SUMMER 2008

PERSPECTIVES

IN THIS ISSUE: Land Use & Natural Resources | Finance | Litigation | Residential | Environmental

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table of contents

COX, CASTLE & NICHOLSON LLP has devoted nearly 50 years to providing a broad range of legal services to the real estate industry. The Firm represents publicly and privately held businesses, major financial institutions, public agencies, pension funds, underwriters, developers and industry entrepreneurs in their respective real estate activities.

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THE NEW "PLAYBOOK" FOR LENDING IN 2008

by Jess R. Bressi and Ryan C. Stottlemyer

In the "Good Old Days," (*i.e.*, more than ten or fifteen years ago) most real estate loans were made by "Balance Sheet" lenders. "Balance Sheet" lenders are lenders who made, owned, and serviced their own loans and included them on their balance sheets. Starting in the late 1980s, real estate lending shifted to securitized and syndicated loans where those functions were divorced one from the other. The loan itself is not held by the originating lender at all. Rather, the loan is sliced and diced into many pieces or combined with many other loans to create securities. Out of this sea change came a proverbial alphabet soup of acronyms for parties somehow connected with the loan. SPE, CDS, CDO, CLO, SIV and CMBX are now part of our lending vocabulary and impact what should be considered when discussing loan defaults. This article discusses one of the most prevalent "innovations" engendered by such change, namely credit derivatives, and the general characteristics of the most prevalent category of credit derivatives, credit default swaps ("CDS"). In particular, we'll be discussing the changes that CDS have made to the lending landscape, as well as key issues that lenders are likely to face as CDS litigation catches up with the growth of the credit derivatives market.

> ***The $50 trillion question — what role, if any, will CDS play in the rapidly evolving world of lender liability?***

Some Basic Definitions.

Before we begin our discussion, let's briefly define one or two of the main concepts we'll be talking about. A credit derivative is a financial instrument whose value is derived from the likelihood that a third party will be able to meet its credit obligations. At their most basic, credit derivatives are nothing more than hedging transactions. That is to say they are contracts by which one party (called the "*protection buyer*", who many times is the lender for the loan at issue) transfers the risk of an event of default occurring on a particular loan to another party (called the "*protection seller*"). Credit Default Swaps are the most commonly traded credit derivative. Somewhat analogous to insurance, CDS typically involve the *protection seller* selling financial protection against the occurrence of certain pre-agreed default events in relation to a borrower of the *protection buyer,* in exchange for premium payments. However, CDS can also be used for speculative purposes insofar as there are no requirements that the *protection buyer* actually hold any asset or suffer any loss. Stated more bluntly, CDS can be, and often are, more akin to a form of gambling than insurance.

More often than not, CDS amount to two privately contracting parties betting on the bankruptcy, default, or restructuring of a lender's borrower. In practice, if the borrower defaults, the lender loses money on the loan, but makes money on the CDS. In contrast, if the borrower performs, the lender's profits on the loan are reduced by the amount of the CDS premium payments.

The Proliferation of Derivatives.

Now that we understand what they are, let's ask the most basic of questions - Why should you care about credit

continued on page 8

THE FLOW OF WATER — WHO MAKES THE CALL ABOUT WATER SUPPLY ASSESSMENTS by Anne E. Mudge and Sarah E. Owsowitz

California Water Impact Network v. Newhall County Water District[1] ("*C-WIN*") is a significant decision important to developers, public agencies, and all other participants in the CEQA process. It restricts litigation concerning Water Supply Assessments ("WSA") to the realm of CEQA lawsuits brought after project approval. By establishing that cities and counties retain the ultimate decision about water sufficiency through the larger CEQA process (of which WSAs are a part), it avoids ensnaring development projects in multiple overlapping lawsuits. It also allows water agencies to continue to perform their vital role in the process — to provide *information* on which decisions about water can be made.

WSAs are evaluations of water supply sufficiency that are legally required under Public Resources Code section 21151.9 and Water Code sections 10910 through 10915 for development projects, specifically for those projects defined in Water Code Section 10912(a), which includes such major developments as a 500 unit residential project. WSAs must be included in Negative Declarations and EIRs and must be considered by lead agencies before approving a development project. At issue in *C-WIN* was whether project opponents may directly challenge a WSA by suing WSA preparers *before* a city or county has decided to approve a development project.

Court's decision improves the entitlement process by clarifying which agencies can be sued on the issue of water suffiency and when they can be sued.

In *C-WIN*, project opponents sued the Board of Directors of the Newhall County Water Agency (the "Board") to challenge the adequacy of a WSA prepared for a 584-acre industrial park in the City of Santa Clarita (the "Project"). The suit was filed before the City of Santa Clarita could include the WSA in its EIR for the Project and before it could approve the development of the Project. The Board asked the court to throw out the suit because it was premature and failed to state a cause of action.

The Court of Appeal (the "Court") agreed that WSAs are not subject to direct legal challenge. Rather, project opponents may only challenge WSAs through a CEQA suit against a lead agency after project approval. The court reasoned that WSAs are simply one part of a larger decision making process culminating in certification of an EIR and project approval and that, until the fat lady sings, one may not file suit.

The ruling was based on the twin grounds of finality and failure to exhaust administrative remedies. While acknowledging that nothing in the Public Resources or Water Code indicates when a WSA becomes final, the Court held that finality could be determined from a review of "the WSA law framework." A WSA is a "technical, informational, advisory opinion of the water provided," the Court found, and so the "WSA's role in the EIR process is akin to that ofother informational opinions provided by other entities concerning potential environmental impacts – such as traffic, population density or air quality." The Court concluded that "because the adoption of a WSA does not create a right or entitlement to water service or impose, expand or limit any duty concerning the obligation of public water system to

provide certain services, and because the lead agency has a separate (from the water providers' WSA) and independent obligation to assess the sufficiency of water supplies for the proposed project, [a] WSA is not a final agency decision."

The Court also found that the California Water Impact Network (CWIN) was required to first take its grievance about the WSA to the City Council before going to court. Because the City had the authority to evaluate the WSA and to "make the final determination on the sufficiency of water supplies" as part of its review of the updated EIR, the City was empowered in the first instance to "approve or disapprove the WSA, or to request the Water District to revise, modify, amend or supplement the WSA." CWIN had thus failed to "exhaust its administrative remedies," meaning that the Court had no jurisdiction to hear the case.

This case establishes *which* agencies can be sued on the issue of water sufficiency for development projects in California and *when* they can be sued. By prohibiting two bites at the apple, and clarifying that cities and counties remain in the driver's seat, it streamlines what is already a daunting and complex entitlements process.

[1] 161 Cal.App.4th 1464.

IN THIS ISSUE: Land Use & Natural Resources | Finance | Litigation | Residential | Environmental

SHELF LIFE: SHORT AND LONG TERM STRATEGIES FOR RENTING CONDOMINIUMS by Paul J. Titcher and David P. Lari

During the recent real estate boom, we witnessed a renewed interest in condominium development, including mixed-use and infill projects. However, changed market conditions have impacted demand and many developers are faced with the prospect of having completed or nearly completed condominium projects with reduced prospects of selling these units.

This concern is exacerbated by the fact that condominium projects often consist of a single building that is constructed in a single phase. Unlike detached home developments where the developer can elect not to construct additional homes, it is virtually impossible to build half a condominium building. The result is that many condominium developers are now holding (or constructing) excess inventory.

Faced with this reality, condominium developers are exploring other options to generate income. Fortunately, many urban areas have experienced a recent increase in rental rates. Developers are now taking advantage of the relatively strong rental market and turning to leasing programs as a strategic solution to stalled sales programs and mounting unsold inventories. As can be expected, unsold units are a financial anchor on an entire project and threaten the project's long-term viability. Leasing unsold units can provide these projects a source of immediate revenue. Beyond creating a revenue stream, leasing units to fully occupy a project has other benefits. For example, a fully occupied project implies the project is a popular place to live and encourages interest from prospective purchasers. In addition, if and when a developer enacts or restarts a sales program, tenants living in the project at that time will serve as a ready pool of prospective purchasers. However, there are a number of pitfalls that developers must be aware of and plan for when considering a leasing program.

Strategies for Projects with Sold Condominium Units

Project Documents

For completed projects where one or more units have already been sold, a developer should first examine the project documents (*i.e.*, CC&Rs, purchase and sale agreement and the Public Report issued by the California Department of Real Estate) to determine whether they establish the right to rent units in the project. Ideally, the project documents should contain leasing language which specifically discloses and reserves the legal right of the developer to rent units.

Financing

A developer should also review the project's loan documents to determine whether the loan structure is compatible with a leasing program. Often, the loan documents restrict the developer's ability to rent units and contain sales thresholds which must be achieved within specified time periods. Also, the term of the loan is often too short for a leasing program. For these, and other reasons, a developer seeking to implement a leasing program may be forced to restructure or re-finance the project and obtain a "permanent" loan which is compatible with the leasing program. In today's financing environment, this could be a significant hurdle.

Payment of Assessments

Generally, once a condominium unit is sold, the developer is responsible for the payment of association assessments for the unsold units in a project (including reserves). Thus, for an existing project where one or more units have already been sold, the developer will be responsible for paying the assessments for the unsold units. While this is a significant expense, it is important to recognize that the association, not the developer, will have the responsibility to maintain common areas. Such maintenance will be according to the standards set forth in the association's budget, as approved by the California Department of Real Estate ("DRE"). It is unwise for developers to attempt to decrease such standards in an effort to reduce assessments since existing owners purchased their units with an expectation of a certain level of maintenance and service and such a move could lead to claims against a developer. In addition, the association's budget contains a "reserve" component aimed at covering the expenses associated with the long-term repair and replacement of the common areas. By decreasing the assessments, a developer increases the likelihood of a shortfall to cover such expenses.

continued on page 5

SHELF LIFE, cont'd

Existing Owner Reaction

In a project with sold units, developers may face a mixed reaction from existing and potential residents when offering the unsold units for rent. Whether or not a leasing program is positively embraced by existing owners can depend on how a developer implements the program. Ultimately, to foster consumer satisfaction, the developer must fully disclose the terms of a leasing program and establish procedures and safeguards to maintain existing project standards.

Owners at condominium projects may have differing views on the desirability of leasing programs. Some owners may object that a leasing program devalues their units. Owners may also claim that tenants are less likely to respect the project and may be more prone to cause damage to common areas, engage in loud activities and other negative behavior. Some owners may claim that they would not have purchased their units if they knew that the developer was planning to lease units. Aggrieved owners may pursue an action against a developer, claiming the developer deceived them by not informing them of the developer's intent to lease units.

Another potential risk is that some lenders refuse to provide financing to purchasers of units in projects where a high percentage of units are occupied by renters. This refusal may have a significant impact on an existing owner's ability to sell or refinance his or her unit.

In order to maximize the likelihood of a positive reaction from current unit owners and future prospective purchasers, a developer should engage in an outreach program to demonstrate the benefits of a leasing program and minimize any concerns. Such outreach should highlight that: 1) all leases are subject to the CC&Rs and all rules and regulations; 2) the developer will remain responsible for assessments on all unsold units; 3) the association will continue to maintain and operate the project in accordance with existing standards; and 4) the developer will be responsible for any damage caused by tenants to common areas.

Abandoning efforts to complete the entitlement and the DRE Public Report registration processes can cost developers valuable vested rights that may facilitate alternate disposition strategies in the future.

Strategies for Projects without Sold Condominium Units

Some developers who are holding a project (either complete or under construction) where units have not been sold may wish to convert the entire project to rentals. In such cases, the developer may be tempted to abandon any efforts to complete the entitlement process and the DRE Public Report registration process. However, such action could cost the developer valuable vested rights that may facilitate alternate disposition strategies in the future.

A Public Report provides certain vested rights which make it easier to sell units in the future and protect certain developer rights. If units are rented before a Public Report is obtained, the project will be subject to any future condominium conversion ordinance in effect at the time the developer elects to commence a sales program. If the project is "vested" and a Public Report is obtained, and if the developer obtains all necessary discretionary approvals and satisfies all requirements to offer units for sale, the local municipality(ies) may not impose further restrictions or conditions for the project. For example, the project would not be subject to subsequent local condominium conversion ordinances. However, the project would be subject to any applicable rent control provisions pursuant to Civil Code Section 1954.52(a)(3)(B).

Completing the entitlement and DRE application process provides a long-term competitive advantage to the developers. Once the market returns to normal, developers of "vested" condominium projects will be able to quickly commence a sales program, avoiding a lengthy and expensive conversion process and the uncertainties associated with the same.

Sale of Condos after Rental

Developers must comply with a number of local and state government statutes and regulations when offering individual condominium units for sale after rental. These laws include the requirement, under the California Subdivision Map Act (Government Code Section 66410 *et seq.*), that the owner of a condominium project provide the tenants with (a) written notice at least ninety (90) days prior to the sale of units within the project and (b) a right of first refusal to purchase the unit occupied by each tenant. It is important to note that in many instances, the existing tenants of a project are an excellent pool of prospective purchasers.

continued on page 11

LITIGATION UPDATE: KEY CASES SINCE JANUARY 1, 2008

by Fredrick "Rick" Kranz and Heather E. Stern

In our regular column, we once again highlight some of the recent cases with potential ramifications for our real estate and business clients. Among those were two appellate cases in which Cox, Castle & Nicholson LLP litigators were involved as counsel, namely: *California Water Impact Network v. Newhall County Water Dist. (GateKing Properties)* (Cal.App. 2 Dist. Apr. 16, 2008) 161 Cal.App.4th 1464, see article *The Flow of Water - Who Makes the Final Call about Water Supply Assessments?* in this Perspectives; and *Affordable Shelters, Inc. v. AMCAL Multi-Housing, Inc.* (Cal.App. 2 Dist. Apr. 30, 2008) 2008 WL 1887127, unpublished/noncitable, which was a successful challenge to a trial court's erroneous award of prejudgment interest after trial.

In addition to these cases, here are some other cases that were recently decided, with importance for our real estate and business clients:

Arbitration clauses in particular warranty booklets deemed unenforceable.

Two appellate cases recently addressed the enforceability of arbitration clauses contained in warranty booklets given to home buyers. In *Bruni v. Didion* (Cal.App. 4 Dist. Mar. 12, 2008) 160 Cal.App.4th 1272, as modified (Mar 24, 2008), review filed (Apr 17, 2008), a homebuilder sought to compel arbitration against homebuyers pursuant to arbitration provisions contained in a warranty booklet described by the court as a preprinted form contract that was presented on a take-it-or-leave-it basis. The arbitration clause itself consisted of one full page of single-spaced, 10-point type, contained in a larger, 30 page booklet of the same typeface, without anything distinguishing or singling out the arbitration clause or emphasizing its importance. The homebuyers were never asked to sign or initial the booklet. In light of these facts, the appeals court agreed with the trial court that the scope of the arbitration clause was "unforeseeably broad," exceeding the homebuyers' reasonable expectations, and that the clause was adhesive, unconscionable, and unenforceable.

Similarly, in *Baker v. Osborne Development Corporation* (Cal.App. 4 Dist. Jan. 31, 2008) 159 Cal.App.4th 884, review denied (Apr. 30, 2008), a homebuilder sued for construction defects sought to compel arbitration based on an arbitration agreement contained in a home warranty booklet signed by purchasers. The purchasers presented evidence that the warranty booklet was not sent to them until after escrow had already closed, the arbitration agreement was not negotiated or negotiable, the arbitration agreement in the warranty booklet was not called out to them or explained to them in any way, and they did not understand the significance of what they were signing. Based on that evidence, the trial court found that the arbitration agreement was both procedurally and substantively unconscionable, and therefore refused to compel arbitration. The appeals court found no error and affirmed.

> ***Court agreed that the scope of the arbitration clause was "unforeseeably broad," exceeding the homebuyers' reasonable expectations, and that the clause was adhesive, unconscionable, and unenforceable.***

Tenant's right to verify common area expenses.

In *McClain v. Octagon Plaza, LLC* (Cal.App. 2 Dist. Jan. 31, 2008) 159 Cal.App.4th 784, review denied (Apr. 30, 2008), a tenant in a shopping center sought a detailed, comprehensive audit of common area expenses incurred by the landlord and passed on to the tenant. Among other things, the tenant questioned certain expenditures, disputed the need for others, and sought documentation beyond that verifying the actual expenses incurred. Although the lease did not give the tenant any express right to any audit, the appeals court agreed that the tenant had an implied right to at least verify that the expenses had been incurred (but no more): "Because [the tenant's] share of the common expenses under the lease is determined by the *actual expenses* incurred by [the landlord], she is entitled to verify that such expenses were, in fact, incurred and that the listed amounts are accurate. Accordingly, if requested, [the landlord] must provide [the tenant] with the documents it used in preparing the 'reasonably detailed statement' [of common area expenses, per the lease terms]; to hold otherwise would necessarily 'frustrate' [the tenant's] rights to the benefits of the contract." The case also addressed whether an exculpatory clause in the lease that described the square footage of the leased property precluded a claim for negligent or fraudulent misrepresentation of that square footage amount, and found under the facts here that the claim was not barred.

continued on page 11

JUST WHEN YOU THOUGHT THE SITE WAS CLEAN: A NEW STANDARD FOR SOIL VAPOR ASSESSMENT by Keith B. Walker

The latest "hot button" issue in the environmental arena relates to the air we breathe in buildings. Real estate acquisitions, ownership and management just got complicated by the introduction of a new standard for determining whether indoor air is impacted by below-ground contamination.

The new standard could arise in a variety of contexts and raise questions about sites previously deemed to be clean. For example, you may be considering purchasing a site that was once contaminated, but for which a regulatory agency granted "No Further Action" status after remediation. Alternatively, you might be looking to purchase an otherwise clean site under which contaminated groundwater flows as the result of an off-site contamination source. Based on the regulatory closure in the first case, or the lack of an on-site contamination source in the second case, does your company move forward with the transaction?

Due to the growing awareness in the regulatory and scientific community regarding health risks associated with the inhalation of toxic vapors, the answer to this question has become more complicated. Sites for which "No Further Action" status was previously issued – usually due to low contaminant concentrations in soil and/or groundwater – may soon be subject to a second look by environmental regulatory agencies. In addition, sites above contaminated groundwater aquifers may also be investigated by regulatory agencies eager to address previously ignored vapor intrusion risks. As a result, owners and operators of these sites could quickly find themselves required to perform additional, and potentially costly, investigation, remediation and mitigation work to address soil vapor intrusion issues.

Soil vapor is the gas that surrounds particles of soil. Soil vapor intrusion is the migration of toxic chemicals, such as volatile organic compounds, from contaminated subsurface soil or groundwater into the buildings above. Both at the federal and state levels, there is no consistent regulatory approach with respect to assessing or addressing vapor intrusion risks. For example, although California Human Health Screening Levels ("CHHSLs") provide a standard against which to compare detected soil vapor levels, higher concentrations do not necessarily mean that remediation is warranted, and concentrations below CHHSLs do not necessarily mean that no human health risks are present.

In the midst of this uncertainty, the American Society for Testing and Materials ("ASTM") recently released a new standard to evaluate the presence of soil vapor. ASTM is the organization that issues the due diligence standard for performance of Phase I Environmental Site Assessments ("ESAs"). This standard, ASTM E 1527-05, must be followed in order to satisfy the requirements of conducting "All Appropriate Inquiries" under federal law, and potentially enable parties to avoid certain liabilities under the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA").

ASTM's new soil vapor standard, E 2600-08 ("Standard Practice for Assessment of Vapor Intrusion into Structures on Property Involved in Real Estate"), provides useful guidance for evaluating and addressing vapor intrusion issues. The standard sets out the following four different tiers of analysis:

- Tier 1: Data collection (as with a Phase I ESA, e.g., from regulatory databases) and evaluation of factors that include groundwater depth, contaminant migration pathways, and the types of contaminants at issue;
- Tier 2: More refined screening processes focusing on site-specific factors, and, potentially, sampling of soil, soil vapor and groundwater;
- Tier 3: Collection and modeling of data obtained from additional and more sophisticated sampling of soil, soil vapor, groundwater, and indoor air; and
- Tier 4: Evaluation of potential institutional controls (such as deed restrictions regarding the use of the site), engineering controls (such as remediation), and building design measures (such as the installation of vapor barriers and active and/or passive ventilation).

Although performance of a vapor intrusion assessment in accordance with ASTM E 2600-08 is not currently necessary for satisfying either the Phase I ESA standard or for conducting All Appropriate Inquiries, a properly conducted soil vapor assessment may provide the information necessary to avoid the risk of a site with "No Further Action" status being subject to further scrutiny based on potential vapor intrusion issues. In the absence of such data, both state and federal agencies have begun to reconsider the regulatory closure that was granted to thousands of sites during the 1990s based solely on seemingly low contaminant concentrations in the soil and/or groundwater.

The reason for the new level of scrutiny arises because although a site may have contaminant concentrations in groundwater that comply with drinking water standards, and negligible contaminant concentrations in soil, these low

continued on page 10

NEW LENDING PLAYBOOK, cont'd

derivatives? In his February 21, 2003 annual letter to Berkshire Hathaway's shareholders, Warren Buffett characterized derivatives generally as "financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal." Of course derivatives are not without their defenders, including another fellow with a bit of market influence, Alan Greenspan. The difference of opinion between the "Sage of Omaha" and the "Maestro" fostered academic debate and attention at that time, but it has been more recent events, and those still to play out, that will provide the empirical evidence from which the discernment of these financial icons will ultimately be judged. One thing is for certain, however, and that is simply that regardless of whoever is correct, the ramifications of derivatives, good or bad, will be monumental. The credit derivatives market, and the CDS market in particular, has experienced tremendous growth in the past ten years. Today, the principal amount of CDS outstanding is estimated to equal $50 trillion, or more than three times the gross domestic product of the United States.[1] And CDS, while certainly the dominant derivative product, represent only about one third of the credit derivatives market.

Engendering Change in Lender Incentives.

Credit derivatives, and CDS in particular, have fundamentally changed the landscape of lending, where traditional lenders are rapidly being replaced by risk managers. The changes are most pronounced with regard to the lender's behavior when a default looms imminent.

In the traditional Balance Sheet lending model, it made sense for the lender holding the loan on its balance sheet to monitor a loan and become intimately familiar with the borrower and its principals. After all, the lender had an incentive to limit losses, and it was exposed fully to all losses flowing from any default. The lender also had an incentive to foster its relationship with the borrower, as a continued relationship may lead to repeat-business and thus additional loans and profits. As a result, the lender was typically more willing to make concessions and negotiate a restructuring if the borrower's financial condition changed, thereby staving off a borrower bankruptcy.

In contrast, the credit derivatives model diminishes those lender incentives. In fact, a lender that purchased CDS may profit more if the borrower defaults than the lender would in a restructuring. This reversal of incentives can be exacerbated when the borrower's debt has been syndicated or securitized and is owned by a heterogeneous group of "lenders" with even more divergent incentive structures. If any of those lenders stand to make more money from the pay-out of their CDS, such lenders may prefer to use their voting rights to ensure that the borrower defaults rather than make concessions and negotiate a restructuring that would avoid borrower bankruptcy. Of course, the existence of an incentive to force a default does not necessarily mean that the lender will (or should) do so, but the lack of transparency and disclosure in the CDS market makes it difficult, if not impossible, for the borrower to know what factors may be driving the lender's decision-making process so that the parties may adjust their behavior and negotiations accordingly.

Issues and Concerns in this New Environment.

To date, the rate and scope of change engendered by the growth of CDS has outpaced the judicial system's ability to analyze the potential legal consequences of this new paradigm. Indeed, part of CDS' attractiveness is that they have been largely unaffected by litigation and judicial review. As the subprime mortgage market crisis and economic downturn continue to unfold, however, we can likely expect to see a substantial increase in CDS litigation.

The most frequent issue in CDS litigation involving protection buyers and protection sellers will be contract interpretation, such as whether an event of default for which the protection seller must pay (called a "credit event") has occurred. CDS are most often documented using standardized agreements developed by the International Swaps and Derivatives Association ("ISDA"). Although such agreements help reduce the risk of unenforceability by providing uniform definitions and terms and by reducing the risk of incompatibility of laws between jurisdictions, they should not be exclusively relied upon. Legal counsel should also be consulted to analyze the compatibility of the CDS documentation with the underlying loan documentation and to ensure that the lender's

continued on page 9

NEW LENDING PLAYBOOK, cont'd

expectations are specifically expressed and captured in the CDS documentation.

Unlike letters of credit, insurance policies, and other traditional credit documents, the courts have not yet developed principles to fall back on when analyzing disputes where the CDS documentation is silent. As a result, traditional contract law principles will be applied, which may lead to results inconsistent with the lender's expectations concerning what constitutes a credit event, the scope of waivers, sufficient payment procedures, etc. Should litigation arise, a protection buyer will be better-positioned to recover under the CDS if those issues were expressly addressed at the outset in the CDS documentation as opposed to relying on the courts to apply established principles to obtain the intended result.

At the end of the day, in any loan transaction where CDS are even potentially involved at any level of debt or equity, the lender has to reevaluate its playbook for loan transactions.

In addition, protection sellers are frequently offshore hedge funds, which may be difficult to locate and serve lawsuits upon efficiently. This could delay court proceedings and make it more time consuming and expensive to obtain provisional remedies and ultimate relief. Indeed, even if the CDS documentation has an acceptance of service of process provision, failure to comply with the Hague Convention procedures governing service may nonetheless be grounds for a foreign court to refuse enforcement of any judgment in that foreign country. The protection buyer must therefore be cognizant of the protection seller's characteristics to ensure that its litigation efforts are not made in vain.

Moreover, CDS necessarily expose protection buyers to the credit risk of the protection sellers. Commentators believe that an overwhelming number of protection sellers do not have anywhere close to the liquidity or capitalized pocket portfolio to cover the credit derivative transactions to which they are parties. The vulnerability of protection sellers to a "run on the bank" on even a small fraction of CDS within their portfolios may render litigation futile, such that the protection buyer is actually being exposed to more risk, not less, by the CDS.

The $64,000 question (or, perhaps, $50 trillion question) is what role, if any, CDS will play in the rapidly-evolving world of lender liability. It is almost certainly only a matter of time before the courts become inundated with plaintiffs pushing for the application of lender liability theories to credit derivatives. And the issues likely to be raised in such litigation will be novel, adding another layer of uncertainty to an already uncertain process.

At the end of the day, in any loan transaction where CDS are even potentially involved at any level of debt or equity, the lender has to reevaluate its playbook for such lending transactions, and would be well advised to consult experienced counsel in completing such reevaluation.

[1] Martin Hutchinson, "Credit Default Swaps: A $50 Trillion Problem."

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SOIL VAPOR ASSESSMENT, cont'd

contaminant concentrations may nevertheless generate soil vapor contamination at levels that represent a human health risk. No Further Action letters are typically highly contingent on multiple factors, such that the regulatory closure they provide can be revoked when previously unknown information identifies new environmental issues or health concerns. Therefore, the data generated by an evaluation of soil vapor intrusion issues could easily trigger such a change in a site's regulatory status.

There is evidence that this process is already beginning to occur, and on a large scale. For example, the State of New York recently announced that it would begin evaluating soil vapor intrusion pathways at all remediated sites for which regulatory closure was granted prior to January 2003. To date, New York has compiled a list of more than 431 such sites. In addition, the U.S. EPA recently used the five-year performance review provided under CERCLA to re-evaluate vapor intrusion pathways at sites where soil vapor issues had not been analyzed as part of the regulatory closure process, including the Middlefield-Ellis-Whitman site in Mountain View, California.

In California, legislators have also been pushing for such reviews. Assembly Bill 2092 (Hancock, 2006) sought to create a list of sites with known or potential vapor intrusion issues resulting from hazardous substance releases by January 1, 2008, and to post such information on the Cal-EPA website. This bill was vetoed, but is unlikely to be the last attempt of its kind.

Even if not legally required, however, there are several advantages to assessing soil vapor conditions at a site in accordance with ASTM E 2600-08. First, by being proactive, property owners have the opportunity to discover and either remediate or mitigate hazardous conditions so as to avoid toxic tort claims that could arise in the future. Further, as discussed above, property owners which discover and address soil vapor issues at their site may be able to prevent a "re-opener" of the case and have their No Further Action status

revoked. When a site is part of an ongoing investigation/remediation process, owners may also be able to realize costs savings by incorporating activities to address soil vapor intrusion issues into the process, as opposed to having to perform work at a later time when there may be reduced access to contaminant sources, ongoing business operations that make further investigation and remediation activities more difficult to perform, or a change in regulators. Just as important, proactive property owners and managers can prevent their property from becoming devalued or stigmatized as the result of unmitigated vapor intrusion issues.

In addition, potential buyers considering the purchase of a remediated site can obtain a much better idea of whether further investigation and remediation activities may be required in the future, and the extent to which potential mitigation measures (such as soil vapor barriers, which can prevent vapor intrusion into overlying buildings) may be beneficial and cost-effective. Lenders can use soil vapor assessment data to better understand the risks to their collateral, analyze potential negative impacts to the borrower's ability to repay the loan, evaluate complications that could occur in the event of foreclosure, and assess the risks to their reputations should a vapor intrusion claim arise. Also, property owners counting on leasing revenue can avoid liability to tenants and potential rent losses arising from tenants citing the presence of an unsafe working environment as justification for breaking their lease. In fact, with increasing frequency, sophisticated prospective tenants are conducting their own vapor tests to assess health risks prior to entering into leases.

By collecting information regarding soil vapor conditions early through the performance of soil vapor assessment under the ASTM E 2600-08 standard, parties can avail themselves of a larger set of options for addressing any detected issues. This can help avoid potential liability for health concerns associated with contaminated soil vapor, and also provide a higher level of security with regard to a property's regulatory status. Though it may take a little more work up front to achieve the desired No Further Action status, by identifying and addressing soil vapor issues at the very beginning, there likely will be far less chance for that status to be subject to change.

SHELF LIFE, cont'd

Developers should provide prospective purchasers detailed disclosures of past, present and future rental operations. In addition, the developer should provide detailed disclosures regarding the condition of the unit. Indeed, recently enacted DRE Regulations may require the developer to provide additional disclosures to prospective purchasers regarding the condition of the unit.

Conclusion

In today's market, leasing strategies may be an attractive option for a condominium project, but developers need to be careful to minimize the potential for claims and maximize future disposition strategies. With proper planning and counsel, a condominium developer can maximize the potential for a successful leasing program.

upcoming

Tamar Stein and Stanley Lamport will participate as speakers in Lorman's **"The Development Process in California"** on September 12th in San Diego.

Randy Orlik will participate as a speaker in the seminar **"Guide to Foreclosure - Part 1"** hosted by the Finance Subcommittee of the Real Property Section of the Los Angeles County Bar Association on September 17th in Los Angeles.

Anne Mudge will moderate the panel "The Environmental Impacts of Developing Renewable Energy: Goals, Benefits and Trade-offs" in the **CA State Bar Association's Environmental Law Conference** on October 16-19 in Yosemite.

LITIGATION UPDATE, cont'd

No inverse condemnation based on rights arising from contract.

In *County of Ventura v. Channel Islands Marina, Inc.* (Cal.App. 2 Dist. Jan. 30, 2008) 159 Cal.App.4th 615, time for grant or denial of review extended to 06/09/2008 (Apr. 29, 2008), a tenant constructed substantial improvements (boat slips and buildings) under a 40-year ground lease of land from the County of Ventura. As the end of the lease term approached, the tenant tried to negotiate an extension of its lease but was unsuccessful. The tenant then wanted to be paid the fair market value of its improvements, but the County refused to pay anything more than salvage value (even though the County ultimately leased the property, including the improvements, to a new ground tenant and thereby benefited from the improvements). The tenant sought to remove its improvements from the property and the County objected. When the tenant sued for breach of contract and inverse condemnation, the County argued that there were no damages since the tenant could not legally remove the improvements (even though the lease allowed such removal) since the Coastal Commission, among other various government agencies, would never allow removal at all, let alone removal in the 60-day timeframe originally contemplated by the lease. The tenant went to trial on an inverse condemnation theory and was awarded $3.5 million in damages plus attorneys' fees. The appeals court reversed this award in its entirety, finding that the tenant could not sue for inverse condemnation when its rights arise from a contract; the proper claim is for breach of contract, not inverse condemnation. Additionally, whether on a breach of contract or an inverse condemnation theory, the appeals court found that there were no damages caused by the County under these circumstances and that the tenant's damages were caused by the Coastal Commission regulations, which unfortunately left the tenant with "nothing substantial to sell."

Litigation privilege not applicable in client's suit against own expert witness.

An expert witness is hired in the course of litigation to provide his or her expert opinion and assist the trier of fact in understanding issues that require special knowledge and experience. If that expert negligently performs his or her job and the client is unsatisfied with the expert's testimony at trial, does the expert have any liability of his or her own? In *Lambert v. Carneghi* (Cal.App. 1 Dist. Jan. 11, 2008) 158 Cal.App.4th 1120, review denied (Apr. 23, 2008), the appeals court addressed this issue, including the expert's proffered defense that since the allegedly negligent act took place in the course of trial, the litigation privilege applies and bars any lawsuit for liability. The appeals court rejected the expert's defense and found that the litigation privilege does not apply when a client sues its own expert for negligence.

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