BUSINESS LAW NEWS

THE STATE BAR OF CALIFORNIA • ISSUE 1 2009

IN THIS ISSUE

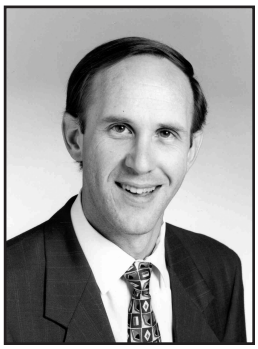
The State Bar of California
180 Howard Street
San Francisco, CA 94105
(415) 538-2341
www.calbar.ca.gov

A First Look at What May Be California's New Limited Liability Company Act

Donald M. Scotten and Phillip L. Jelsma

Donald M. Scotten

Donald Scotten specializes in business law and business entity governance. He is a Lecturer in Law at USC Law School where he teaches business organizations. He also serves on the State Bar's Partnerships and Limited Liability Companies Committee, and is a contributing editor to the Unincorporated Business Law Professor's Blog.



Phillip L. Jelsma

Phil Jelsma is a tax partner with Luce Forward Hamilton & Scripps LLP in San Diego. Having spent a long period of time on the Partnerships and LLCs Committee.

Introduction

Since California authorized the use of limited liability companies (LLCs) in 1994, these entities have been governed by the Beverly-Killea Limited Liability Company Act (the California LLC Act).[1] The California LLC Act, though, may soon be in for a major overhaul, or may even be entirely replaced. In a renewed effort to create uniform LLC laws, the National Conference of Commissioners on Uniform State Laws (NCCUSL) recently adopted, and recommended that each state enact, the Revised Uniform Limited Liability Company Act (RULLCA). RULLCA contains many rules consistent with the California LLC Act. It also introduces several major innovations to the law of LLCs that have no counterpart in the California LLC Act.[2] Shortly, California's legislature will consider enacting RULLCA in whole or in part. This article will introduce business law practitioners to RULLCA. Specifically, the article provides a brief overview of RULLCA's various noteworthy, and in some instances innovative, provisions.

NCCUSL, as its name suggests, seeks to promote uniformity in state laws.[3] The goal of uniformity is to reduce unnecessary legal complexities caused by major differences in state laws.[4] NCCUSL first tried to create uniform LLC laws with its adoption of the Uniform Limited Liability Company Act (ULLCA) in 1994.[5] California, like most states, drafted its own LLC statute and did not adopt ULLCA. In fact, only a handful of states adopted ULLCA.[6] As a result, state LLC statutes vary substantially in how they approach various substantive issues and in the language they employ.[7] With RULLCA, NCCUSL makes a second attempt to bring uniformity to LLC statutes, and it seeks to incorporate the best elements of the myriad "first generation LLC statutes enacted and amended over the past 25 years."[8]

RULLCA's most noteworthy, and sometimes innovative, provisions concern the following topics, which this article will address below:

- The operating agreement;
- Fiduciary duties;
- The power of a member or manager to bind the LLC;
- Forming and filing the LLC, including shelf LLCs;
- A remedy for oppressive conduct;
- Derivative claims and special litigation committees; and
- Series LLCs.[9]

Continued on Page 22

BUSINESS LAW NEWS

Editorial Board

James Menton, *Editor-in-Chief*
Alan Insul , *Vice-Chair & Managing Editor*
Robert Braun, *Associate Editor*
Robert Brayer, *Associate Editor*
Lena Chang, *Associate Editor*
Efrat Cogan, *Associate Editor*
Leslie Hakala, *Associate Editor*
Carrie Giovine, *Associate Editor*
David Saltzman, *Associate Editor*
John Yates, *Associate Editor*
Emily Yukich, *Associate Editor*
Stewart McDowell, *Liason*
Marc Olson, *Style Editor*

Editorial Advisory Board

Charles Crouch
Suzanne S. Graeser
Timothy G. Hoxie
Neil J. Wertlieb

Design and Coordination

Megan Lynch
Sublime Designs Media
(415) 225-1046
meganalynch@gmail.com
www.sublimedesignsmedia.com

Section Administrator

Susan Orloff
The State Bar of California
(415) 538-2341
susan.orloff@calbar.ca.gov

Executive Committee: Message from the Chair

Peter C. Bronson*

One of my goals as Chair of the Business Law Section of the State Bar of California is to make certain that our members are fully informed about the many benefits and opportunities offered by the Section.

One of those benefits is the annual State Bar Section Education Institute, which has just taken place in Berkeley. Your Section presented five timely continuing education programs at the SEI.

Another benefit, of course, is the publication you are now holding in your hands (or reading on your computer screen): The Business Law News. This issue continues a popular practice we began last year, of including an article in each issue that you can read not only for personal enjoyment and professional improvement, but also to obtain an hour of MCLE credit. The MCLE article in this issue, written by Neil Wertlieb and Nancy Avedissian, offers that elusive and coveted one-hour credit in legal ethics, which you can obtain by answering a series of true-or-false questions that follow the article.

You will also find articles in this issue on such hot topics as: launching and managing your business in China; standing requirements under the unfair competition law; risks and opportunities in bankrupcty sales; the revised Uniform Limited Liability Company Act; and a bankruptcy law "primer" for commercial landlords.

Continued on Page 27

Message from the Editor

James P. Menton*

This issue of Business Law News provides informative and timely articles on such varied topics as what may be California's new Limited Liability Company Act, California's unfair competition law and its evolving standing requirements, launching and managing business activities in China and other foreign markets, and bankruptcy. This issue also includes a fascinating article on ethical issues involving ex parte communications in a transactional practice for which you can receive one hour of MCLE Ethics credit by reading the article and then sending in your answers to 20 questions along with a nominal fee. Thanks to David Saltzman and Emily Yukich for their terrific work as co-editors of this issue.

If you have any suggestions on how Business Law News can be more useful to you, we encourage you to let us know. ■

* *James P. Menton, Jr. is a partner at Peitzman, Weg & Kempinsky LLP, in Los Angeles, California. He can be reached at (310) 712-0090 or jmenton@pwkllp.com.*

MCLE Article: *Ex Parte* Communications in a Transactional Practice

Neil J Wertlieb and Nancy T. Avedissian

This article is the second in a series by the authors and focuses on ethical issues of particular interest to transactional attorneys in California.

Neil J Wertlieb
Mr. Wertlieb is a partner at Milbank, Tweed, Hadley & McCloy LLP in Los Angeles. He is a member of the firm's Ethics Group. Additionally, Mr. Wertlieb is the former Chair of the Business Law Section of the State Bar of California, a former Co-Chair of the Corporations Committee of the Business Law Section, and an Adjunct Professor at UCLA Law School.

Nancy T. Avedissian
Ms. Avedissian is an associate at Milbank, Tweed, Hadley & McCloy LLP in Los Angeles. She is a member of the firm's Ethics Group.

You are sitting at your desk when your secretary announces that your most active client is on the phone. You take the call, looking forward to hearing about her next big M&A deal. After some pleasantries, the client announces that she also has on the line the counterparty with whom she is negotiating a term sheet. The client informs you that the counterparty is also represented by counsel, but your client explains that they are trying to hammer out some of the key business terms before they incur significant legal costs. The client then proceeds to ask for your input on how to best structure the deal.

Sounds familiar, right? But do you also hear the sound of alarm bells ringing? This all-too-common occurrence may result in a violation of the California Rules of Professional Conduct (CRPC)—specifically CRPC Rule 2-100, which prohibits communication by an attorney with a represented party without the consent of the party's attorney. The rule relating to such *ex parte* communications does not appear to be of obvious importance to many transactional attorneys. In fact, the term itself suggests that the rule is more relevant to our colleagues, the litigators, than to us deal lawyers. However, the rule prohibiting such communication does indeed apply to transactional attorneys, and violations of the rule can carry consequences including disqualification and discipline.

The rule aims to protect a represented party from possible overreaching by an attorney who may take advantage of the opportunity to gain a better deal for his or her client. It is not difficult to anticipate other potential mishaps, such as interference with the attorney-client relationship and inadvertent disclosure of confidential or privileged information. In the above example, however, many transactional attorneys would not hear alarm bells ringing, and even for those who do, they may feel that terminating the discussion to prevent a violation is awkward at best and may demonstrate a lack of cooperativeness to the client and other parties on a transaction.

There are few cases and interpretive opinions applying CRPC Rule 2-100 to transactional representations. One may conclude from this that there is little risk to the transactional attorney for violating the rule, but the fact remains that the rule still applies and, especially where a violation created an unfair advantage for one party, discipline or disqualification is a real possibility. This article discusses the prohibition on *ex parte* communications, paying particular attention to issues commonly faced by transactional attorneys.

The Basic Rule

The rules regulating attorney conduct in the State of California are set forth in the CRPC, which were promulgated by the California State Bar, were approved by the California Supreme Court, and are binding on all members of the California State Bar.[1] The CRPC are disciplinary rules, not statutory laws, but courts use the CRPC to determine whether attorneys or law firms should be disqualified from a particular representation.

An attorney's obligations with respect to *ex parte* communications are governed by paragraph (A) of Rule 2-100 of the CRPC:

> While representing a client, a member [of the State Bar of California] shall not *communicate directly or indirectly* about the *subject of the representation* with a *party* the member *knows to be represented* by another lawyer *in the matter*, unless the member has the *consent of the other lawyer*.[2]

CRPC Rule 2-100 is not limited to the litigation context, and the rule expressly applies to transactional matters as well.[3] However, terminating the telephone call in the example above or ceasing a friendly conversation with someone seated across a conference table simply because the person's attorney steps out for a bathroom break may not be second nature to most transactional attorneys. Therefore,

it is important to note that the rule applies not just to communications "which are intentionally improper, but, in addition, [communications] which are well intentioned but misguided."[4]

What Types of Communications Are Covered?

Generally, any form of communication is covered by CRPC Rule 2-100. The most common forms of communication include in-person meetings, traditional or electronic correspondence, and telephonic communication. For most transactional attorneys, the telephone call described above presents a real-life scenario. For purposes of CRPC Rule 2-100, it is not relevant that the client initiated the call or that the advice given is impartial—the attorney's participation in the discussion is a violation of the rule. Similarly, when an attorney dials into a conference call and it becomes evident that some parties are participating with their counsel while others are not, the ethical attorney should either drop off the line or request that all represented parties get their counsel on the line. While parties are assembling and engaging in small talk, it may also be advisable to email or call opposing counsel to either invite them to the call or obtain their consent to the *ex parte* communication.

The foregoing hypothetical conference call raises an interesting question: is it a permissible alternative for the attorney to stay on the call and just listen without speaking? Would that constitute prohibited communication? There is no clear answer to these questions. Although the attorney's conduct might not technically qualify as "communication with a party," it does put the attorney in the position of possibly obtaining confidential information from the represented party or otherwise gaining an unfair advantage.

Another awkward situation involves discussions between an attorney and a party where the party is a client of the attorney in one matter, but separate counsel represents the party with respect to the matter that is the subject of the discussion. Of course, both parties to that matter would need to consent to the conflict of interest,[5] but even with such consent, the attorney must additionally secure the consent of the separate counsel in order to discuss that matter with the party. Without such consent, any such discussion (even though the party is a client) would be a communication prohibited by CRPC Rule 2-100.

"Would everyone check to see they have an attorney? I seem to have ended up with two."

Reprinted with permission of The New Yorker.

"Directly or Indirectly"

CRPC Rule 2-100 expressly extends to both direct and indirect communications. Clearly, the use by an attorney of an intermediary or agent to communicate with a represented party could be a prohibited form of indirect communication. Interestingly, the prohibition might even extend to the use of the client as an intermediary of the attorney. In such a situation, there is a tension between improper indirect communications with a represented party, on the one hand, and encouraging principal-to-principal communications on the other hand. In most business transactions, having the principals get together to discuss and agree upon material business terms is necessary, beneficial, and cost effective. However, if the content of a communication between principals originates with or is directed by the attorney (who either scripts the principal's questions or conveys his or her own thoughts or positions through the principal), then the communication may be improper.[6] The attorney may confer with and advise a client with respect to a principal-to-principal communication, but the attorney may not direct the conversation. There is no bright line test, but generally reviewing, commenting on, or proofing letters and emails at the request of a client is probably acceptable, but ghostwriting them may not be.

The prohibition on indirect communication may also extend to providing a represented party with copies of correspondence sent to the party's attorney.[7] For example, separately sending a represented party copies of correspondence you sent to his or her counsel (e.g., to incite the party to "light-a-fire" under counsel) would be an example of behavior in violation of the rule. Likewise, sending a represented party a "courtesy copy" of email correspondence without consent may also be prohibited.

"Subject of the Representation"

There is little guidance regarding this specific element of CRPC Rule 2-100, probably because its meaning should be self-evident. A literal reading provides that only communications about the subject of a particular representation between an attorney and a represented person (individual or entity) are prohibited. Clearly, an attorney and a represented party can discuss the weather, the economy, or anything else unrelated to the representation. The

Continued on Page 28

BLN MCLE Test No. 5
Ex Parte Communications in a Transactional Practice

1. True or False: CRPC Rule 2-100 applies to both transactional attorneys and litigators.

2. True or False: Oral consent of opposing counsel is not sufficient under CRPC Rule 2-100 to permit an attorney to communicate directly with a represented party about the subject of the representation; such consent must be in writing.

3. True or False: Email communications are not covered by CRPC Rule 2-100.

4. True or False: Ghostwriting letters or emails for use by a client may be prohibited under CRPC Rule 2-100.

5. True or False: An attorney and a represented party (not his or her client) cannot communicate at all, whether or not related to a representation, without the consent of the party's attorney.

6. True or False: When the represented party is an entity, communications with a current employee may be prohibited, especially if the subject matter involves acts or omissions by that person which may be binding on the entity in connection with the matter in dispute.

7. True or False: Even if an attorney has no reason to know a party is represented, CRPC Rule 2-100 mandates that the attorney inquire whether or not the party is represented before communicating with such party.

8. True or False: Knowing a party will likely retain counsel for a particular matter does not prohibit communication under CRPC Rule 2-100.

9. True or False: If a party was represented by counsel in the past, an attorney must assume the same counsel will represent the party in a new matter unless there is reason to know otherwise.

10. True or False: CRPC Rule 2-100 does not prohibit an attorney from communicating with a former officer of a corporate party with respect to a current representation.

11. True or False: Consent to an *ex parte* communication must be obtained from the represented party's lawyer, not the party.

12. True or False: Communications with a public officer who is a represented party are permissible without the consent of counsel.

13. True or False: CRPC Rule 2-100 bars a represented party from seeking advice from an independent lawyer.

14. True or False: Certain statutes may override CRPC Rule 2-100.

15. True or False: A common penalty for violation of CRPC 2-100 in transactional matters is a three-month suspension of an attorney's license to practice law.

16. True or False: The California Rules of Professional Conduct (or CRPC) are statutory laws enacted by the California legislature and binding on all attorneys in the state.

17. True or False: Absent consent from counsel, CRPC 2-100 prohibits an attorney from communicating with a member of the board of directors of a represented party.

18. True or False: CRPC Rule 2-100 expressly provides that implied consent from the counsel of a represented party is sufficient to comply with the rule.

19. True or False: A party to a transaction who happens to be an attorney does not violate CRPC Rule 2-100 by communicating with a represented party on the other side of the transaction without the consent of the party's counsel.

20. True or False: If an entity party to a transaction has an in-house general counsel, it is prudent for an attorney representing a counter-party to assume the entity is represented by counsel in the transaction.

MCLE Test Instructions -- Test No. 5

After reading the MCLE credit article, complete the following test to receive 1.00 hour of MCLE Ethics self-study credit.

- Answer the test questions on the form below. Each question has only one answer.
- Make a $20 check payable to The State Bar of California.
- Correct answers and justifications will be mailed to you within eight weeks.

After you finish the test, mail the original completed Answer Sheet and the $20 check to:

Business Law Section
State Bar of California
180 Howard Street
San Francisco, CA 94105

Certification: The State Bar of California certifies that this activity conforms to the standards for approved education activities prescribed by the rules and regulations of the State Bar of California governing minimum continuing legal education. This activity has been approved for the minimum continuing education credit by the State Bar of California in the amount of 1.00 hour, which will apply to Ethics Credit.

ANSWER SHEET TO BLN MCLE TEST NO. 4

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

Name: _____ State Bar Number: _____

Law Firm/Organization: _____

Address: _____

City: _____ State_____ Zip:_____

Email: _____

The Unfair Competition Law And Its Evolving Standing Requirements

Efrat M. Cogan

Efrat M. Cogan

Efrat M. Cogan is Senior Counsel at Buchalter Nemer. She is a certified specialist in appellate law. She is part of the litigation and appellate group of Buchalter Nemer and focuses on complex commercial litigation, unfair competition, governmental litigation, as well as post trial and appellate work.

I. Introduction

When California voters enacted Proposition 64, amending California's unfair competition law, they imposed new standing requirements for claims brought under that law. What seemed like a relatively straightforward amendment has spawned scores of cases addressing the nature, scope, and reach of Proposition 64's standing requirement. One thing is clear: parties suing for unfair competition must be able to show individualized injury and compensable loss. What remains unclear? How Proposition 64 will affect representative class suits, and what, if any, standing has to be shown for unnamed class members for class actions to be certified in unfair competition cases.

II. California's Unfair Competition Law and the 2004 Amendments

California's unfair competition law (UCL) commences with Business & Professions Code section 17200 and was intended to provide public officials and individuals a statutory basis upon which to challenge business practices that were unlawful, unfair, or deceptive.[1] The reach of the statute was broad,[2] but the remedies available (injunction and restitution) were narrow.[3]

The UCL defines unlawful acts as those that violate a statute or regulation. Under section 17200, a party may sue for acts that constitute a violation of law even if the statute or law violated does not itself provide a private right of action. There is one limitation: if the law otherwise provides a "safe harbor" or exemption from liability for certain conduct, a complaining party may not use the unfair competition laws to sue and avoid the safe harbor. [4]

The unfairness prong of the UCL historically had been used to attack any business practice that seemed unfair or improper, even if it was not a technical violation of a statute or regulation. Recognizing that so amorphous a standard created a danger that the courts would impose their own sense of fairness into the equation,[5] the Supreme Court in *Cel-Tech Communications, Inc. v. Los Angeles Cellular Telephone Co.* articulated a more objective standard. "When a plaintiff who claims to have suffered injury from a direct competitor's 'unfair' act or practice invokes section 17200, the word 'unfair' . . . means conduct that threatens an incipient violation of an antitrust law, or violates the policy or spirit of one of those laws because its effects are comparable to or the same as a violation of the law, or otherwise significantly threatens or harms competition."[6] The deceptiveness prong of the statute is intended to reach conduct that is misleading, and the courts have historically stated that it does not require that a party prove fraud.[7]

Use of the statute came under criticism over the years as some law firms and clients sued even though the suing plaintiffs themselves had suffered no injuries. These plaintiffs sued as private attorney generals, and critics alleged that their goal was more to extort a settlement that included an attorneys' fees award than it was to resolve real issues.[8]

In 2004, in part to address these abuses, the voters enacted Proposition 64. The reasons given were salutary and aimed to:

- Protect California businesses from "[f]rivolous unfair competition lawsuits [that] clog our courts[,] cost taxpayers" and "threaten[] the survival of small businesses"[9] by substantially narrowing standing under the unfair competition laws;
- Prevent misuse by some private attorneys who file frivolous lawsuits as a means of generating attorneys' fees without creating a corresponding public benefit;
- Prevent misuse by private attorneys who file lawsuits where no client has been injured in fact;
- Prevent misuse of the UCL through the filing of lawsuits by plaintiffs who have not used the defendant's product or service, viewed the defendant's advertising, or had any other business dealing with the defendant; and
- Prevent misuse of the UCL by the filing of actions on behalf of the general public without any accountability to the public and without adequate court supervision. [10]

Unharmed individuals could no longer file suit in the hopes of leveraging a settlement. Parties suing had to demonstrate "injury in fact" and "economic loss."[11] No longer could individuals use the statute to bring a "private attorney general" action on behalf of others.

A suing individual or entity had to meet the requirements for all class actions.

While the unfair competition law requires that plaintiffs show injury in fact and economic loss in order to establish standing, the courts continue to grapple with how to apply these concepts. The result has been a focus on the facts of each case and on the type of claim (unlawful, unfair, or deceptive) being made.

Further, while the statute requires that a representative suit meet the requirements for class actions, the courts have grappled with whether or not this requires that all class members fulfill the standing requirements of the statutory amendments. As discussed below, the appellate courts have reached differing results, and the California Supreme Court has taken a number of these cases up on review but has yet to decide the issue.

III. Standing in the Post-Proposition 64 World

A. Generally

Before Proposition 64, and in the context of other statutes requiring "injury in fact," the California Supreme Court adopted the federal definition for "injury in fact." The courts explained the concept as follows: injury in fact requires a showing or allegation that a party has suffered "an invasion of a legally protected interest that is '(a) concrete and particularized; and (b) actual or imminent, not conjectural or hypothetical.'"[12] The legal definition of "injury in fact" aside, most lay people understand the "standing" requirements of the unfair competition law as requiring a complaint about *a service used, a product purchased, or a practice adopted* that *causes* the consumer harm.

Schulz v. Neovi Data Corp.[13] provides an easy-to-understand illustration of this requirement. Schultz, an Internet consumer, sued four Internet payment processors (Neovi Data Corporation, Ginix, Inc., PaySystems, Inc., and PayPal, Inc.) under section 17200 alleging that each abetted the operation of an illegal Internet lottery. Shultz had decided to participate in an Internet lottery that allegedly gave participants the opportunity to receive expensive Internet products at a fraction of their regular price. In order to qualify, Internet consumers (like Schulz) had to pay a fee in exchange for which they received "worthless" e-books to enter the website's matrix. Only after a sufficient number of additional consumers paid in did the subscribing consumer receive a prize. After entering the lottery and paying in, Schultz decided that the scheme was an illegal Ponzi scheme. He asked for a refund and was refused. He then sued the four payment processors who took customer payments for the lottery, alleging that these processors knew the lottery was illegal but nonetheless facilitated its operations by providing credit card processing for the e-books.

Schultz admitted during oral argument that he had used only the services of one of the processors—Ginix—and not the others. Thus, as a threshold matter, the court determined that Schultz had no standing to sue any of the other processors.[14] In other words, he could only sue the processing company he used and alleged was involved in wrongfully taking his money.

B. Standing as Inclusive of an Element of Reliance/Causation

While *Schultz* did not speak of standing in terms of reliance or causation, an increasing number of post-Proposition 64 cases recognize that parties must show reliance and/or causation.

Laster v. T-Mobile United States, Inc., 407 F.Supp.2d 1181 (S.D. Cal. 2005), demonstrates this principle. In *Laster*, plaintiffs (cell phone purchasers) filed a class action unfair competition claim alleging that defendants falsely advertised and sold phones (in bundled phone/service packages) as "free" or substantially discounted when, in fact, purchasers were required to pay the sales tax on the full retail value of the phones. The *Laster* plaintiffs alleged that they had purchased cell phone and service packages and had paid the full sales tax on an allegedly "free" phone.

The *Laster* plaintiffs could not pursue their claims as pled because they had not alleged that they ever saw or relied on any advertisement or representation in purchasing the phones and services. Thus, the allegedly misleading statements did not cause them to suffer injury as they were not aware of the advertisements or representations when they made their purchase decision. [15]

C. Injury In Fact May Not Be "Manufactured"

While the 2004 amendments to the unfair competition law were intended to prevent uninjured plaintiffs from bringing suit, enterprising plaintiffs have attempted various ways of getting around this impediment. Some courts have signaled that they will not allow this.

For example, in *Buckland v. Threshold Enterprises, Ltd.*, 155 Cal.App.4th 798, 814 (2007), Buckland sued a skin cream manufacturer contending that the skin cream contained chemicals and hormones that violated FDA standards. She sued on her own behalf and on behalf of other purchasers of the product. Buckland, however, admitted that she only purchased the skin cream to expend money so as to create standing to sue, not to use it.

Her claims were dismissed. The court explained that a plaintiff may not "manufacture the injury necessary to maintain a suit" by buying a product simply to pursue litigation. "Were the rule otherwise, any litigant could create injury in fact by bringing a

Continued on Page 31

Bankruptcy Sales: A Recent Decision Illustrates Some Risks and Opportunities

Clear Channel Outdoor, Inc. v. *Knupfer* (*In re PW, LLC*), 391 B.R. 25 (B.A.P. 9th Cir. 2008)

Neil Bason

Neil Bason

Neil Bason is special counsel with the Bankruptcy & Reorganization Group of Howard Rice Nemerovski Canady Falk & Rabkin, P.C. in San Francisco. He represents creditors, debtors, committees, trustees, and third parties involved in bankruptcy cases.

There are numerous advantages to purchasing and selling assets out of a bankruptcy estate. One advantage is the power to sell assets free and clear of liens and other interests under section 363 of the Bankruptcy Code.[1] To use a simple example, a bankrupt retail store may be able to sell its inventory and all other assets free and clear of suppliers' and lenders' liens and other interests, and such sales are often combined with other bankruptcy powers such as the ability to assign executory contracts and unexpired leases to the buyer.[2] Unlike foreclosure sales, this bankruptcy sale process preserves the going concern value of the business. That benefits both the buyer and creditors of the bankruptcy estate. Liens and other interests usually attach to the proceeds of sale. This protects the holders of those interests without having to delay the sale to resolve disputes as to priority and amount of liens or other issues.

These advantages come at a price. Bankruptcy is often time-consuming and expensive, and the law is still evolving on some of the issues encountered, including sales free and clear of liens. This can create a mix of delay and added risk but also opportunities for those willing to assess the risks and proceed accordingly. The present uncertainty in the law is illustrated by a recent decision of the Bankruptcy Appellate Panel for the Ninth Circuit (the "BAP"), *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25 (B.A.P. 9th Cir. 2008).

In *Clear Channel*, the property being sold was a real estate development encumbered by a senior lien of more than $40 million and a junior lien of roughly $2 million. The junior lien was "out-of-the-money." The highest cash bid for the property was roughly $25 million, far short of the senior lien amount, and the winning bid was ultimately the senior lienholder's credit bid. In addition, the BAP noted that the senior lienholder likely would have been granted relief from the automatic stay had it not reached an agreement with the chapter 11 trustee.[3] In other words, the senior lienholder could have foreclosed on the property, rather than purchasing it out of the bankruptcy estate, and the junior lien would have been discharged by operation of state law. Instead, the senior lienholder agreed to pay the estate a "carve-out" of up to $800,000 and to credit bid the entire amount of its debt, meaning that it would have no deficiency unsecured claim and therefore would not share in any distribution to general unsecured creditors. The bankruptcy court approved the sale under section 363 free and clear of the junior lien.

The BAP reversed in part and dismissed the appeal in part as moot. The BAP's decision is controversial in two respects. First, *Clear Channel* has been read to require a plan confirmation process rather than a motion under section 363 to sell most property free and clear. But, it is impossible to have a plan of reorganization in a chapter 7 liquidation case, and it may be impractical in a chapter 11 case to spend the time seeking confirmation of a plan if the assets are declining rapidly in value.

Second, in dismissing only part of the appeal as moot, the BAP held that while the transfer of *title* could not be challenged, the *free and clear* aspect of the bankruptcy court's order could be reversed and the $2 million junior lien could reattach to the property. In other words, the senior lienholder in *Clear Channel* arguably was left with the worst of both worlds: the transfer of title could not be unwound, but the property that the senior lienholder had just irrevocably acquired would be subject to the $2 million junior lien that would have been discharged if the senior lienholder had foreclosed its senior lien under state law.

While *Clear Channel* involved a credit bid, the BAP's reasoning (discussed below) might apply to any bidder. Anecdotal evidence suggests that in the wake of *Clear Channel*, title insurers nationwide may be reluctant or unwilling to issue policies on property purchased from bankruptcy estates until all appeals have been finally resolved. In other words, the uncertainty regarding sales under section 363 is a nationwide issue, and it affects nearly every type of party in interest: secured creditors, unsecured creditors, and purchasers of assets out of bankruptcy.

The parties in *Clear Channel* ultimately reached a confidential settlement, so the Court of Appeals did not have the opportunity to address the issues raised in the case. The rest of this article provides some background regarding bankruptcy law, explores the implica-

tions of *Clear Channel*, and then suggests some techniques to help maximize the benefits and reduce the risks of purchasing or selling assets free and clear under the Bankruptcy Code.

Junior Liens and Bankruptcy Sales Free and Clear

When a claim is supported by collateral but the value of the collateral is less than the amount of the claim, the claim is said to be "under water." The Bankruptcy Code bifurcates such claims into a secured claim to the extent of the value of the collateral and an unsecured claim with respect to the balance,[4] but a separate proceeding is required to "strip down" the lien (to use the BAP's terminology).[5] Similarly, an out-of-the-money junior lienholder like the one in *Clear Channel* would mostly be treated as the holder of an unsecured claim, but that does not mean that its lien is automatically "stripped off" or that any sale can simply ignore the junior lien.

Sales, free and clear or otherwise, are covered by section 363 of the Bankruptcy Code. Section 363(c) generally authorizes the "trustee" (which may include a chapter 11 debtor-in-possession acting as trustee[6]) to sell property in the ordinary course of business without court authorization. Alternatively, section 363(b) provides that the trustee can sell property "other than in the ordinary course of business" after notice and a hearing. In either event, section 363(f) provides that the sale can be made free and clear in some circumstances, including under the following provisions interpreted in *Clear Channel*:

> The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if—
>
> * * *
>
> (3) Such interest is a lien and the price at which such property is to be sold is *greater than the aggregate value of all liens on such property*; [or]
>
> * * *
>
> (5) Such entity could be compelled, in *a legal or equitable proceeding*, to accept a *money satisfaction* of such interest.[7]

Paragraph (3) above uses the term "value," which the BAP observed is "nonstandard" terminology. Bankruptcy courts have disagreed whether the "value" of a lien is its entire face amount or only the secured portion of the lien.[8] The dispute may be academic because it has been held that even if liens are stripped down to their secured portion, their aggregate amount would be exactly equal to the property's value, so the sale price could never be "greater than" the aggregate value of all liens as required by section 363(f)(3).[9] The BAP adopted this latter interpretation, which may now be the prevailing view, and held that section 363(f)(3) cannot be used to sell assets free and clear of liens that are under water, even if the liens are entirely out-of-the-money. In this view, section 363(f)(3) can be used only when the bankruptcy estate has equity in the property.

Section 363(f)(5), quoted above, presents what the BAP called a conundrum: how should section 363(f)(5) be interpreted by a bankruptcy court so as not to be either "all powerful" or "so specialized as never to be invoked?"[10] There is some authority that any claim payable in money damages (as opposed to requiring specific performance) is subject to section 363(f)(5).[11] But does this render section 363(f)(3) superfluous? If all liens are subject to section 363(f)(5) regardless of whether the proposed sale price is greater or less than the aggregate amount of all liens on the property, then why did Congress enact section 363(f)(3)?

At least one court has resolved this tension by interpreting section 363(f)(5) not to apply to liens at all.[12] Another approach is to hold that if section 363(f)(3) applies only to oversecured liens, then perhaps implicitly section 363(f)(5) applies only to undersecured liens.[13]

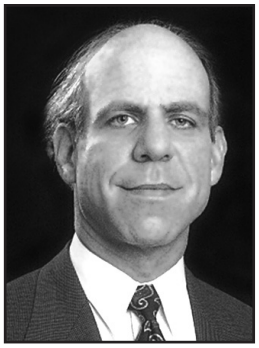
Alternatively, the difference between sections 363(f)(3) and (f)(5) may be the type of proof required of the movant. Section 363(f)(3) may be intended to provide an easy path to a sale free and clear when the circumstances allow (i.e., when the bankruptcy estate has equity in the property above the aggregate amount of all liens). Section 363(f)(5) would present a more difficult path, but one that applies to all liens regardless of whether the property at issue is over-encumbered or not, and to non-lien interests. The movant would have to prove that some "legal or equitable proceeding" could *actually* be used to compel a money satisfaction—*e.g.*, a foreclosure by a senior lienholder (if it were granted relief from the automatic stay) or a non-consensual plan of reorganization that would actually be confirmable under section 1129(b) ("cramdown")[14]. The existence of these alternatives would show that a sale under section 363(f) would not unduly prejudice the objecting lienholder if the sale were made free and clear of its lien. Consistent with this approach, some courts recognize cramdown as a qualifying "legal or equitable proceeding."[15]

Clear Channel does not adopt any of these alternatives, and it specifically rejects cramdown as a qualifying "legal or equitable proceeding." The cramdown provisions themselves include a separate basis for sales free and clear that does not appear to incor-

Continued on Page 35

Lessor Update: What Commercial Landlords Should Understand About Bankruptcy

Jeffrey L. Schaffer and Gary M. Kaplan



Jeffrey L. Schaffer

Mr. Schaffer is a director and shareholder of Howard Rice Nemerovski Canady Falk & Rabkin, a Professional Corporation. He specializes in commercial finance, representing institutional lenders and corporate borrowers in a wide range of financing transactions, including acquisition financing, conventional revolving and term loan credit facilities, public and private senior and subordinated debt issuances and debtor-in-possession financing. His practice also encompasses both out-of-court and Chapter 11 restructurings. He has lectured and authored materials on a variety of commercial law and bankruptcy topics.

Gary M. Kaplan

Gary M. Kaplan is a shareholder in the San Francisco law firm of Howard Rice Nemerovski Canady Falk & Rabkin, concentrating on bankruptcy, creditors' rights, and commercial law.

I. Introduction

Lease agreements are subject to special treatment in bankruptcy cases that is often contrary to the terms of the lease itself or relevant non-bankruptcy law. Thus, a tenant's filing of a bankruptcy case presents a myriad of issues for a commercial landlord. This article discusses several of the most important matters affecting a landlord in the bankruptcy case of its tenant, including the tenant's assumption, rejection, or assignment of the relevant lease; lease obligations pending assumption, rejection, or assignment; deadlines for assuming, rejecting, or assigning a lease; and the treatment of claims arising from the assumption, rejection, or assignment of a lease. This article focuses on bankruptcy law provisions unique to nonresidential real property leases, which are of the greatest interest to most commercial landlords.

Sections 365 and 502 of the Bankruptcy Code[1] are the primary statutes governing the treatment of leases in bankruptcy. Section 365 provides for the assumption, rejection, and assignment of unexpired leases. Assumption is akin to ratification of a lease by the bankruptcy estate and is typically desired by the lessor. This is because the debtor or trustee must cure all arrearages as a condition of assumption, and any post-assumption breach of the lease will give rise to an administrative claim for damages against the estate (generally the highest-priority claim other than a secured claim). Rejection, on the other hand, is effectively an anticipatory repudiation of a lease by the bankruptcy estate, and the principal consequence of a rejection is to relegate the lessor to a general unsecured claim for damages against the estate (not very desirable in many bankruptcy cases, inasmuch as general unsecured claims often receive little if any distribution), which, to add insult to injury, is then subject to a strict limitation in the form of a "cap" under Bankruptcy Code section 502 (discussed more specifically below). Section 365 deals with a tenant's obligations under a nonresidential real property lease pending assumption, rejection, or assignment, and it also contains specific provisions for "shopping center" leases. Section 502 deals with the treatment of claims arising from the breach of a lease, including limitations on claims arising from the rejection of a lease.

II. Debtor's Lease Obligations Pending Assumption or Rejection of a Nonresidential Real Property Lease

Bankruptcy Code section 365(d)(3) requires a debtor-tenant to continue performing its post-petition (*i.e.*, post-bankruptcy) obligations under a nonresidential real property lease until the lease is assumed, rejected, or assigned pursuant to section 365. Such obligations, if unpaid, give rise to an administrative expense claim (which is entitled to payment priority over virtually all other unsecured claims), generally in the amount of the obligation as provided in the lease, regardless of the actual value of the lease to the bankruptcy estate.[2]

There is a split in authority regarding whether a debtor is obligated to pay all amounts arising from its post-petition lease obligations under section 365(d)(3) where there may be insufficient funds to satisfy other administrative expense claims. The conflict centers around whether such claims should effectively receive a "super-priority" such that they are fully paid even if doing so will prevent other administrative expense claims from being paid. The cases can generally be divided into three groups. The plurality, if not the majority, of cases hold that obligations under section 365(d)(3) effectively do not give rise to a "super-priority" administrative claim and should not be paid until it is determined that there are sufficient funds in the bankruptcy estate to fully pay all administrative claims.[3] By contrast, a substantial minority of courts have ruled that obligations arising under section 365(d)(3) give rise to a "super-priority" administrative claim that must be timely paid regardless of the bankruptcy estate's ability to pay other administrative claims.[4] Finally, a substantial number of cases

effectively take an approach midway between those two lines of cases, holding that the bankruptcy estate should pay all obligations under section 365(d)(3) subject to later partial disgorgement if it turns out that there are insufficient funds in the bankruptcy estate to pay all administrative claims in full (so that all allowed administrative claims end up receiving the same pro rata distribution).[5]

Section 365(d)(3) and interpretive case law establish the scope of a debtor's post-petition lease obligations. Most courts have ruled that section 365(d)(3) encompasses post-petition obligations for taxes, insurance, common area maintenance, utilities, repairs, hazardous materials clean-up costs, late charges, interest, and other monetary obligations.[6] However, at least a few courts have held that a debtor's post-petition failure to comply with maintenance responsibilities and obligations to restore the premises to their pre-lease condition gives rise to an unsecured claim deemed to arise pre-petition, rather than to a post-petition administrative claim, because such obligations do not accrue until the lease is rejected.[7] Further, there is a split in the case law regarding whether section 365(d)(3) requires a debtor to pay the attorneys' fees incurred post-petition by a landlord seeking to enforce the debtor's lease obligations, with a majority permitting such recovery to the extent allowed under the lease.[8]

Certain types of post-petition lease obligations specified in section 365(b)(2) are expressly excluded from the debtor's performance duties under section 365(d)(3). These include penalty rates or provisions arising from the debtor's failure to perform non-monetary obligations, as well as so called "*ipso facto*" provisions that impose obligations or penalties based on the commencement of a bankruptcy case by or against the debtor, the financial condition of the debtor, or the appointment of a trustee in a bankruptcy case (or a custodian prior to the commencement of a bankruptcy case).

There is a split in the case law regarding the extent of a debtor's obligations under section 365(d)(3) where a portion of an obligation falling due post-petition accrued during the pre-petition period. Most courts hold that where obligations falling due post-petition include amounts accruing pre-petition, the debtor must pay a pro-rated amount under section 365(d)(3) based on the proportion that the post-petition period bears to the entire period to which the payment relates.[9] Similarly, several courts have required pro-rated payment under section 365(d)(3) of lease obligations attributable to the post-petition period even where the payment fell due (and was not made) pre-petition.[10]

By contrast, a substantial minority of courts have ruled that obligations falling due post-petition that include amounts accruing pre-petition must be fully paid under section 365(d)(3) without pro-ration.[11] Likewise, some courts have ruled that a debtor need not pay any portion of rent falling due pre-petition even if it relates to post-petition occupancy.[12]

III. Deadlines to Assume or Reject a Nonresidential Real Property Lease

Pursuant to Bankruptcy Code section 365(d)(4), a debtor's lease of nonresidential real property is deemed rejected if it is not assumed or rejected by the earlier of (i) 120 days following the debtor's bankruptcy petition; and (ii) the date of entry of an order confirming a reorganization plan, in either case unless the court extends the time for assumption or rejection before such period expires. The statute authorizes the bankruptcy court to extend the 120-day period if cause is shown for up to an additional 90 days, but it conditions any further extensions on the lessor's consent.

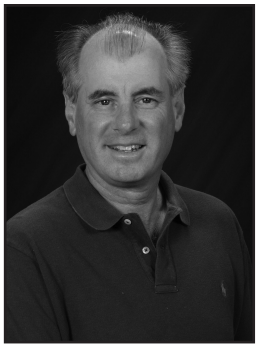
Although the Bankruptcy Code does not provide a standard for determining whether there is "cause" for granting an extension of the time to assume or reject a lease, courts typically consider a number of factors in determining whether to grant an extension, including the following:

1. Whether the lease(s) is/are the primary asset(s) of the debtor;
2. Whether the lessor continues to receive rental payments;
3. Whether the case is exceptionally complex and involves a large number of leases;
4. Whether the decision to assume or reject the lease(s) would be central to any plan of reorganization;
5. Whether there is a reasonable possibility that the debtor will submit a plan capable of being confirmed;
6. Whether the debtor has had the time necessary to appraise its financial situation and the potential value of its assets in terms of the formulation of a plan;
7. Whether the lessor will be subject to damages beyond compensation available under the Bankruptcy Code due to the debtor's continued occupation;
8. Whether the lessor has a reversionary interest in the building built by the debtor on the lessor's land;
9. Whether the property remains vacant, thereby affecting neighboring tenants; and
10. The existence of any other facts bearing on whether the debtor has had a reasonable amount of time to decide whether to assume or reject the lease(s).[13]

Continued on Page 39

Launching and Managing Your Business in China—Issues to Consider Regarding Regulation of the Employment Relationship

Alan S. Gutterman and Tiffany Lau



Alan S. Gutterman

Alan Gutterman is a partner at the San Francisco and Silicon Valley offices of The General Counsel, a provider of interim in-house general counsel and attorney recruitment services. He is also a former member of the Executive Committee of the Business Law Section of the State Bar of California.

Tiffany Lau

Tiffany Lau is currently attending Wellesley College and is obtaining her B.A. in International Relations with an emphasis in Economics. While attending Wellesley College, she also studied at the University of International Business and Economics in Beijing and worked as a legal research assistant in both China and in the United States.

Companies often outsource to China with the intent of creating a sister firm outside of the U.S. whose sole responsibility is to support production and business in the U.S. and Canada. Such companies hope to generate a more economical method of maintaining business in North America by taking advantage of China's large and less costly labor force. However, often they soon begin to realize the difficulties of monitoring and recruiting a consistent workforce in China.

Because of China's recent history of turmoil and instability, many employees in China place great priority on earning high wages, with a focus on short-term, rather than long-term, outcomes. Loyalty to their employer is of less importance as such employees frequently decide to change jobs within similar fields, often for a raise of no more than 100 Yuan, or the equivalent of approximately $12.00 per year. Accordingly, data security is a significant and recurring issue for Chinese employers, and basic employment contracts and policy handbooks may not be enough protection.

As foreign employers in China, companies can better understand how to do business in China by understanding the basics of Chinese law. This article offers a general introduction to legal issues that should be considered before entering any new foreign market, discusses with greater specificity China's labor and employment laws, and provides practice tips for applying those laws to foreign businessses operating in China.

Legal Issues To Consider Before Entering Any New Foreign Market

The managers and attorneys of firms that are establishing cross-border business operations must expand their understanding and expertise to include "international law," or the extensive set of United States federal laws and regulations pertaining to all aspects of international trade and commerce, including exports, imports, immigration, antitrust, inbound foreign investment, anti-corruption, embargoes, and unfair trade practice by foreign countries and firms that injure U.S. industries. Companies will soon find that they are subject to regulation by a number of different agencies, sometimes with overlapping jurisdictions, and that the costs associated with compliance can quickly become material and must be factored into the level of investment necessary for the company to launch and maintain cross-border operations.

Before investing significant time and resources into launching new business activities in a foreign country, companies should consider the impact of the following U.S. laws:

- Export Controls. Under the Export Administration Act of 1979,[1] the Department of Commerce is responsible for implementing and enforcing controls on the transfer outside of the country of tangible goods, technology, and other related services. Exporters must collect and evaluate information regarding foreign customers, comply with all applicable licensing requirements, and obtain certifications from customers regarding their intended uses of controlled goods. In addition, other types of export controls are administered by other federal agencies including the Departments of State, Treasury and Energy.
- Anti-Bribery Laws. Compliance with the Foreign Corrupt Practices Act (FCPA)[2] is a matter of concern in any foreign sales representative agreement, particularly in situations where local customs may be different from those in the U.S. Among other things, the FCPA, which is enforced by the Department of Justice with support from the Securities and Exchange Commission, makes it illegal for a U.S. exporter to "corruptly" pay or offer to pay a foreign public official for assistance in obtaining or retaining business or from paying a representative if the exporter knows that a portion of the payment will go to a public official for the same reason.
- Import Laws. U.S. Customs and Border Protection, which is part of the Department of Homeland Security, is responsible for enforc-

ing the laws and regulations concerning the importation of foreign goods. Generally speaking, all goods imported into the U.S. must be declared to Customs and must be clearly and conspicuously marked with identifying information.

- Immigration Laws. U.S. immigration laws[3] will apply whenever the proposed business activities involve the movement of foreign employees to the U.S., as might occur when a U.S. party forms a domestic joint venture with a foreign firm, or foreign personnel are brought to the U.S. for training in the manufacture of U.S. products that will be sold overseas. Visas are necessary for entry into the U.S. There are two basic types of visas: non-immigrant visas, which permit foreign nationals to enter the U.S. temporarily, and immigrant visas, which permit foreign nationals to live in the U.S. permanently.
- Trade Laws. U.S. anti-dumping laws address situations where imports are being sold at prices that are below their "normal value" ("dumping") and where, as a result, material injury is or may be caused to a U.S. industry. In addition, countervailing duty laws assess whether imports are being subsidized by foreign governments and whether the effects of the subsidy are causing injury to domestic industries. If serious injury is caused by imports of a particular product, the International Trade Commission will investigate and determine the appropriate measures.
- Antitrust Laws. Federal antitrust laws prohibit monopolies and practices that restrict trade and competition between business entities. Various federal statutes, notably the Sherman Antitrust Act of 1890[4] and the Clayton Act of 1914 (the "Clayton Act"),[5] prohibit contracts, combinations, and conspiracies in restraint of trade; monopolization and attempts to monopolize; specified discriminatory pricing practices that injure competition among purchasers of the products; and "exclusive dealing" requirements. Section 7A of the Clayton Act, often referred to as the Hart-Scott-Rodino Antitrust Improvements Act, forbids certain acquisitions of voting securities or assets unless a prior notification has been filed with the government and the specified waiting period has expired.[6] The Federal Trade Commission Act of 1914[7] outlaws any "unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce." The federal antitrust laws are administered by the Federal Trade Commission and the Department of Justice.
- Tax Laws. U.S. tax aspects of international business transactions can be broken down into outbound transactions, which involve the application of U.S. taxes to the foreign operations and activities of U.S. taxpayers, and inbound transactions, which involve foreign persons who may be investing or otherwise engaging in business activities in the U.S. In addition, U.S. taxpayers doing business in a foreign country may be subject to taxation in that country, and payments of foreign taxes must be taken into account in computing U.S. tax liability.

While the laws and regulations described above pertain primarily to activities within the U.S., there are situations where federal statutes will also be applied to conduct outside of U.S. borders. As a general matter, absent an express provision in the statute that requires the statute to be applied to overseas conduct, the test will be whether the conduct in question has sufficiently direct and foreseeable consequences in the U.S.

In addition, of course, the local laws of the country in which the activities will occur must also be considered since U.S. firms will be expected to comply with the rules and regulations that each jurisdiction has established with respect to the operation of businesses and trade and commerce involving local citizens. Areas of potential concern under the local laws of the country in which the operations are to occur include the following:

- Contract Laws. Although there are differences among contract laws in various jurisdictions, in general, they are based on the premise of supporting market-based transactions within a framework that restricts contracting parties from bargaining for duties and obligations that violate some recognized public policy. While contract laws in industrialized countries, particularly those with a common law background, are similar to those in the U.S., the rules in emerging markets and developing countries are still evolving. However, it is now common to expect that the parties will be allowed to determine the essential elements of an economic contract, such as quantity, quality, and price, and to also establish their own terms relating to delivery, guarantees, and duration.
- Sales Agency Laws. One way that U.S. companies enter new foreign markets is through the appointment of a local distributor or sales agent that will be responsible for promoting the company's products and identifying customers without the U.S. firm having to incur the expense of setting up its own branch and hiring employees. While this strategy makes sense, U.S. companies must be mindful of local laws in many countries relating to the relationship between a foreign manufacturer and local agents or distributors, including laws that regulate the duration and termination of the arrangement, require that local law governs the contractual relationship, and restrict post-termination non-competition covenants

on the local party. In addition, laws in some foreign countries give sales representatives who are natural persons the protections available to employees under local labor laws, including employee benefits and rules relating to termination of employment.

- Product Testing Laws. Products sold in international markets may be subject to testing and approval before they can be offered for sale in a given country. In the past, certain countries have used their product testing standards as a way to restrict imports of certain types of products or to make importing unreasonably costly for foreign firms that might seek to compete with local producers. Currently, however, industries are moving toward adopting international standards for larger numbers of products and services, and these standards have begun to replace the somewhat arbitrary rules that previously had to be complied with on a country-by-country basis.
- Consumer Protection Laws. Consumer laws address the quality and accuracy of information provided to consumers regarding products and services, as well as the quality of the products themselves. Industrialized countries have followed the lead of the U.S. in adopting sweeping and strict laws and regulations designed to afford protections to consumers. In many cases, local product liability laws may expose the company to substantial financial risk or require substantial modifications to the company's basic product.
- Intellectual Property Laws. While companies can achieve some level of protection under U.S. laws pertaining to patents, copyrights, trademarks and trade secrets, these rights extend only through the U.S. and its territories and possessions. Once a product is exported outside the U.S., it will no longer be protected unless the exporter fulfills the requirements for protection in the importing country. Accordingly, intellectual property laws in each importing country must be examined to determine the protection that will be available for the company's patents, trademarks, and other intellectual property once its products have been sold into the market. Substantial progress has been made on harmonizing the laws of the various countries relating to patents, copyrights, and trademarks; however, trade secret rights still vary substantially around the world and depend, in large part, on the content and enforcement of local laws pertaining to unfair competition and business ethics and practices in the importing country.
- Health and Safety Laws. Health and safety laws cover a variety of matters, including safety conditions in the factories and other workplaces, infectious diseases, health and sanitary conditions in public places, food hygiene, and safety conditions in specific industries.
- Environmental Laws. Environmental protection has been a growing area of concern for many countries. Countries have developed many global environmental international agreements and standards in order to preserve natural resources, and they may have a substantial impact on a wide range of operational activities, including manufacturing, packaging, and transportation. Environmental-based "green" initiatives have also created demand for products that are healthier and more energy-efficient.
- Competition Laws. As with antitrust laws in the U.S., competition laws in foreign countries have been created to promote fair and effective competition among autonomous enterprises and ensure that the interests of consumers are protected without the need for direct state management of the enterprises or competition. Regulators in foreign countries, including industrialized nations, often have differing ideas about the potential impact of particular business transactions. Therefore, U.S. firms must be mindful of structuring their foreign operations in a way that conforms with competition law guidelines in applicable jurisdictions. In addition to regulating mergers and acquisitions, foreign competition laws often regulate in detail the terms and conditions of agency and distribution arrangements to prevent foreign parties from including provisions that would restrict competition in the local market.
- Import Laws. Like the U.S., foreign countries have their own form of customs laws to regulate the inward flow of goods. These laws serve a variety of purposes, including revenue collection through tariffs and other import fees, and the enforcement of regulations that have been specifically adopted with respect to imported goods, such as quotas, trade restrictions, antidumping laws, and country-of-origin marking requirements. U.S. exporters obviously need to be concerned with the customs laws of each country where they intend to sell their goods, and U.S. importers relying on goods and materials produced in foreign countries will need to be sure those items will be allowed to leave those countries without delay or undue expense. A related issue to consider is the scope and enforcement of import controls in foreign countries. In general, import controls can be classified as import prohibitions, import restrictions (quotas), and import licensing

requirements, and they may be based on a variety of factors, including country of origin, product type, or product characteristics (e.g., products produced by convicts or under conditions deemed to be inappropriate by regulators in the foreign country).

- Company Laws. Company law, sometimes referred to as enterprise law, is necessary to define the legal entities or enterprises that can be used to conduct commercial activities, as well as the rights and obligations of each enterprise and the governance process for the enterprises. U.S. firms investing in foreign companies must keep in mind different international business practices, from employee representation to procedures and disclosures. In general, foreign countries offer a choice of entity forms similar to those found in the U.S., including corporations, limited liability companies, and partnerships. Developing countries have also made significant progress toward constructing a legal framework for local and foreign businesses; however, governmental regulations and registration requirements may still present hurdles for U.S. investors in certain instances.
- Inbound Foreign Investment Laws. Most countries, including the U.S., have some sort of "investment law" or "investment code" that applies to foreign investment in the country, including direct investment or a joint venture with one or more local partners. Foreign investment laws may regulate any type of foreign investment or may be limited to investments in a specific industry sector, such as tourism, agriculture, services, or certain manufacturing areas. Foreign investment laws usually require review of the transaction by at least one, and sometimes more than one, governmental authority. In addition, investments by foreigners may be affected by other local legislative acts, including laws and statutes regulating foreign exchange, unfair and restrictive business practices, and mergers and acquisitions.
- Employment and Labor Laws. Employment and labor laws are necessary to create a labor contract system and a system for providing and protecting workers' rights and benefits. These laws and regulations play an important role in enhancing the level of worker confidence in the labor system and in promoting labor mobility. Countries vary substantially with respect to the rights they afford to workers, and labor unions still play a significant role in determining how workers must be treated. Among other things, U.S. companies establishing a new branch or subsidiary in a foreign country may be required to comply with stringent rules and procedures relating to compensation, benefits, and term/termination of employment contracts.

Understanding and respecting applicable U.S. and foreign laws and regulations is obviously an ongoing challenge that does not end once the business activities have been launched and operations in a foreign country have commenced. In fact, U.S. companies should not venture into foreign markets unless and until they are prepared to invest the time and resources necessary to establish and maintain an effective global law and compliance program. Though lengthy and costly, establishing a compliance program has its legal and business advantages. Compliance programs can be used to educate employees and set standards for acceptable conduct in all the company's operations around the world. The relative importance of specific compliance areas will vary depending on the particular foreign business activities and the countries in which the company is operating; however, as U.S. companies start doing business globally, they inevitably have a need for formal compliance programs relating to immigration laws, export controls, anti-bribery laws (e.g., the U.S. Foreign Corrupt Practices Act), and customs laws.

The Current Landscape for Launching Business Activities in China

China has one of the fastest growing economies in the world, but its employment and labor laws are currently in flux, with the result that many foreign corporations are still unclear about basic laws affecting their Chinese employees. Awareness and understanding of those laws is crucial to recruiting and retaining a productive workforce in China. As discussed in greater detail below, two new and significant employment laws took effect in China on January 1, 2008: the new Labor Contract Law and the Employment Promotion Law.

The Labor Contract Law

The intent of the Labor Contract Law was to address certain unfair labor practices in China and perhaps to create a better image of China in the eyes of foreigners, thus allowing China to climb the industrial ladder. Not surprisingly, this law contains ambiguities that have yet to be clarified.

Data Security

As previously mentioned, data security is more prone to compromise in a mobile labor market such as China's. Article 24 of the Labor Contract Law allows for an employer and worker to negotiate an employment contract to include matters concerning trade secrets:

> If a worker has the obligation to maintain the confidentiality of his Employer's trade secrets, the Employer may agree with the worker on competition restriction

provisions in the employment contract or confidentiality agreement, and stipulate that the Employer shall pay financial compensation to the worker on a monthly basis during the term of the competition restriction after the termination of the employment contract. If the worker breaches the competition restriction provisions, he shall pay liquidated damages to the Employer as stipulated.[8]

In addition, Article 25 of the law states that non-compete provisions may be included only in the employment contracts of "senior management, senior technicians, and other personnel who have knowledge of trade secrets of the Employer. The scope, territory, and term of the competition restrictions shall be agreed upon by the Employer and the worker, and such agreement shall not violate laws and regulations."[9]

One challenge to maintaining data security under the Labor Contract Law is that non-compete provisions are limited to two years in duration. After those two years, employees can be on an open-term contract, which permits them to leave or stay mainly at their own discretion and based on the terms of their contract.[10]

Practice Note: *Job mobility remains high in China, and it is common for employees to change jobs quickly in order to obtain an incremental increase in their salary. U.S. employers should be concerned about the damage that may occur when an employee with access to confidential information moves to a competitor and engages in essentially the same activities that he or she was doing for his or her prior employer—including selling to the same customers. In appropriate cases, the employment contract should include non-competition requirements; however, such provisions are limited to senior management and senior technical personnel who are subject to non-disclosure obligations. Moreover, under the new law the terms of the non-compete (i.e., its duration and geographic limits) must be mutually agreed by the parties, and in no event can the non-competition restriction extend beyond two years. The penalty for breach of a non-competition provision is payment by the employee of liquidated damages in the amount agreed upon in the contract.*

Workplace Safety

The Labor Contract Law also touches upon workplace safety. Article 10 of the law contains employer disclosure obligations regarding the workplace environment and any associated hazards: "When an Employer concludes an employment contract with a worker, it shall truthfully inform him as to the content of the work, the working conditions, the place of work, occupational hazards, production safety conditions, labor compensation, and other matters directly relating to the employment contract which the worker wishes to know."[11]

Employment Contracts

Whereas previously many companies did not establish any written contracts with their employees, Article 7 of the Labor Contract Law now requires all employers to produce a written employment contract with each employee.[12] Article 17 of the Law provides that employment contracts should specify the following matters:

- Name, domicile, and legal representative of the employer;
- Name, domicile, and resident ID card number of the worker;
- Term, or the conditions for the termination, of the contract;
- Job description and the place of work;
- Working hours, rest, and leave;
- Labor compensation;
- Social insurance;
- Labor protection and working conditions; and
- Other matters that laws and administrative statutes require to be included in employment contracts.

In addition to the requisite terms mentioned above, employers and workers are free to include other matters in the employment contract such as probation period, training, confidentiality of trade secrets, and supplementary insurance and benefits.[13]

Practice Note: *One of the main purposes of the Labor Contract Law was to change the historical practices of many Chinese companies to avoid the use of written labor contracts with their employees. The new law requires that the employment relationship be based on the terms of a written contract that must be executed on a timely basis in relation to the date that the employment relationship commences. The best practice is to have the employment contract signed before the employee begins work; however, if the employee starts to work before a written labor contract has been executed, the contract must be executed within one month of the employee's first day on the job. Model contracts should be prepared in advance of hiring new employees, and explanatory materials should also be available for human resources personnel so that they can answer any questions raised by employees during the initial entry interview and get the contract signed before the employee is allowed to begin work. Given the need to create, maintain, and administer labor contracts for all employees, U.S. companies must consider whether the local human resources function is sufficiently trained and also should determine how relations with labor unions*

will be handled.

Practice Note: *As is the case in the U.S., it is advisable to enter into agreements with employees in China that explicitly address ownership of inventions conceived by the employee during the employment relationship. In general, Chinese law provides that employers own the patent rights for an "invention for hire," which includes the following inventions: (1) inventions created within the employee's scope of employment; (2) inventions created out of the employee's scope of employment but according to other work assigned to him or her by the employer; (3) inventions created by the employee within one year of his or termination of employment with the employer and related to his scope of employment at or other work assigned to him by such employer; and (4) inventions created by the employee mainly with the employer's funds, equipment, raw materials, confidential technical materials, and similar resources. The agreement should also address ownership and protection of "know-how" that employees develop or otherwise gain access to during the employment relationship since Chinese law conditions protection of "know-how" as a trade secret on a showing that the owner (i.e., employer) took actions to keep in confidential.*

The Labor Contract Law identifies three types of employment contract terms: fixed terms, open-ended terms, and terms to expire upon completion of the job. Article 13 describes a fixed-term employment contract as "an employment contract whose termination date is agreed upon by the Employer and the worker."[14] Article 14 defines an open-ended employment contract as "an employment contract for which the Employer and the worker have agreed not to stipulate a termination date."[15]

Article 15 defines an employment contract with a "term to expire upon completion of a certain job" as a contract on a certain job agreed upon by the employer and the worker that is terminated once the job is completed. The article also notes four ways in which this employment contract may be used:

1) An employment contract with a term to expire upon completion of a single job;
2) An employment contract for completion of a contracted task by means of project contracting;
3) An employment contract for temporary employment by reason of a seasonal factor; or
4) Another employment contract which, as agreed upon by the parties, is to expire upon completion of a certain job.[16]

Practice Note: *Under the Contract Labor Law, the expiration of a fixed term contract creates an obligation for payment of severance. This obligation did not exist prior to the effectiveness of the new law, and employers can no longer allow the fixed term contracts of underperforming employees to expire as a way to get rid of them without having to make severance payments. As a result, it is expected that the use of fixed term contracts will be reduced substantially in the future. Open-ended terms will become more common, and this may create problems for employers since termination of an open-ended contract can be more difficult and the probationary period for employees working under such a contract cannot exceed six months.*

Termination

The new Labor Contract Law integrates different provisions addressing the employer's rights as well as the employee's rights to termination. Article 38 states the events for which a worker or employee may terminate his employment upon 30 days' prior written notice to his employer with the company:

1) Employer fails to provide working conditions in accordance with the employment contract or fails to provide safe production conditions that are compliant with regulations;
2) Employer fails to pay labor compensation in full and on time;
3) Employer fails to pay the social insurance premiums for the worker in accordance with the law;
4) Employer's rules and regulations violate laws or regulations, thereby harming the worker's rights and interests;
5) Employer took advantage of the worker's difficulties to cause him to conclude the employment contract contrary to his true intent;
6) Other circumstances specified in laws or administrative statues.[17]

On the other hand, Article 39 states that an employer has the right to terminate an employment contract if the worker:

1) Is proved during the probation period not to satisfy the conditions of employment;
2) Materially breaches the Employer's rules and regulations, and, according to such rules and regulations, the employment contract should be terminated;
3) Commits serious dereliction of duty or practices graft, causing substantial damage to the Employer's interests;
4) Has additionally established an employment relationship with another Employer which materially affects the completion of his tasks, and he refuses to rectify the matter after the same is brought to his attention by the Employer; or
5) Has his criminal liability pursued in accordance with the law.[18]

Practice Note: *The Labor Contract Law retains the right of*

the employer to terminate a labor contract if it is proved during the probationary period that the employee cannot satisfy the conditions of employment. Prior to the passage of the new law probationary periods were established based on the anticipated term of the contract; however, the new law provides the following strict guidelines: (i) no probationary period for labor contracts of less than three months duration, or the contracts for completing a defined project; (ii) a probationary period of no more than one month for a labor contract of three months to one-year fixed duration; (iii) a probationary period of no more than two months for a labor contract of one- to three-years fixed duration; and (iv) a probationary period of no more than six months for a labor contract of more than three-years fixed duration, or a non-fixed duration ("open term") labor contract.

Article 42 states that an employer *cannot* terminate an employment contract if the worker:

1) Is engaged in operations exposing him to occupational hazards and has not undergone a pre-departure occupational health check-up, or is suspected of having contracted an occupational disease and is being diagnosed or under medical observation;
2) Has been confirmed as having lost or partially lost his capacity to work due to an occupational disease or a work-related injury;
3) Has contracted an illness or sustained an injury, and the set period of medical care therefore has not expired;
4) Is a female employee in her pregnancy, confinement, or nursing period;
5) Has been working for the Employer continuously for not less than fifteen years and is less than five years away from his legal retirement age;
6) Finds himself in other circumstances stipulated in laws or administrative statues.[19]

However, Article 44 of the law lists situations in which an employment contract will be terminated:

1) Its term expires or a condition for termination specified therein arises;
2) The worker has commenced drawing his basic old age insurance pension in accordance with the law;
3) The worker dies, or is declared dead or missing by a People's Court;
4) The Employer goes out of business or is dissolved;
5) The Employer is declared bankrupt, has its business license revoked or is ordered to close down in accordance with the law; or
6) Another circumstance specified in laws or administrative statues arises.[20]

The Labor Contract Law restricts employers from including additional termination contracts not within the scope of the labor law. While the new law offers some clarifications, it is mainly intended to prevent companies from attempting to work around the labor law.

Practice Note: *Termination of an employment contract may subject the employer to liability for the statutory amount provided in the Labor Contract Law—one month of salary for every year of service. Since the average wage in China remains quite low in relation to the U.S. and other industrialized countries, the cost of termination generally does not create substantial risk to U.S. employers. It should be noted, however, that the circumstances under which severance must be paid have been expanded in the new law. Employers may also be able to avail themselves of one of the permitted bases for a "lay off," but there are various ambiguities in the initial version of the new law that will need to be resolved before employers can act with certainty.*

Duties And Liabilities Of Employers

The Labor Contract Law also provides for employer liability in the event of violation of labor laws and regulations.[21] For example, Article 82 of the law provides that if an employer fails to establish a written employment contract with a worker within one month of employment, the employer must pay twice the amount in worker wages.[22] In addition, the employer must compensate the worker if the employer fails to pay the worker labor compensation as stated in the employment contract, pays the worker below the minimum wage rate, fails to pay for overtime, or terminates an employment contract without paying the worker severance pay.[23] Criminal charges will also be filed if an employer physically or emotionally abuses or threatens a worker or forces a worker to perform dangerous operations that threaten his personal safety.[24]

Role of Labor Unions

The Labor Contract Law allows for the formation of unions or employee councils who have the right to review an employer's employee manual and negotiate collective contracts regarding issues such as labor hours, safety issues, and insurance and benefits. Labor unions play an active role in employee terminations. Labor union representatives must be notified in advance of termination and must be informed of the cause for termination. Employers must also provide labor unions 30 days advance notice of the termination of twenty or more employees or 10% of the workforce.[25]

Practice Note: *The Contract Labor Law seeks collaboration among employers, employees, and labor unions regarding important elements of the employment relationship including salaries, benefits, and workplace safety. However, the new law does not provide a specific mechanism for final resolution of differences among these groups on particular issues, and it appears that the employer will have the final word subject to the right of the labor union to bring an action in front of the local labor arbitration commission in the event that the union believes the employer has taken actions that are harmful to the interests of the employees.*

Implementation Rules

In order to further clarify some of the provisions of the Labor Contract Law and perhaps address the concerns of some foreign investors that the new law was overly protective of employees, the State Council of PRC released the Implementation Rules of Labor Contract Law ("Implementation Rules") on September 16, 2008. As noted above, it is anticipated that companies will make greater use of open-ended contracts under the new law, and Article 19(3) of the Implementation Rules makes it clear that such contracts are not necessarily permanent contracts given that employers would have the right to terminate such a contract in cases where an employee is found to be in "serious violation" of the company rules established by the employer. In order to take advantage of this window, however, employers must be sure that their rules include clear guidelines regarding job descriptions and responsibilities, work requirements, and the remedies available to them in the event of a breach by the employee. Among other things, the Implementation Rules also address various issues relating to branches and employees working at different locations from the place where the employer/company is registered, including requirements that employers must have detailed lists of employees and procedures that must be followed when a labor contract is terminated. The Implementation Rules also confirm that termination conditions of a labor contract are statutory, and the parties are not allowed to agree on other conditions for termination when drafting their contract.

The Employment Promotion Law

The purpose of the Employment Promotion Law is to encourage job creation and fairer employment practices among both local and foreign businesses. Article 2 of the Employment Promotion Law states: "The State shall put employment expansion as a priority of the economic and social development, implement pro-active employment policies, upholds [sic] the guideline according to which the labourers choose jobs on their own initiative, the market regulates employment and the government promotes employment, and expand employment through multiple channels."[26]

The most prominent provision in the Employment Promotion Law prohibits discriminatory practices. While an earlier version of the law prohibited discrimination based on gender, age, race, religion, and physical disability, the current version also includes additional prohibitions against discrimination based on hepatitis B carriers, HIV carriers, AIDs sufferers, and their family members.[27]

While the effects of violating these anti-discrimination provisions are not clearly stated in the Employment Promotion Law, the anti-discrimination provisions do suggest that candidates for employment may use discrimination as a cause for a lawsuit. Article 62 states that "the labourers may lodge a lawsuit in the people's court against those who commit employment discrimination in violation of the provisions of this Law."[28]

Vocational and employment training is also addressed in the Employment Promotion Law. The Chinese government wants to encourage workers to participate in training institutions and educational services in order to enhance their skills and employability. Article 47 of the law states that employers must have the funds to provide employment skill training, and it requires enforcement of the law by local government. However, penalties for violating Article 47 are not stated, and companies rarely comply with this law. ■

Endnotes

1 50 U.S.C.A. §§ 2401-2420.

2 15 U.S.C.A. §§ 78dd-1 *et seq*.

3 8 U.S.C.A. §§ 1 *et seq*.

4 15 U.S.C.A. §§ 1 to 7.

5 15 U.S.C.A. §§ 12 to 27a.

6 15 U.S.C.A. § 18a.

7 15 U.S.C.A. §§ 41-58.

8 Baker & McKenzie, "Law of the People's Republic of China on Employment Contracts" Unofficial Translation Prepared by Baker & McKenzie (2007), available at http://www.bakernet.com/NR/rdonlyres/F8A5388C-CC3C-4ECA-87BD-8-BE76A5D6EB9/0/Translation.pdf.

9 Baker & McKenzie, "Law of the People's Republic of China on Employment Contracts," Unofficial Translation Prepared by Baker & McKenzie (2007), available at http://www.amcham-shanghai.org/NR/rdonlyres/4EC2208A-D768-4CD5-8-FC7-26BB72E5A180/3830/ChinaDraftLaborLawThirdEdition.pdf.

10 Id.

11 Baker & McKenzie, "Anti-discrimination Legislation is Passed," China Employment Law (Sept 2007), available at http://www.bakernet.com/NR/rdonlyres/3781A8A9-51ED-47B0-8337-38A100CF56EE/42674/ChinaAlertEmploymentSep2007.pdf.

12 Baker & McKenzie, "Law of the People's Republic of China on Employment Contracts," Unofficial Translation Prepared by Baker & McKenzie (2007), available at http://www.bakernet.com/NR/rdonlyres/F8A5388C-CC3C-4ECA-87BD-8-BE76A5D6EB9/0/Translation.pdf.

13 Id.

14 Id.

15 Id.

16 Id.

17 Id.

18 Id.

19 Id.

20 Id.

21 "If a labor rule or regulation formulated by an Employer violates laws or administrative statutes, such rule or regulation shall be invalid and the labor administration authority shall give a warning and order rectification. If the said rule or regulation caused a worker to suffer harm, the Employer will be liable for damages." Baker & McKenzie, "Law of the People's Republic of China on Employment Contracts," Unofficial Translation Prepared by Baker & McKenzie (2007), Article 79, available at http://www.bakernet.com/NR/rdonlyres/F8A5388C-CC3C-4ECA-87-BD-8BE76A5D6EB9/0/Translation.pdf.

22 Id.

23 Baker & McKenzie, "Law of the People's Republic of China on Employment Contracts," Unofficial Translation Prepared by Baker & McKenzie (2007), Article 85, available at http://www.bakernet.com/NR/rdonlyres/F8A5388C-CC3C-4ECA-87-BD-8BE76A5D6EB9/0/Translation.pdf.

24 Baker & McKenzie, "Law of the People's Republic of China on Employment Contracts," Unofficial Translation Prepared by Baker & McKenzie (2007), Article 87, available at http://www.bakernet.com/NR/rdonlyres/F8A5388C-CC3C-4ECA-87-BD-8BE76A5D6EB9/0/Translation.pdf.

25 McLaughlin& Kurlinski, "China Adopts New Labor Contract Law," (Aug. 5, 2008) available at <http://www.gklaw.com/publication.cfm?publication_id=653>.

26 Natlex, "Employment Promotion Law of the People's Republic of China," International Labour Organization (30 August 2007), available at http://www.ilo.org/dyn/natlex/docs/MONOGRAPH/76984/81380/F1735089926/76984.pdf.

27 Baker & McKenzie, "Anti-discrimination Legislation is Passed," China Employment Law (Sept 2007), available at http://www.bakernet.com/NR/rdonlyres/3781A8A9-51ED-47B0-8337-38A100CF56EE/42674/ChinaAlertEmploymentSep2007.pdf.

28 Natlex, "Employment Promotion Law of the People's Republic of China," International Labour Organization (30 August 2007), available at http://www.ilo.org/dyn/natlex/docs/MONOGRAPH/76984/81380/F1735089926/76984.pdf

Business Law Section Calendar

❑ March 30, 2009	Deadline Business Law News Issue No. 2, 2009
❑ June 30, 2009	Deadline Business Law News Issue No. 3, 2009
❑ September 30, 2009	Deadline Business Law News Issue No. 4, 2009

Visit www.calbar.ca.gov for additional events.

Continued from page 1 . . . California's New LLC Act

1. The Operating Agreement Under RULLCA

Similar to the California LLC Act, RULLCA considers the operating agreement to be foundational to the LLC.[10] RULLCA's drafters note that an LLC is as much a creature of contract as of statute.[11] Accordingly, RULLCA is primarily a default statute; this means that to the extent members have not agreed on an issue in their operating agreement, the provisions of the statute govern that issue.[12] The operating agreement is the exclusive consensual process for members to modify RULLCA's various default rules.[13]

RULLCA defines the operating agreement expansively and recognizes a wide scope of authority for it.[14] Under RULLCA, the operating agreement is any agreement by all the members of the LLC, including the sole member of a single member LLC, even if not referred to as the operating agreement, and whether oral, written, or some combination of the two, concerning the matters described in section 110(a) of RULLCA.[15] The matters described in section 110(a) cover a broad spectrum of topics, including all relations among the members of an LLC, and also all activities of the company and the conduct of those activities.[16]

RULLCA does not require an operating agreement. Yet, because of the act's expansive definition of "operating agreement," LLC members will always have an operating agreement simply by agreeing to be a member of the LLC.[17] The drafters explain it this way:

> [A]s soon as a limited liability company has any members, the limited liability company has an operating agreement. […] '[A]ll the members' have agreed on who the members are, and that agreement – no matter how informal or rudimentary – is an agreement….[18]

Based on the fact that an operating agreement will always exist, RULLCA refers to *the* operating agreement, rather than *an* operating agreement.[19] Importantly, though, RULLCA does not require an LLC or its members to take any formal action to adopt the operating agreement.[20] The drafters specifically contrast this liberality with section 17050 of the California LLC Act, which does require members, either before or after the filing of the articles of organization, to have entered into an operating agreement.[21] In further contrast to the California LLC Act, under RULLCA, there can be no operating agreement until *after* the LLC is formed.[22] RULLCA treats any agreement made *before* the formation of the LLC as a preformation agreement, not an operating agreement.[23]

RULLCA's expansive definition of the operating agreement poses some risk to those who join an existing LLC. Upon joining an LLC, a member is deemed to assent to the operating agreement, including any oral or implied-in-fact component to it.[24] Therefore, a person who joins an existing LLC should be careful to ascertain fully the contents of the operating agreement given the possibility of oral and implied-in-fact components of the operating agreement.[25] In practice, to provide certainty as to the terms of their operating agreement, members may want to require that their agreement, or amendments thereto, be written. RULLCA, though, does not expressly authorize the operating agreement to limit the sources in which terms of the operating agreement might be found, or limit amendments to specified modes.[26] Accordingly, it is uncertain whether RULLCA provides authorization for members to impose a private statute of frauds.[27] The drafters simply comment: "RULLCA "*could* be read to encompass such authorization."[28]

2. Fiduciary Duties Under RULLCA

Similar to the California LLC Act, RULLCA generally provides that members of a member-managed LLC owe to the company and each other fiduciary duties of loyalty and care.[29] Also similar to the California LLC Act, RULLCA provides that, in a manager-managed LLC, members do not have any fiduciary duty to the company or to any other member solely by reason of being a member.[30]

a. The Duty of Loyalty

With respect to the duty of loyalty, RULLCA codifies the core duty, but it does not purport to identify every possible category of violative conduct.[31] In other words, RULLCA does not seek to codify exhaustively the duties that are owed by managers or members in an LLC.[32] The consequence of RULLCA's partial codification is that courts may create and impose new duties beyond those stated in the statute.[33] The duty of loyalty under RULLCA includes, but is not limited to, duties:

1) To account to the company and to hold as trustee for it any property, profit, or benefit derived by the member:
    a. In the conduct or winding up of the company's activities;
    b. From a use by the member of the company's property; or
    c. From the appropriation of a limited liability company opportunity;
2) To refrain from dealing with the company in the conduct or winding up of the company's activities as or on behalf of a person having an interest adverse to the company; and
3) To refrain from competing with the company in the conduct of the company's activities before the dissolution of the company.[34]

Absent from RULLCA is a provision to the effect that "[a]

member … does not violate a duty or obligation under this [act] or under the operating agreement merely because the member's conduct furthers the member's own interest."[35] The California LLC Act includes such a provision.[36] RULLCA does not include this type of provision because its drafters believe the provision is axiomatic as a matter of contract law and is at best incomplete, and at worst wrong in the context of fiduciary duty.[37] In place of this type of provision, RULLCA introduces an innovation with respect to conflict of interest transactions: a fairness qualification.[38] Under RULLCA, the fairness of a transaction is a defense to a duty of loyalty claim.[39] Thus, so long as a member's activities are fair to the LLC, she may pursue her own personal interest regardless of whether the operating agreement contains a provision to that effect.

b. The Duty of Care

With respect to the duty of care, RULLCA imposes a standard of ordinary care, not gross negligence.[40] The California LLC Act uses a standard of gross negligence.[41] In raising the standard from gross negligence to ordinary care, the drafters note that a plurality of state statutes use an ordinary care standard.[42] They also state that in a post-Enron era, gross negligence sets the bar too low.[43]

The use of a higher duty of care is tempered, though, because RULLCA expressly conditions the duty of care on the familiar corporate law concept of the business judgment rule.[44] In effect, the Act's duty of care is a hybrid.[45] RULLCA reads:

> Subject to the business judgment rule, the duty of care of a member of a member-managed limited liability company in the conduct and winding up of the company's activities is to act with the care that a person in a like position would reasonably exercise under similar circumstances and in a manner the member reasonable believes to be in the best interests of the company.[46]

As a practical matter, subjecting the duty of care to the business judgment rule may in effect keep the standard of care at gross negligence.[47]

c. The Duty of Good Faith and Fair Dealing

With respect to the duty of good faith, RULLCA returns this concept to its contract law moorings.[48] RULLCA expressly qualifies the duty of good faith with the word "contractual" in order to signal a more conservative view of the obligation.[49] The more conservative view emphasizes that the *contractual* duty of good faith and fair dealing "is not an invitation to re-write agreements among the members."[50] Unlike RULLCA, the California LLC Act does not expressly qualify the duty of good faith and fair dealing with the word "contractual."[51]

d. Waiver and Limitation of Fiduciary Duties

In general, fiduciary duties under RULLCA are subject to the operating agreement. Yet, the act imposes important limitations on the power of the operating agreement to affect these duties and the obligation of good faith. RULLCA permits members to limit or eliminate aspects of their fiduciary duties, but it prevents the wholesale elimination of all fiduciary duty.[52]

i. Duty of Loyalty

The operating agreement may not eliminate entirely the duty of loyalty under RULLCA.[53] It may, however, eliminate each specific aspect of the duty that is codified in the statute (and identified above).[54] RULLCA further allows the parties to identify specific types or categories of activities that do not violate the duty of loyalty.[55] Even with the broad authority given to members to limit or eliminate their duties of loyalty, RULLCA permits the exercise of this authority only if not manifestly unreasonable.[56] RULLCA provides specific rules to guide courts in applying this standard.[57] Lastly, RULLCA does not permit members to limit money damages for breach of the duty of loyalty.[58]

ii. Duty of Care

RULLCA does not permit members to eliminate entirely the duty of care.[59] It does permit members to alter the duty of care, except to authorize intentional misconduct or knowing violation of law.[60] Any alteration to the duty of care, however, is subject to the limitation that it not be manifestly unreasonable.[61] The act provides specific rules to guide courts in applying this standard.[62] Unlike for violations of the duty of loyalty, though, members may entirely eliminate liability for money damages for breach of the duty of care.[63]

iii. Obligation of Good Faith and Fair Dealing

Under RULLCA, members may prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing.[64] The ability to prescribe these standards, though, is constrained by the requirement that any prescription not be manifestly unreasonable.[65] The act provides specific rules to guide courts in applying this standard.[66]

3. The Power of a Member or Manager to Bind the LLC under RULLCA

RULLCA introduces innovations related to the power of a member or manager to bind the LLC and giving public notice of that power.

a. Elimination of Statutory Apparent Authority

RULLCA eliminates the power of members and managers to

bind the LLC as agents through statutory apparent authority.[67] In contrast, the California LLC Act provides for statutory apparent authority for members in a member-managed LLC and managers in a manager-managed LLC.[68] The concept of statutory apparent authority developed from partnership law where "[t]he act of every partner … for apparently carrying on in the usual way the business of the partnership binds the partnership."[69] Under RULLCA, members do not have statutory apparent authority because "[a] member is not an agent of a limited liability company solely by reason of being a member."[70] Managers do not have statutory apparent authority either.[71]

As a result of the elimination of statutory apparent authority, RULLCA does not address the power of members and managers to bind the LLC. Instead, RULLCA leaves it to agency and other law to address that power.[72] The drafters posit the following examples where agency and other law will cause members to bind the LLC or impose liability on it for their actions:

(i) A member might have actual or apparent authority to bind an LLC to a contract;

(ii) The doctrine of *respondeat superior* might make an LLC liable for the tortious conduct of a member (i.e., in some circumstances a member acts as a "servant" of the LLC); and

(iii) An LLC might be liable for negligently supervising a member who is acting on behalf of the LLC.[73]

b. Statements of Authority by Position

RULLCA permits an LLC to file a public statement of authority for a position, not merely a particular person.[74] The statement would publicly disclose the authority of LLC members or managers in certain positions to act for or bind the LLC. The purpose of the disclosure is to make public the LLC's management structure in order to facilitate transactions and to avoid having to disclose to third parties the entirety of the operating agreement.[75] RULLCA provides:

> The statement: […] with respect to any position that exists in or with respect to the company, may state the authority, or limitations on the authority, of all persons holding the position to: (A) execute an instrument transferring real property held in the name of the company; or (B) enter into other transactions on behalf of, or otherwise act for or bind, the company….[76]

RULLCA imposes certain limitations on the effect of statements of authority. Statements of authority concerning real property will give constructive notice only if properly filed with the state *and* in the appropriate land records.[77] Further, statements pertaining to other matters only affect third parties *with knowledge* of the filed statements.[78] It remains to be seen if this will lead to greater use of officers in LLCs.

4. Forming and Filing the LLC under RULLCA

RULLCA introduces two significant deviations from the California LLC Act regarding the formation and registration of LLCs. First, RULLCA permits the registration of "shelf LLCs."[79] A shelf LLC is an LLC that is created without having any members.[80] According to the drafters, permitting the registration of shelf LLCs accommodates the desire of many practitioners and their clients to have an LLC "formed and on the public record while the relevant deal coalesces—i.e., before the precise identity and relationship of the members has been finally determined."[81] Under RULLCA, an organizer may deliver for filing a certificate of organization[82] without the company having any members and the filing officer will file the certificate.[83] The certificate must state that the LLC has no members at the time of filing.[84] In order for the LLC to be formed, though, this first filing must then be followed by a second filing, in which the organizer must deliver to the filing officer notice that the company has at least one member.[85] The drafters recommend that states adopt a 90-day window for filing of the second notice.[86] If the organizer does not timely deliver the required second notice, the previously filed certificate lapses and is void.[87]

The second significant deviation introduced by RULLCA regarding the forming and registration of LLCs is that the act does not require the certificate of organization to designate whether the LLC is manager-managed or member-managed.[88] The act permits the operating agreement to establish the LLC's status as member or manager-managed, rather than requiring that disclosure in a public document (such as the certificate or articles of organization).[89] This rule differs from the California LLC Act.[90] The drafters explain the rule this way: given that members cannot bind the LLC through statutory apparent authority, the knowledge of the management structure has no effect on third parties dealing with the LLC.[91] Thus, there is no need under RULLCA for public disclosure of an LLC's management structure. RULLCA still retains, though, the familiar member-managed and manager-managed constructs as options for members to use as they structure the *internal* affairs of the LLC.[92]

5. Oppression Remedy Under RULLCA

RULLCA expressly provides members with a remedy for oppressive conduct, but the California LLC Act does not.[93] The drafters note that providing a remedy for oppression in LLCs makes "good sense" because "[l]ike most close corporations, most limited liability companies face the 'lock in' problem and the cor-

responding susceptibility of minority owners to oppression by those in control."[94] Accordingly, under RULLCA, a member may ask the court to dissolve an LLC on the grounds that the managers, or those members in control of the company, "have acted or are acting in a manner that is oppressive and was, is, or will be directly harmful to the applicant."[95] RULLCA does not detail the factors for courts to consider in determining whether conduct is oppressive; it leaves this to the court.[96] In comparison, California Corporations Code section 17351(a)(5) permits the Superior Court to dissolve an LLC if those in control of the LLC have been guilty of, or knowingly countenanced persistent and pervasive fraud, mismanagement, or abuse of authority.

Dissolution is not the only remedy available for a claim of oppressive conduct under RULLCA; "the court may order a remedy other than dissolution."[97] Members cannot waive their right to seek a judicial dissolution for oppressive conduct.[98] Yet, they can restrict or eliminate a court's power to craft a remedy *other than* dissolution, such as a lesser remedy like a buyout.[99] In other words, members can limit the court to the all-or-nothing dissolution remedy. The California LLC Act permits members to stop a judicial dissolution by agreeing to purchase the complaining member's interest in the LLC.

6. Derivative Claims and Special Litigation Committees Under RULLCA

RULLCA provides for derivative claims by members and innovates by providing for special litigation committees. The California LLC provides for derivative claims, but it does not provide for special litigation committees.[100] Under RULLCA, if a member seeks to enforce a right of the LLC, she must bring a derivative suit.[101] Further, the plaintiff's complaint must state with particularity when a demand was made, or if one was not made, the reasons a demand would be futile.[102]

RULLCA innovates by providing for a special litigation committee (SLC) when a derivative claim is brought.[103] An SLC may be composed of one or more disinterested and independent individuals who may be members.[104] The drafters acknowledge that SLCs are best known in the corporate context, but they believe SLCs will serve several useful purposes for LLCs. Specifically:

> An "SLC" can serve as an ADR mechanism, help protect an agreed upon arrangement from strike suits, protect the interests of members who are neither plaintiffs nor defendants (if any), and bring to any judicial decision the benefits of a specially tailored business judgment.[105]

After an appropriate investigation, the SLC must make a determination in the best interests of the company regarding what to do with the derivative proceeding.[106] The SLC then must file with the court a statement of its determination and its report supporting the determination.[107] The court then will review the SLC's determination under the standard established in the New York case of *Auerbach v. Bennett*.[108] *Auerbach* requires the court to defer to the SLC's business judgment so long as the SLC "conducted its investigation and made its recommendation in good faith, independently, and with reasonable care."[109] The drafters selected the *Auerbach* standard, rather than the standard set out in the Delaware case of *Zapata Corp. v. Maldonado*, because *Zapata* requires a court to apply its *own* business judgment instead of accepting the SLC's business judgment, and this standard generally has not been followed in other states.[110]

7. RULLCA Has No Provision for Series LLCs

Similar to the California LLC Act, RULLCA does not authorize series LLCs.[111] In a series LLC, the company may establish separate series that are treated as a separate enterprise from each other and the LLC itself.[112] "Each series has associated with it specified members, assets, and obligations, and—due to what have been called "internal shields"—the obligations of one series are not the obligation of any other series or of the LLC."[113] This concept was pioneered by Delaware and adopted by only a handful of other states.[114] One rationale for series LLCs "is that, if properly designed and drafted, they may give firms a safe harbor against courts' piercing the veil and holding an entity or entities liable for debts incurred by sister entities or subsidiaries."[115]

The drafters provide two rationales for why RULLCA does not authorize series LLCs. First, they note difficult and substantial questions regarding various legal aspects of series LLCs, including, among others: whether they can be separate legal persons if defined as part of another legal person; how they will be treated for tax purposes; whether they will be recognized as a legal person under bankruptcy law; and whether they will be respected in states that do not provide for series LLCs.[116] Second, the drafters contend that there is no need for series LLCs given the availability of alternate structures, such as multiple single-member LLCs and an LLC "holding company" with LLC subsidiaries."[117]

Conclusion

For more than ten years, LLCs in California have been governed by the California LLC Act. RULLCA, though, may soon replace it in whole or in part. If it does, practitioners will need to learn many new aspects of LLC law. Although RULLCA contains

many rules consistent with California's present LLC statute, it also introduces several major innovations that have no counterpart in the present statute.[118] This article has provided a first look at RULLCA to help practitioners learn what changes may be coming to California's LLC law. ■

Endnotes

1 Beverly-Killea Limited Liability Company Act, Cal. Corp. Code §§ 17000-17656.

2 Kleinberger and Bishop, *The Next Generation: The Revised Uniform Limited Liability Company Act*, 62 Bus. Law 515, 516 (2007).

3 Website of the Uniform Law Commission, *available at* http://www.nccusl.org/Update/.

4 Website of the Uniform Law Commission, *available at* http://www.nccusl.org/Update/DesktopDefault.aspx?tabindex=0&tabid=9.

5 Revised Uniform Limited Liability Company Act (2006) (hereinafter "RULLCA"), *available at* http://www.law.upenn.edu/bll/archives/ulc/ullca/2006act_final.pdf, Prefatory Note.

6 Website of the Uniform Law Commission, *available at* http://www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-ullca.asp.

7 RULLCA, Prefatory Note.

8 RULLCA, Prefatory Note.

9 RULLCA, Prefatory Note.

10 Kleinberger and Bishop, *supra* note 2, at 545.

11 RULLCA § 110 Cmt.

12 RULLCA § 110(b).

13 RULLCA § 110 Cmt.

14 RULLCA § 102, Cmt., Para. (13).

15 RULLCA § 102(13).

16 RULLCA § 110(a)(3).

17 RULLCA § 102, Cmt., Para. (13).

18 RULLCA § 102, Cmt., Para. (13).

19 RULLCA § 110, Cmt.

20 RULLCA § 110, Cmt.

21 RULLCA § 110, Cmt.

22 RULLCA § 111(c) and Cmt., Sub. (c).

23 RULLCA § 111(c) and Cmt., Sub. (c).

24 RULLCA § 111(b).

25 RULLCA §111, Cmt.

26 RULLCA § 110, Cmt., Sub. (a)(4).

27 Ribstein, *An Analysis of the Revised Uniform Limited Liability Company Act*, 3 Va. L. & Bus. Rev. 35, 46 (2008).

28 RULLCA § 110, Cmt., Sub. (a)(4) (emphasis added).

29 RULLCA § 409(a).

30 RULLCA § 409(g)(5).

31 RULLCA § 409, Cmt., Sub. (a) and (b).

32 Kleinberger and Bishop, *supra* note 2, at 522-23.

33 Ribstein, *supra* note 27, at 63.

34 RULLCA § 409(b)(1)-(3).

35 RULLCA § 409, Cmt., Sub. (e).

36 *See* Cal. Corp. Code § 16404(e).

37 RULLCA § 409, Cmt., Sub. (e).

38 Ribstein, *supra* note 27, at 64.

39 RULLCA § 409(e).

40 RULLCA § 409(c) and Cmt., Sub. (c).

41 *See* Cal. Corp. Code § 16404(c).

42 RULLCA § 409, Cmt., Sub. (c).

43 Kleinberger and Bishop, *supra* note 2, at 526.

44 RULLCA § 409 (c).

45 Kleinberger and Bishop, *supra* note 2, at 527.

46 RULLCA § 409 (c).

47 Ribstein, *supra* note 27, at 65.

48 Kleinberger and Bishop, *supra* note 2, at 524.

49 Kleinberger and Bishop, *supra* note 2, at 525.

50 RULLCA § 409(d).

51 *See* Cal. Corp. Code § 16404(d).

52 RULLCA § 110(c)(4); Kleinberger and Bishop, *supra* note 2, at 547.

53 RULLCA § 110(c)(4).

54 RULLCA § 110(d)(1).

55 RULLCA § 110(d)(2).

56 RULLCA § 110(d).

57 RULLCA § 110(h).

58 RULLCA § 110(g)(1); Ribstein, *supra* note 27 at 68.

59 RULLCA § 110(c)(4).

60 RULLCA § 110(d)(3).

61 RULLCA § 110(d).

62 RULLCA § 110(h).

63 RULLCA § 110(g).

64 RULLCA § 110(d)(5).

65 RULLCA § 110(d).

66 RULLCA § 110(h).

67 RULLCA § 301.

68 *See* Cal. Corp. Code § 17157.

69 RULLCA, Prefatory Note, at 3.

70 RULCCA § 301(a).

71 RULLCA § 407, Cmt., Sub. (c).

72 RULLCA § 301(b), and Cmt.

73 RULLCA § 301, Cmt., Sub. (b).

74 RULLCA § 302(a).

75 Kleinberger and Bishop, *supra* note 2, at 532, and RULLCA, Prefatory Note.

76 RULLCA § 302(a)(2).

77 RULLCA § 302, Cmt.

78 RULLCA § 302, Cmt.

79 RULLCA § 201.

80 RULLCA § 201, Cmt.

81 Kleinberger and Bishop, *supra* note 2, at 528.

82 RULLCA refers to the "articles of organization" as a "certificate of organization." This nomenclature is intended to signal that: "(i) the certificate merely reflects the existence of an LLC (rather than being the locus for important governance rules); and (ii) this document is significantly different from articles of *incorporation*, which have a substantially greater power to affect *inter se* rules for the corporate entity and its owners." RULLCA § 102(1) cmt. (emphasis in original).

83 RULLCA § 201.

84 RULLCA § 201(b)(3).

85 RULLCA § 201(e)(1).

86 RULLCA § 201, Cmt.

87 RULLCA § 201(e)(1).

88 RULLCA § 201(b) and Cmt.

89 RULLCA § 102, Cmt., Paragraph (10).

90 *See* Cal. Corp. Code § 17151(b).

91 RULLCA § 102, Cmt., Paragraph (10) and Prefatory Note, at 4.

92 RULLCA § 407, Cmt., Sub. (a).

93 *See* Cal. Corp. Code § 17351(a).

94 Kleinberger and Bishop, *supra* note 2, at 536.

95 RULCCA § 701 (a)(5)(B).

96 Kleinberger and Bishop, *supra* note 2, at 537.

97 RULLCA § 701(b).

98 RULLCA §§ 110(c)(7) and 701, Cmt., Sub. (a).

99 RULLCA § 701, Cmt., Sub. (b).

100 *See* Cal. Corp. Code § 17501.

101 RULLCA § 902.

102 RULLCA § 904.

103 RULLCA § 905.

104 RULLCA § 905(b).

105 RULLCA § 905, Cmt.

106 RULLCA § 905(d).

107 RULLCA § 905(e).

108 RULLCA § 905(e) and Cmt., Sub. (d).

109 RULLCA § 905(e).

110 RULLCA § 905, Cmt., Sub. (d).

111 RULLCA, Prefatory Note, at 5.

112 RULLCA, Prefatory Note, at 5.

113 RULLCA, Prefatory Note, at 5.

114 Ribstein, *supra* note 27, at 42-43.

115 Ribstein, *supra* note 27, at 43.

116 RULLCA, Prefatory Note, at 5.

117 RULLCA, Prefatory Note, at 5.

118 Kleinberger and Bishop, *supra* note 2, at 516.

Continued from page 2 . . . Message from the Chair

I urge you to check the Section's website, as well as the websites maintained by each of the Section's 13 standing committees, all of which may be accessed via the State Bar's website. There are many opportunities to get involved in the work of the standing committees, including presentation of programs and involvement in the legislative process. I encourage you to consider participating.

On behalf of the Business Law Section, I wish you a happy and prosperous 2009, and I thank you for your membership in and support of the Section. ■

**Peter C. Bronson is a principal of Peter C. Bronson, A Professional Corporation, and is 2008-09 Chair of the State Bar's Business Law Section. His practice emphasizes the representation of creditors and other non-debtor parties in insolvency proceedings throughout California; and business litigation in state, federal and appellate courts. He can be reached at (916) 444-1110 or pbronson@pbronsonlaw.com.*

Continued from page 4 . . . *Ex Parte* Communications in a Transactional Practice

exact scope of what constitutes the subject matter of the representation, however, may be somewhat elusive in certain matters. Consider a situation where an attorney represents the issuer in a private placement, and the lead investor is represented by counsel. Absent consent by such counsel, the attorney must direct all communications with respect to the private placement through counsel. Suppose sometime after closing of the investment, the issuer needs shareholder consent for a proposed corporate action. Is the subject matter sufficiently different that the issuer's attorney can now communicate directly with the investor without going through counsel? On the one hand, a corporate action is a different matter than an investment in the issuer. On the other hand, the representation may be in connection with all matters relating to the investor's interests in the issuer, not just the initial investment. The attorney must use common sense and his or her reasonable judgment to make the determination. Often the prudent course of action is to inquire, either of the party or (if known) counsel, whether the party is represented by counsel with respect to the particular matter proposed to be discussed.

Who is the Party?

Attorneys are not barred from communicating with any person simply because that person happens to be represented by counsel. CRPC Rule 2-100 only applies to a represented party in a matter. Communications with a represented person are permissible if such person is represented in an *unrelated* matter and not a party to the matter which is the subject of the communication.

Where an entity is a party, that "party" for purposes of CRPC Rule 2-100 includes any *current* officer, director, or managing agent[8] of the entity. It also includes any employee of the entity where the subject of the communication is an act or omission by that person that may be binding on the entity in connection with the matter in dispute, or the employee is one whose statement may constitute an admission on the part of the organization.[9] When dealing with officers or directors, it is irrelevant whether the contacted person is, in reality, a member of the control group or has power to speak on behalf of the corporation.[10] Even in situations where a director or officer is in a dispute with the entity, an attorney cannot communicate with a dissenting director or officer of the entity without the consent of the entity's counsel.[11] However, if such dissident officer or director is represented by separate counsel, direct contact may be permitted if separate counsel consents.[12]

Even where an entity is the party and such entity is represented by outside counsel, it may be permissible to communicate with the entity's in-house counsel without securing the consent of the outside counsel.[13] The rationale under such circumstances is that the in-house counsel is not likely to inadvertently make harmful disclosures. However, if the in-house counsel (i) was a party in a dispute and represented by the entity's outside counsel; (ii) otherwise participated in giving business advice; or (iii) was involved in the decision-making which gave rise to the dispute, then the prohibition on communication could still apply.[14]

Note that CRPC Rule 2-100 does not prohibit an attorney from communicating with a represented party if the attorney is acting on his or her own behalf. Just because the party in a particular matter happens to be an attorney does not mean that the party has given up his or her right to communicate directly with the party on the other side of a transaction.[15] The same is true for an in-house attorney acting on behalf of an entity, as long as the in-house attorney is acting as principal, and not as legal counsel, for the entity.

"Knows to be Represented" . . . "in the Matter"

A violation of Rule 2-100 requires that the attorney know that the contacted party is represented in the particular matter that is the subject of the communication. Although the authorities appear to be split as to whether constructive knowledge is sufficient,[16] knowledge can be established using an objective standard based on circumstantial evidence to determine if the attorney had reason to believe that a party was represented but failed to obtain counsel's consent prior to initiating contact.[17] In such cases, an attorney ought to inquire about the existence and nature of a representation to confirm his or her understanding. If the attorney has no reason to know a party is represented, the attorney is not obligated to inquire.[18] If the attorney is unsure, it is prudent to ask the party whether or not the party is represented before initiating any communication regarding the matter. Even if the party denies that counsel has been engaged or claims that counsel is acting without authorization, if a reasonable attorney would know that such denials or statements were untrue, then the attorney should curb any *ex parte* communication with the party without the consent of counsel.[19]

The fact that an attorney knows a party will likely retain counsel for a particular matter but has not yet done so does not mean that the attorney is barred from communicating with the party.[20] It follows, for example, that an attorney would be free to meet with his or her client and other unrepresented parties at the

early stages of a transaction in order to help analyze the practicality of a potential transaction. Conversely, a representation is not perpetual, "forever excluding other attorneys from contacting [a] former [party]."[21] Once a representation has concluded and an attorney does not have any reason to believe there is a continuing representation, communication is permitted. It is not always clear, however, when a transactional representation has ended. As a practical matter, in many instances a transactional representation has ended once the deal has closed, your fees have been paid, the closing dinner has occurred, and the closing sets have been distributed. However, where there are post-closing obligations and survival provisions, and especially where the notice provisions in the principal transactional document call for copies to be sent to counsel, the attorney should assume that the relationship continues for post-closing disputes. In such a case, the attorney should not communicate with a party without at least inquiring as to the current status of the representation.

Where an entity is a party, the fact that the entity has in-house counsel may well suggest that the entity is represented in all matters, especially if the entity has a general counsel (or in-house counsel fulfilling a similar function). In such instances, an attorney may not communicate with current officers, directors, managing agents, or other covered employees (see discussion above) without the consent of such in-house counsel. However, the mere presence of an in-house specialist (e.g., regulatory or IP counsel) does not necessarily put the attorney on notice that the entity is represented in any particular matter outside such specialty.

"Consent of the Other Lawyer"

Consent is the cornerstone of compliance with CRPC Rule 2-100. However, consent of the represented party is not sufficient. Consent must be obtained from opposing counsel before the attorney may communicate with the represented party. Where an entity is the party, consent of in-house counsel may be sufficient (depending on the function and role of such counsel). The rule does not expressly require that consent be documented, but as an evidentiary matter, it is good practice to confirm a consent in writing.

The rule also does not expressly address whether consent can be implied from facts and circumstances, and there appears to be no authority specifically addressing this issue. Consent may well be implied by the joint presence of counsel and the represented party on a conference call or at a meeting, and transactional practitioners (if they think about it at all) could assume that such implied consent is sufficient to permit direct communication. However, failure to expressly address the issue in such circumstances might mean that the existence of proper consent could be subsequently disputed and/or reviewed.

Also consider standard notice provisions in agreements, which contractually mandate that notices and other communications under such agreements be directed to a party (often, but not always, with copies to counsel). If consent were not implied by the existence of such provision, the attorney providing notice under the agreement might need to choose between a potential violation of CRPC Rule 2-100 or a breach of the contractual mandate. The attorney could have the client provide the notice, but he or she might run the risk of a prohibited indirect communication (see discussion above). At a minimum, the attorney should copy counsel on such notices, even if it is not expressly required by the agreement.

Exceptions

CRPC Rule 2-100 recognizes three exceptions where communications with a represented party are permissible without the consent of counsel: (i) contact with a public officer, board, committee, or body; (ii) communications initiated by a represented party seeking advice or representation from an independent attorney (not opposing counsel); and (iii) communications otherwise authorized by law.[22]

For example, an attorney may discuss a matter pending before a city tribunal with a city official without the city attorney's consent.[23] Similarly, attorneys are permitted to communicate directly with government regulators at the Securities and Exchange Commission or the Federal Trade Commission in connection with investigative or compliance matters without consent. On a deal where a principal is dissatisfied with his or her current counsel, it is also permissible for an attorney not yet involved in that matter to provide independent advice to the principal or substitute into the representation as long as the attorney did not initiate the contact.[24] Certain statutes may also override CRPC Rule 2-100 to protect other established rights, such as the right of employees to organize and to engage in collective bargaining.[25] In light of the current economic climate, we may see an increase in the application of the "authorized by law" exception by government prosecutors who contact represented persons in connection with pre-indictment, non-custodial investigations of white collar crime.

Consequences of Failure to Comply

Improper communications with a represented party can lead to consequences even for transactional lawyers. The State Bar of California may discipline an attorney for a violation of Rule 2-100.

While we have found no instance in the transactional context, a violation in a litigation context typically results in a three-month suspension of the attorney's license to practice law.[26] Whether an attorney can be disqualified from representing the client rests with a trial court (if applicable).[27] Normally, a technical violation alone may not warrant disqualification unless it "led to the disclosure of confidential communications protected by the attorney-client privilege … or created an unfair advantage, or impacted … the integrity of the judicial system."[28] In determining whether disqualification of counsel is appropriate, the court will consider whether the violation will likely have a "continuing effect" on the matter.[29] Disqualification due to a willful or reckless violation of the rule may also result in malpractice liability, fee disallowance, or disgorgement where the client's interests are jeopardized or prejudiced by the termination of the representation. It may be, however, that disqualification is most relevant where the transactional matter also involves or results in litigation.

Conclusion

The prohibitions on *ex parte* communications are binding on all attorneys in the State of California, including transactional attorneys. Unlike litigators who routinely perceive such non-consensual communications as an abusive violation, many transactional attorneys inadvertently violate these rules and run the risk of discipline or disqualification. However, attorneys can prevent such outcomes by simply being mindful of the foregoing issues. Here's a good start: make a mental note of all parties present at a meeting or on a call and ensure that an attorney for each party is also present. Pay attention as individuals drop off a call or leave the room, and you may prevent a violation of CRPC Rule 2-100 and simultaneously preserve a party's right to effective counsel—even if the party is not your client. ■

Endnotes

1 Bus. & Prof. Code §§ 6076 – 77 (West 2003).

2 Rules of Prof. Conduct (hereinafter "CRPC") R. 2-100(A) (2008) (emphasis added).

3 *See Graham v. U.S.*, 96 F.3d 446, 449 (9th Cir. 1996). *See also* CRPC R. 2-100 Discussion (2008).

4 *Abeles v. State Bar*, 9 Cal.3d 603, 609 (1973).

5 *See* the first article in this series, Neil J. Wertlieb and Nancy T. Avedissian, *Addressing Conflicts of Interest in a Transactional Practice*, 4 Bus. Law News 7 (2008).

6 Cal. Bar Form. Op. 1993-131 (1993).

7 *See Crane v. State Bar*, 30 Cal.3d 117, 121 (1981).

8 A "managing agent" is an employee who exercises "substantial discretionary authority over decisions that determine organizational policy." *Snider v. Superior Court*, 113 Cal.4th 1187, 1209 (2003).

9 CRPC 2-100(B)(1)-(2) (2008).

10 *Id.*

11 *See Mills Land & Water Co. v. Golden West Refining Co.*, 186 Cal.3d 116, 128 (1986).

12 *La Jolla Cove Motel & Hotel Apts., Inc. v. Super. Ct.*, 121 Cal.4th 773, 789-790 (2004). Despite the fact that corporate or in-house counsel's consent in such a situation is not required, it may be "advisable and prudent" for the dissent's separate counsel to consult with corporate counsel prior to granting a consent to communicate because it is possible for confidential or privileged information to be accidentally disclosed. *Id.* at 788.

13 ABA Form. Op. 06-443 (2006).

14 *Id.*

15 CRPC 2-100 Discussion (2008).

16 See *Snider*, 113 Cal.4th at 1209; Cal. Bar Form. Op. 1996-145 (1996).

17 *Snider*, 113 Cal.4th at 1215-16.

18 Cal. Bar Form. Op. 1996-145 (1996).

19 *See Abeles*, 9 Cal.3d at 609-10.

20 *Jorgenson v. Taco Bell Corp.*, 50 Cal.4th 1398, 1402 (1996).

21 *Jackson v. Ingersoll-Rand Co.*, 42 Cal.4th 1163, 1168 (1996).

22 CRPC 2-100(C)(1)-(3) (2008).

23 Cal. Bar Form. Op. 1977-43 (1977).

24 However, attorneys must be mindful not to persuade a represented party to discontinue representation by existing counsel so as not to trigger potential tort liability for alleged interference with a contractual relationship. *See Frazier, Dame, Doherty, Parrish & Hanawalt v. Boccardo, Blum, Lull, Niland, Teerlink & Bell*, 70 Cal.3d 331, 337–9 (1977).

25 *See* CRPC 2-100(C)(3) Discussion (2008).

26 *See Levin v. State Bar*, 47 Cal.3d 1140, 1150 (1989).

27 *Chronometrics, Inc. v. Sysgen, Inc.*, 110 Cal.3d 597, 607–8 (1980).

28 *Continental Ins. Co. v. Super. Ct.,* 32 Cal.App.4th 94, 111, n.5 (1995).

29 *Chronometrics*, 110 Cal.3d at 607–8.

Continued from page 8 . . The Unfair Competition Law

case, and Article III would present no real limitation."[16] The court contrasted this with a situation where a plaintiff expended funds independently of the litigation to investigate or combat the defendant's misconduct. In the latter case, a plaintiff could still establish "injury in fact." [17]

D. While Injury May Not Be Manufactured, The Nature and Extent of Injury or Loss Need Not Be Monetarily Significant

As mentioned above, the unfair competition law does not allow aggrieved parties to sue for prospective damages; its remedy is restitutionary, and this often results in cases being brought where the money expended or loss sustained is not large. Generally speaking, this is not an impediment to an unfair competition claim.

The cases in which injury in fact has been found are ones in which a defendant's conduct caused the plaintiff to spend money or incur costs that he or she could have avoided but for the defendant's conduct. The amount of the loss was not the determinative factor. The following are examples of cases in which the court found injury in fact:

- *Aron v. U-Haul Co. of California*, 143 Cal.App.4th 796, 802-803 (2006): plaintiff alleged that he (and others) were required to purchase more fuel than was necessary when returning rental trucks because the trucks' fuel gauges were not properly calibrated, and defendants would not correct the problem or refund the excess fuel costs.
- *Monarch Plumbing Co. v. Ranger Ins. Co*., 2006 U.S.Dist. LEXIS 68850 (E.D. Cal., 2006): plaintiff alleged that he paid higher insurance premiums than he otherwise would have paid because of defendant insurer's settlement policies.
- *Witriol v. LexisNexis Group*, 2006 U.S.Dist. LEXIS 26670 (N.D. Cal., 2006): plaintiff incurred costs to monitor and repair damage to his credit caused by defendants' unauthorized release of his private information.
- *Southern Cal. Housing v. Los Feliz Towers Homeowners Ass'n.*, 426 F.Supp.2d 1061, 1069 (C.D. Cal. 2005): housing rights center lost financial resources and diverted staff time investigating case against defendants.

The following are examples of cases in which the court declined to find injury in fact because the defendant's conduct *did not induce* the plaintiff to take action or did not cause any loss. Again, the amount of loss was not the significant issue.

- *Hall v. Time Inc.*, 158 Cal.App.4th 847, 853 (2008): plaintiff had no standing to allege an unfair competition claim based on Time Book's alleged practice of charging for a book purchased online before the period expired in which the purchaser needed to decide whether to keep the book or return it; in this case, plaintiff kept the book that he received but nonetheless complained that Time Book had charged his credit card too early.
- *Medina v. Safe-Guard Products, Int., Inc.*, 164 Cal.App.4th 105 (2008): plaintiff claimed that the defendant's practice of selling vehicle service contracts without a license was unlawful and unfair because this voided the contracts defendant entered into. The court explained that such contracts were not void and that the law would impose an obligation on the part of the defendant to honor the contract in question; thus there was no factual basis upon which to premise an unfair competition claim. The fact that the plaintiff did not want it to be enforceable was of no moment. Absent allegations that the plaintiff had been denied services, was duped into a contract, or paid more for this contract than necessary, he had suffered no cognizable injury in fact.
- *Cattie v. Wal-Mart Stores, Inc.*, 504 F.Supp.2d 939, 945 (S.D. Cal. 2007): in a case where plaintiff claimed defendants falsely advertised the thread count on sheets, plaintiff lacked standing to bring UCL or False Advertising Act claims because she did not allege that she relied on any advertisements in purchasing the sheets.

An unpublished case, *Freeman v. Gallery*, 2007 Cal. App. Unpub. LEXIS 9102 (2007), illustrates a certain tension concerning the type of loss that may sustain an unfair competition claim. Ultimately, the court found that standing existed on the facts of the case, but that holding came over a strong dissent—one which might be persuasive under different circumstances. *Freeman* involved what the plaintiff called a "bait and switch" advertisement. Plaintiff saw a Mattress Gallery advertisement explaining that a manufacturing error resulted in the production of thousands of mattresses with the wrong cover. The ad therefore offered these mattresses at special pricing. Plaintiff drove to the store to purchase a mattress for his daughter's house, only to discover that the ad was part of an alleged "bait and switch" scheme in which store salespersons suggested that the advertised mattresses were not comfortable, and instead recommended that he buy a different mattress at a much higher price. Plaintiff never purchased a mattress but instead sued alleging a violation of section 17200.

The trial court held that since Plaintiff did not purchase a mattress, he could not pursue his claim despite his argument that he had spent the time and cost (gas and tire wear) to go to the store

based on the advertisement. The court of appeal, over a strong dissent, agreed with Plaintiff and reversed the lower court. The majority reasoned that if Plaintiff could allege a loss of gas and wear and tear on his tires, this would be sufficient injury to allow him to proceed on an unfair competition claim.

The dissent charged that the majority opinion had collapsed the two concepts of injury in fact and economic loss into one. The dissent explained that this did violence to the statutory language:

> It is clear from the plain language of the statute that a private person has standing to sue under Section 17204 only if that person has (1) suffered an 'injury in fact,' and (2) lost money or property as a result of such unfair competition. (§ 17204) Since '[c]ourts should give meaning to every word of a statute if possible, and should avoid a construction making any word surplusage"'(*Arnett v. Dal Cielo* (1996) 14 Cal.4th 4, 22), Freeman cannot satisfy the standing requirement unless he can demonstrate that, in addition to losing money, he suffered an 'injury in fact.' The damages alleged by Freeman do not rise to the level of an 'injury in fact.' Therefore, he cannot amend his complaint to allege damages sufficient to confer standing and he is not entitled to pursue his UCL claims. [18]

IV. Do Class Members Have to Have Standing? Must They Have Relied?

As discussed above, post-Proposition 64 cases have imposed reliance/causation requirements for individual plaintiffs suing under the UCL. The question now appears to be whether class members must meet the same standing requirements.

In two cases, courts of appeal have said that they do. *See In re Tobacco Cases II*, 142 Cal.App.4th 891 (2006), *review granted, depublished,* 51 Cal.Rptr.3d 707, 146 P.3d 1250 (2006); and *Pfizer Inc. v. Super. Ct.*, 141 Cal.App.4th 290 (2006), *review granted, depublished,* 2006 Cal. LEXIS 13327 (Nov. 1, 2006).

In one case (*see McAdams v. Monier, Inc.*, 151 Cal.App.4th 667 (2007), review granted, depublished 2007 Cal. LEXIS 10072 (Sept. 19, 2007)), the appellate court held that reliance/causation could be presumed. As discussed below, the difference between these holdings may have to do with the facts of the cases. But in any event, the Supreme Court is now set to review and decide the issue, using at least one of these cases to do so.

In re Tobacco Cases II involved a class action unfair competition claim by representative plaintiffs—smokers seeking to recover economic losses based on the purchase of cigarettes—against various cigarette manufacturers. The plaintiffs theorized that they were misled and harmed by the defendants' misrepresentations about the health risks of smoking and (lack of) addictiveness of cigarettes. The trial court initially certified a class but subsequently decertified it. The court of appeal affirmed the trial court's decertification.

The court recognized certain general principles applicable to all class actions: (1) since Proposition 64, a plaintiff class representative must meet the elements of standing required under section 17204 (injury in fact and loss of money or property); (2) as with any class action, the definition of a class cannot be so broad as to include persons who are without standing to bring a claim on their own behalf; and (3) there is nothing magic about a class action. It cannot create substantive rights that did not previously exist.

Thus, "[i]f a specific form of relief is foreclosed to claimants as individuals, it remains unavailable to them even if they congregate into a class." [19]

The court recognized that plaintiffs' "reliance on advertisements" theory was based on the following:

- Defendants' general marketing activities in California, *rather than* specific representations made to the plaintiff class; and
- Plaintiff class members who became smokers heard or were aware of those marketing efforts and believed them. [20]

Because the plaintiffs pointed to no fixed, identifiable representations that came from a single source, and because they would not be able to show that all plaintiffs believed all the representations that were made, or even that they were aware of any specific representations, the court of appeal held that the trial court was well within its discretion to deny class certification.[21]

Pfizer involves an unfair competition class action in which plaintiff charged that Pfizer marketed Listerine in a misleading manner by indicating that using the product could replace dental floss in reducing plaque and gingivitis.

The trial court certified a class of "all persons who purchased Listerine in California from June 2004 through January 7, 2005." Pfizer sought a writ of mandate challenging the class certification order on the grounds that it was improper under newly-amended Business & Professions Code section 17204. The court of appeal agreed, holding that in the post-Proposition 64 world, courts are required to assess whether there is a community of interest between the class representative and the class. This requires an inquiry not only into whether the class representative has suffered an injury in fact and lost money or property, but whether *class members* have as well.[22]

Moreover, because Proposition 64 added a requirement that a plaintiff suffer injury in fact and loss "as a result of" any act of

unfair competition, the court found that both the class representative, *and all class members*, had to show reliance.[23] Thus, the court found it would be improper to certify a class of all purchasers of Listerine because that formulation would not take into account whether potential class members had relied upon any misleading representations.[24]

In *McAdams*,[25] the plaintiff brought a class action alleging an unfair competition claim against a roof tile manufacturer, claiming the latter had failed to disclose that the color composition of its roof tiles would erode well before the end of the tiles' represented 50-year life.

The trial court refused to certify a class, finding that each class member's need to prove his or her reliance on representations defeated any typicality of claims. The court of appeal disagreed at least in part. It did agree that each class member, as well as McAdams, ultimately had to establish standing.[26] However, it found that class member reliance could be presumed under the facts of the case.

The particular representations at issue in *McAdams* were that the tiles: (1) were free from manufacturing defects, would remain structurally sound for a period of 50 years, and were warranted for that period; (2) had a permanent color glaze that required no resurfacing; and (3) would need no care or maintenance.[27]

The court of appeal held that where, as in *McAdams,* a representation was material, specific, identifiable, and came from a single source, the court could presume reliance for purposes of the remaining class members. [28]

The Supreme Court may ultimately decide (1) that standing requirements do not apply to class members in the same way they do for the representative plaintiff; or (2) that standing requirements do apply equally to both the representative plaintiff and to unnamed class members. Given the trend in the law, the latter appears more likely than the former. This would also comply with the general law concerning class actions in California, law that existed well before the 2004 amendment to the UCL.

Even so, a decision in one or more of these cases may not end the debate. Class certification determinations are complicated and often fact-driven, and the differing results in the three cases before the court can be explained on their facts. In *In re Tobacco Cases,* certification was denied because the alleged representations were not sufficiently detailed, came from too many sources, and would have created significant legal and logistical proof problems concerning reliance and causation as a result. In *McAdams*, the representations were specific and all came from a single source, and thus would not have created the same problems. The cases currently before the court will likely provide needed guidance to the lower courts, but they may not fully resolve the standing controversy.

V. Can the Right to Be a Class Action Representative Be Assigned?

The class certification/reliance cases are not the only ones pending before the Supreme Court. *Amalgamated Transit Union, Local 1756, AFL-CIO v. Super. Ct.*, 148 Cal.App.4th 39 (151 Cal. App. 4th at 672), *review granted,* 161 P.3d 1 (Cal. 2007)) has been taken up, and it presents the question of whether a party who has suffered cognizable loss may assign his or her right to act as a class action representative.

In *Amalgamated*, two labor unions representing mechanics and transit operators (Unions), along with 17 members or former members of the Unions (collectively, plaintiffs), filed a lawsuit against several transit company employers. They alleged the defendants failed to provide employees with the meal and rest periods required by law, and they sought millions of dollars in unpaid wages and civil penalties. In a second cause of action, plaintiffs alleged that the employers' failure to provide the legally required meal and rest periods violated the unfair competition law (i.e. the "unlawful" prong of the statute). Pursuant to that claim, plaintiffs sought injunctive relief and restitution of unpaid wages.

The operative complaint alleged that the Union plaintiffs were suing in their representative capacity (a) on behalf of members who are or were employed by the defendant employers and (b) as assignees of rights transferred to the Unions by over 150 employees and former employees of the defendant employers.

The trial court found that the assignments were ineffective to confer upon the Unions the right to bring a representative class action. The Unions took the matter up on writ to the court of appeal. That court found that an injured party could assign his or her personal claims for unpaid wages but could not transfer his or her rights to bring representational claims on behalf of other employees: "The right to bring a representative suit is not itself a cause of action (or any other form of property) that is owned and therefore assignable. Unlike causes of action, which arise from obligations or from the violation of property rights of the owner, the right to sue on behalf of others is a procedural mechanism created by the Legislature to facilitate the prosecution of similar claims owned by many different persons. Authorization to bring a representative suit is conferred by the Legislature, and persons authorized to bring suit have no power to assign that authorization to a third party, nor does an assignment of a cause of action include, by operation of law, the authorization to bring a represen-

tative suit."[29] Stay tuned as to how the Supreme Court will resolve that issue.

VI. Conclusion

As the courts grapple with issues of standing, injury in fact, and reliance, we can expect to see continuing refinements in the law, refinements that will, we hope, effectuate the purposes behind the amendments to the Business & Professions Code. Proposition 64 has put an end to "private attorney general" suits. It has required plaintiffs either to sue individually based on actual injury suffered, or to sue under the rules of class actions. As courts seek to mesh class action requirements with the requirements of amended section 17200, we can expect resolution of many of the issues related to standing and reliance discussed above. In the interim, businesses have experienced at least some relief from the types of 17200 claims that had for quite some time adversely affected businesses. ■

Endnotes

1 Bus. & Prof. Code § 17200.

2 "Its coverage is 'sweeping, embracing' anything that can properly be called a business practice and that at the same time is forbidden by law . . . It governs 'anti-competitive business practices' as well as injuries to consumers, and has as a major purpose 'the preservation of fair business competition.'" *Cel-Tech Communications, Inc. v. Los Angeles Cellular Telephone Co.*, 20 Cal.4th 163, 180 (1999).

3 *See, e.g.*, *Korea Supply Co. v. Lockheed Martin Corp.*, 29 Cal.4th 1134, 1140 (2003) (non-restitutionary damages, including disgorgement of profits, are not available).

4 *Cel-Tech*, 20 Cal.4th at 180.

5 "Courts may not simply impose their own notions of the day as to what is fair or unfair." *Id.* at 182. Further, "courts may not apply purely subjective notions of fairness. 'The appellate courts have neither the power nor the duty to determine the wisdom of any economic policy; that function rests solely with the legislature . . . '" *Id.* at 185.

6 *Id.* at 187. California courts agree that the *Cel-Tech* test applies to unfair competition claims between competitors. They disagree, however, on whether that test applies in the consumer context and, as a result, courts have applied two alternative tests in that context. *See, e.g.*, *Smith v. State Farm Mutual Automobile Ins. Co.,* 93 Cal.App.4th 700 (2001); *Camacho v. Automobile Club of Southern California,* 142 Cal.App.4th 1394 (2006); *Gregory v. Albertson's, Inc.*, 104 Cal.App.4th 845 (2002); *Buller v. Sutter Health*, 160 Cal.App.4th 981 (2008).

Smith v. State Farm Mutual Automobile Ins. Co. teaches that a consumer claiming that a business practice is unfair must show (1) that he or she suffered injury; (2) that the practice complained of "offends an established public policy or . . . is immoral, unethical, oppressive, unscrupulous, or substantially injurious to consumers"; and (3) that the plaintiff's injury outweighs any reasons or justifications that the defendant may have to justify its conduct. Under *Camacho v. Automobile Club of Southern California*, a consumer must be able to show that he or she suffered injury; that the injury was substantial; that it is an injury that the consumer could not have reasonably avoided; and that the defendant's complained of conduct does not have sufficient countervailing benefits to consumers or competition.

The stricter standard—and the one that most closely follows *Cel-Tech* in the consumer context—requires any contention that a business practice is unfair to be "'tethered' to a legislatively declared policy" or to have "some actual or threatened impact on competition." *Belton v. Comcast Cable Holdings, LLC*, 151 Cal. App.4th 1224, 1239-1240 (2007), citing *Gregory v. Albertson's, Inc.*, 104 Cal.App.4th 845, 853-854 (2002).

7 *See Cel-Tech*, 20 Cal. 4th at 180.

8 Section 17200 *et seq.* does not provide an independent basis for fees. However, Code of Civil Procedure section 1021.5 allows a party suing on behalf of the public to seek its attorneys' fees if it prevails, or if its lawsuit caused the offending defendant to change its conduct. It is under the latter section that uninjured plaintiffs would request fees under the unfair competition laws, claiming that they were acting in the public interest, and not to vindicate their own personal rights.

9 *Californians for Disability Rights v. Mervyn's, LLC*, 39 Cal.4th 223, 228 (2006).

10 *Californians for Disability Rights*, 39 Cal.4th at 228.

11 Business & Professions Code section 17204 requires that actions for any relief under the unfair competition laws may only be brought (1) by various prosecuting authorities or (2) by persons who have "suffered injury in fact and [have] lost money or property as a result of the unfair competition."

12 *Associated Builders & Contractors v. San Francisco Airports Com.,* 21 Cal.4th 352, 362 (1999).

13 *Schulz v. Neovi Data Corp.,* 152 Cal.App.4th 86 (2007).

14 Bus. & Prof. Code § 17204; *Schulz,* 152 Cal.App.4th at 92.

15 *Laster*, 407 F.Supp.2d at 1194.

In *O'Brien v. Camisasca Automotive Manufacturing, Inc.*, 161 Cal.App.4th 388, 400 (2008), the plaintiff sued an automobile license plate manufacturer for representing that its plates were made in the USA when they allegedly had not been. The court

held that plaintiff did not have standing because he could not show that he purchased a plate in reliance on any alleged representation. "For a private party to have standing under sections 17204 and 17535, Proposition 64 dictates that the plaintiff have 'suffered injury in fact … as a result of' an unfair business practice or false advertising. . . . *Parsing this language, it unavoidably implicates causation. That is to say, the unfair business practices or false advertisement must have caused injury in fact to the plaintiff*. For a plaintiff to suffer 'injury in fact … as a result of' the alleged unfair business practice or false advertising (§§ 17204, 17535), necessarily the plaintiff must have actually relied on the false advertising or unfair business practice, and as a result, suffered injury therefrom. To have standing in this case, a consumer must have relied on a representation.'" *O'Brien*, 161 Cal.App.4th at 400 (emphasis added). However, the Supreme Court has granted review in *O'Brien* and has deferred briefing pending its determination of the *In Re Tobacco Cases* discussed below.

16 *Buckland*, 155 Cal.App.4th 798 at 815.

17 *Id*. While the distinction between these two situations might be difficult to see in some circumstances, this was not the case in *Buckland* where the plaintiff had offered a declaration demonstrating that she had purchased the defendant's product only to pursue litigation.

18 *Freeman*, 2007 Cal. App. Unpub. LEXIS 9102 (2007).

19 *In re Tobacco Cases II*, 142 Cal.App.4th at 898.

20 *Id*. at 899.

21 In a related case (also named *In re Tobacco Cases II,* 41 Cal.4th 1257 (2007)), the Supreme Court held that the Federal Cigarette Labeling and Advertising Act, 15 U.S.C. § 1331 *et seq*., preempts any state law or cause of action that seeks to regulate cigarette advertising on the grounds that it targets minors and encourages them to begin smoking. This determination likely moots any need to determine the class certification issue now pending in the other *In re Tobacco Cases*. The Supreme Court has not taken definitive action yet.

22 *Pfizer*, 141 Cal.App.4th 290 at 295.

23 *Id*. at 305.

24 *Pfizer* was taken up at about the same time as *In re Tobacco Cases II*, but it was placed on a grant and hold with briefing deferred while the latter case was briefed and decided.

25 *McAdams* was also accepted as a grant and hold.

26 *McAdams*, 151 Cal.App.4th at 683.

27 *Id*. at 672.

28 *Id*.

29 *Amalgamated,* 148 Cal.App.4th at 48.

Continued from page 10. . .Bankruptcy Sales

porate all of the restrictions of section 363(f).[16] The BAP stated that it would be "circular reasoning" to "sanction[] the effect of cramdown without requiring any of section 1129(b)'s substantive and procedural protections," and more generally a bankruptcy estate "would not need section 363(f)(5) at all" if the legal or equitable proceeding were "found elsewhere in the Bankruptcy Code" because then the estate "could simply use the other Code provision."[17] Therefore, the BAP implied, only a "nonbankruptcy" proceeding qualifies under section 363(f)(5).[18] Curiously, the BAP did not discuss whether foreclosure under state law would qualify as a "legal or equitable proceeding" that could compel the junior lienholder to accept a "money satisfaction." But, it did interpret a "money satisfaction" to require a proceeding that could compel lien- or interest-holders to accept something less than "full payment" or something less than "what their interest is worth."[19] The BAP also listed some examples of what it had in mind, including a liquidated damages clause and "a buy-out arrangement among partners, in which the controlling partnership agreement provides for a valuation procedure that yields something less than market value of the interest being bought out."[20] The BAP acknowledged that this creates a very "narrow" interpretation of section 363(f)(5), but it held that such a reading is warranted to prevent overlap of the various paragraphs of section 363(f).

The point of the foregoing discussion is not to resolve these issues but to point out that there is no consistent interpretation of section 363(f). Courts disagree even within the Ninth Circuit, let along among the other circuits nationwide. For the practitioner who represents any of the parties to a proposed purchase and sale involving a bankruptcy estate, the key is to recognize that there are alternative interpretations and attempt to persuade the Bankruptcy Court and any appellate court to adopt a favorable interpretation of section 363(f) or, possibly, other sections of the Bankruptcy Code. Some alternatives are described below.

Accomplishing Sales Free and Clear

Despite the holding in *Clear Channel*, there are still several reasons to believe that parties may continue to buy and sell assets free and clear under the Bankruptcy Code.

First, although the tenor of *Clear Channel* may be representative of those courts nationwide that disfavor sales outside of a plan of reorganization, *Clear Channel* itself is not necessarily binding authority. The BAP has ruled that its own decisions are binding on all bankruptcy courts within the Ninth Circuit, but many bankruptcy court judges do not believe that they are bound

by BAP decisions.[21] At the very least, however, *Clear Channel* is binding on the BAP itself, which has no process for *en banc* review. So, in any appeal involving *Clear Channel* issues, the buyer presumably will want to "opt out" of the BAP and appeal to a District Court instead.[22] The buyer might even want to seek a direct appeal to the Ninth Circuit.[23]

Second, other paragraphs of section 363(f) may apply to authorize a sale free and clear, making the BAP's interpretation of section 363(f)(3) and (5) less critical. One paragraph that is frequently cited allows a sale free and clear of an interest that is "in bona fide dispute."[24]

Third, *Clear Channel* may be distinguishable from typical bankruptcy sales. Some practitioners believe that *Clear Channel* might be limited to situations involving credit bids because portions of the BAP's discussion focus on this fact. Another distinction may be that the transaction at issue in *Clear Channel* was unlikely to benefit general unsecured creditors, despite the "carve-out" of up to $800,000, because in practice those funds were likely to be consumed by professionals' fees and other costs. In addition, the BAP may have felt that the senior lender should not be able to obtain the benefits of the Bankruptcy Code, such as the ability to take assignments of contracts that could not be assigned outside of bankruptcy, without accepting what the BAP called the "checks and balances" of the plan confirmation process. That issue might not arise if in a given bankruptcy case it is not necessary to assign executory contracts or unexpired leases as part of the sale of assets. These and other factual distinctions might help to persuade a Bankruptcy Court, District Court, or Court of Appeals not to follow *Clear Channel* in other cases.

Fourth, a two-stage approach offers an alternative to utilizing section 363(f). The party seeking a sale would first need to obtain a ruling by the Bankruptcy Court under section 506(d) that the lien at issue is void to the extent it is under-secured, perhaps using an adversary proceeding. Then, after such ruling is obtained, the now-stripped-down lien would be paid in full out of escrow at the sale closing, which presumably would give the buyer clean title by discharging the lien under state law without the need to use section 363(f). As a practical matter, these various proceedings could be combined into a single hearing, but conceptually they would remain distinct.[25]

Fifth, if all else fails and it is deemed necessary or advisable for the bankruptcy estate to use a plan of reorganization to sell assets free and clear, several procedures can greatly expedite the process. A pre-packed or pre-negotiated plan may be possible, and some Bankruptcy Courts are amenable to combining a plan and disclosure statement into a single document with a single hearing. Other techniques also exist that may ameliorate the delay and expense that are often attendant on the process of confirming a plan.[26]

Mootness Issues in Clear Channel

As noted above, mootness is important because if an appeal is not moot, there are substantial risks to closing a purchase and sale transaction. In *Clear Channel*, there were many indications that the entire appeal may have been moot: (a) the Bankruptcy Court found that the senior lienholder was a good faith purchaser under section 363(m);[27] (b) the junior lienholder's motions to stay the sale were denied by both the Bankruptcy Court and the BAP; and (c) the buyer closed the sale, took assignment of executory contracts and unexpired leases, and ultimately paid out over $1.5 million in connection with the purchase (to the estate, to a pre-petition receiver, to a more senior lienholder, and for real estate taxes and closing costs). The BAP applied the well-recognized equitable mootness standard in the Ninth Circuit that "[u]ltimately, the decision whether to unscramble the eggs turns on what is practical and equitable."[28] It held that the transfer-of-title issues were moot because persons who were not parties to the appeal had relied on the transfer of title, and it was impossible to "unscramble the eggs." But, the BAP also held that the "free and clear" aspect of the sale order was not moot because (i) that aspect could be addressed separate from the transfer of title; (ii) the buyer was a party to the appeal and was "aware of the risks of going forward with the sale;" and (iii) the junior lien could reattach to the property.[29] This decision illustrates that what is "equitable" and what can be "unscrambled" can be difficult to predict.

Turning from equitable mootness to statutory mootness, the BAP ruled that section 363(m) did not render the appeal moot as to the "free and clear" issues. Section 363(m) states in full:

> (m) The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

The BAP held that "§ 363(m) does not apply to lien-stripping under § 363(f)" because "§ 363(m) by its terms applies only to 'an authorization under subsection (b) or (c) of this section ...'" and "[h]ere, the remaining challenge is to the authorization under

subsection (f) ...."[30] The BAP further held that "Congress intended that § 363(m) address only changes of *title or other essential attributes of a sale*, together with the changes of authorized possession that occur with leases. The *terms of those sales, including the 'free and clear' term at issue here, are not protected*."[31] Finally, the BAP commented that "Congress could easily have broadened the protection of § 363(m) to include lien-stripping" but "stripping a lien is not a sale [and therefore is not] protected by the language of § 363(m), either directly or indirectly."[32]

Arguably, the BAP's reasoning is circular. Section 363(m) is indeed limited to an authorization "under subsection (b) or (c) of this section," but section 363(f) also applies to a sale "under subsection (b) or (c) of this section," so it is difficult to parse why the "free and clear" aspect of the order was not an "essential attribute" of the sale under subsection (b) or (c). Similarly, one could argue that the only reason the "remaining" challenge was limited to subsection (f) was that a few pages earlier the BAP had stated that this aspect of the order could be separated from the authorization of the sale under section 363(b), but that assumes the conclusion. Finally, Congress did not refer to lien-stripping in either subsection (f) or (m), so it is not clear why the absence of references to lien-stripping in one of those two subsections is significant. Whatever the merits of such arguments and counter-arguments, it is clear that the BAP was convinced that it was both possible and equitable to separate the transfer of title from the subsection (f) aspect of the order and to reattach the junior lienholder's lien on the property after the sale.

If a purchase and sale is not stayed but closing the transaction might not moot an appeal, then the buyer of assets from a bankruptcy estate will have to decide whether to wait for all appeals to be exhausted or take the risk of closing. Closing may increase the chances that the entire appeal will be moot, but closing also increases the buyer's investment. It may take years for all appeals to be resolved, so the critical question is what the parties who favor the purchase and sale can do to mitigate the risks of closing.

Mitigating the Risks of Closing a Sale Notwithstanding an Appeal

The risks associated with closing a purchase and sale in bankruptcy while an appeal is pending can be mitigated by a variety of factors that might render the appeal moot.

First, the buyer and other parties supporting the sale can oppose any motion for a stay pending appeal.

Second, the appellate process can be expedited by a direct appeal to the Ninth Circuit, an early motion to dismiss the appeal as moot, or both.[33]

Third, any substantial reliance by persons who are not parties to the appeal is likely to help moot the appeal. If the buyer is not a senior lender who credit bids (as in *Clear Channel*) but instead borrows funds from a third-party lender who then records a deed a trust, that may moot any appeal. The buyer also should consider selling the asset to a subsequent transferee after careful analysis and consultation with counsel.

Fourth, the Ninth Circuit has held that "even if an appeal is not equitably moot, a court may still hold that the equities weigh in favor of dismissing the appeal."[34]

Fifth, there is authority that mootness under section 363(m) encompasses any provision that is "integral" to a sale and that a provision is integral if "modifying or reversing the provision would adversely alter the parties' bargained-for exchange."[35] Similarly, under parallel provisions of section 364(e) concerning appeals from financing agreements, the Ninth Circuit has held that "any provisions of the financing agreement that [the lender] might have bargained for or that helped to motivate its extension of credit are protected by § 364(e)."[36]

Conclusion

There are numerous advantages to purchasing and selling assets out of a bankruptcy estate. The bankruptcy process tends to flush out and resolve adverse claims, override intransigent minorities, enable businesses to maintain going concern value, and enable purchasers to acquire clear title to property free and clear of adverse interests and with assignments of valuable executory contracts and unexpired leases. These advantages can make the difference between a successful transaction and a prospective sale that never attains the momentum to close. The BAP's decision in *Clear Channel* illustrates that all parties who favor a purchase and sale transaction must be careful and creative both in moving for a sale free and clear before the Bankruptcy Court and in deciding whether to close the transaction while an appeal is pending. The above techniques should help experienced counsel guide their clients through the bankruptcy process and maximize the benefits while reducing the risks of purchasing and selling assets free and clear under the Bankruptcy Code. ■

Endnotes

1 11 U.S.C. § 363.

2 For a recent discussion of some issues involving assignment of executory contracts generally and licenses in particular, see Tobias Keller, *Counseling the Licensee through a Licensor's Chapter 11 Sale*, 4 Bus. Law News, 7 (2007).

3 *Clear Channel*, 391 B.R. at 31 & n. 2.

4 *See* 11 U.S.C. § 506(b).

5 *See* 11 U.S.C. § 506(d) and Fed. R. Bankr. P. 3012 and 7001(2).

6 *See* §§ 1101(1) and 1107(a).

7 11 U.S.C. § 363(f)(5) (emphasis added).

8 *Compare, e.g., Criimi Mae Services Ltd. v. WDH Howell, LLC (In re WDH Howell, LLC)*, 298 B.R. 527 (D.N.J. 2003) (the "value" of liens under § 363(f)(3) is their face amount) *with, e.g., In re Collins*, 180 B.R. 447 (Bankr. E.D. Va. 1995) (approving sale for less than face amount of lien); *In re Becker Indus.*, 63 B.R. 474, 475 (Bankr. S.D.N.Y. 1986).

9 *See In re Canonigo*, 276 B.R. 257, 265 (Bankr. N.D. Cal. 2002).

10 *Clear Channel*, 391 B.R. at 38.

11 *See EEOC v. Knox-Schillinger (In re Trans World Airlines, Inc.)*, 322 F.3d 283, 290-91 (3d Cir. 2003) (agreeing with lower court that employees' discrimination and benefits claims were "subject to monetary valuation" because they would have received a monetary distribution in a chapter 7 case, and therefore the debtor's assets could be sold free and clear of successor liability for such claims under § 363(f)(5)).

12 *Canonigo,* 276 B.R. at 265 (avoiding any overlap between § 363(f)(3) and (f)(5) by interpreting an "interest" in the latter not to include a lien).

13 *In re Healthco Int'l, Inc.*, 174 B.R. 174, 176 (Bankr. D. Mass. 1994) (avoiding any overlap between § 363(f)(3) and (f)(5) by interpreting the latter to apply only to undersecured liens).

14 In a chapter 7 case, the movant would have to show that cramdown would be possible if the case were converted to chapter 11.

15 *See, e.g., Healthco Int'l,* 174 B.R. at 176 (summarizing arguments for and against recognizing cramdown as a qualifying "legal or equitable proceeding" under § 363(f)(5)); *In re Gulf States Steel, Inc. of Ala.*, 285 B.R. 497, 508 (Bankr. N.D. Ala. 2002) (under § 363(f)(5) a "lienholder would only be required to receive what it would receive in the event of cramdown," which could be "nothing").

16 *See* 11 U.S.C. § 1129(b)(2)(A)(ii).

17 *Clear Channel*, 391 B.R. at 46.

18 *Id*.

19 *Clear Channel*, 391 B.R. at 43-44 (footnote omitted, emphasis added).

20 *Clear Channel*, 391 B.R. at 43 (citations omitted).

21 *Compare Zimmer v. PBS Lending Corp. (In re Zimmer)*, 313 F.3d 1220, 1225 n. 3 (9th Cir. 2002) (binding nature of BAP decisions still an open issue) *and CASC Corp. v. Milner (In re Locke)*, 180 B.R. 245, 254 (Bankr. C.D. Cal. 1995) (B.A.P. decisions not binding on bankruptcy courts) *with In re Windmill Farms, Inc.*, 70 B.R. 618, 621 (B.A.P. 9th Cir. 1987) (BAP views its decisions as binding), *rev'd on other grounds*, 841 F.2d 1467 (9th Cir. 1988) and *Life Ins. Co. of Va. v. Barakat (In re Barakat)*, 173 B.R. 672, 676-80 (Bankr. C.D. Cal. 1994) (BAP decisions binding on bankruptcy courts), *aff'd on other grounds*, 99 F.3d 1520 (9th Cir. 1996).

22 *See* 28 U.S.C. § 158(b)(1); *Arkansas Teachers Ret. Sys. v. Official Inv. Pool Participants Comm. (In re County of Orange)*, 183 B.R. 593 (B.A.P. 9th Cir. 1995) (election must be in a separate document, filed separately from the notice of appeal); *Ioane v. Collins (In re Ioane)*, 227 B.R. 181, 183 (B.A.P. 9th Cir. 1998) (statutory deadline for making the election is time the notice of appeal is filed). *See also Bank of Maui v. Estate Analysis, Inc.*, 904 F.2d 470, 472 (9th Cir. 1990) (B.A.P. decisions cannot bind district courts, but declining to decide the authoritative effect of a B.A.P. decision).

23 *See* 28 U.S.C. § 158(d)(2).

24 11 U.S.C. § 363(f)(4).

25 *See Canonigo*, 276 B.R. at 263.

26 *See* 11 U.S.C. §§ 105(d)(2)(B)(vi) (combined plan and disclosure statement hearing) and 1126(b) (acceptances of plan prior to petition date); Fed. R. Bankr. P. 3017-18.

27 *See* 11 U.S.C. § 363(m) (quoted later in the text).

28 *Clear Channel*, 391 B.R. at 33 (citation omitted).

29 *See Id*. at 33-37.

30 *Id.* at 35.

31 *Id.* at 35-36 (emphasis added).

32 *Id.* at 36.

33 *See* 28 U.S.C. § 158(d)(2); Fed. R. Bankr. P. 8011.

34 *S.S. Retail Stores Corp. v. Ekstrom (In re S.S. Retail Stores Corp.)*, 216 F.3d 882, 885 (9th Cir. 2000).

35 *Official Comm. of Unsecured Creditors v. Trism, Inc. (In re Trism, Inc.)*, 328 F.3d 1003, 1007 (8th Cir. 2003).

36 *In re Cooper Commons, Inc.*, 430 F.3d 1215, 1219-20 (9th Cir. 2005), *but cf. Clear Channel*, 391 B.R. at 36 (finding support in § 364(e) for its reading of § 363(m)).

Continued from page 12 . . . Commercial Landlords & Bankruptcy

Courts have adopted various procedures to protect the interests of a landlord during the extension of the time for the debtor to assume or reject a lease. These include (i) granting an extension conditioned on the debtor's continued compliance with its post-petition lease obligations under section 365(d)(3); (ii) requiring the debtor to continue operating for a certain period of time (*e.g.*, keeping a retail store open through the Christmas shopping season) even if it would otherwise elect to reject the lease sooner; and (iii) requiring the debtor to continue making rental payments beyond the time when the debtor would otherwise elect to reject the lease.[14] At least one court has granted an extension under section 365(d)(4) in order to allow a third party purchaser of the debtor's assets to determine whether to assume or reject leases.[15]

In addition, a debtor may be authorized to renew a lease pending assumption or rejection despite uncured defaults, even where the lease conditions renewal on the absence of any defaults. However, the bankruptcy court has discretion over whether to allow a tenant in default to exercise its renewal option after considering the scope of the default, the causes of the default, any subsequent cure, and the significance of the lease to the tenant's ability to reorganize, and then balancing these factors against the policy of section 365(d)(3) to provide the landlord with the right to timely post-petition payments.[16]

IV. Rejection of an Unexpired Lease in Bankruptcy

The "business judgment rule" is the standard that governs a bankruptcy court's approval of a debtor's decision to reject an unexpired lease. Under this rule, the debtor's determination that rejection of the lease will benefit the bankruptcy estate will be accepted by the court unless shown to be manifestly unreasonable. Generally, the potential damages to the non-debtor party resulting from rejection is not relevant to the court's analysis[17] although the court may refuse to authorize rejection of a lease where the lessor would suffer disproportionate damage (*e.g.*, where most of the benefit of rejection would be captured by a third party rather than the bankruptcy estate).[18]

V. Assumption of an Unexpired Lease in Bankruptcy

As with lease rejection, the business judgment rule technically is the standard that governs the bankruptcy court's approval of a debtor's decision to assume an unexpired lease. However, because a key consequence of the court's approval of assumption of a lease is that any existing monetary defaults must be cured and virtually any post-assumption breach by the debtor will give rise to administrative claims against the estate that by definition will have priority over general unsecured claims, bankruptcy courts tend to be more probing and activist in considering whether to approve an assumption (as opposed to a rejection) of a lease, particularly if key estate constituents such as a creditors' committee or other important party in interest object to assumption.

Pursuant to Bankruptcy Code section 365(b)(1), if there has been a default under a lease, in order to assume such lease, the debtor must:

1. Cure (or provide adequate assurance of prompt cure of) pre- and post-petition defaults;
2. Compensate (or provide adequate assurance of prompt compensation of) all pecuniary loss resulting from pre- and post-petition defaults; and
3. Provide adequate assurance of future performance under the lease.

Generally speaking, all monetary defaults must be cured in order for a debtor-tenant to assume a lease under section 365(b)(1). This may include a landlord's recovery of its attorneys' fees in enforcing the lease. To recover attorneys' fees, a lessor generally must establish that the lease specifically provides for recovery of such fees and that the attorneys' fees were reasonably incurred.[19] The lease must be construed as a whole to determine the scope of the lessor's contractual right to attorneys' fees. Thus, standard lease language may not encompass attorneys' fees incurred by a landlord in enforcing its lease rights and participating in a tenant's bankruptcy case.[20] Lease provisions that provide for recovery of attorneys' fees by the "prevailing party" with respect to a disputed matter may also be interpreted to limit a landlord's recovery of attorneys' fees in connection with a landlord's objection to assumption or assignment.

Pursuant to Bankruptcy Code section 365(b)(2), certain defaults are excluded from the defaults that must be cured by the debtor in order to assume a lease. These exceptions include defaults related to "*ipso facto*" provisions and penalty rates or provisions, consistent with the obligations excluded from a debtor's post-petition lease obligations pursuant to Bankruptcy Code section 365(d)(3), as discussed above. In addition, the debtor need not cure non-monetary defaults under a real property lease that are impossible to cure by performing nonmonetary acts (e.g., violation of a prohibition against "going dark"), although, to the extent such defaults arise from a failure to operate in accordance with the terms of a non-residential real property lease, such defaults must be prospectively cured at the time of lease assumption. The lessor must also be compensated for any pecuniary loss resulting from the prior defaults.

With respect to the third prerequisite for assuming a lease—i.e., adequate assurance of future performance—Bankruptcy Code section 365(b)(3) contains special requirements for the debtor's assumption of a lease in a "shopping center," mandating that the debtor demonstrate adequate assurance:

1. Of the source of rent and other consideration due under the lease;
2. That any percentage rent due under the lease will not decline substantially;
3. Of compliance with all lease provisions, including those regarding radius, location, use and exclusivity, as well as compliance with such provisions in other shopping center leases, financing agreements, and master agreements relating to the shopping center; and
4. Of no disruption of tenant mix or balance in shopping center.

The term "shopping center" is not defined in the Bankruptcy Code and therefore has had to be fleshed out by case law. Although there are up to fifteen different factors that courts consider in determining whether a non-residential real property lease is in a "shopping center" for purposes of section 365, as a general principle it appears that the most important characteristics of a "shopping center" are a combination of leases on contiguous spaces held by a single owner/landlord that are leased to commercial distributors of goods or services with the presence of a common parking area.

VI. Assumption and Assignment of an Unexpired Lease in Bankruptcy

Pursuant to Bankruptcy Code section 365(f)(1), a debtor may assign a lease in accordance with section 365(f)(2) notwithstanding lease provisions that purport to prohibit, restrict, or condition assignment. Assignment under section 365(f)(2) requires assumption of the lease pursuant to section 365(a) and a showing of adequate assurance of future performance under the lease by the proposed assignee, even if there have been no defaults under the lease. Pursuant to section 365(l), the landlord may require a deposit or other security from the assignee comparable to what the landlord would have required upon the initial leasing to a similar tenant. The assignment of a lease, like the assumption of a lease, must be approved by bankruptcy court order.

Just as the assumption of a shopping center lease is subject to special lessor-friendly provisions, as discussed in the preceding section, the assignment of a shopping center lease is subject to additional requirements pursuant to Bankruptcy Code section 365(b)(3), including a showing of adequate assurance that the financial condition and operating performance of the assignee (and its guarantors, if any) is similar to the financial condition and operating performance of the debtor (and its guarantors, if any) when the debtor became the lessee under the lease. In assessing the financial condition and operating performance of a proposed assignee without an established "track record," courts have looked at such factors as the business experience of the principals of the assignee.[21]

Pursuant to Bankruptcy Code section 365(k), the assignment of a real property lease pursuant to Bankruptcy Code section 365(f) relieves the bankruptcy estate of all claims resulting from a subsequent breach of the lease. Since landlords often make various year-end accounting adjustments with their tenants (e.g., to reflect the difference between actual expenses for certain items and the estimated amount previously charged to tenants), it is prudent for a landlord to obtain a carve-out for certain post-assignment adjustments for a specified period in the order authorizing assignment of the lease.

VII. Claims Arising from Rejection of a Lease in Bankruptcy

A landlord's claim arising from the debtor-tenant's rejection of a lease is treated as a pre-petition unsecured claim under Bankruptcy Code sections 365(g) and 502(g), even though the rejection actually occurs post-petition. The calculation of a claim arising from lease rejection is based on the terms of the lease and relevant non-bankruptcy law, and certain adjustments are required by bankruptcy law.

Because lease rejection claims pertaining to long-term real property leases can be very large relative to the other unsecured claims against a bankruptcy estate and in order to mitigate the risk that one or more large lease rejection claims will dominate a bankruptcy case, Bankruptcy Code section 502(b)(6) limits the maximum recovery for a landlord's claim arising from termination of a real property lease to (1) any unpaid rent owed under the lease; *plus* (2) a portion of the remaining future rent, equal to the rent reserved in the lease for the greater of one year or 15% (not to exceed three years) of the remaining term of the lease. There is a split of authority regarding whether the 15% should be calculated based on the *time* remaining or the *rent* remaining under the lease.[22] After taking account of any mitigation, this cap on damages is applied after calculating the total damages arising from rejection of the lease.[23] In addition, relevant case law generally requires that the landlord's total damages arising from lease rejection be discounted to present value before applying the section 502(b)(6) cap.[24]

One of the most difficult issues in calculating section 502(b)(6)'s cap on a lease termination claim is determining what

amounts are considered as "rent reserved" under the cap formula. Some courts have established a three-factor test for ascertaining whether charges owed by a debtor-tenant under a lease constitute "rent reserved" for purposes of calculating the limitation on lease rejection damages under section 502(b)(6):

1. The charge must (a) be designated as "rent" or "additional rent" in the lease or (b) provided as the tenant's obligation in the lease;
2. The charge must be related to the value of the property or the lease; and
3. The charge must be properly classifiable as rent because it is fixed, regular, or periodic.[25]

Although the relevant case law is not uniform, it reveals certain general principles regarding the types of charges that are generally included or excluded from the determination of "rent reserved" pursuant to section 502(b)(6). Charges generally treated as "rent reserved" include minimum rent, real estate taxes, insurance, common area maintenance charges, and annual capital improvement fees. Charges typically excluded from "rent reserved" include utility charges, maintenance and repair expenses, remodeling and reconstruction costs, service charges, re-letting fees, attorneys' fees, janitorial expenses, liquidated damages, and interest.[26] Other ancillary damages associated with breach of a lease that have been held not to be subject to the section 502(b)(6) cap include expenses resulting from a debtor's failure to comply with its obligations to maintain the premises and to restore them to the condition they were in at commencement of the lease, and construction allowances payable by the debtor upon an event of default.[27]

Under an emerging majority view, once the section 502(b)(6) cap is calculated, any security deposit (whether in the form of cash or a letter of credit) securing the debtor-tenant's lease obligations must be deducted in determining the landlord's maximum allowable claim for lease termination damages.[28] This means that the landlord holding a security deposit generally cannot apply such security deposit to the excess (i.e., beyond the capped) amount of its claim resulting from rejection of the lease, and instead it must credit such security deposit to the capped amount, thus reducing the amount of the capped claim.[29] Note, however, that in most jurisdictions, a security deposit also may be applied against any of the landlord's other prepetition unsecured claims (i.e., a prepetition claim for rent unpaid as of the bankruptcy filing, for damage to the premises as of the bankruptcy filing, or other unsecured claims that do not arise from rejection of the lease), but not against the lessor's administrative claim for unpaid postpetition rent and other obligations.[30] After such application, any excess proceeds from the security deposit must be refunded to the extent it exceeds the lease damages cap.[31]

In view of the foregoing array of principles regarding the requisite application of security deposits in the bankruptcy context and the still-emerging case law, it may be prudent for a landlord at the outset of the lease to seek one security deposit for potentially capped lease termination damages and one or more additional security deposits for other uncapped claims. While this does not guarantee that the landlord will be able to apply the security deposit(s) in the way most advantageous to the landlord, it may give the landlord more flexibility and more arguments, particularly in jurisdictions where the courts have not fully articulated or developed the rules regarding application of security deposits.

VIII. Claims Arising from Breach of a Previously Assumed Lease

Under Bankruptcy Code section 365(g)(2), the rejection of a previously assumed lease is deemed a post-petition breach of such lease (in contrast to section 365(g)(1), which provides that the rejection of an unassumed lease is deemed to be a prepetition breach). Generally speaking, a landlord's entire claim resulting from the debtor's breach of a previously assumed lease is entitled to administrative expense priority treatment under section 503(b). However, pursuant to section 503(b)(7), a landlord's administrative claim for damages resulting from the rejection of a previously assumed nonresidential real property lease is limited to all monetary obligations (excluding those arising from a failure to operate or a penalty provision) for a period of two years following the later of (i) the rejection date, or (ii) the date of turnover of the premises, without reduction or setoff, except for amounts received from a third party (e.g., a guarantor). Any remaining amounts due for the balance of the lease term are treated as a general unsecured claim subject to the limitations of section 502(b)(6) (discussed above).

IX. Conclusion

As is apparent from the foregoing discussion, the filing of a bankruptcy case by a tenant presents a number of challenges for a commercial landlord because of various provisions of the Bankruptcy Code that may change the parties' otherwise applicable rights and obligations pursuant to the terms of the lease and applicable non-bankruptcy law, as well as the non-uniform interpretation of these provisions by the courts. Commercial landlords typically are in a better position to protect and advance their interests if they understand the bankruptcy principles that will become applicable in the event of a tenant's bankruptcy. This enables com-

mercial landlords, to the extent possible, to craft their leases to take such principles into account and then take any appropriate action to assert their rights following a tenant's bankruptcy filing. ■

Endnotes

1 All references in this article to the Bankruptcy Code refer to Title 11 of the United States Code, 11 U.S.C. §§ 101 *et seq.*

2 *See, e.g.*, *In re Cukierman*, 265 F.3d 846 (9th Cir. 2001); *In re Pacific Atlantic Trading Co.*, 27 F.3d 401 (9th Cir. 1994).

3 *See, e.g., In re National Refractors & Minerals Corp.*, 297 B.R. 614 (Bankr. N.D. Cal. 2003); *In re Far West Corp. of Shasta County*, 120 B.R. 551 (Bankr. E.D. Cal. 1990); *In re Orvco, Inc.*, 95 B.R. 724 (B.A.P. 9th Cir. 1989), *overruled on other grounds*, *In re Pacific Atlantic Trading Co.*, 27 F.3d 401 (9th Cir. 1994); *In re Tandem Group, Inc.*, 61 B.R. 738 (Bankr. C.D. Cal. 1986). *See also In re LPM Corp.*, 300 F.3d 1134 (9th Cir. 2002) (lessor not entitled to superpriority administrative claim for obligations accruing during Chapter 11 case if case converts to Chapter 7).

4 *See*, *e.g.*, *In re Leisure Time Sports, Inc.*, 189 B.R. 511 (Bankr. S.D. Cal. 1995).

5 *See*, *e.g.*, *In re PYXSYS Corp.*, 288 B.R. 309 (Bankr. D. Mass. 2003).

6 *See, e.g., In re Cukierman*, 265 F.3d 846 (9th Cir. 2001) (debtor required to perform all post-petition obligations under lease, regardless of whether related to use of premises); *In re National Refractors & Minerals Corp.,* 297 B.R. 614 (Bankr. N.D. Cal. 2003) (cleanup costs incurred by lessor in removing hazardous materials from leased premises and in repairing damage caused by debtor's breach of lease obligation to maintain and return leased premises in good condition is entitled to administrative expense priority to extent occurring during post-petition, pre-rejection period); *In re Far West Corp. of Shasta County*, 120 B.R. 551 (Bankr. E.D. Cal. 1991) (interest included).

7 *See, e.g., In re TreeSource Industries, Inc.*, 363 F.3d 994 (9th Cir. 2004).

8 *Compare, e.g.*, *In re Midway Airlines Group*, 406 F.3d 229 (4th Cir. 2005); (finding Section 365(d)(3) obligations include attorneys' fees in enforcing lease), *with In re Pacific Arts Publishing, Inc.*, 198 B.R. 319 (Bankr. C.D. Cal. 1996) (finding post-petition attorneys' fees incurred in enforcing lease are not included in section 365(d)(3) obligations because they arise from pre-petition contract).

9 *See*, *e.g.*, *In re Handy Andy Home Improvement Centers, Inc.*, 144 F.3d 1125 (7th Cir. 1998); *In re National Refractors & Minerals Corp.*, 297 B.R. 614 (Bankr. N.D. Cal. 2003).

10 *See*, *e.g.*, *In re Victory Markets, Inc.*, 196 B.R. 6 (N.D.N.Y. 1996).

11 *See*, *e.g.*, *In re Montgomery Ward Holding Corp.*, 268 F.3d 205 (3d Cir. 2001); *In re Koenig Sporting Goods, Inc.*, 203 F.3d 986 (6th Cir. 2000); *In re RB Furniture, Inc.*, 141 B.R. 706 (Bankr. C.D. Cal. 1992).

12 *See. e.g., In re Appletree Markets, Inc.,* 139 B.R. 417 (Bankr. S.D. Tex. 1992).

13 *See In re Ernst Home Center, Inc.*, 209 B.R. 974 (Bankr. W.D. Wash. 1997), *appeal dismissed*, 221 B.R. 243 (B.A.P. 9th Cir. 1998); *In re Victoria Station, Inc.*, 88 B.R. 231, 236, n.7 (B.A.P. 9th Cir. 1988), *aff'd on other grounds*, 875 F.2d 1380 (9th Cir. 1989).

14 *See, e.g., In re Pacific Sea Farms, Inc.*, 134 B.R. 11 (Bankr. D. Haw. 1991).

15 *In re Ernst Home Center, Inc.*, 209 B.R. 974 (Bankr. W.D. Wash. 1997), *appeal dismissed*, 221 B.R. 243 (B.A.P. 9th Cir. 1998).

16 *See, e.g., In re Leisure Corp.*, 234 B.R. 916 (B.A.P. 9th Cir. 1999). *See also In re Fifth Taste Concepts Las Olas, LLC,* 325 B.R. 42 (Bankr. S.D. Fla. 2005) (requiring debtor to assume lease and cure defaults as condition to exercising renewal option).

17 *See, e.g.*, *Borman's, Inc. v. Allied Supermarkets, Inc.*, 706 F.2d 187, 189-91 (6th Cir. 1983), *cert. den.*, 464 U.S. 908 (1983).

18 *See In re Chi-Feng Huang,* 23 B.R. 798, 801 (B.A.P. 9th Cir. 1982) (involving executory contracts subject to same provisions in section 365 as unexpired leases.)

19 *See, e.g., In re Bullock*, 17 B.R. 438 (B.A.P. 9th Cir. 1982).

20 *See*, *e.g.*, *In re Westside Print Works, Inc.*, 180 B.R. 557 (B.A.P. 9th Cir. 1995) (denying recovery of attorneys' fees where lease provided for attorneys' fees only in connection with recovery of premises).

21 *See*, *e.g.*, *In re Service Merchandise Co., Inc.*, 297 B.R. 675 (Bankr. M.D. Tenn. 2002).

22 *See In re Connectix Corp.*, 372 B.R. 488 (Bankr. N.D. Cal. 2007) (collecting cases holding that the reference to 15% in section 502(b)(6) refers to the *time* remaining on the lease and cases holding that the 15% refers to the aggregate rent due under the remainder of the lease).

23 *See*, *e.g.*, *In re Highland Superstores, Inc.*, 154 F.3d 573 (6th Cir. 1998); *In re Iron Oak Supply Corp.*, 169 B.R. 414 (Bankr. E.D. Cal. 1994). *But see* Cal. Civ. Code § 1951.2 (finding lessee has burden of proving amount of rental loss that lessor could have reasonably avoided as a result of lessee's breach of lease).

24 *See In re Merry-Go-Round Enterprises, Inc.*, 241 B.R. 124 (Bankr. D. Md. 1999).

25 *See, e.g., In re JSJF Corp.*, 344 B.R. 94, 100 (B.A.P. 9th Cir. 2006); *In re McSheridan,* 184 B.R. 91, 99-100 (B.A.P. 9th Cir. 1995), *overruled on other grounds, In re El Toro Materials Company, Inc.*, 504 F.3d 978 (9th Cir. 2007).

26 *See cases collected in In re McSheridan,* 184 B.R. 91, 97-99 (B.A.P. 9th Cir. 1995), *overruled on other grounds, In re El Toro Materials Company, Inc.*, 504 F.3d. 978 (9th Cir. 2007). *See also In re JSJF Corp.*, 344 B.R. 94, 101 (B.A.P. 9th Cir. 2006) (remanding to determine whether section 502(b)(6) cap applied to landlord's claim for attorneys' fees and costs awarded in prepetition litigation brought by landlord for defaulted lease obligations and debtor's counterclaim for constructive eviction).

27 *See, e.g., In re El Toro Materials Company, Inc.*, 504 F.3d 978 (9th Cir. 2007).

28 *See, e.g., In re AB Liquidating Corp.*, 416 F.3d 961, 963-64 (9th Cir. 2005); *In re Mayan Networks Corp.*, 306 B.R. 295, 299 (B.A.P. 9th Cir. 2004); *In re Connectix Corp.*, 372 B.R. 488 (Bankr. N.D. Cal. 2007).

29 There is as yet little case law on whether a third party guaranty in favor of a landlord will be treated the same as a letter of credit for purposes of determining whether any recovery on such a guaranty must be applied against the landlord's capped claim. Many bankruptcy lawyers and commentators believe that it will be difficult to distinguish a third party guaranty from a letter of credit as a form of lease deposit and/or lease credit support, and that a guaranty therefore may be subject to the same treatment as a letter of credit.

30 *See, e.g., In re Far West Corp. of Shasta County*, 120 B.R. 551, 553 (Bankr. E.D. Cal. 1990).

31 *See, e.g., In re Builders Transport, Inc.*, 471 F.3d 1178, 1191 (11th Cir. 2006), *cert. den.*, 127 S.Ct. 112 (2007).

Standing Committee Officers of the Business Law Section 2008–2009

AGRIBUSINESS

Nina Ortega, Co-Chair
American AgCredit

Jason Resnick, Co-Chair
Western Growers

Barry Freeman, Co-Vice Chair
Jeffer Mangels et al LLP

Paul Moncrief, Co-Vice Chair
Johnson & Moncrief

BUSINESS LAW NEWS

James Menton, Editor-in-Chief
Peitzman Weg & Kempinsky LLP

Alan Insul, Vice Chair/
Managing Editor
The Law Office of Alan M. Insul

CONSUMER FINANCIAL SERVICES

Veronica McGregor, Chair
Perkins Coie LLP

Arnold Rosenberg, Vice Chair
Thomas Jefferson School of Law

CORPORATIONS

W. Derrick Britt, Co-Chair
Doty Barlow Britt & Thomas LLP

Samuel Dibble, Co-Chair
Farella Braun + Martel LLP

Edward Deibert, Co-Vice Chair
Howard Rice, et. al.

Charles P. Ortmeyer, Co-Vice Chair
Law Office of Charles P. Ortmeyer

David Hernand, Co-Vice Chair
Gibson, Dunn & Crutcher LLP

CYBERSPACE

James Snell, Chair
Bingham McCutchen LLP

Matt Cooney, Co-Vice Chair
California State Automobile Association

Jean Magistrale, Co-Vice Chair
CEB

Bennet Kelley, Co-Vice Chair
Internet Law Center

FINANCIAL INSTITUTIONS

Bruce Belton, Chair
Tri Counties Bank

Robert Stumpf, Vice Chair
Sheppard Mullin et al LLP

FRANCHISE

Jeffrey Dasteel, Co-Chair
Skadden, Arps, Slate, Meagher et. al.

Tal Grinblat, Co-Chair
Lewitt Hackman et. al.

Dawn Newton, Co-Vice Chair
Fitzgerald Abbott & Beardsley LLP

Steve Colley, Co-Vice Chair
Law Offices of Stephen A. Colley

HEALTH LAW

Kenneth Yood, Chair
Paul Hastings

Michael Dowell, Vice Chair
Theodora Oringher Miller & Richman

Christine Cohn, Vice Chair, Comm.
Buchalter Nemer

Julie Simer, Vice Chair, Ed.
Enterprise Counsel Group,
A Law Corporation

INSOLVENCY LAW

Elizabeth Berke-Dreyfuss,
Co-Chair
Wendel Rosen Black & Dean

Ellen Friedman, Co-Chair
Friedman Dumas & Springwater LLP

John Bingham, Co-Vice Chair
Danning Gill Diamond & Kollitz LLP

Eric Winston, Co- Vice Chair
Stutman Treister & Glatt, PC

INSURANCE LAW

Robert Cerny, Vice Chair
Barger & Wolen LLP

Harold (Tom) Watson,
Co-Vice Chair
Horvitz & Levy, LLP

Thomas Welsh, Co-Vice Chair
Orrick, Herrington & Sutcliffe LLP

NON-PROFIT ORGANIZATIONS

Lani Collins, Chair
Collins & Associates

Cherie Evans, Co-Vice Chair
Evans & Rosen

Joel Corwin, Co-Vice Chair
Law Offices of Joel S. Corwin

Elizabeth Bluestein, Co-Vice
Chair
Public Counsel Law Center

OPINIONS

Jerome A.Grossman, Co-Chair
Luce Forward Hamilton & Scripps LLP

John Power, Co-Chair
O'Melveny & Myers LLP

James Fotenos, Co-Vice Chair
Greene Radovsky Maloney & Share LLP

Timothy Hoxie, Co-Vice Chair
Jones Day

PARTNERSHIPS AND LLCs

Charles McKee, Chair
Nevers, Palazzo, Maddux & Packard

Ronald Wargo, Co-Vice Chair
Friedemann Goldberg LLP

Phillip Jelsma, Co-Vice Chair
Luce Forward Hamilton Scripps LLP

UCC

Patrick Costello, Co-Chair
Bialson Bergen & Schwab

Edith Warkentine, Co-Chair
Western State University College of Law

Zachary Finley, Co-Vice Chair
Orrick Herrington & Sutcliffe LLP

Michael DuQuesnay,
Co-Vice Chair
Dewey & LeBoeuf LLP

Business Law News

State Bar Education Foundation

Business Law Section

180 Howard Street

San Francisco, CA 94105-1639

NON-PROFIT ORG
U.S. POSTAGE
PAID
DOCUMATION

Contains Dated Material

SFI Certified Fiber Sourcing
www.sfiprogram.org