On the bottom left of this Google page, a "Manage Your Alerts" sign-in offer appears. The benefit of this process is that every time you log onto Google Alerts, you can view your list of alerts, run an e-alert search on the spot (when you cannot wait to receive an automatic e-alert), and edit or delete e-alerts. For example, one may create a daily Web e-alert with Iraq as the topic. Later, it is simple to revise this alert to add "news" to monitor Google's news database in addition to the Web. The alert can be edited to send news as it happens rather than daily.

If a user does not select the "Manage Your Alerts" sign-in offer, editing e-alerts is not an option. In this case, the alert must be deleted entirely (by clicking on a link at the bottom of an alert e-mail) and a brand new alert must then be created to the new specifications that are desired.

To use Yahoo e-alerts, see http://alerts.yahoo.com. Unlike Google, Yahoo requires users to set up accounts (for free) before being allowed access to the feature. Once logged into a Yahoo account, a user can add key words to an alert search or modify a search by excluding key words (by adding them to a "Do Not Include" box). Yahoo offers fewer delivery frequency choices than Google, but Yahoo offers more options for where it delivers its alerts. To choose to receive Yahoo alerts once daily or as they happen, users click the "Change Delivery Options" link near the bottom of the alert set-up screen. To receive alerts via e-mail, Yahoo Instant Messenger, or a text-message-enabled cell phone, users can click on the "My Alerts" tab. Because Yahoo and Google do not monitor all the same sources, it may be useful to set up an e-alert on both services.

Another way to keep tabs on a company is to monitor its Web site for any changes. To accomplish this, users can sign up for a free service at Watch That Page (found at www.watchthatpage.com). After signing up, a user enters one or more URLs (for example, www.lacba.org) into the "Add Pages" box. When a page on a monitored site changes, Watch That Page sends an e-alert on a daily or weekly basis. One can choose an e-alert that displays only the URLs of the pages that have changed or one that shows what text on the page has changed. Web sites belonging to clients or opposing parties are prime candidates for Watch That Page monitoring. Clicking on "Add New Channel" on Watch That Page allows the user to have new content on all watched pages collated into one e-mail message or separated into several messages. Users can also restrict the monitoring to specific key words on the watched pages instead of all changes on a page.

Watch That Page can be used to monitor the dockets of courts that do not offer docket monitoring of their own. To monitor the docket of a pending U.S. Supreme Court case (and receive an e-alert for any new action about the pending case), visit the court's Web site (www.supremecourtus.gov) and click on "Docket." Enter a party name or a key word into the "Search For" box to find a case. Select the link to the case, and note the URL for the case's docket (for example, http://www.supremecourtus.gov/docket/03-1238.htm). Copy this URL into the Watch That Page monitoring page. Watch That Page will monitor the docket sheet and send an e-alert when the page changes.

E-alerts can be a way for a busy attorney to stay ahead of the competition by keeping track of the news, legislation, regulations, and dockets that are important to his or her practice area. Shortly after signing up for e-alerts, they begin to arrive in a designated mailbox. The alerts offer an excellent supplement to the services provided by the larger information brokers. Best of all, e-alerts can be established for free. ■

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Index to Advertisers

27th Annual Child Custody Colloquium

ON SATURDAY, SEPTEMBER 24, the Family Law Section will present the 27th Annual Child Custody Colloquium. Contested child custody issues are often the most difficult in family law. While the best interest of the child is paramount, sometimes there are issues which surface that have no easy answer. This year's colloquium will address several of the conundrums that practitioners face, including the special needs child; negative 730 and solution-focused evaluations; parental substance abuse; and situations in which the family law matter becomes entangled in dependency, criminal, or probate court. This colloquium will take place at the Marriott Los Angeles, 333 South Figueroa Street, Downtown. Hotel valet parking is $9. On-site registration and continental breakfast will begin at 8 A.M., with the program continuing (with a lunch break at noon) from 8:30 A.M. to 4:30 P.M. The registration code number is 009019.

$130—CLE+*Plus* members
$200—Family Law Section members
$215—Association members
6 hours of CLE family law legal specialization credit

Second Annual Healthcare Law Compliance Symposium

ON THURSDAY, SEPTEMBER 29, the Healthcare Law Section will present a symposium addressing the challenges of compliance with healthcare laws. Speakers Allen E. Briskin, Greg Endicott, Steven Goldsobel, Jill H. Gordon, Joy M. Harris, Russell Hayman, Brian J. Hennigan, Patric Hooper, Greg Koonsman, John P. Krave, Thomas F. McNamara, Jeremy N. Miller, Anthony H. Schiff, Consuelo S. Woodhead, and U.S. Attorney Debra W. Yang will discuss how virtually every facet of the healthcare industry is subject to a complex web of federal and state laws, rules, and regulations. Government efforts to enforce these laws, and punish violators, have become increasingly common and successful. The consequences of an enforcement action, regardless of the outcome, can be ruinous for providers and suppliers. In this climate, the need to understand and function in a changing compliance landscape has never been greater. The distinguished group of speakers will guide those in attendance through a variety of today's most important compliance issues. The symposium will take place at the Hilton Los Angeles Airport, 5771 West Century Boulevard in Los Angeles. Hilton Los Angeles Airport self parking costs $8; valet parking costs $12. On-site registration will begin at 7:30 A.M., with the program continuing from 8:00 A.M. to 4:30 P.M. The registration code number is 009121.

$150—CLE+*Plus* members
$190—Healthcare Law Section members
$210—other Association members
$225—all others
$245—all at-the-door registrants
7 hours of CLE credit, including 1 hour of legal ethics credit

2005 Annual Seminar for Corporate Counsel

ON FRIDAY, SEPTEMBER 30, the Corporate Law Section will hold its Annual Seminar for Corporate Counsel at the Marriott Coronado Island Resort. Topics to be presented will include recent trends and developments that are of importance to corporate in-house counsel, including an employment law update, a legislative overview, and important strategies for in-house counsel. The social events will provide an opportunity for attendees to network with other corporate counsel who share similar interests and concerns. As in the past, you may register your spouse or guest to participate in the numerous social and recreational activities planned. These include a reception and dinner on Friday evening and an outdoor reception and dinner on Saturday evening. Please plan to join us for this exceptional educational and social event. The seminar will take place at the Marriott Coronado Island Resort, 2000 Second Street, in Coronado. Overnight self-parking costs $7 per day; overnight valet parking costs $11 per day. On-site registration will begin at 1 P.M., with the Friday program continuing from 2 to 5 P.M. On Saturday, the program will begin at 9 A.M. and continue until 12:15 P.M. The registration code number is 009133.

$295—CLE+*Plus* members
$425—Corporate Law Section members
$425—Orange County Bar Association members
$195—spouses and guests
$455—all others
6 CLE hours

The Los Angeles County Bar Association is a State Bar of California MCLE approved provider. To register for the programs listed on this page, please call the Member Service Department at (213) 896-6560 or visit the Association Web site at http://calendar.lacba.org/. For a full listing of this month's Association programs, please consult the *County Bar Update*.

BY IAN C. BALLON

Reconsidering the Winners and Losers in *MGM Studios* v. *Grokster*

ALTHOUGH SOME COMMENTATORS PORTRAY digital copyright law as a zero-sum game in an ongoing battle between Hollywood and Silicon Valley, the U.S. Supreme Court's 9-0 decision in *MGM Studios, Inc.* v. *Grokster, Ltd.*[1] in fact represents a victory for both the entertainment industry and legitimate technology companies.

U.S. copyright law seeks to establish a delicate equilibrium between protecting artistic creativity and fostering technological innovation. Digital technologies have posed especially difficult challenges for copyright owners because of the ease with which inexpensive, picture-perfect, exact digital copies may be made. During the dot-com boom, some companies rushed to market with risky business models on the assumption that their inevitable success would force copyright owners to give them a license rather than sue for infringement.

While early case law generally applied copyright principles to cyberspace in a relatively seamless fashion, the district court and Ninth Circuit decisions in *Grokster* turned copyright law on its head by creating perverse incentives for companies to profit from third-party acts of infringement through business models that were deliberately designed so that their owners could maintain "plausible deniability" (in the words of the Electronic Frontier Foundation, in advice to potential clients) that they were profiting from large-scale infringement.

Specifically, the Ninth Circuit ruled that the defendants, Grokster and StreamCast, could not be held contributorily liable for copyright infringement because their products were capable of commercially significant noninfringing uses (even though approximately 90 percent of the files traded at the time of the summary judgment motion were infringing) and, therefore, the plaintiffs were required to show that the defendants failed to take action in response to actual knowledge of specific acts of infringement, which they arguably did not have because of the decentralized nature of their services. The court likewise affirmed the entry of summary judgment for the defendants on the plaintiffs' claim for vicarious infringement.

In reversing the Ninth Circuit, the Supreme Court held that one who distributes a device with the object of promoting its use to infringe copyright, as shown by "clear expression or other affirmative steps taken to foster infringement," is liable for the resulting acts of infringement by third parties. The Court clarified that liability for inducement must be "purposeful, culpable expression and conduct." Drawing from patent law, the Court explained that "the classic instance of inducement is by advertisement or solicitation that broadcasts a message designed to stimulate others to commit violations."

In the *Grokster* case, the Court deemed significant three aspects of the evidence of the defendants' intent. First, each company marketed its products to users of the former Napster service, which the Court characterized as a known source of demand for copyright infringement. Second, neither company attempted to develop filtering tools or other mechanisms to diminish the infringing activity. Third, the defendants' business model depended on a high volume of use, which the record showed was overwhelmingly infringing. The Court thus adopted a pragmatic approach, based largely on a party's intent.

At the same time, the Court protected innovation by adopting a broad test that insulates from liability legitimate technology developers and service providers. The Court pointed to its decision in *Sony Corporation* v. *Universal City Studios, Inc.*,[2] as creating a safe harbor against liability for third party acts of infringement when there is substantial noninfrgining uses. In *Grokster,* the Court could not agree on the level of noninfringing use required; however, all nine justices agreed that the Ninth Circuit had read *Sony* too broadly.

The Court has provided useful guidance to legitimate technology innovators, who should have nothing to fear from the decision.

The Court's discussion of the grounds on which liability for inducement may be imposed provide useful guidance to technology developers and product distributors on how to avoid liability for inducement. Companies plainly must avoid advertising or promoting potentially infringing uses of their products. Developers of new technologies would also be well advised to do whatever they can to thwart potentially infringing uses of their products. Technology firms should involve copyright lawyers in the development process to ensure that engineers are educated about a company's potential exposure for inducement and the benefits of implementing engineering solutions to limit, rather than encourage, infringement.

The Supreme Court's 9-0 decision in *Grokster* ultimately represents the reassertion of traditional copyright law principles to digital technology and the Internet. By adopting an intent-based test for inducement, the Supreme Court has created reasonable incentives for technology companies to deter or at least not encourage infringement. At the same time, the Supreme Court has provided useful guidance to legitimate technology innovators, who ultimately should have nothing to fear from the Court's decision. ■

[1] MGM Studios, Inc. v. Grokster Ltd., 545 U.S. ___ (2005), *remanding* 380 F 3d 1154 (9th Cir), *affirming* 259 F. Supp. 2d (C.D. Cal. 2003).
[2] Sony Corp. v. Universal City Studios, Inc., 464 U.S. 417 (1984).

Ian C. Ballon is the firm-wide co-chair of Manatt, Phelps & Phillips, LLP's Intellectual Property and Internet practice group and represents entertainment, media, and technology clients in copyright and other intellectual property and Internet-related litigation. He filed an amicus brief on behalf of copyright owners in the Ninth Circuit appeal of *MGM Studios* v. *Grokster*.

DEAN'S REPORT
HIGHLIGHTS

Neil H. Cogan
Vice President and Dean

FACULTY: Minority 15% Women 43%

PUBLIC SECTOR EMPLOYMENT: 19%

WPILF Raised Nearly $60,000 to Fund 14 Summer Grants in Agencies such as California Women's Law Center; Children's Law Center of Los Angeles; Protection and Advocacy, Inc.; and Orange County Public Defender

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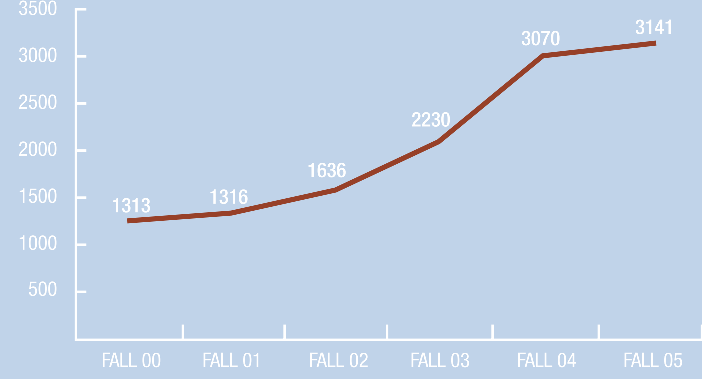
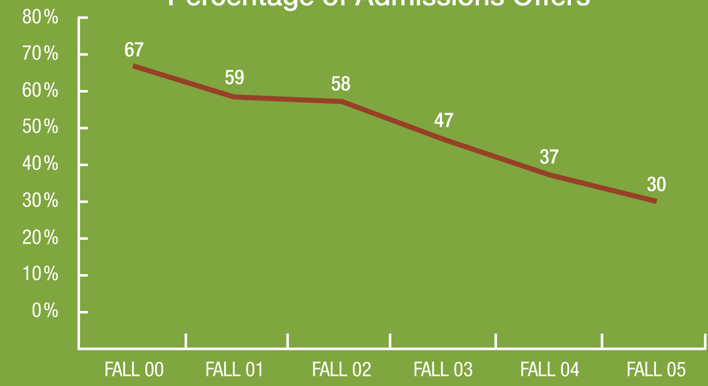
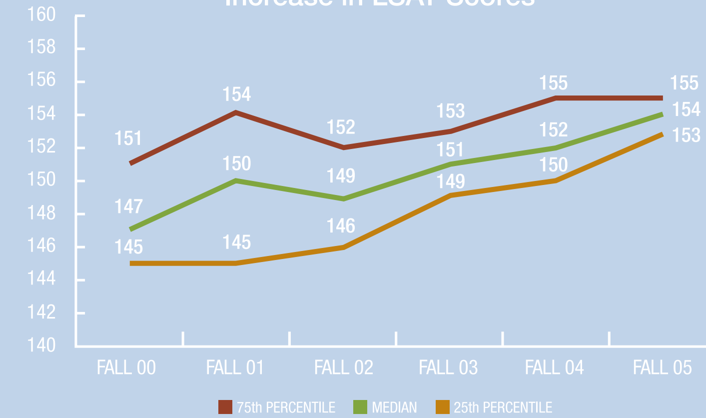
Number of Applicants



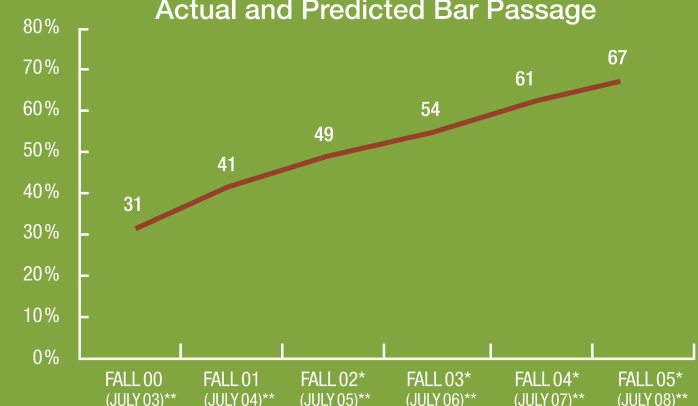
Percentage of Admissions Offers



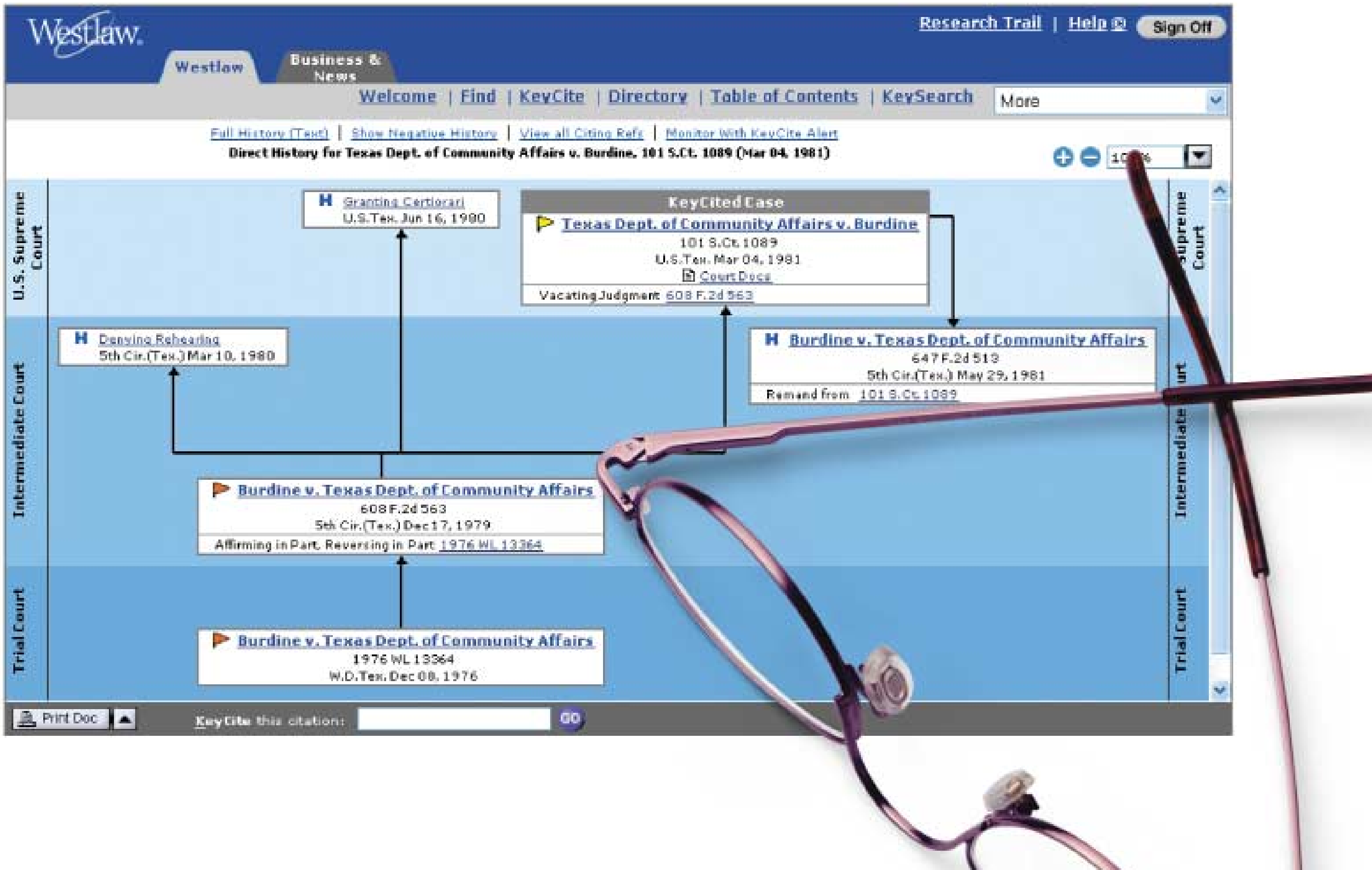
Increase in LSAT Scores



Actual and Predicted Bar Passage



* Beneath each entering class is the probable bar examination test date for that class
** July 2005 and subsequent bar examination pass rates are based upon a study by Dr. Dan Heitjan, University of Pennsylvania, Spring 2005



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