
A GUIDE TO
DOING BUSINESS IN CALIFORNIA
MORRISON | FOERSTER

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CHAPTER 1

OVERVIEW OF CALIFORNIA

A. California at a Glance

If California were a separate nation, it would rank as the fifth-largest economy in the world. The state's gross domestic product was $1.4 trillion in 2001. The state accounts for approximately 13% of the total domestic economy of the United States. The economy is widely diversified and includes an enormously productive agricultural sector, leading financial institutions, leading biotech companies, a world-class tourist industry, the world-renowned entertainment industry centered in Hollywood, and the world-renowned high-technology companies of Silicon Valley.

California stretches 825 miles from its northwest corner at the intersection of the 42nd parallel with the Pacific Coast to its southeast corner on the 32nd parallel at the junction of the Gila and Colorado Rivers. The Pacific Ocean coastline is 1,264 miles long. Elevations run from 14,495 feet above sea level at the peak of Mount Whitney to 282 feet below sea level at Death Valley, with these landmarks being little more than 50 miles apart. California's climates are as varied as its physical regions. There are heavy winter snows in the high mountain ranges, mild and temperate conditions along the coast, wide variations in temperature and humidity in the valleys, and arid conditions and great temperature fluctuations in the deserts.

The total population of California is 35 million. No one ethnic group constitutes a majority of the population in California. Persons of Caucasian descent are the largest minority, followed by large populations of people of Hispanic, Asian, African and Native American ancestry.

B. Government

1. Political (Legislature and Executive)

The state's first constitution was drafted and adopted in 1859, and the second, which remains in place today, was adopted 30 years later. The California Constitution is noted for its progressive provisions, and includes provisions for adoption of laws by public initiative outside of the legislative process. California's government structure consists of the executive, legislative and judicial branches.

The legislature consists of two chambers, with 40 state senate members each serving a maximum of two four-year terms, and 80 state assembly members each serving a maximum of three two-year terms. The legislature drafts, considers and passes bills, which become law upon approval by the executive branch.

The supreme executive power of California is vested in the Governor and 12 statewide-elected officers, including the Lieutenant Governor, Secretary of State and Treasurer. Each officer may serve a maximum of two four-year terms. The Governor recommends legislation to the legislature and has the power to convene the legislature for special sessions.

The state elects 52 Representatives to the United States Congress, as well as its two United States Senators. In 1992, California became the first state to simultaneously elect two women to the United States Senate.

2. Judiciary

a. Federal Courts and State Courts: Two Components of One Judicial System

The United States has one court system with two different major components: the federal court system and the state court system (which is actually 51 different court systems, established in each of the fifty states and the District of Columbia). Both court systems consist of two levels of courts: trial courts and appellate courts. Cases are originally tried in trial courts; appellate courts review the decisions of the lower courts. Appellate courts can correct errors committed by the trial court and aid in the development of the law, allowing for its gradual growth and progress. Appealable issues are generally limited to final judgments of the lower court in order to avoid piecemeal appeals of the different issues in a case.

The state and federal courts can hear and decide (or have "jurisdiction over") different types of cases. State courts are courts of general jurisdiction, while federal courts are courts of limited jurisdiction. In some cases, both the federal and the state court systems have jurisdiction over the same issue. In these cases of concurrent jurisdiction, litigants can choose whether to litigate their dispute in federal or state court. Some matters, however, can be litigated only in either federal or state court. For example, bankruptcies and admiralty cases are handled exclusively in federal courts.

b. The Federal Court System

The federal court system comprises the Supreme Court and the lower trial courts and courts of appeal. The federal judiciary has jurisdiction over cases or controversies arising from federal questions as well as diversity of citizenship jurisdiction. Federal courts usually decide cases involving the United States government, the United States Constitution, acts of Congress or treaties, or controversies between the states or between the United States and a foreign government. They also hear disputes between citizens of different states. The limited jurisdiction of federal courts can be defined in very specific terms. For example, when jurisdiction is based on diversity of citizenship, the amount in controversy must exceed $75,000.

Trial Courts

In the federal court system, trial courts are called district courts. There are 94 judicial districts across the country. The federal system also has trial courts of special and exclusive jurisdiction that decide specific types of controversies such as copyright or bankruptcy issues. Federal bankruptcy courts, the Court of Federal Claims, and the Court of International Trade are all trial courts that are not district courts.

Appellate Courts

District and special courts are divided into circuits, and appeals from these trial courts are taken to the court of appeals for the circuit in which the trial court sits. The United States is divided into eleven circuits (plus the District of Columbia Circuit and the special Federal Circuit, which handles patent cases and Claims Court cases). California is in the Ninth Circuit with Oregon, Washington, Idaho, Nevada, Arizona, Alaska, and Hawaii. Appeals from the circuit courts are taken to the United States Supreme Court. (State court appeals can also be taken to the Supreme Court if the case involves a federal question such as a Constitutional issue.)

The United States Supreme Court

The United States Supreme Court can review a case through two routes — by appeal and by *certiorari*. For certain types of cases (claims that state statutes are unconstitutional) there is a right to appeal to the Supreme Court. However, for most cases there is no right of appeal to the Supreme Court. A party who has lost a case at the federal court of appeals level can petition for *certiorari* with the Supreme Court. In a petition for *certiorari*, the party explains why the Supreme Court should review the case. If the Supreme Court grants *certiorari*, the appeal proceeds. If the Supreme Court denies it, the Court of Appeals' decision stands. Thousands of petitions for *certiorari* are filed each year, and most are denied. The Supreme Court is likely to grant *certiorari* on a case only if the case involves a matter of national interest. The Supreme Court also tends to take cases that will resolve conflicts of law between different circuit courts.

Judges sitting in courts at any level in the federal court system can have their own rules specific to their courtroom. It is critical that one understand these rules as soon as litigation is initiated, because they will govern almost every step of the litigation process, from pleadings to the procedures followed during the trial itself. The local rules also include procedures for attorney admission to practice in the district or appellate court in which the attorney will appear. One can access the local rules for most trial and appellate courts via the Internet. For example, local rules for the Northern District of California are available at <www.cand.uscourts.gov/>. The website for the federal court system provides links to the various district and appellate courts: <www.uscourts.gov/>.

c. The State Court System in California [1]

State courts generally develop common law through their decisions interpreting the state's constitution and statutes. The organization of most state court systems is basically the same as that of the federal court system. Cases first enter the system at the trial court level, while appellate courts review those decisions, decide points of law, and thereby establish laws that are to be enforced throughout the state. Every state has a court of last resort that hears appeals from the lower trial or appeals courts and has the final word on interpretation of state law.

California has two types of courts: trial courts (58 total, with one in each county), and appellate courts. Trial courts are called superior courts; appellate courts are the courts of appeal (six districts) and the California Supreme Court. [2] In the trial courts, a judge and sometimes a jury hear witnesses' testimonies and other evidence and decide cases by applying the relevant law to the facts they heard. In the appellate courts, cases are appealed by people who are not satisfied with a trial court decision.

State trial and appellate courts have their own sets of local rules that require the use of certain forms for pleadings and institute important deadlines for filings and responses. It is critical that one understand the local rules in any court in which one has a case pending, because the rules will govern almost every aspect of the litigation. They prescribe the form of all pleadings as well as other important practical matters such as the processes through which an attorney can gain admission to practice.[3]

Trial Courts

Superior courts in California have trial jurisdiction over all criminal cases, including felonies, misdemeanors, and traffic matters. They also have jurisdiction over all civil

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1 The California state government has established a website providing information about the California court system. Information for this chapter was gathered from the website, which can be found at <www.courtinfo.ca.gov/>.

2 California Courts, The Judicial Branch of California Website, Trial Courts, *available at* <www.courtinfo.ca.gov/courts/trial/about.htm/>.

3 Most courts in California have posted their local rules on line. These rules can be accessed through the California Courts main website at <www.courtinfo.ca.gov/courts>.

cases, including family law, probate, juvenile, and general civil matters. Appeals in limited civil cases (where $25,000 or less is at issue) and misdemeanors are heard by the appellate division of the superior court. When a small claims case is appealed, a superior court judge decides the case.

Appellate Courts

Panels of three justices hear appeals from California superior courts, except in death penalty cases, which are appealed automatically to the California Supreme Court. The California courts of appeal determine whether a trial court committed legal error in handling the cases that are presented on appeal. The decisions of these three-judge panels may be published in California Appellate Reports if they establish a new rule of law, involve a legal issue of continuing public interest, criticize existing law, or otherwise make a significant contribution to legal literature. The courts of appeal are organized into six districts, with 19 divisions and 105 justices. For example, the First District includes five divisions, all in San Francisco; the Second District includes seven divisions in Los Angeles and one in Ventura.[4]

The State Supreme Court

The state's highest court, the Supreme Court, may grant review of cases decided by the courts of appeal. Certain other cases, such as death penalty appeals and disciplinary cases involving judges and attorneys, are appealed directly to this court. At least four of the seven justices must agree on decisions of the court. The court's decisions are binding on all other state courts.[5]

C. Economy

California's 1999 Gross State Product of $1.2 trillion was the largest in the United States, and if California were a separate nation, its economy would rank among the largest in the world. In calendar 2000 the Gross State Product was $1.3 trillion, and personal income rose 11% compared to a 6.5% national increase.

The California economy is very diversified and well balanced, and includes agriculture, viticulture, forestry and fishing, construction, manufacturing, transportation, wholesale and retail trade, tourism, electronic technology, biotechnology, finance, insurance and real estate. The distribution of employment sectors in May 2000 was 31.4% service, 22.7% trade, 13.4% manufacturing, and 16.3% government, with an unemployment rate of 5.2%.

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4 California Courts, The Judicial Branch of California Website, Courts of Appeal, *available at* <www.courtinfo.ca.gov/courts/courtsofappeal/about.htm/>.

5 California Courts, The Judicial Branch of California Website, Supreme Court, *available at* <www.courtinfo.ca.gov/courts/supreme/about.htm/>.

The state is a leading producer of electronic equipment, software, technology equipment components, and other high-technology goods and services, and is home to several leading biotechnology companies. The state has several leading universities and colleges, placing it in the forefront of research and development in all areas of endeavor. California is the major United States center for motion-picture, television, and other entertainment industries, especially in the Hollywood and Burbank areas. Tourism is an important industry, and world-famous theme parks of Southern California draw millions of visitors each year, as do San Francisco and the vineyards of Napa Valley.

D. Financial System

1. Banking System (State / National)

California has become the financial hub of the western United States, with its high number of banking and other financial institutions. In 1999 there were 325 commercial banks insured by the Federal Deposit Insurance Corporation ("FDIC"), with deposits exceeding $226.3 billion, and 46 FDIC-insured savings institutions with deposits exceeding $311.6 billion in the state. The FDIC is an independent agency of the United States government that insures deposits with qualified financial institutions up to specified limits. The FDIC performs the routine compliance, trust, and safety examinations of all domestic and foreign financial institutions to ensure that the standards are met.

The Department of Financial Institutions ("DFI") is responsible for regulating the safety and soundness of California's state-chartered financial institutions. The DFI licenses and regulates state-licensed banks, state-licensed savings and loan associations, state-licensed credit unions, state-licensed industrial banks, state-licensed offices of foreign banks, trust companies, business and industrial development corporations, issuers of traveler's checks and payment instruments (money orders), and transmitters of money abroad.

2. Stock Exchange

The Pacific Exchange ("PCX") is the only stock market in the world with trading floors in two cities — San Francisco and Los Angeles. The PCX is a marketplace where individual and institutional investors, professional broker-dealers, and registered member firms meet to buy and sell more than 1,800 stocks, bonds, and other securities issued by publicly traded companies, as well as options on more than 800 stocks. It is the third-largest stock options exchange in the world.

The PCX trades the most active stocks and bonds listed on the New York Stock Exchange ("NYSE") and the American Stock Exchange ("ASE"), as well as many growth companies that are too young or too small to meet NYSE or ASE listing requirements. The bulk of PCX activity is in "blue chip," large-company issues listed on the NYSE.

Individual retail order flow is a specialty of the PCX. The average order sent to the Pacific is for 500 shares, with every order filled at the best price available in the National Association of Securities Dealers Automated Quotations ("Nasdaq") system.

The PCX is the world's market for technology stock options. The San Francisco options floor averages approximately 420,000 contracts per day, with Microsoft, Compaq, Sun Microsystems, Micron Technology, AOL, 3Com, Applied Materials, and Advanced Micro Devices topping the list of most active issues. The exchange also trades options on Schering-Plough, Nike, McKesson HBOC, Schwab, R&B Falcon, Bank One Corporation, and more than 800 other companies. The PSE Tech 100SM is the leading benchmark for the broad-based technology sector.

CHAPTER 2

TYPES OF BUSINESS ENTITIES

This chapter focuses on the following business entities: corporations, limited liability companies, general partnerships, limited partnerships, limited liability partnerships, and sole proprietorships. Except for sole proprietorships, the California Corporations Code ("Cal. Corp. Code") governs the aforementioned business entities in California.

All of the forms that the Secretary of State of California ("Secretary of State") requires to be filed can be obtained from the Secretary of State.[6] A schedule of filing fees, which accompanies almost all documents to be filed with the Secretary of State, can be found on the website or in the following statutory provisions of the California Government Code: Cal. Gov't Code §§ 12186 (corporations), 12187 (general partnerships), 12188 (limited partnerships), 12189 (limited liability partnerships), 12190 (limited liability companies), and 12191 (foreign business entities).

A. Corporation

1. Description

A corporation is owned by its shareholders, managed by its board of directors ("Board"), and operated by its officers and employees. It is one of the most common forms of entities used by businesses and is the equivalent of a company in other jurisdictions outside the United States. Shareholders normally are not liable for the debts and obligations of the business. To the extent corporate formalities are met and the corporation is not thinly capitalized, shareholders' liability is limited to their respective investments. Creditors may require that principal shareholders guarantee corporate indebtedness, particularly for small or closely-held corporations. In addition, shareholders may in certain circumstances be liable for their own tortious conduct on behalf of the corporation. The organization and operation of a corporation are usually governed by the corporation statute in the jurisdiction in which the corporation is organized. Corporation statutes may distinguish between corporations organized for profit under a general corporation law, *see* Cal. Corp. Code §§ 100-2319, and nonprofit corporations organized under a nonprofit corporation law. *See id.* §§ 5110 *et seq*. (governing nonprofit public benefit corporations) *and id.* §§ 7110 *et seq*. (governing nonprofit mutual benefit corporations, including trade associations). However, some states, such as Delaware, provide for organization of both profit and nonprofit corporations under one general corporation law, distinguishing between stock and non-stock corporations. In order to raise capital, shares of stock are issued in compliance with state and federal securities laws.

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6 California Secretary of State: website <http://www.ss.ca.gov/>; telephone (1-916) 657-5448

2. Formation

Business corporations organized under California law must file their charter or formation document, known as the Articles of Incorporation, accompanied by the appropriate filing fee, with the Secretary of State. Such corporations are authorized to issue stock and are organized under the Cal. Corp. Code, particularly Title 1, Division 1, Chapter 2. The minimum content requirements of the Articles of Incorporation for stock corporations are: (1) the name of the corporation (a proposed corporate name can be checked for availability and reserved for a period of 60 days by delivering a written request to the Name Availability Unit of the Secretary of State, accompanied by the appropriate fee); (2) purposes and powers; (3) authorized capital; and (4) the name and address of an initial agent. *See id*. § 202. A number of optional provisions are also available for inclusion in the Articles of Incorporation, and it is suggested that private counsel be consulted for advice regarding the proposed corporation's specific business needs, which may call for the inclusion of certain of those provisions. *See id*. § 204. It should also be noted that certain statutory standards relating to directors and shareholders cannot be varied in the Articles of Incorporation, which must be signed by at least one incorporator. *See id*. § 200. Upon the filing of the Articles of Incorporation, the corporation's existence commences. *See id*.

On the effective filing date of the Articles of Incorporation or soon thereafter, the incorporator by written consent must appoint the initial directors of the corporation (assuming that they were not named in the Articles of Incorporation). The initial directors need, in the first meeting of the Board or in the first written consent of the Board without a meeting, to adopt resolutions ratifying the acts of the incorporator in connection with the initial formation of the corporation and indemnifying the incorporator, to the fullest extent possible, for any liabilities arising from the incorporation of the corporation. In addition, at this first meeting or in this first written consent, the Board must adopt resolutions approving the bylaws of the corporation ("Bylaws"), which set forth the rules and procedures governing the decision-making process of the Board and the general operation of the corporation. Thereafter, the corporation must satisfy other corporate formalities on a regular basis. The corporation is required to hold annual meetings of its shareholders and the Board regarding the general transaction of business, and special meetings as necessary to consider significant matters that cannot wait to be discussed at the annual meetings. The corporation needs to keep adequate and correct books and records of account and keep written minutes of the proceedings of its shareholders, the Board, and any committees of the Board. The corporation also needs to keep at its principal executive office a record of its shareholders, including the name and address of each shareholder and the number and class of shares held by each. *See id.* § 1500. The accounting books and records and minutes of proceedings must be made available for inspection by any shareholder upon the written demand of such shareholder at any reasonable time during normal business hours for a purpose reasonably related to the shareholder's interests as a shareholder. *See id.* § 1601.

The Cal. Corp. Code includes numerous general provisions that automatically apply to a California corporation by default unless the corporation's Articles of Incorporation or Bylaws provide otherwise. As mentioned above, some statutory standards cannot be varied by these documents. For instance, directors' liability to the corporation for certain misconduct cannot be altered. *See id.* §§ 204, 307, 402, 403. Also, since a number of considerations must be taken into account in designing the capital structure of the corporation and designating classes of capital stock, local counsel should be consulted in establishing the appropriate capital structure.

Every corporation must file an information statement with the Secretary of State within 90 days after filing its original Articles of Incorporation. It must file the same form again during the applicable biennial filing period. *See id*. § 1502(a). The applicable filing period is the calendar month during which the corporation's original Articles of Incorporation were filed and the immediately preceding 5 calendar months. *See id*. § 1502(d). The information statement must contain the following information: (1) the names and complete business or residence addresses of the corporation's incumbent directors; (2) the number of vacancies on the Board, if any; (3) the names and complete business or residence addresses of the corporation's chief executive officer, secretary, and chief financial officer; (4) the street address of the corporation's principal executive office; (5) if the address of the corporation's principal executive office is not in California, the street address of its principal business office in California, if any; and (6) a statement of the general type of business that constitutes the principal business activity of the corporation. *See id*. § 1502(a). The information statement must also designate the corporation's agent for the purpose of service of process. *See id*. § 1502(b). The corporation must file the information statement again whenever the information in the current information statement has changed or the agent for service of process or the agent's address is changed. *See id*. § 1502(e).

No later than 120 days after the close of the fiscal year, the Board must send an annual report to the corporation's shareholders, unless in the case of a corporation with fewer than 100 shareholders, this requirement is expressly waived in the Bylaws. *See id*. § 1501(a). The annual report needs to contain a balance sheet as of the end of that fiscal year and an income statement and statement of changes in financial position for that fiscal year, accompanied by any report of independent accountants or, if there is no such report, the certificate of an authorized officer of the corporation that the statements were prepared without audit from the books and records of the corporation. *See id*. Unless waived, the annual report must be sent to shareholders at least 15 (or, if sent by third-class mail, 35) days prior to the annual meeting of shareholders to be held during the next fiscal year. *See id*.

Businesses incorporating in California are subject to California corporation franchise tax requirements until such time as they formally dissolve. Information regarding franchise tax requirements can be obtained from the main website of the California Franchise Tax Board ("Franchise Tax Board") at <www.ftb.ca.gov/> or by calling the Franchise Tax Board at (1-800) 852-5711.

3. Dissolution

Corporations can wind up and dissolve voluntarily under Cal. Corp. Code §§ 1900-1907. Corporations may be dissolved involuntarily under Cal. Corp. Code §§ 1800-1809.

In order to wind up voluntarily, the shareholders holding shares representing 50% or more of the voting power may elect that the corporation be dissolved voluntarily. The Board is not required to take any action. The Board may adopt resolutions winding up the corporation if the corporation is (1) one as to which an order of relief has been entered into under Chapter 7 of the federal bankruptcy law, (2) one which has disposed of all its assets and has been inactive for a period of five years, or (3) one which has issued no shares. In these three limited situations, only a simple majority of the Board is required to dissolve the corporation.

If a corporation has elected to wind up and dissolve, a certificate evidencing such election must be filed with the Secretary of State. Such certificate may be (1) an officer's certificate, (2) signed and verified by not less than a majority of the Board, or (3) signed and verified by one or more shareholder representatives authorized to do so by no less than a majority of the voting power held by shareholders. *See id*. § 1901.

When a corporation has been completely wound up without court proceedings, a Certificate of Dissolution, signed and verified by a majority of the directors then in office, must be filed with the Secretary of State. *See id.* § 1905. The Certificate of Dissolution must contain the following information: (1) that the corporation has been completely wound up; (2) that all known debts have been paid or adequately provided for; (3) that all known assets have been distributed; (4) that if a certificate of election was executed, the election to dissolve was made by a vote of all outstanding shares; (5) that a person or entity assumes the tax liability, if any, as security for issuance of a tax clearance certificate from the Franchise Tax Board, *see* paragraph immediately below; and (6) that the corporation is dissolved. *See id*.

The corporation must also obtain a Tax Clearance Certificate from the Franchise Tax Board by filing form FTB 3555, Request for Tax Clearance Certificate — Corporation. Once the Franchise Tax Board notifies the Secretary of State that all franchise taxes have been paid or secured, the corporation is dissolved retroactively as of the date of filing the Certificate of Dissolution. *See id.* §§ 1905, 2010. A publication containing information about terminating a corporation, explaining the entire dissolution process and the required filing documents, is available from the Franchise Tax Board (FTB 1149).

With an involuntary dissolution, a verified complaint for involuntary dissolution may be filed by (1) one-half or more of the directors in office; (2) a shareholder or shareholders who hold shares representing not less than 33-1/3% of (a) the total number of shares outstanding (assuming conversion of preferred shares convertible into common shares), (b) the outstanding common shares, or (c) the equity of the corporation, exclusive in each case of shares owned by persons who personally participated in transactions involving fraud, mismanagement, abuse of authority, persistent unfairness toward any shareholders, or the misapplication or waste of property; (3) any shareholder of a close corporation; (4) any shareholder if the ground for dissolution is that the period for which the corporation was formed has terminated without extension; or (5) any other person expressly authorized to do so in the Articles of Incorporation. *See id.* § 1800(a). The grounds for involuntary dissolution are that: (1) the corporation has abandoned its business for more than one year; (2) the corporation has an even number of directors who are equally divided and cannot agree upon the proper management of the corporation, and the shareholders are so divided into factions that they cannot elect a Board consisting of an uneven number of directors; (3) there is internal dissension, and two or more factions of shareholders are so deadlocked that the corporation's business can no longer be conducted to the advantage of its shareholders, or the shareholders have failed at two consecutive annual meetings to elect successors to directors whose terms have expired; (4) those in control of the corporation have been guilty of or have knowingly countenanced persistent and pervasive fraud, mismanagement, abuse of authority, persistent unfairness toward any shareholders, or the misapplication or waste of property; (5) in the case of a corporation with 35 or fewer shareholders, liquidation is reasonably necessary for the protection of the rights of shareholders; or (6) the period for which the corporation was formed has terminated without any extension of the period. *See id.* § 1800(b).

The Attorney General of California may also bring an action for involuntary dissolution on its own or upon the complaint of a private party to procure a judgment dissolving the corporation upon any of the following grounds: (1) the corporation has seriously offended any provision of the statutes regulating corporations; (2) the corporation has fraudulently abused or usurped corporate privileges or powers; (3) the corporation has violated any law for which violation is a ground for forfeiture of the corporation's existence; or (4) the corporation has failed to pay the appropriate taxes to the Franchise Tax Board for five years. *See id.* § 1801.

After a court hearing, the court may decree the winding up and dissolution of the corporation if cause is shown. Involuntary proceedings for winding up a corporation begin when the order for winding up is entered by the court. The corporation must cease carrying on its business except to the extent necessary to wind up the business. *See id.* §§ 1804-1805. When a corporation is dissolved, a copy of the court order, certified by the clerk of the court, should be filed with the Secretary of State. *See id.* § 1809.

4. Costs

Filing fees and franchise taxes may be slightly higher for a corporation than for a limited liability company ("LLC") (*see* Chapter 2.C *infra*) or a limited partnership ("LP") (*see* Chapter 2.E *infra*), but attorneys' fees may be more or less. Many of the documents prepared for a corporation are quite standard, whereas LLC and LP agreements can be very complicated.

5. Management and Control

A corporation has a standard, hierarchical control structure. It is managed by or under the direction of a Board and its officers, although shareholders vote on important corporate issues, such as election of directors, mergers, sale of all corporate assets, and dissolution. A closely held corporation, by agreement among its shareholders, may adopt management characteristics substantially similar to those of a general or limited partnership.

6. Personal Liability

A shareholder's liability in a corporation is usually limited to the shareholder's investment in the corporation so long as requisite corporate formalities have been met and the corporation is not undercapitalized. As a general rule, a shareholder of a corporation is not individually responsible for the liabilities of the corporation. In general, a well-maintained corporation will serve as an adequate shield to its shareholders from liabilities arising out of the operations of the corporation. A court, however, may permit creditors of a corporation to "pierce the corporate veil" and recover from a shareholder if the court finds that the parties have failed to observe certain corporate formalities adequately. "Piercing the corporate veil" is sometimes referred to as finding that the corporation is the "alter ego" of the shareholder. Although a court's decision whether to "pierce the corporate veil" hinges on the particular facts and circumstances of the case before the court, regular adherence to corporate formalities will increase the likelihood that a court would decline to hold a shareholder liable to the creditors of a corporation. Examples of these corporate formalities include: (1) maintaining adequate capitalization of the corporation; (2) maintaining adequate insurance coverage; (3) strict recognition of the separate existence of the corporation and the shareholder (including avoidance of commingling funds, maintenance of separate bank accounts, and appropriate documentation of intercorporate transactions); (4) adherence to proper procedures for actions of shareholders and directors; and (5) maintenance of thorough and accurate records of the corporation's operations as a separate legal entity. Adequate capitalization is often a central focus of litigation seeking to pierce the corporate veil.

Note also that creditors may require that principal shareholders guarantee corporate indebtedness, particularly debts of small or closely-held companies. Furthermore, shareholders may be liable for their own tortious conduct on behalf of the corporation.

7. Continuity

Corporations are perpetual in form unless the Articles of Incorporation provide otherwise. However, the business may fail, be sold, or be dissolved.

8. Transfer of Ownership Interests

Shares of stock in corporations are freely transferable as long as a market exists for the stock. Any sale must comply with applicable federal and state securities laws. The governing documents of small closely-held corporations often provide for the redemption of shares to ease the liquidity problems of the shareholders. Reasonable restrictions on transfer may be imposed by agreement among the shareholders or by the Articles of Incorporation or Bylaws.

9. Taxation

A corporation, unlike a sole proprietorship, partnership, or LLC, is subject to entity-level taxation. A corporation pays taxes on its taxable income (gross income less deductible expenses) and, like other taxpayers, may be entitled to credits against the tax. Corporate profits are generally taxed a second time, this time as ordinary income to shareholders, when they are distributed as dividends. However, unlike other business entities, a corporation can accumulate profits (subject to certain limitations and other potential taxes) for later use in the business by not declaring dividends, thus protecting its shareholders from current tax on the accumulated profits until a dividend is paid.

Eligible corporations can avoid double taxation by electing Subchapter S tax treatment. Subject to certain other requirements, a corporation can elect such treatment if all of its shareholders so agree and if it has no more than 100 shareholders who are individual United States citizens or individual United States residents (and certain limited forms of trusts), has only one class of stock, and has either a calendar tax year or a business purpose for adopting a different fiscal year. For purposes of the 100-shareholder limit, family members may elect to be treated as one shareholder. In brief, the income of an S Corporation, like that of a partnership or LLC, generally passes through to its shareholders and is taxed only at the shareholder level.

If, as is often the case, a new business projects initial operating losses, it may be best to delay incorporation and operate as a partnership or LLC or elect "S Corporation" treatment until the business shows a profit. This will enable owners to take current deductions for early losses, rather than having the corporation carry the losses forward to offset future corporate income.

10. Raising Capital

Corporations (together with LLCs) offer the most flexibility in raising capital — from equity (common stock, preferred stock, options, warrants) to debt instruments (convertible notes, subordinated notes, bonds, commercial paper). Management can be centralized in the Board and officers, regardless of the number of shareholders, although securities laws will remain an important consideration.

11. Fringe Benefits for Employees

The difference between qualified plans for self-employed individuals and those for corporate employees has been essentially eliminated. Contributions and benefit limits are now substantially equivalent for incorporated and unincorporated businesses. Therefore, incorporation should be considered only if it meets other business and tax objectives.

B. Foreign Corporations and Other Foreign Business Entities

1. Description of the Foreign Corporation

In general, a corporation's relationship with its shareholders is governed by the corporate laws of the jurisdiction in which the corporation is organized. Therefore, a foreign corporation is one that is incorporated under the laws of a jurisdiction other than California. *See id.* § 171. Foreign corporations include corporations organized both overseas and in states of the United States other than California. If, however, a foreign corporation has certain contacts with California, by way of Cal. Corp. Code § 2115, that corporation may be subject to specified provisions of the Cal. Corp. Code. *See* Chapter 2.B.4 *infra* (discussion of the Quasi-California Corporation).

2. Qualification of the Foreign Corporation to Do Business

Before "transacting intrastate business," *see* paragraph below, in California, a foreign corporation must qualify to do business in the state by obtaining a Certificate of Qualification from the Secretary of State. *See* Cal. Corp. Code § 2105. A Statement and Designation by Foreign Corporation ("S & D") is the required form for this purpose. The Secretary of State will not file the S & D form if the name of the foreign corporation is deemed too similar to the name of either an existing domestic California corporation or a foreign corporation already qualified in California. A foreign corporation may still qualify to do business in California even if its name is similar to that of either a pre-existing domestic corporation or a foreign corporation qualified in California if the Secretary of State determines that the business to be conducted by the applicant corporation in California is not the same as or similar to the business conducted by the pre-existing corporation and that the public will not be deceived by the name. *See id.* § 2106. To avoid this problem, a corporation should check with the Secretary of State prior to filing an S & D form to see if its name is available in California.

The S & D form is easy to complete, requiring only information concerning the corporation's designated agent for service of process in California, the address of the corporation's principal place of business, and the corporation's state of incorporation, as well as a consent by the corporation that service of process be directed to the designated agent. Once qualified, a foreign corporation must file each year an annual Statement by Foreign Corporation with the Secretary of State prior to the anniversary month of its original qualification to transact intrastate business in California. *See id.* § 2117. The following items must be disclosed in the Statement by Foreign Corporation: (1) the names and addresses of the foreign corporation's chief executive officer, secretary, and chief financial officer; (2) the chief address of its principal executive office; (3) a description of the principal business activity of the corporation; and (4) information concerning the designated agent for service of process.

The failure to qualify, as required, subjects a foreign corporation to a $20-per-day penalty, a fine not less than $500 nor more than $1,000, and potential prosecution for a misdemeanor. *See id.* § 2203. Likewise, the failure to file a Statement by Foreign Corporation may subject the foreign corporation to financial penalties as well as possible forfeiture or suspension of its right to "transact intrastate business" in California. *See id.* §§ 2204-2206.

"Transacting intrastate business" in California refers to a corporation "entering into repeated and successive transactions of its business in this state, other than interstate or foreign commerce." *See id.* § 191(a). A corporation will not be considered to be transacting intrastate business by reason of carrying on any one or more of the following activities in California: (1) maintaining or defending any action or administrative or arbitration proceeding, or effecting the settlement thereof; (2) holding director meetings, holding shareholder meetings, or conducting other internal affairs so long as these activities are not regular, continuous, and systematic; (3) maintaining bank accounts; (4) maintaining offices or agencies for the transfer, exchange, and registration of securities or depositaries; (5) effecting sales through independent contractors; (6) soliciting or procuring orders, whether by mail or otherwise, and maintaining offices therefor, where the orders require acceptance outside California before becoming binding contracts; (7) creating evidences of debt or mortgages, liens, or security interests in real or personal property; and (8) conducting an isolated transaction completed within a period of 180 days and not in the course of a number of repeated transactions of like nature. *See id.* § 191. Since this list is not exclusive and speaks of what does *not* qualify as "transacting intrastate business," an analysis should be conducted based on the facts of each case.

3. Termination of the Foreign Corporation

A foreign corporation qualified in California may withdraw from doing business in California and surrender its Certificate of Qualification by filing a Certificate of Surrender of Right to Transact Intrastate Business in accordance with Cal. Corp. Code § 2112. The Certificate of Surrender must be accompanied or proceeded by a request for a Tax Clearance Certificate from the Franchise Tax Board (Form 3555 — Assumption of Tax Liability/Request for Tax Clearance).

4. The Quasi-California Corporation

Under Cal. Corp. Code § 2115, foreign corporations having certain specified contacts with California are required to comply with many sections of the Cal. Corp. Code, thereby making them quasi-California corporations. A two-part test is used to determine whether an otherwise foreign corporation is deemed a quasi-California corporation under Cal. Corp. Code § 2115. The first part of the test is whether or not more than one-half of the corporation's outstanding voting securities are held of record by persons having addresses in California. The second part of the test is whether or not the corporation has more than half of its business in California. The second part of the test is calculated on the basis of three factors. They are the corporation's property factor (defined in Cal. Rev. & Tax. Code § 25129), the corporation's payroll factor (defined in Cal. Rev. & Tax. Code § 25132), and the corporation's sales factor (defined in Cal. Rev. & Tax. Code § 25134). The property factor is equal to the corporation's California property, divided by its total property. The payroll and sales factors are calculated in the same way. The three factors are averaged, and if more than half is allocated to California, then the corporation meets the second part of the two-part test. *See id*. § 2115(a)(1). The calculation of the three factors is done on a consolidated basis. Under Cal. Corp. Code § 2115(a)(2), the calculation of the three factors includes the property, payroll, and sales of a parent that directly or indirectly holds more than 50% of the outstanding shares of a subsidiary that conducts business in California. However, there is a deduction from each factor equal to the percentage of minority ownership in the subsidiaries.

A corporation that meets the two-part test of § 2115 is subject to certain provisions of the Cal. Corp. Code, including Cal. Corp. Code § 301 (annual election of directors), §§ 303-305 (removal of directors and filling of director vacancies), § 309 (directors' standard of care), § 316 (liability of directors for unlawful distributions), § 317 (indemnification of directors, officers, and others), §§ 500-505 (limitations on corporate distributions in cash or property), § 506 (liability of shareholder who receives unlawful distribution), § 600(b)-(c) (requirement for annual shareholders' meeting and remedy if same not timely held), § 708(a)-(c) (shareholder's right to cumulate votes at any election of directors), § 710 (supermajority vote requirement), § 1001(d) (limitations on sale of assets), § 1101 provisions following subdivision (e) (limitations on mergers), Chapter 12 commencing with § 1200 (reorganizations), Chapter 13 commencing with § 1300 (dissenters' rights), §§ 1500-1501 (records and reports), § 1508 (action by Attorney General), and Chapter 16 commencing with § 1600 (rights of inspection). *See* Cal. Corp. Code § 2115. A quasi-California corporation must comply with these provisions beginning on the 135th day of the income year immediately following the latest income year in which the aforementioned test has ceased to be met. *See id*. A foreign corporation can cease abiding by these provisions at the end of the first income year immediately following the latest income year in which the aforementioned test has been met. *See id*.

5. Other Foreign Business Entities

A foreign LP that would like to transact business in California must register with the Secretary of State. To register, a foreign LP must submit to the Secretary of State an Application for Registration (Form LP-5) as a foreign LP. The Form LP-5 must be signed and acknowledged by a general partner. In order to terminate its registration, the foreign LP must file a Certificate of Cancellation (Form LP-4/7).

A foreign LLC that would like to transact business in California must also register with the Secretary of State. To register, a foreign LLC must submit to the Secretary of State an Application for Registration (Form LLC-5). In addition, every LLC organized under California law and every foreign LLC registered to transact business in California must file a Statement of Information (Form LLC-12) with the Secretary of State within 90 days after filing its organizational document and also during the applicable biennial filing period. In order to terminate its registration, the foreign LLC must file a Certificate of Cancellation (Form LLC-4/7).

A foreign business entity that wishes to convert into a domestic California business entity must file the relevant Form of Conversion with the Secretary of State.

C. Limited Liability Company

1. Description

An LLC combines certain characteristics of a partnership and a corporation. It is owned by its members. It may be managed by its members or by one or more managers, who may or may not be members. It may be operated either by its members, or its managers, or its officers and employees. The organization and operations of an LLC are governed by statute. Although there is a Uniform Limited Liability Company law, most jurisdictions have adopted their own statutes. *See*, *e.g.*, *id.* §§ 17000 *et seq*. LLC membership interests may be considered securities which must be qualified or registered under state and federal securities laws unless an exemption is available. Formalities, such as minutes of members' and managers' meetings, are not required, but it is suggested that such records be maintained.

2. Formation

An LLC comes into existence when its Articles of Organization are filed with the Limited Liability Company Unit of the Secretary of State. *See id.* § 17050. The Articles of Organization must be filed on Form LLC-1, which can be obtained from the Secretary of State. The Articles of Organization must also be accompanied by the applicable filing fee. The mandatory provisions of the Articles of Organization are as follows: (1) the name of the LLC (on payment of a filing fee, an applicant may reserve an available LLC name with the Secretary of State for 60 days); (2) a statement regarding the purpose of the LLC; (3) the name and address of the initial agent; and (4) if the LLC is to be managed by managers and not by all of its members, a statement to that effect, and if it is to be managed by only one manager, a statement to that effect. *See id.* § 17051. A number of optional provisions are also available for inclusion in the Articles of Organization, and it is suggested that private legal counsel be consulted for advice regarding the proposed LLC's specific business needs, which may call for the inclusion of certain of those provisions. *See id*. An LLC (including a foreign LLC) may record a certified copy of its Articles of Organization with any county recorder. *See id.* § 17052. In effect, this filing gives notice to those who do business with the LLC.

Before or after (presumably promptly after) the filing of the Articles of Organization, the members must enter into a written or oral operating agreement, although an LLC begins its existence only upon the filing of its Articles of Organization. *See id.* § 17050. Although an operating agreement can be either written or oral, it is advisable that an operating agreement be written since it is likely to be the key document of an LLC. In addition, a written operating agreement may need to be submitted to the United States Internal Revenue Service ("IRS") for federal tax purposes if the LLC requests a ruling from the IRS on a particular tax issue. Finally, the Cal. Corp. Code includes numerous general provisions that automatically apply to a California LLC by default unless changes to such provisions are made in a written operating agreement or in the Articles of Organization. It is suggested that changes be made in the written operating agreement since any amendments to the Articles of Organization must be filed with the Secretary of State.

If a provision of the Articles of Organization conflicts with a provision of the written operating agreement, the Articles of Organization control. *See id.* § 17005. These documents should be carefully drafted to avoid confusion and possible inconsistencies regarding the inclusion of similar provisions. When drafting amendments to the operating agreement, one should always consider related provisions in the Articles of Organization.

Every domestic LLC and every foreign LLC registered to transact business in California must file a Statement of Information (Form LLC-12) with the Secretary of State within 90 days after filing its original Articles of Organization. It must file the same form again during the applicable biennial filing period. *See id.* § 17060. In addition, an LLC must continuously maintain an office in California at which it keeps the following required documents: (1) a current list of the name(s) and address(es) of each member and each holder of an economic interest; (2) a current list of the name(s) and address(es) of each manager, if applicable; (3) a copy of the Articles of Organization and any amendments thereto; (4) copies of federal, state, and local income tax returns for the six most recent fiscal years; (5) a copy of the operating agreement, if in writing, and any amendments thereto; (6) copies of the financial statements for the six most recent fiscal years; and (7) the books and records of internal affairs for the current and past four fiscal years. *See id.* §§ 17057-17058.

3. Dissolution

An LLC will be dissolved and its affairs wound up when the first of the following occurs: (1) the expiration of the duration of existence set forth in the Articles of Organization; (2) the occurrence of events specified in the Articles of Organization or written operating agreement; (3) the vote of a majority-in-interest of the members (or of a greater percentage as specified in the Articles of Organization or written operating agreement); (4) the entry of a decree of judicial dissolution; or (5) except as otherwise provided in the Articles of Organization or written operating agreement, upon the death, resignation, expulsion, or bankruptcy of a member-manager, or any member if the LLC has no managers, unless the business of the LLC is continued by a vote of the majority-in-interest of the remaining members within 90 days of that event. *See id.* § 17350.

Generally, when an LLC dissolves, its managers must file a Certificate of Dissolution in the office of the Secretary of State on Form LLC-3. *See id.* § 17356. It must set forth the name of the LLC, the Secretary of State's file number, and any other information that the managers or members filing the certificate determine to include. *See id*. A dissolved LLC may not continue business except as necessary to wind up its affairs. *See id.* § 17354.

Despite the filing of a Certificate of Dissolution, a majority-in-interest of members may file a Certificate of Continuation (Form LLC-8) with the Secretary of State. *See id.* § 17357. Upon the filing of the Certificate of Continuation, the Certificate of Dissolution is of no effect. *See id*.

Alternatively, if the members do not file a Certificate of Continuation and in fact wind up the LLC, a Certificate of Cancellation (Form LLC-4/7) must be filed with the Secretary of State. *See id*. § 17356. The Certificate of Cancellation must contain the following information: (1) the name of the LLC and the Secretary of State's file number; (2) a statement that a person or entity assumes the tax liability, if any, as security for issuance of a tax clearance certificate from the Franchise Tax Board; and (3) any other information the managers or members filing the certificate decide to include. *See id*.

Like a corporation, an LLC must obtain a Tax Clearance Certificate from the Franchise Tax Board. Once the Franchise Tax Board notifies the Secretary of State that all franchise taxes have been paid or secured, the LLC is dissolved retroactively as of the date of filing the Certificate of Cancellation. *See id*.

4. Costs

Filing fees and taxes associated with LLCs may be comparable to those for a corporation. Attorneys' fees may be more, depending on the complexity of the operating agreement, although it can be prepared on a standard form.

5. Management and Control

As discussed earlier, an LLC may be managed by its members or by one or more managers, who may or may not be members. A board of managers may manage the LLC in a manner similar to that of the Board of a corporation, with officers reporting to the managers. The right of members to vote on matters affecting the LLC is usually governed by the agreement of the members, as reflected in its organization documents, such as its Articles of Organization and/or operating agreement, but may to some limited extent be specified in the statutes of the state under which the LLC is organized.

6. Personal Liability

Members are normally not liable for the debts and obligations of the LLC; however, as is the case with shareholders of a corporation, members may be liable in some jurisdictions for the debts of the LLC if the LLC is undercapitalized. Members are liable for their own tortious conduct on behalf of the LLC.

7. Continuity

The period of existence of an LLC is normally specified in its organizational documents, and in some states, such as California, it must have a specified term, which can be extended by amending its Articles of Organization. In other states, such as Delaware, its existence can be perpetual if so stated in its operating agreement.

8. Transfer of Ownership Interests

All members must normally approve a transfer of a member's interest unless the Articles of Organization or operating agreement provide otherwise.

9. Taxation

Generally, unless it elects to be treated for tax purposes as a corporation, an LLC is not subject to separate entity-level taxation of its income, although it does file an informational return. Typically, a member's distributive share of membership income and loss is treated as income or loss to the member and reported on his or her individual return, regardless of whether the member actually receives the income. Deductible expenses of the business generally offset income and reduce the member's tax. LLCs that have one owner are generally disregarded as entities separate from their owners. If an LLC's single owner is a corporation or a partnership, the LLC is generally treated as a division of the corporation for tax purposes. If an LLC's single owner is an individual, the LLC is generally treated as a sole proprietorship for tax purposes.

Formerly, there was a risk that LLCs might be treated as corporations for federal income tax purposes if they possessed sufficient corporate characteristics, such as any three of the four characteristics of unlimited life, limitation of liability of owners, free transferability of ownership interests, and centralized management. As a result of changes in IRS policy, LLCs generally are treated as partnerships unless they elect to be treated as corporations under the "check-the-box" rules. Consideration may still be required as to applicable state income tax laws that do not follow federal rules in determining whether an LLC will be taxed as a corporation.

10. Raising Capital

An LLC offers the same flexibility in raising capital as a corporation, as discussed in Chapter 2.A.10 *supra*.

D. General Partnership

1. Description

A general partnership ("GP") exists when two or more persons or entities combine their property, services, and/or capital in furtherance of a business venture. Each partner owns an interest in the business, shares in the profits and losses, and is liable for the debts and obligations of the business as discussed in Chapter 2.D.6 *infra*.

2. Formation

Under the Revised Uniform Partnership Act ("RUPA"), a partnership is an entity distinct from its partners. *See id.* § 16202. The partnership can arise in one of several different ways: (1) by express written or oral agreement; (2) by the partners' conduct, which may create an implied partnership; and (3) by estoppel (*i.e.* actions taken by a person or entity that prevent such person or entity from denying that a partnership exists). *See id*. The mere sharing of gross returns of property is not necessarily sufficient to establish a partnership, but the sharing of net profits does raise the inference that the recipients are partners, unless those profits are received to satisfy a previous debt, such as wages, or received as consideration for the sale of business assets. *See id*. Partners need not be individuals. They can be corporations, limited liability companies, or any other business entity, including other partnerships.

If two or more individuals or entities intend to form a partnership, a written partnership agreement should be executed. RUPA contains numerous general provisions that automatically apply to a California GP by default unless changes to such provisions are made in a written partnership agreement. *See id.* § 16103. In addition, all property that the partners intend to contribute to the business should be properly transferred to the partnership. *See id.* § 16204. For other pertinent legal issues affecting general partnerships, see the discussion at Section G, *infra*, regarding sole proprietorships.

GPs are permitted, but not required, to record their partnership agreement with the county recorder's office in the county where the GP is located. GPs may also register at the state level by filing a Statement of Partnership Authority with the Secretary of State.

3. Dissolution

While certain events cause the dissolution of all partnerships, certain other events apply to the dissolution of only at-will partnerships or partnerships organized for a definite term or a particular undertaking. An at-will partnership can be dissolved by the express will of at least half of the partners. Partners that have dissociated from the partnership within the past 90 days are deemed willing to dissolve. *See id.* § 16801. A partnership organized for a definite term or a particular undertaking is dissolved by (1) the dissociation of a partner and the failure of a majority of the remaining partners to vote, within 90 days of the dissociation, to continue the partnership; (2) the express will of all of the partners; or (3) the expiration of the term or the completion of the undertaking. *See id*. A "dissociation" refers to the death, withdrawal, expulsion, or bankruptcy of a partner.

All partnerships will dissolve upon the occurrence of any of the following: (1) an event stated in the partnership agreement; (2) an event making it unlawful for the partnership to carry on its business, unless the situation is cured within 90 days; or (3) upon the application of a partner, a judicial determination that the partnership's economic purpose is likely to be frustrated, that another partner has engaged in conduct that would make it impracticable for business to be carried on with that partner, or that the business of the partnership may no longer be carried on in accordance with the partnership agreement. *See id*. A partner who has not wrongfully dissociated from the partnership may file a Statement of Dissolution with the Secretary of State. A Statement of Dissolution cancels a Statement of Partnership Authority. Third parties are deemed to have notice of the dissolution and limitation of a partner's authority 90 days after the Statement of Dissolution is filed. *See id.* § 16805.

The partnership continues after dissolution only for the purpose of winding up its business, which includes settling its liabilities and capital accounts. *See id.* § 16803. During this time, any partner can waive the right to have the business wound up. If such a waiver occurs, the partnership will resume carrying on its business as though the dissolution never occurred. *See id.* § 16802. When the partnership's business is wound up, the partnership is terminated. *See id*.

4. Costs

The principal costs incurred in forming a partnership are those associated with drafting the partnership agreement. If an attorney is consulted, fees vary considerably depending on the complexity of the agreement.

5. Management and Control

In general, each partner can participate in the management of the business and can enter into an agreement that will be enforceable against or by the partnership. The partnership agreement, however, will control the GP's actual management structure. Many GPs find it helpful to centralize control in one or more managing partners. The partnership agreement may limit a general partner's ability to act on behalf of the partnership, although this will not generally prevent the partner from contracting with third persons who have no knowledge of his or her limited status. Without an agreement, control is exercised by a numerical majority of all partners.

6. Personal Liability

Each partner is personally liable to outside creditors for acts committed by and obligations incurred on behalf of the partnership, except that newly admitted partners are liable for previous GP liabilities only to the extent of their capital contribution, unless they otherwise agree. Some protection from creditors can be achieved if the general partners are corporations, provided that the corporations have sufficient net worth. Insurance may be available.

7. Continuity

Under the Uniform Partnership Act, a GP underwent a formal dissolution upon the death, withdrawal, expulsion, or bankruptcy of a partner, and any general partner could force dissolution. However, the partnership agreement could be drafted to allow the remaining partners to continue the business despite the above occurrences. Under RUPA, dissociation does not affect the existence of the partnership.

8. Transfer of Ownership Interests

No ready market typically exists for GP interests; however, an interest can be sold without disrupting partnership business, transferring partnership assets, or changing the partnership form of organization. All existing partners must normally approve the prospective purchaser unless the partnership agreement provides otherwise.

9. Taxation

Generally, unless it elects to be treated for tax purposes as a corporation, a partnership is not subject to separate entity-level taxation of the income, although it does file an informational return. Typically, a partner's distributive share of partnership income and losses is treated as income or loss to the partner and reported on his or her individual return, regardless of whether the partner actually receives the income. Deductible expenses of the business generally offset income and reduce the partner's tax.

Formerly, there was a risk that GPs might be treated as corporations for federal income tax purposes if they possessed sufficient corporate characteristics, such as any three of the four characteristics of unlimited life, limitation of liability of owners, free transferability of ownership interests, and centralized management. As a result of changes in IRS policy, however, GPs generally are treated as partnerships unless they elect to be treated as corporations under the "check-the-box" rules.

10. Raising Capital

An unlimited number of contributors can be relied upon for capital (in the form of either contributions or loans), although too many active participants can make management difficult.

E. Limited Partnership

1. Description

The organization and operations of an LP are governed by the Revised Uniform Limited Partnership Act ("RULPA"), which replaced an earlier Uniform Limited Partnership Act ("ULPA"). RULPA has been adopted in almost all jurisdictions, including California. *See id.* §§ 15611 *et seq*. However, under California law, an LP existing on or before July 1, 1984, is still governed by the earlier ULPA. *See id.* § 15711.

An LP is a partnership formed by two or more persons under the laws of a particular state. An LP is similar to a GP, except that it consists of at least one general partner and one or more limited partners. LP interests are typically considered securities which must be qualified or registered under state and federal securities laws unless an exemption is available. In most instances, a GP interest is not considered a security. An LP may conduct any business that a GP is permitted to conduct, except for the following: banking, insurance, and trust company business. *See id.* §§ 15503, 15616.

2. Formation

In order to form a domestic LP, the general partners must execute, acknowledge, and file a Certificate of Limited Partnership (Form LP-1), together with an accompanying filing fee, with the Secretary of State. *See id.* §§ 15621, 15712. The LP also has the option of filing the certificate with the county clerk in each county where the LP owns real property. In effect, this filing gives notice to all who do business with the LP.

Before or after (presumably promptly after) the filing of the certificate, the partners must enter into a written or oral partnership agreement. It is advisable that a partnership agreement be written since the ULPA and RULPA contain numerous general provisions that automatically apply to a California LP by default unless changes to such provisions are made in a written partnership agreement.

A California LP must maintain an office and store certain business records in California. *See id.* § 15614. A detailed list of the records required to be on file in California can be found at Cal. Corp. Code § 15615.

Both the RULPA and the ULPA impose name requirements on a proposed LP. For example, under the RULPA, the name of each LP must contain the words "limited partnership" or the abbreviation "L.P." at the end of its name, and the name may not contain the words "bank," "insurance," "trust," "trustee," "incorporated," "inc.," "corporation," or "corp." In addition, the name may not be one which the Secretary of State determines is likely to mislead the public or is the same as or closely resembles the name of another LP registered in California. *See id.* § 15612. Under the ULPA, the surname of a limited partner cannot be used in the LP name unless it is also the surname of a general partner or unless the business of the LP had been carried on using the surname prior to the time the limited partner became a limited partner. A limited partner whose name appears in an LP name contrary to the ULPA will be liable as a general partner to creditors who do not have actual knowledge that the limited partner is not a general partner. *See id.* § 15505. In contrast, under the RULPA, a limited partner is not liable as a general partner unless named as a general partner in the Certificate of Limited Partnership or unless the limited partner participates in the control of the business. *See id.* § 15632.

3. Dissolution

An LP shall be dissolved and its affairs wound up when any of the following occurs: (1) an event specified in the written partnership agreement; (2) the written consent of all of the general partners and a majority-in-interest of the limited partners; (3) the termination of a general partner's status as a general partner for the reasons stated in Cal. Corp. Code § 15642; or (4) the entry of a decree of judicial dissolution. *See id.* §§ 15681-15682.

Upon dissolution, a Certificate of Dissolution (Form LP-3) should be filed with the Secretary of State by the general partners. *See id.* § 15623. Despite the filing of a Certificate of Dissolution, all of the general and limited partners may by written consent agree to file a Certificate of Continuation (Form LP-8) with the Secretary of State. *See id.* § 15623. Upon the filing of a Certificate of Continuation, the Certificate of Dissolution is of no effect, and the LP can resume doing business.

Alternatively, if the general and limited partners do not file a Certificate of Continuation and in fact wind up the LP, a Certificate of Cancellation (Form LP-4/7), which cancels the Certificate of Limited Partnership, should be filed with the Secretary of State. *See id.* § 15524.

4. Costs

Costs associated with forming an LP typically exceed those of forming a GP. Attorneys' fees can be higher since the LP agreement is often more complex and compliance with securities laws may be necessary.

5. Management and Control

An LP is managed by its general partner(s). Limited partners are not actively involved in the management of the LP. If limited partners participate in management, they risk losing their limited liability status. However, most state statutes allow a limited partner to vote on important partnership issues, such as termination of the partnership, removal of the general partner, sale of all partnership assets, and amendment of the partnership agreement, without losing their limited liability status. In some instances, the limited partner can contract to provide services to the partnership.

6. Personal Liability

A general partner has unlimited liability for the debts and obligations of an LP to the same extent as general partners who participate in GPs. A limited partner's liability for the debts and obligations of the LP is generally limited to the partner's investment in the LP.

7. Continuity

An LP will be dissolved upon a general partner's death or retirement, unless the business is continued by the remaining general partners or, in the event no other general partners exist, the limited partners vote to substitute a new general partner. A limited partner's death or retirement does not affect the LP's continuity.

8. Transfer of Ownership Interests

The market for LP interests and the ease with which they can be transferred generally parallel that of a GP interest. However, an LP interest is a security, and state and federal securities laws must be consulted before any transfer. A limited partner's investment is typically assignable without the other partners' consent, although an assignee needs this consent to acquire more than a bare financial interest in the business, such as voting rights and the ability to inspect partnership books and records.

9. Taxation

Generally, unless it elects to be treated for tax purposes as a corporation, a partnership is not subject to separate entity-level taxation of its income, although it does file an informational return. Typically, a partner's distributive share of partnership income and losses is treated as income or loss to the partner and reported on his or her individual return, regardless of whether the partner actually receives the income. Deductible expenses of the business generally offset income and reduce the partner's tax.

Formerly, there was a risk that LPs might be treated as corporations for federal income tax purposes if they possessed sufficient corporate characteristics, such as any three of the four characteristics of unlimited life, limitation of liability of owners, free transferability of ownership interests, and centralized management. As a result of changes in IRS policy, LPs generally are treated as partnerships unless they elect to be treated as corporations under the "check-the-box" rules.

10. Raising Capital

An unlimited number of contributors is possible, with most of these contributors being passive limited partners, thereby making management easier. However, large numbers of limited partners may necessitate compliance with state and federal securities laws, thus increasing the expense and time needed to raise capital.

F. Limited Liability Partnership

1. Description

A limited liability partnership ("LLP") is a general partnership that has registered as an LLP with a state agency. In some jurisdictions, an LLP may be utilized only by certain specified types of businesses or professions.

2. Formation

In order to become an LLP, a partnership must file a Certificate of Registration (Form LLP-1) with the Secretary of State. *See id.* § 16953. This form sets forth (1) the name and address of the partnership; (2) the name and address of the agent for service of process; (3) a brief description of the business of the partnership; (4) a statement that the partnership is registering as a registered LLP; and (5) any other matters that the partners want to include. It is generally advisable to have a written partnership agreement establishing the manner in which the LLP is to be operated. LLP interests, like GP interests, will generally not be considered securities.

3. Dissolution

In order to dissolve, the LLP must complete and submit a Notice of Change of Status (Form LLP-4) with the corresponding filing fee. A Tax Clearance Certificate must also be received from the Franchise Tax Board before the Notice of Change of Status can be filed. To obtain a Tax Clearance Certificate, the LLP must submit a Request for Tax Clearance Certificate – Limited Liability Partnership (Form 3555L) to the Secretary of State, who will in turn forward the request to the Franchise Tax Board. Once the Franchise Tax Board has determined that all fees and penalties have been paid or secured, it will forward a copy of the Tax Clearance Certificate to the Secretary of State's office. The LLP is retroactively dissolved on the date the Notice of Change of Status form was filed.

4. Costs

Costs associated with forming an LLP will typically be similar to the costs incurred in forming a GP, although filing fees are required to register the LLP with appropriate authorities and, in some states, taxes similar to corporate franchise taxes must be paid.

5. Management and Control

An LLP is managed by its partners, subject to agreement among them. Unlike an LP, all of the partners of an LLP may participate in management without losing their limited liability status.

6. Personal Liability

Partners are liable for the partnership's debts only to the extent of their individual capital contributions, except to the extent that they agree to assume greater liability.

Partners are also liable for their own tortious conduct and, in some jurisdictions, for negligent supervision of others acting for the LLP who engage in tortious conduct.

7. Continuity

As in the case of a GP, an LLP will be dissolved upon the death, withdrawal, expulsion, or bankruptcy of a partner. However, the partnership agreement can be drafted to allow the remaining partners to continue the business.

8. Transfer of Ownership Interests

All existing partners must normally approve a transfer of a partnership interest unless the partnership agreement provides otherwise.

9. Taxation

Generally, unless it elects for tax purposes to be treated as a corporation, under the "check-the-box" rules, an LLP is not subject to separate entity-level taxation of the income, although it does file an informational return. Typically, a partner's distributive share of partnership income and losses is treated as income or loss to the partner and reported on his or her individual return, regardless of whether the partner actually receives the income. Deductible expenses of the business generally offset income and reduce the partner's tax.

10. Raising Capital

Capital-raising for an LLP is similar to that of a GP, except that in states where only licensed professionals may be partners in an LLP, the number of contributors may be limited.

G. Sole Proprietorship

It should be noted that the discussion on sole proprietorships deals with issues that every form of business entity in California will confront, but they are explained in the context of sole proprietorships because they are ordinarily the issues that a sole proprietor will face.

1. Description

The sole proprietorship is an unincorporated business owned and managed by one person for the purpose of making a profit. The individual is fully liable for the debts and obligations of the business. Since the owner is not held accountable to other partners or investors, fewer records must be kept, thus offering a great deal of privacy and flexibility. No formal procedures must be followed or consents obtained in order to form a sole proprietorship; however, as with any business, local governments may require the proprietor to obtain certain business licenses or permits. Registration of the business name may be advisable. The organization and operation of a sole proprietorship are generally governed by common law principles. The California Business and Professional Code imposes certain obligations on sole proprietors.

2. Formation

Filing a Fictitious Business Name Statement (Form 1-3) ("FBNS") is required if the name of the business is different from the sole proprietor's own name. *See* Cal. Bus. & Prof. Code §§ 17900-17902, 17910. Without an FBNS on file, a sole proprietorship may neither sue nor defend a lawsuit, except in tort. *See id.* § 17918. The FBNS must ordinarily be filed with the county clerk's office within 40 days of commencement of business. *See id.* § 17910. It must also be published in a newspaper within 30 days of the date of filing. *See id.* § 17917. Proof of publication must then be filed with the county. Name-checking services are available for avoiding any possible trade names litigation.

If the business is within city limits, the sole proprietor should consult the city clerk regarding any required business permits. If the business is within county but not city limits, the county clerk should be consulted. Finally, the proposed business may require a special state license or permit. The State Department of Consumer Affairs (*see* website at <www.dca.ca.gov/>) should be consulted to see if the proposed business falls within the ambit of any state licensing agency.

Certain types of insurance may be required, such as worker's compensation, product liability, and fire and premises liability insurance. In addition, if the sole proprietorship intends to sell goods in the retail market, it must obtain a Seller's Permit from the State Board of Equalization (*see* website at <www.boe.ca.gov/> and Cal. Rev. & Tax. Code §§ 6014, 6066). Further, a sole proprietor who hires employees must consider nondiscrimination, payroll withholding, overtime, minimum wage, union activity, and Occupational Safety and Health Administration requirements. Lastly, every business that pays wages to one or more employees or is required to have an identification number for use on any tax return must obtain a federal taxpayer identification number.

3. Costs

Costs associated with forming a sole proprietorship typically include only those present in any business venture, such as fees for licenses and permits.

4. Management and Control

The owner has complete control of the business unless he or she has surrendered some control, for example, to creditors.

5. Personal Liability

The sole proprietor is personally liable for all business debts. Although the proprietor's assets can be reached by creditors, he or she can insure against some liabilities, such as tort and product-based liability.

6. Continuity

A sole proprietorship terminates on the proprietor's death or withdrawal from business. The business cannot continue unless it is reorganized.

7. Transfer of Ownership Interests

The proprietor's investment in his business is not easily transferred, since no ready market exists for a private business that usually cannot be sold in pieces. Of course, the proprietor can convert the business into a partnership, with new partners paying him or her or contributing capital to the business. The owner can also sell the assets, name, and goodwill of the business, although this will entail transferring the title to assets, protecting the trade names, assuming old liabilities, and other complications. These approaches involve time, money, and effort in reorganizing the business and finding new compatible investors.

8. Taxation

The business profits of a sole proprietorship are ordinarily taxed to the owner, whether the owner withdraws the profits or puts them back into the business. Although the proprietor is entitled to business deductions, his or her own salary is not a deductible business expense. Generally, a sole proprietorship receives more favorable capital loss treatment than does a corporation.

9. Raising Capital

Capital contributions are made by the owner. The remaining capital must be raised by private or commercial loans.

H. Conversion from One Form of Entity to Another Form

Modern corporation and partnership statutes are increasingly recognizing the ability to convert from one form of entity to another, typically by merger. Use of a merger avoids the more cumbersome process of transforming assets to a new entity. The statute under which the entity was originally organized and the statute under which the successor entity is to be organized must be consulted to determine if such a conversion is possible by merger.

Delaware now has a simplified procedure for converting an operating company into a holding company and operating subsidiary without the necessity of shareholder approval. *See* Del. Code Ann. tit. 8, § 251(g).

Careful attention must be paid to the tax consequences of any such conversion, which will not necessarily be the same as the tax consequences of a merger between two corporate entities.

CHAPTER 3

CHOICE OF STATE OF INCORPORATION AND CHOICE OF LAW

A. Choice of State of Incorporation

The selection of a state in which to incorporate involves the consideration of a number of factors, including the following: differing costs; the extent to which the state's corporation statute is kept up to date; the extent to which such statute permits efficiency and flexibility in conducting operations (including the circumstances requiring shareholder approval and the manner in which directors and shareholders may take action); the extent to which the state has a judiciary experienced in corporate law; and the extent to which a state has an established and predictable body of corporate law. With the advent of hostile takeovers and increasing litigation involving directors and officers, corporations that are, or contemplate becoming, publicly owned businesses have a particular interest in the means available to respond to unsolicited tender offers and investments in their shares and to protect their directors and officers through exculpation or indemnification provisions in charter documents. Since many corporations with principal operations in California choose to incorporate in Delaware, the discussion below highlights some of the more important ways in which these issues have been addressed both in California and in Delaware.

Several factors favor incorporation in the state in which the corporate headquarters will be located or in which the corporation has the most contacts or business activities. Costs are generally higher if a corporation must qualify to do business in a foreign jurisdiction (a jurisdiction other than the state of incorporation) due to additional filing fees, organizational taxes, and franchise or other income taxes. In addition, some states require foreign corporations with significant business activity within their jurisdictions to comply with certain corporate laws. For instance, in California, a corporation organized in another jurisdiction is considered a "pseudo-foreign" or "quasi-California" corporation and must comply with many of the California statutory provisions discussed below if more than one-half of the corporation's outstanding voting securities are held by Californians and the corporation meets certain California franchise tax criteria. *See* Cal. Corp. Code § 2115. California exempts from "pseudo-foreign" or "quasi-California" status corporations listed on the NYSE or ASE, corporations with outstanding securities designated as qualified for trading on the Nasdaq National Market of the Nasdaq Stock Market, or wholly owned subsidiaries of other corporations not subject to the "pseudo-foreign" corporation provision.

A California court and older United States Supreme Court decisions have concluded that California may constitutionally apply its corporate laws to a corporation organized in another state even though the laws of the corporation's state of incorporation may produce a different result. If a corporation is, or expects to be, publicly owned and operated in many states, then the justification for giving preference to the state where the business is to be located over the state of incorporation is less compelling.

The following are some of the more important factors to be considered in determining the state of incorporation:

1. Costs of Incorporation

Differing costs may ultimately be the key factor in deciding where to incorporate. Corporations generally must pay a filing fee or organization tax to incorporate within a state ("domestic corporation") or to qualify to "do business" within the state if incorporated elsewhere ("foreign corporation"). Aside from the filing fee and organization tax, corporations often pay an *annual* filing fee or franchise tax and will pay income tax (in at least one state). *See* Chapter 3.A.2 *infra*. "Doing business" may be defined differently for purposes of qualifying a foreign corporation than for assessing taxes. Generally, corporations must qualify to "do business" in a state if they engage in repeated and successive business transactions within that state. Corporations "doing business" in a state where they are not incorporated and have failed to qualify may be subject to monetary penalties and may be denied access to that state's courts.

a) California

Domestic corporations pay $100 in filing fees if their Articles of Incorporation provide for shares of stock, and $30 if the corporation will not issue stock. *See* Cal. Gov't Code § 12186. Foreign corporations qualified to do business in California pay $100 in filing fees. *See id*.

b) Delaware

Domestic corporations that assign a par value to their capital stock pay an organization tax of 2¢ for each share of authorized capital stock up to and including 20,000 shares, $400 plus 1¢ for each share over 20,000 but under 200,000 shares, and two-fifths of 1¢ for each share over 200,000. Each $100 unit of par value capital is counted as one taxable share. If the corporation does not assign a par value to its capital stock, a different schedule is used. If a substantial number of shares are to be authorized, capital stock without an assigned par value becomes more expensive than par value stock. According to the Delaware General Corporation Law, the minimum organization tax is $15. *See* Del. Code Ann. tit. 8, § 391(a)(1). Domestic corporations also pay a filing and indexing fee of $25. Foreign corporations pay an initial fee of $80. *See id.* § 371(b).

2. Tax Burden

a) California

California corporations and corporations doing business in California (other than banks and financial corporations) pay an annual franchise tax of the greater of 8.84% of net income from California sources for the preceding income year or $800. *See* Cal. Rev. & Tax. Code § 23151. Other corporations deriving income from California sources pay a tax on income derived from these sources at the rate of 8.84% unless this tax is offset by the franchise tax. *See id.* §§ 23501, 23503. Corporations not otherwise taxed generally pay a tax of $800. *See id.* § 23153. However, a corporation that incorporates or qualifies to do business in California will not be subject to the minimum franchise tax for its first two taxable years. *See id*.

b) Delaware

Delaware corporations and foreign corporations doing business in Delaware pay an income tax at the rate of 8.7% on net income derived from Delaware sources. *See* Del. Code Ann. tit. 30, § 1902(a). Domestic corporations also pay an annual franchise tax. Rates are based on the number of authorized shares and range from $30 to $150,000. Foreign corporations pay a $50 annual filing fee instead of the franchise tax. *See* Del. Code Ann. tit. 8, § 391(a)(8).

3. Shareholder Voting Rights — Other Corporate Governance Matters

The following is a summary of some of the statutory provisions governing shareholder rights, such as cumulative voting, rights of inspection, and shareholder approval of loans to officers and directors, mergers, and the sale of corporate assets not within the regular course of business. Brief mention is made of restrictions on the payment of dividends and directors' proceedings. There are many other provisions concerning corporate governance contained in the corporation codes of the various states, as well as in judicial decisions.

a) California

As a general rule, California corporations must allow shareholders to cumulate votes in electing directors and to elect directors annually. *See* Cal. Corp. Code §§ 301(a), 708(a). These requirements may be eliminated by provisions in the Articles of

Incorporation dividing directors into two or three classes and electing them for two- or three-year terms if the corporation has shares listed on the NYSE or ASE, or if the corporation has outstanding securities available for quotation on the National Market System of the Nasdaq Stock Market. *See id.* § 301.5. Together, the mandatory cumulative voting provision and the prohibition against staggered or classified Boards assist minority shareholders in securing Board representation. In "staggered" or "classified" Boards, the Board is divided into classes with the term of office of the first class expiring at the first annual meeting, the second class at the second annual meeting, and so forth. Staggered Boards tend to diminish the effect of cumulative voting and help target corporations defeat hostile takeovers.

Shareholders holding at least 5% of the outstanding voting shares (and 1% of the outstanding voting shares under certain conditions) have an absolute right to inspect shareholder lists. *See id.* § 1600. Any shareholder has a right to inspect shareholder lists, accounting books and records, and minutes of shareholder, director, or committee meetings for a purpose reasonably related to the person's capacity as a shareholder. *See id.* §§ 1600(c), 1601.

Subject to certain exceptions, loans to officers and directors must be approved by a majority of the voting shares. *See id.* § 315(a). (Shareholder votes discussed throughout this Guide are based on the percentage of outstanding shares entitled to vote unless otherwise noted.)

Corporate combinations may be effected by a "reorganization" (as defined in Cal. Corp. Code § 181 as a merger reorganization, an exchange reorganization, or a sale-of-assets reorganization). Merger reorganizations may involve issuance of various forms of equity or debt securities or cash. Exchange reorganizations require issuance by the acquiring corporation of its stock as at least part of the consideration used, in exchange for shares of the acquired corporation, and acquisition of "control" (more than 50% of the voting power) of the acquired corporation. *See id.* § 160(b). Sale-of-assets reorganizations require issuance by the acquiring corporation of its stock or unsecured debt securities with a maturity of more than five years. In general, reorganizations require the approval of a majority of the voting shares of both corporations in a merger or sale-of-assets reorganization or the acquiring corporation in an exchange reorganization unless the shareholders of the corporation continue to own more than five-sixths of the voting power of the acquiring or surviving corporation. *See id.* § 1201. Under some circumstances, the vote of non-voting shares may also be required. *See id.* § 1201.

In addition to "reorganizations," corporate combinations may be effected by a sale of assets for cash or secured or short-term debt securities. Normally, such sales must be approved by a majority of the voting shares of the selling corporation. *See id.* § 1001. Corporate combinations may also be effected by a "share exchange tender offer." *See id.* § 183.5. Rules governing share exchange tender offers are similar to those governing exchange reorganizations, except that acquisition of control is not required in the case of a share exchange tender offer.

In a merger reorganization, all shares of the same class must receive the same type of consideration unless all shares consent, fractional shares are paid in cash, or a permit is obtained from the California Commissioner of Corporations ("Corporations Commissioner"). *See id.* § 1101. In addition, in a merger reorganization or a sale-of-assets transaction (whether or not it is a "reorganization"), common shares of the acquired corporation must normally be converted into nonredeemable common shares if the acquiring corporation controls the acquired corporation, unless 90% of the shareholders of the acquired corporation approve the transaction. *See id.* §§ 1001, 1101. These requirements may be avoided by securing the approval of the Corporations Commissioner or other governmental officer with regulatory jurisdiction. There is no similar requirement in an exchange reorganization or share exchange tender offer, but federal securities law requirements may require equal treatment of shareholders under certain circumstances. *See* Rule 14d-10 of the Securities Exchange Act of 1934, as amended.

Shareholders entitled to vote on a reorganization have dissenters' rights with certain exceptions. *See id.* § 1300(a).

California has liberal provisions on directors' actions, including approval through unanimous written consent, meetings via telephone, and waiver of notice requirements. *See id.* § 307. However, directors cannot change the number of directors, except within a range established by the shareholders. *See id.* § 212(a).

Shareholders holding 10% or more of the voting power have the right to call shareholders' meetings, and this right cannot be limited by the Articles of Incorporation or Bylaws. *See id.* § 600(d). Shareholders may act by written consent of the minimum number of votes necessary to authorize the action at a meeting. Unanimous written consent of the shareholders is required to elect directors, except to fill a vacancy. A vacancy may be filled with the written consent of a majority of the outstanding shares entitled to vote except if the vacancy is caused by a removal of the director *See id.* § 603.

Restrictions (based on generally accepted accounting principles rather than on concepts of capital and surplus) limit the Board's discretion to declare dividends. For instance, no distribution of corporate earnings may be made unless there are sufficient retained earnings to cover the distribution or the distribution will not reduce the ratio of assets to liabilities below specified levels. *See id.* §§ 500 *et seq.*

b) Delaware

Delaware permits but does not require a corporation to implement cumulative voting. *See* Del. Code Ann. tit. 8, § 214. Delaware allows staggered Boards with up to three classes of directors. *See id.* § 141(d).

Stockholders may inspect stockholder lists and books and records for a "proper purpose," meaning a purpose reasonably related to the person's interest as a stockholder. *See id.* §§ 219, 220.

A corporation may make a loan to an officer or a director (who is also an officer) without stockholder approval. *See id.* § 143.

Although stockholders may act by written consent of the minimum number of votes necessary to authorize action at a meeting, this right and the right of stockholders to call a meeting of stockholders may be eliminated in the corporation's charter or formation document, known as the Certificate of Incorporation. *See id.* §§ 211, 228.

Majority stockholder approval is required for mergers and sales of all or substantially all assets. *See id.* §§ 251, 271. However, no vote is required by the stockholders of the surviving corporation in a merger transaction if certain criteria are met, such as the condition that the stock to be issued does not exceed 20% of the stock outstanding prior to the merger. *See id.* § 251(f). Furthermore, the creation of a holding company may be effected without any stockholder vote if certain conditions are satisfied. *See id.* § 251(g).

Delaware requires appraisal rights for mergers, but not for sales of assets. Appraisal rights give stockholders the opportunity to dissent from a transaction and demand that their shares be appraised and paid in cash. Appraisal rights are also not required for shares listed on stock exchanges, traded on Nasdaq, or held by more than 2,000 stockholders unless the merger transaction provides for their conversion into cash or a non-equity security. *See id.* § 262.

Delaware allows unanimous written consent by directors and committees in lieu of meetings, and permits directors to hold meetings by telephone. *See id.* § 141.

Delaware has relatively flexible requirements on the payment of dividends, allowing dividends to be paid out of any surplus (not just earned surplus), and also allowing limited dividends to be paid out of net profits even if capital is impaired. *See id.* § 170.

4. Anti-Takeover Provisions

Many states, including Delaware, initially adopted so-called "first generation" statutes requiring a bidder to file tender offer disclosure materials with a state agency, and permitting the state agency to pass on the fairness of the disclosure on the offer. After this type of statute was declared unconstitutional by the United States Supreme Court in 1982, the states have either repealed these statutes or ceased to enforce them. Subsequently, some states have adopted a variety of anti-takeover devices, including the following principal devices:

Control share acquisition statutes (whose constitutionality was upheld in *CTS v. Dynamics Co. of Am.*, 481 U.S. 69 (1987)), empowering shareholders to vote on whether to permit acquisition of specified percentages of the corporation's stock by tender offer or open market purchases.

Fair price statutes, requiring an extraordinary shareholder vote to approve a merger with a substantial investor (typically a 10% shareholder), unless the target's Board has approved the transaction prior to the initial investment or the investor has satisfied certain other criteria, such as paying a price for the target's shares that is at least as high as the price that the investor paid for prior share purchases.

Merger moratorium statutes, which provide that if an investor acquires more than a specified percentage of a target corporation's stock without prior approval of the target's Board, a follow-up merger to acquire the rest of the target's outstanding shares may not be permitted for a specified period of time, such as five years. The rationale underlying the merger moratorium statutes, as sometimes stated, is to discourage bidders from seeking to finance their acquisition by liquidating substantial portions of the target after gaining control in order to repay the debt incurred to finance the takeover. If a bidder is unable to gain complete control of the target, the bidder's ability to sell a substantial portion of the assets to repay its own debt will be limited.

A few states have adopted other types of statutes, including statutes dealing with directors' discretion in responding to hostile tender offers, precluding corporations from paying "greenmail" (where the target pays a bidder a premium over the market price to buy back target shares owned by the bidder and the bidder agrees to stop its takeover bid), affirming the right to adopt shareholder rights plans or "poison pills" (where the target takes steps to makes its stock or financial condition unattractive to a bidder), and providing severance pay to employees.

In addition to statutory enactments, state statutes and judicial decisions have recognized or permitted a variety of private sector initiatives to deal with hostile takeovers, including shareholder rights plans or "poison pills." These may include charter and Bylaw provisions that require payment of a fair price, extraordinary voting requirements for corporate combinations, limited and capped voting rights (such as higher voting rights for long-term shareholders, per capita voting and limited voting stock); classified Boards; limitations on shareholder voting rights such as the right to call special meetings or vote by written consent; or requiring advance notice of motions for shareholders meetings.

The following summary with respect to California and Delaware constitutes only a brief overview of the anti-takeover statutes and judicial decisions in these jurisdictions. It is not surprising that Delaware has the most extensive judicial decisions governing permissible defensive conduct. However, in the development of those rules on a case-by-case basis, the Delaware courts have in recent years created a certain amount of confusion with respect to the rights and duties of directors in defending against hostile takeovers and entering into corporate combination transactions.

a) California

California does not have a control share acquisition statute, fair price statute, merger moratorium statute, or any other type of anti-takeover legislation designed to discourage hostile takeovers. Furthermore, several statutory provisions tend to discourage defensive tactics:

As noted earlier, the Cal. Corp. Code does not permit a corporation to deny a shareholder holding 10% or more of the voting power of a corporation the right to call special meetings of shareholders or act by written consent. *See* Cal. Corp. Code § 600(d).

Except for certain types of publicly traded corporations (such as NYSE- and ASE-listed or Nasdaq-traded), provision cannot be made for a classified Board. *See id.* § 301.5.

For publicly held corporations, restraints are placed on the use of supermajority voting (which is commonly used with fair price provisions inserted in the Articles of Incorporation or Bylaws), such as requiring the vote to adopt a supermajority provision to be as large as the vote required by the supermajority provision, limiting the provision to no more than a 66-2/3% vote, and providing that the supermajority provision shall cease to be effective after two years. *See id.* § 710.

It is unlikely that time-weighted, per capita, or capped voting rights would be permitted in California in view of the requirements of the Cal. Corp. Code that all shares in any one class or series have the same voting rights, and that one class or series have full voting rights. *See id.* § 700.

The validity of shareholder rights or "poison pill" plans is unsettled in California.

b) Delaware

Delaware does not have a control share acquisition statute or a fair price statute. However, Delaware does have a modified form of merger moratorium statute, *see* Del. Code Ann. tit. 8, § 203, which provides for a three-year moratorium on follow-up mergers by a shareholder who holds 15% or more of the outstanding shares of a target, but allows the moratorium to be avoided if the shareholder holds 85% of such shares (excluding shares held by the target's officers and directors and certain employee stock plans) or if the follow-up merger is approved by the Board and two-thirds of the outstanding voting shares of the target not owned by the shareholder. The Delaware statutory restriction on follow-up mergers is also avoided if the target's Board approves the initial investment or the follow-up merger before the shareholder makes the investment that makes it a holder of 15% or more of the outstanding shares of target. There are also certain other circumstances under which the Delaware statute will not be applicable, including corporations that do not have 2,000 shareholders, or have no class of voting stock listed on a national securities exchange or authorized for quotation in the over-the-counter market.

Delaware is flexible in permitting classified Boards and denying shareholders the right to vote their shares cumulatively for the election of directors. Where a Board is classified, the Delaware General Corporation Law precludes removal of directors except for cause, unless the Certificate of Incorporation otherwise provides.

Delaware also has a well-developed set of judicial principles governing the responsibilities of directors in resisting hostile takeovers. While these principles are still evolving and have caused some confusion as to their application, it appears clear that Delaware judicial decisions recognize two anti-takeover techniques that can be extremely effective in responding to hostile takeovers: (1) shareholder rights plans or "poison pills," and (2) stock structures designed to favor long-term holders, such as time-weighted and per capita voting rights.

5. Indemnification and Exculpation of Directors and Officers

Both California and Delaware generally permit a corporation to indemnify its officers, directors, employees, or other agents under certain circumstances for litigation expenses (including attorneys' fees), judgments, fines, and amounts paid in settlement. Some statutes provide the exclusive means of indemnification. Other statutes are by their terms non-exclusive, but indemnification beyond that permitted by the statute may be limited by public policy.

Statutes distinguish between proceedings brought against corporate representatives by shareholders suing in the name of the corporation ("derivative actions") and other actions ("third-party actions"). The statutes discussed below permit indemnification only for litigation expenses (including attorneys' fees) in derivative actions with certain exceptions. The corporate representative generally may not be indemnified for judgments, fines, or amounts paid in settling a derivative proceeding, although in some instances there may be indemnification upon court approval. The statutes allow indemnification for judgments, fines, and settlement awards paid in third-party actions with certain exceptions. Further, a corporation must indemnify a corporate representative adjudged successful on the merits in a derivative or third-party action for expenses reasonably incurred. Statutes differ on whether there are other situations in which a corporate representative may or may not be indemnified and on the standards a corporation must use in deciding whether to indemnify when indemnification is permissive.

In addition to permitting indemnification of directors and officers, California and Delaware generally permit a corporation to include a provision in its charter document shielding directors (but not officers) from liability for alleged breaches of the duty of care. There are certain differences in these statutes as to what types of conduct may be covered. Only significant statutory differences are discussed below.

a) California

A corporation may indemnify the expenses, judgments, fines, and settlements of a corporate representative in a third-party action and may indemnify the expenses in a derivative action if the agent acted in good faith and "in a manner such person reasonably believed to be in the best interests of the corporation." *See* Cal. Corp. Code § 317(b)-(c). California permits indemnification of expenses and amounts paid in settlement in a derivative action only if the court approves the settlement. *See id.* § 317(c)(2) and (3). A corporation cannot indemnify an individual adjudged liable in a derivative action unless a court determines that indemnification is warranted.

See id. § 317(c)(1). The California statutory indemnification provisions will not be exclusive if the Articles of Incorporation so provide. *See id.* §§ 204(a)(11), 317(g).

The Cal. Corp. Code permits insertion of a provision in the Articles of Incorporation eliminating or limiting the personal liability of directors for damages in derivative actions for breach of duty, with certain specified exceptions, including intentional misconduct, a knowing and culpable violation of law, receipt of an improper personal benefit, reckless disregard of duty, an unexcused pattern of inattention, or improper payment of dividends. *See id.* § 204(a)(10).

b) Delaware

Section 145 of the Delaware General Corporation Law allows indemnification for third-party and derivative actions if the defendant acted in good faith and "in a manner he reasonably believed to be in or not opposed to the best interests of the corporation." *See* Del. Code Ann. tit. 8, § 145(a)-(b). On the other hand, only reasonable expenses (and not amounts paid in settlement) may be indemnified against in derivative actions. And in derivative suits, if a corporate representative is adjudged liable to the corporation, his or her expenses may be reimbursed only after court approval. *See id.* § 145(b). A corporation must indemnify a corporate representative who has been successful on the merits. *See id.* § 145(c). Delaware allows corporations to alter the provisions of Section 145 of the Delaware General Corporation Law to provide for more expansive indemnification, but such expanded provisions will be limited by public policy. *See id.* § 145(f); *Waltech v. Conticommodity Services, Inc.*, 88 F.3d 87 (2d Cir. 1996).

Delaware also allows corporations, by amendment of the Certificate of Incorporation, to eliminate or limit directors' personal monetary liability for breaches of fiduciary duty except in cases of breaches of the duty of loyalty, bad faith, intentional misconduct, improper personal benefit, knowing violation of the law, or statutory liability for such actions as improper dividends and distributions. *See* Del. Code Ann. tit. 8, § 102(b)(7). By excluding breaches of the duty of loyalty from an exculpatory provision in the Certificate of Incorporation, Delaware has created a potentially troublesome exposure in its statute, particularly in the light of certain Delaware judicial decisions that have broadened the concept of the duty of loyalty with respect to proxy statement disclosures and hostile takeover defensive actions.

6. Case Law

The above discussion primarily reviews the statutory differences between California and Delaware. The presence of a judiciary experienced in corporate law and an established and predictable body of corporate case law in a jurisdiction are also important factors. In the past, many corporations preferred to incorporate in Delaware because of the experience of its courts on corporate issues and the existence of a substantial and predictable body of Delaware case law.

However, in recent years, Delaware courts, particularly in the corporate combination area, have tended to decide cases more on the basis of the facts in the particular case, and to have evolved new rules of corporate governance that make it more difficult to predict results in future cases. Furthermore, an expansion of the concept of the duty of loyalty by the Delaware courts, coupled with the provisions of the Delaware General Corporation Law precluding corporations from exculpating their directors from breaches of the duty of loyalty by provisions in the Certificate of Incorporation, has created potentially greater exposure for directors of Delaware corporations than for directors in corporations of other states. Accordingly, although the Delaware corporation statute is probably one of the most modern and flexible of corporate statutes, the advantage of incorporating in Delaware may not be as clear as it once was for a corporation that is or expects to be a publicly traded corporation. Nevertheless, it must be recognized that Delaware remains the state with the largest body of established case law in the corporate field and the most experienced judiciary on corporate matters.

B. Choice of Law Applicable to the Entity

1. Corporations

Corporations are governed by the law of the state of incorporation with respect to such issues as formation, management and control, personal liability, and continuity, each as discussed above. California has sought to apply its corporate law in many respects to "quasi-California" corporations. *See* Cal. Corp. Code § 2115. Other states may also apply limited aspects of their corporate laws to foreign corporations. *See* N.Y. Bus. Corp. Law §§ 1317-1319.

2. General and Limited Partnerships; Limited Liability Companies

Unlike corporations, there is no generally recognized common law doctrine that automatically defers to the state of organization to govern such issues as organization, management and control, personal liability, and continuity of partnerships and limited liability companies. RUPA, RULPA, and many LLC statutes contain specific choice-of-law provisions that provide for either the law of the state of organization or the law of the state of the entity's principal executive office to govern its internal affairs and determine the liability of its partners or members to third parties. In the absence of such an express statutory choice of law in states where the entity does business, care must be taken to ensure that the law of such states is satisfied with respect to filings or other issues in order to limit the liability of the entity.

Various taxes are levied at different levels of government within the state of California. At the state level, taxes include a personal income tax, corporate franchise or income tax, sales and use tax, unemployment insurance tax, and numerous environmental taxes and fees. Insurance taxes, motor vehicle and motor vehicle fuel taxes, alcoholic beverage taxes, and cigarette and tobacco product taxes are also imposed by California. Taxes that may be imposed at the local city or county level include a property tax, real estate transfer tax, local sales or use taxes, local business license tax, and local payroll expense tax.

CHAPTER 4

TAXATION

A. Personal Income Tax

A state-level personal income tax is imposed on the entire taxable income of California residents and on the income of nonresidents derived from sources within California, and applies to individuals, fiduciaries, estates, and trusts. Personal income tax rates are graduated and range from 1% to 9.3%. California law prohibits the imposition of an income tax by any city, county, or other local jurisdiction.

A "resident" is defined under California law as: (1) every individual who is in the state for other than a temporary or transitory purpose; or (2) every individual who is domiciled in the state but who is outside the state for a temporary or transitory purpose. Also, every individual who spends in the aggregate more than nine months of the taxable year within California is presumed to be a resident. However, this presumption may be rebutted.

B. Corporate Taxation

The California franchise tax and the corporation income tax are measured by income derived from or attributable to sources within California, and apply to corporations organized both within and without California.

The franchise tax is imposed upon all corporations that are doing business in the state. Whether an out-of-state corporation is doing business in California depends on the specific facts and circumstances of that corporation. Factors to consider include the presence of an office or employees in the state, the presence of other tangible property in the state, the number of visits to the state, and the use of independent contractors or agents in the state.

The franchise tax is measured by the net income from California sources of the preceding year. The corporation income tax applies to corporations that derive income from California sources but that are not subject to the franchise tax. Because the franchise tax applies in the great majority of cases, the corporation income tax is infrequently applied.

The franchise and income tax rate is 8.84% for C Corporations, 1.5% for subchapter S Corporations, and 10.84% for banks and financial corporations. The "bank rate" is higher because banks and financial corporations are not subject to personal property taxes and license fees that are paid by other corporations.

In computing the net income of a corporation, California employs the unitary method of taxation as opposed to separate accounting. Unitary taxation is a multistep process. First, the unitary group must be determined. The unitary nature of a business is established by factors such as unity of ownership, unity of operation as evidenced by central purchasing, advertising, accounting and management, unity of use of a general system of operation, and common managerial or operational resources that produce economies of scale, and by whether the operation of the business within the state is dependent on or contributes to the operation of the business without the state. In cases where a single corporate entity has more than one "trade or business," the income of each business is separately apportioned within and without the state.

Generally, a unitary group will include both foreign and domestic corporations that are engaged in a unitary business. However, a water's-edge election may be made that would, in general, exclude foreign corporations from a unitary group. Such an election lasts for seven years, is automatically renewed each year, and cannot be revoked within the seven-year period without permission from the state.

Once the unitary group is determined, the second step is to determine whether the unitary group is engaged in business wholly within California or within and without California. If the unitary group is engaged in business wholly within California, all of the group's income will be reported to California and taxed accordingly.

If the unitary group is engaged in business within and without California, the group's "business income" and "nonbusiness income" must be determined. "Business income" is defined as income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. "Nonbusiness income" is defined as all income other than "business income."

The portion of a unitary group's "business income" that is taxable by California is determined by multiplying the group's total "business income" by the average of four fractions: payroll in California/payroll everywhere, property in California/property everywhere, sales in California/sales everywhere, and sales in California/sales everywhere. The apportionment formula can be represented graphically as:

$$\frac{\dfrac{\text{California Payroll}}{\text{Payroll Everywhere}} + \dfrac{\text{California Property}}{\text{Property Everywhere}} + \dfrac{\text{California Sales}}{\text{Sales Everywhere}} + \dfrac{\text{California Sales}}{\text{Sales Everywhere}}}{4}$$

Deviations from the formula are allowed in some cases, and different apportionment rules exist for specialized industries.

"Nonbusiness income" is generally viewed as income unrelated to the unitary group's business and therefore is allocated to the single state with the closest connection to that income. California employs specific rules for allocating "nonbusiness income" depending on the type of income involved.

Once a group's "business income" is apportioned to California and its "nonbusiness income" is allocated to California, such income is assigned to the individual corporations doing business in the state and reported to the state. California law also allows various credits to be applied against the franchise and corporation income tax, such as research and development credits, manufacturer's investment credits, disabled access expenditures credits, and credits for establishing child care programs or facilities.

California also imposes a minimum corporate tax of $800. However, corporations that incorporate or qualify to do business in California on or after January 1, 2000, are not subject to the minimum franchise tax for the corporations' first and second taxable years.

C. Sales and Use Tax

A state and local sales tax is imposed on the gross receipts of retailers from the sale of tangible personal property. Sales of intangible property, real property, and services are not subject to tax. The tax is not levied directly on consumers, but its cost is usually passed on to consumers by retailers. A use tax is imposed upon the storage, use, or other consumption in California of tangible personal property purchased from a retailer without sales tax, and generally applies to tangible personal property purchased outside California and brought into the state.

The sales and use tax payable for any transaction consists of three components:

> The basic state sales or use tax of 6.25%;
>
> The local tax of up to 1%; and
>
> Additional and local "transactions and use" taxes for various purposes of generally up to 1.5%.

As all counties in California have elected to impose a local sales and use tax, if a transaction is taxable at all, it will be subject to at least a combined rate of 7.25% plus additional miscellaneous taxes.

A "retail sale" is defined broadly as a sale of tangible personal property for any purpose other than for resale in the regular course of business, and the sales and taxes also apply to many rental transactions and occasional and non-recurring sales, such as the sale of an entire business and sales of machinery or equipment, unless specifically exempt.

There are many and various types of exemptions from the sales and use tax.

D. Employment-Related Taxes

An unemployment insurance tax is levied upon employers and is generally based upon wages paid to employees in California. The tax is imposed upon the first $7,000 of taxable wages paid by each employer to each employee. The standard tax rate is 3.4% (plus the 0.1% employment and training tax), and after the first three years, an employer's rate is adjusted on the basis of the employer's "experience rating." The rates can range from 1.5% to 6.2%.

California also levies a tax upon employees, which goes into a special fund for disability rather than employment benefits. The employee tax rate is adjusted annually on the basis of the balance in the disability fund and the level of employee benefits and may range from 0.1% to 1.3%.

E. Environmental Taxes and Fees

Various fees in connection with the generation, storage, treatment, disposal, and cleanup of waste are imposed in California, including:

Hazardous waste disposal fees;

Facility, generator, permit, and hauler fees;

Fees imposed on solid waste landfill operators;

Tire disposal fees;

Oil spill and medical waste fees; and

A general "environmental fee" payable by almost all corporations employing 50 or more persons. The fee ranges from $200 to $9,500 depending on the size of the business.

F. Professional Occupation License Fees

California also imposes professional occupation license fees on numerous occupations, such as architects, attorneys, and physicians, and they range anywhere from $50 to several hundred dollars.

G. Property Tax

Although a general ad valorem tax on real and personal property is not imposed at the state level in California, local governments throughout the state do impose such a tax. Article XIIIA of the California Constitution limits the imposition of property taxes by local government by mandating that: (1) the overall rate of property taxation shall not exceed 1% of "full cash value"; (2) property must be assessed at its current value when it is purchased or newly constructed or a "change in ownership" occurs, with subsequent annual adjustment (up to 2%) for inflation; and (3) no new property, sales, or transaction taxes may be imposed on real property.

H. Realty Transfer Tax

Cities and counties are authorized to impose a tax on transfers of interests in real estate with a value of more than $100. The county tax is at the rate of 55¢ for each $500, and the noncharter city rate is one-half the county rate. Charter cities may also impose transfer taxes in excess of these rates.

I. Local Business License Tax and Payroll Expense Tax

Many California cities impose a business license tax that every owner of a business operating within the city must pay, unless the business is expressly exempt. The tax can be measured in a variety of ways, for example, by gross receipts earned at the business in the city, by the number of employees employed by the business over a set minimum, and by the number of rental units or lots or the square footage of space rented by the business. Some business license taxes require a license for each branch or location of the business within a city, while others do not; some require a license for each separate line of business conducted under the auspices of the business, while others do not. The business license tax burden varies greatly from city to city. In addition, cities may also impose a payroll expense tax based on a business's payroll in the city.

CHAPTER 5

INTELLECTUAL PROPERTY RIGHTS

A. Trademarks and Service Marks

Trademarks and service marks are essentially identical, except that trademarks are used to identify the source of goods sold, and service marks are used to identify the source of services offered. They involve any word, name, symbol, or device or any combination thereof adopted and used by a party to identify goods or services made or sold by it. *See* Cal. Bus. & Prof. Code § 14207. California protects trademarks and service marks under both common law and the state trademark registration statute.

1. Common Law

Under California common law, registration is not necessary for acquisition of a trademark or trade names. *See Kelley Blue Book v. Car-Smarts, Inc.*, 802 F. Supp. 278, 289 (C.D. Cal. 1992). California common law also provides that the first party to adopt and use a trade name either within or outside the state is the original owner of the trade names. *See id*. Although trademarks rights in California are primarily governed by California statutory law discussed below, the rights acquired at common law are also protected under the statute since California courts will not enforce a trademark registration against any party who had used the same (or a confusingly similar) mark prior to the effective date of the registration. In general, priority of use is essential for acquisition; however, the courts typically apply the common-law rule of secondary meaning to trade names that are not subject to technical appropriation, so that priority of use is not necessarily controlling where a subsequent user first establishes a secondary meaning. Secondary meaning refers to an association in the public's mind between the trademark and the product or business represented by the trademark such that the mark and the product or business become synonymous to the public.

A party may enjoin another party from using its mark or a confusingly similar mark where there is a likelihood of injury to the injured party's business reputation or a dilution of the distinctive quality of its mark or trade names valid at common law, even in the absence of competition between the parties or the absence of confusion as to the source of the goods or services. *See* Cal. Bus. & Prof. Code § 14330.

2. Statutory Law

California law provides for registration of trademarks and service marks under California Business and Professions Code §§ 14220 to 14300. The California statute generally follows the Model Act, with some exceptions. Federal registration of a mark with the United States Patent and Trademark Office ("USPTO") (*see* Chapter 5.J *infra*) does not bar registration of the mark in California. To be registrable in

California, the mark must be used by the applicant in California on goods sold or services rendered in the state.

Prior to seeking to register a mark, the applicant should have a search done for other similar names or marks. Such a search is highly advisable before beginning use of a new mark. Otherwise, the applicant could find itself facing an infringement claim by another, senior user.

To register a trademark in California, the applicant must file with the Secretary of State, on form LP/TM100[7] furnished by the Secretary of State, an application for registration of that mark, setting forth: (1) the name and business address of the applicant, and, if a corporation, the state of incorporation; (2) the goods or services in connection with which the mark is used; (3) the date of first use of the mark in commerce; and (4) a declaration that the applicant is the owner of the mark and that no other person has the right to use the mark in this state. The application must be signed and verified by the applicant, and accompanied by three copies of a specimen or facsimile of the mark, and a $70 per-mark, per-class filing fee. *See* Cal. Gov't Code § 12193. Note that California law does not recognize or protect state trademark rights based on intent-to-use applications.

A trademark or service mark will not be registered if it (1) is likely to be confused with an existing registered mark or trade name; (2) is immoral, deceptive, or scandalous; (3) disparages, or falsely suggests a connection with, persons, institutions, beliefs, or national symbols; or (4) involves the use of official flags or insignia or the name, signature, or portrait of any living individual without his or her written consent. Generally, marks that are merely descriptive, a surname or a geographic name, or a color or shape of a container may not be registered. A descriptive mark may be registered, however, if it has become distinctive of the applicant's goods or services.

After the applicant has complied with the registration requirements, the Secretary of State issues a Certificate of Registration. This certificate is admissible in evidence as *prima facie* evidence of ownership of the mark, and registration constitutes constructive notice of the registrant's claim. *See id*. §§ 14241, 14270. However, registration does not adversely affect the rights or the enforcement of rights in marks used by a party prior to the effective date of registration.

Registration of a mark is effective for a term of 10 years from the date of registration. The registration may be renewed for additional and successive 10-year terms if the mark is still in use in California, so long as the registrant files the applicable form with the Secretary of State, together with a $30 fee, within six months prior to the termination of such term. *See* Cal. Bus. & Prof. Code §§ 14250, 12193.

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[7] California Secretary of State: <http://www.ss.ca.gov/business/ts/ts_formfees.htm/>.

Any mark properly registered with the Secretary of State is assignable with the goodwill of the business in which the mark is used. A valid assignment requires a duly executed, written document, filed with the Secretary of State upon payment of a $30 fee. *See* Cal. Gov't Code § 12193. If an assignment is not recorded, the assignment is not valid against any subsequent purchaser for valuable consideration without notice.

Under California statute, trademark infringement is proved if a person (1) uses, without consent, a mark that is identical with, or substantially indistinguishable from, a mark registered in the state in connection with the advertising or sale of goods or services in a manner that is likely to cause confusion of origin of the goods and services; or (2) copies or imitates such mark on any signs, labels, or advertisements in conjunction with goods or service sold in California. *See* Cal. Bus. & Prof. Code §§ 14340 *et seq*. The ultimate issue is likelihood of confusion of prospective purchasers. Factors entering into this assessment include visual and other similarities, the class of goods in question, the marketing channels, the defendant's intent, evidence of actual confusion, and the strengths or weaknesses of the marks.

A party may enjoin another party from using its mark or a confusingly similar mark where there is a likelihood of injury to the injured party's business reputation or a dilution of the distinctive quality of its mark or trade name registered in California, even in the absence of competition between the parties or the absence of confusion as to the source of the goods or services. *See id.* § 14330.

If a counterfeit mark is used in connection with goods and services for which the genuine mark is registered, the owner of the registered mark may enjoin the wrongdoer from using the mark and recover up to three times the profits received by the wrongdoer and three times all damages suffered by the owner. The court may also order seizure and destruction of counterfeit goods upon posting of an appropriate bond. *See id.* § 14340. Counterfeiting of marks is also punishable as a criminal offense. *See* Cal. Penal Code § 350.

California also has an antidilution statute, *see* Cal. Bus. & Prof. Code § 14330, which protects against the "watering down" or dilution of a mark's strength when used on unassociated products or services, and prevents the tarnishment of a mark through use on unsavory products or services. The antidilution statute permits injunctive relief even in the absence of confusion as to the source, in order to prevent a truly coined mark from becoming part of the ordinary language.

3. Enforcement

Once a trademark is registered, some form of enforcement against infringers usually is necessary. Trademark protection can be lost through acquiescence or longstanding inattention. One protection strategy is to appoint a person or persons to audit the trademark registers (federal and state) and the Internet and to attend industry trade shows to discover any infringing marks. In addition, periodic searches of similar marks can be made, much like the search conducted when seeking to register or use a new name or mark. The same search companies have "tracking" services that they will perform for trademark owners. If the owner of a mark identifies a potential infringer, the owner should carefully research the nature and scope of the potential infringement. Not only could the potential infringer's use pre-date the owner's own use (and possibly create rights superior to the owner's rights), but the use also may be distinct enough in terms of trade, market area, or geography to preclude infringement. As discussed, the ultimate test, made up of several factors, is whether there is a likelihood of confusion between the two marks at issue.

If litigation does become necessary, the owner of the mark may have the following remedies available to it: (1) an injunction against threatened or actual infringement; (2) damages for lost profits and lost reputation or goodwill; (3) punitive damages if the infringer's conduct was willful and malicious; and (4) reasonable attorneys' fees under exceptional circumstances.

B. Trade Names

A trade name is distinguishable from a trademark in that a trade name may identify not only goods and services, but also the business and goodwill in an enterprise as a whole. *See id.* § 14208.

Persons conducting business under a "fictitious business name" must, within 40 days of transacting business under the fictitious name, file a registration with the clerk of the county in which the entity has its principal place of business in California, or if none, with the Clerk of Sacramento County. *See id.* §§ 17910, 17917. The fee is $10 for the first fictitious business name and $2 for each additional name filed on the same statement and doing business at the same location. *See id.* § 17929. A Fictitious Business Name Statement ("FBNS") must be published for four weeks in a newspaper of general circulation, followed by an affidavit of publication with the county clerk. *See id.* §§ 17917, 17924. A certified copy of the statement is then furnished to the business. *See id.* § 17916. No court action in the fictitious name may be maintained until the FBNS has been properly filed. *See id.* § 17918. An FBNS must be renewed after five years. *See id.* §§ 17910, 17920. Trade names, as opposed to trademarks and service marks, are not registrable with the USPTO and are thus not readily protected under the federal law relating to trademarks, the Lanham Act (15 U.S.C. §§ 1051 *et seq*.).

Unless the business files an earlier express abandonment, FBNS expires five years from the date it was filed in the office of the county clerk. *See* Cal. Bus. & Prof. Code § 17920.

Filing an FBNS creates a rebuttable presumption that the registrant has the exclusive right to use the trade names in the county in which the filing was made if the registrant is the first to file and is actually using the name in a trade or business. *See id*. § 14411. The filing of any FBNS pursuant to the California Business and Professions Code § 17910 does not, by itself, authorize the use in this state of a fictitious business name in violation of the rights of another as established under the California Business and Professions Code, the Lanham Act, or common law, including rights in a trade name. *See id*. § 14418. Likewise, filing an FBNS for a trade name does not guarantee exclusive rights to use the trade names as a trademark. *See id*. § 14417.

As with trademarks and service marks, infringement of a trade name is proved if a person uses, without consent, a trade name that is identical with, or substantially indistinguishable from, a trade name registered in the state in a manner that creates or is likely to cause confusion with the registered trade names. Likewise, as with trademarks and service marks, any court of competent jurisdiction may restrain, by injunction, any use of trade names in violation of the owner's trade names rights. *See id*. § 14402.

C. Trade Secret Law

1. What Is a Trade Secret

California has adopted the Uniform Trade Secrets Act, *see* Cal. Civ. Code §§ 3426 to 3426.11, which protects information that (1) derives economic value from not being known to the public and (2) is the subject of reasonable efforts to maintain its secrecy. A trade secret can include a business formula, compilation, pattern, program, device, method, technique, or process which, though neither copyrighted nor patented, is used in the conduct of the owner's business, is not disclosed to the public, and provides the owner with some competitive advantage.

Under California law, a trade secret differs from other secret information in a business in that it is not simply information as to a single or ephemeral event in the conduct of the business, such as the terms of a secret bid. The following factors will be considered in determining whether a trade secret exists:

The extent to which the information is known outside the owner's business;

The extent to which it is known by employees and others involved in the business;

The extent of measures taken by the owner to guard the secrecy of the

information (*e.g.*, labeling the information "Trade Secret" or "Confidential," advising employees of the existence of a trade secret, limiting access to the information within the company on a "need-to-know basis," and controlling company access);

The economic value of the information to the owner and the owner's competitors;

The amount of effort or money expended by the owner in developing the information; and

The ease or difficulty with which the information could be properly acquired or duplicated by others.

As a general principle, the more difficult the information is to obtain and the more time and resources expended by the employer in gathering it, the more likely it is that a court will find such information to be a "trade secret" under the Uniform Trade Secrets Act. *Morlife, Inc. v. Perry*, 56 Cal. App. 4th 1514 (1st Dist. 1997).

2. Misappropriation of Trade Secrets

Protection against the misappropriation of trade secrets is a branch of the law of unfair competition. Misappropriation means:

Acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by improper means; or

Disclosure or use of a trade secret of another without express or implied consent by a person who:

Used improper means to acquire knowledge of the trade secret; or

At the time of disclosure or use, knew or had reason to know that his or her knowledge of the trade secret was:

Derived from or through a person who had utilized improper means to acquire it;

Acquired under circumstances giving rise to a duty to maintain its secrecy or limit its use; or

Derived from or through a person who owed a duty to the person seeking relief to maintain its secrecy or limit its use; or

Knew or had reason to know that it was a trade secret and that knowledge of it had been acquired by accident or mistake.

Misappropriation of trade secrets is an intentional tort. *PMC, Inc. v. Kadisha*, 78 Cal. App. 4th 1368 (2d Dist. 2000) (*modified on denial of reh'g, review denied*). An action for misappropriation must be brought within three years after the misappropriation is, or reasonably should have been, discovered. *See* Cal. Civ. Code § 3426.6.

The Uniform Trade Secrets Act provides for injunctive relief if a trade secret is misappropriated or there is a threat that a trade secret will be misappropriated. *See id*. § 3426.2. The Uniform Trade Secrets Act also provides for awards of monetary damages, covering both actual loss and unjust enrichment caused by the misappropriation. Absent proof of actual loss or unjust enrichment, a reasonable royalty may be awarded. If the misappropriation is "willful and malicious," the court may award exemplary damages of up to twice the above-mentioned damages, plus attorneys' fees if a misappropriation claim is made in bad faith. *See id.* §§ 3426.3, 3426.4.

Pursuant to the Uniform Trade Secrets Act, misappropriation is not limited to the initial act of improperly acquiring trade secrets. The use and continuing use of the trade secrets is also misappropriation. *PMC, Inc. v. Kadisha*, 78 Cal. App. 4th 1368 (2d Dist. 2000) (*modified on denial of reh'g, review denied*). It is noteworthy that the Uniform Trade Secrets Act does not require that the defendant gain any advantage from disclosure of the trade secret in order for misappropriation to occur. It is sufficient to show "use" by disclosure of the trade secret with actual or constructive knowledge that the secret was disclosed under circumstances giving rise to a duty to maintain its secrecy. *Religious Tech. Ctr. v. Netcom On-Line Communication Servs., Inc.*, 923 F. Supp. 1231 (N.D. Cal. 1995).

Under the Uniform Trade Secrets Act, mere disclosure, without any unauthorized "use," of a trade secret can constitute "misappropriation" sufficient to create entitlement to judicial relief (at least of equitable character) and thus trigger the running of the statute of limitations. *See, e.g.*, *Intermedics, Inc. v. Ventritex, Inc.*, 822 F. Supp. 634 (N.D. Cal. 1993). Moreover, misappropriation of a trade secret by a joint owner of that trade secret could constitute misappropriation of the trade secret "of another." *See, e.g.*, *Morton v. Rank Am., Inc*., 812 F. Supp. 1062 (C.D. Cal. 1993).

California also provides statutory protection against false or misleading advertising and against unfair competition. *See* Cal. Bus. & Prof. Code §§ 17200 *et seq*. Under this California statute, there is additional protection for acts that may not amount to violations of the Uniform Trade Secrets Act. California law specifically provides for injunctive relief to enjoin acts of unfair competition. *See id.* § 17203.

The penal code also has a broad trade secrets misappropriation act, which criminalizes the intentional stealing or unauthorized use of a trade secret, fraudulent appropriation of any article containing or representing a trade secret, unauthorized copying of such an article, or bribing anyone to obtain such a trade secret. *See* Cal. Penal Code § 499c.

It is important to note, however, that a trade secret is not protected against discovery by fair and honest means, such as independent invention, accidental disclosure, or reverse engineering.

D. Employee Inventions

1. Statutory Law

The California Labor Code regulates the manner in which a company can claim ownership of employee inventions. Any provision in an employment agreement which requires assignment to the employer of an employee's rights in an invention developed entirely on the employee's own time without using the employer's equipment, supplies, facility, or trade secret information is unenforceable, except for inventions that either (1) relate to the business of the employer or the employer's actual or demonstrably anticipated research or development, or (2) result from any work performed by the employee for the employer. *See* Cal. Lab. Code § 2870. The California Business and Professions Code also regulates services contracts related to invention development, limiting the rights that a provider of such services may acquire in the customer's invention. *See* Cal. Bus. & Prof. Code §§ 22370 *et seq*. The California Business and Professions Code mandates that no invention developer shall acquire any interest in the title to the customer's invention, unless the invention developer contracts to manufacture the invention and acquires an interest in the manufacture at the time the contract is executed. *See id.* § 22375. If an invention developer violates the relevant provisions of the California Business and Professions Code, the customer may bring a civil action against the invention developer for the greater of the following amounts: (1) $3,000 or (2) three times the amount of the actual damages, if any, sustained by the customer. In addition, the court may award reasonable attorneys' fees to the customer. *See id.* § 22386. The invention developer in violation of the California Business and Professions Code may also be subject to an injunction and/or criminal misdemeanor charges. *See id.* § 22387.

2. Common Law

At common law, an employer is entitled to a "shop right." A "shop right" is essentially an irrevocable, non-exclusive license that is acquired by an employer under certain circumstances to use the invention of its employee. The doctrine was originated and perpetuated by the United States Supreme Court as an equitable principle of common law, even though the existence of shop rights potentially conflicts with federal patent statutes which purport to confer upon a patentee the exclusive right to practice his or her invention. *See* 35 U.S.C. §§ 261, 271(a) (1976). The rule, succinctly stated, is that "where a servant, during his or her hours of employment, working with his or her master's materials and appliances, conceives and perfects an invention for which he obtains a patent, he must accord his or her master a non-exclusive right to practice the invention." This right does not deprive the employee of the invention, nor does it entitle an employer to use an invention or idea of an employee developed outside the scope of employment. Likewise, the shop right rule does not apply where the use of materials is slight. An employee does not lose his or her right to an invention by reason of the fact that the employment may have furnished him or her the opportunity or occasion for the conception of the idea or the development of his or her skill or knowledge.

E. Employee Confidentiality

1. Statutory Law

The Uniform Trade Secrets Act, as adopted in California, has been deemed to protect employers against the use of confidential information by former employees. Such disclosure may be enjoined as an unfair trade practice under the Uniform Trade Secrets Act. To obtain an injunction under the Uniform Trade Secrets Act, the employer must show (1) that the information is a trade secret (*e.g.*, that the information derives economic value from not being disclosed to the public and is the subject of reasonable efforts to maintain its secrecy); (2) misappropriation by the employee; and (3) use of such information to solicit former customers. *See* Cal. Civ. Code § 3426.2.

2. Common Law

A former employee may not use or divulge confidential knowledge or trade secrets acquired during employment. There is an implied contract that an employee will not divulge confidential knowledge gained in the course of employment or use such information to the employer's prejudice. Breach of a confidential relationship can give rise to a claim under California unfair competition law. The former employee's duty not to use or divulge information does not extend to information and expertise of a general nature that was acquired by the employee during the course of employment.

At common law, for a former employer to obtain an injunction against the unlawful use of confidential information regarding customers of the former employer by a former employee: (1) the information must have been confidential and not readily accessible to competitors; (2) the former employee must have solicited the former employer's customer with intent to injure the former employer and must have sought out preferred and profitable customers not generally known to the trade; (3) the nature of the business must be such that the customer would ordinarily patronize only one business; and (4) the nature of the relationship between the customer and the former employer must have been one that would normally have continued in the absence of interference. As noted above, however, these requirements have liberalized under the Uniform Trade Secrets Act.

F. Noncompetition Clause in Employment Contracts

1. Statutory Law

The California Business and Professions Code generally prohibits agreements that may be anticompetitive, including noncompetition agreements. Section 16600 of the California Business and Professions Code provides: "…every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." California courts have consistently declared this provision an expression of public policy to ensure that every citizen retains the right to pursue any lawful employment and enterprise of their choice. Section 16600 of the California Business and Professions Code has specifically been held to invalidate employment contracts to the extent that they prohibit an employee from working for a competitor when the employment has terminated, unless the prohibition is necessary to protect the employer's trade secrets. *See, e.g.*, *Metro Traffic Control, Inc. v. Shadow Traffic Network*, 22 Cal. App. 4th 853, 859 (2d Dist. 1994).

There is a limited exception under which noncompetition provisions can be enforceable where they are entered into in connection with the sale of a business and apply to: (1) any person who sells the goodwill of a business; (2) any shareholder who sells all of his or her shares in a corporation, division, or subsidiary; or (3) any shareholder of a corporation who sells all or substantially all of the assets of the corporation, a division, or a subsidiary. *See* Cal. Bus. & Prof. Code § 16601. Dissolution, dissociation, or sale of a partnership or limited liability company is another basis for exemption from the rule against noncompetition agreements. *See id.* §§ 16602, 16602.5. Even where noncompetition provisions are permissible, they are subject to a requirement of reasonableness, both temporal and geographic. The geographic requirement limits the scope of the noncompetition provisions to specified counties or cities where the business is operated and where the buyer continues to carry on a like business. These exceptions reflect the understanding that when a business is sold, it would be "unfair" for the seller to engage in competition which diminishes the value of the asset sold. *See, e.g.*, *Hill Medical Corp. v. Wycoff*, 103 Cal. App. 4th 895, 902 (2d Dist. 2001).

2. Common Law

In the light of the above statute, California law generally does not permit blanket noncompetition clauses. California courts do not recognize choice-of-law provisions that would override this policy. *See, e.g.*, *Application Group, Inc. v. Hunter Group, Inc.*, 61 Cal. App. 4th 881, 901 (1st Dist. 1998) (stating "California courts are not bound to enforce a contractual conflict of law provision which would thus be 'contrary to this state's fundamental policy'"). However, employees can be contractually restricted from unfair competition or the use of trade secrets or confidential information of their former employer. *See, e.g.*, *Vacco Industries, Inc. v. Van Den Berg*, 5 Cal. App. 4th 34, 51 (2d Dist. 1992).

G. Right of Publicity

Both a common law and a statutory right of publicity are recognized in California. California prohibits the knowing use of a living person's name, voice, signature, photograph, or likeness for advertising or soliciting purchases of goods or services without consent. Actual and punitive damages are recoverable, including lost profits and attorneys' fees. The statutory minimum damages is $750. Injunctive relief and general damages are also available.

The elements of a cause of action for violation of a right of publicity are: (1) use of the person's identity; (2) appropriation of the plaintiff's name or likeness to defendant's advantage, commercial or otherwise; (3) lack of consent; and

(4) resulting injury. The right of publicity can survive for 50 years beyond the lifetime of the plaintiff, but requires registration with the Secretary of State of any claim of ownership of such right before damages may be recovered.

Common law protection of privacy in California includes the torts of intrusion into the seclusion, or private affairs, of the plaintiff, public disclosure of private facts, placing the plaintiff in a false light, and commercial exploitation of the plaintiff's name or picture.

H. Franchises and Business Opportunities

California has not adopted the Uniform Franchise and Business Opportunity Act. However, California has its own comprehensive franchise disclosure statute. Under the Franchise Investment Law, all offers of a franchise must be registered with the California Commissioner of Corporations ("Corporations Commissioner"). The registration fee is $450. Under the statute, a franchise consists of an agreement under which (1) the franchisee is granted the right to engage in a business under a plan or system prescribed by the franchisor; (2) the operation of the business is associated with the franchisor's trademark or other commercial symbol; and (3) the franchisee is required to pay a fee, either directly or indirectly. The Corporations Commissioner may issue a stop order for registration if: (a) the applicant has failed to comply with the Franchise Investment Law; (b) the offer or sale would constitute fraud on the purchasers; (c) the applicant has failed to provide adequate financial arrangements; or (d) the applicant has been convicted of or held liable for fraud or misappropriation, or is subject to injunctive or regulatory orders restricting business activity that creates an unreasonable risk to purchasers. The Corporations Commissioner may require an escrow of franchise fees or a surety bond. If no stop order is in effect, registration of these offers becomes effective 15 business days after filing.

The application must set forth the financial statement of the franchisor, a copy of the franchise agreement, a statement of other terms, costs and fees, the terms regarding renewal or termination, any restrictions or exclusivity imposed on the franchisee, a statement of estimated earnings, and a statement of the number of franchises presently operating and proposed to be sold. The registrant must authorize the Corporations Commissioner to examine its financial records.

The Corporations Commissioner may issue a cease and desist order stopping the offer of franchises until registration has been effected. Willful violation of the cease and desist order is punishable as a crime. Franchises and subfranchises have standing to sue for damages for violation of the Franchise Investment Law, and if the violation is willful, for rescission of the franchise agreement. The Corporations Commissioner may sue for injunctive relief, and the district attorney may bring criminal proceedings.

The offer and sale of a franchise are exempt from registration if: (1) the franchisor has a consolidated net worth of at least $5,000,000 or if its net worth is at least $1,000,000 and it is owned at least 80% by a corporation that has a consolidated net worth of at least $5,000,000; (2) the franchisor has had at least 25 operating franchises in the preceding five years, or has conducted business that is the subject of the franchise continuously for at least five years, or if any corporation which owns at least 80% of the franchisor has had at least 25 operating franchises within the past five years; and (3) general information is disclosed about the sale and a notice of exemption is filed with the Commissioner and a fee paid. The offer or sale of a franchise by a franchisee for his or her own account is also exempt from registration.

I. Protection of Fine Art

California has an extensive statutory framework providing for the protection of literary and artistic property. As a result, state copyright protection may be available for works not copyrightable under federal law. There is statutory protection for artists against unauthorized reproductions of their work, and an artist may transfer this right of reproduction. The Fine Arts Resale Royalties Act requires that a commission of at least 5% be paid to the artist (or his/her heirs until 20 years after his/her death) of an original work of fine art resold for over $1,000. Other statutes protect against alteration or defacement and require certain disclosures in the sale of fine prints.

J. Federal Trademark Protection

Similar to trademark rights under California law, federal trademark rights may arise from either (1) actual use of the mark or (2) the filing of a proper registration application with, and the issuance of a certification of registration by, the USPTO. Trademark rights based on federal registration enjoy greater protection than rights based on use alone. The issuance of a certificate of registration for a trademark by the USPTO grants the registrant the right to prevent others from using the registered trademark in the United States. Registration also provides competitors with constructive notice that the registrant owns the trademark.

The term of a federal trademark registration is 10 years, with unlimited 10-year renewals upon the filing of an application and a showing that the trademark is in current use. During the sixth year after the date of the initial registration, a trademark registrant must file an affidavit of continued use of the mark or of non-use because of special circumstances. If an affidavit is not filed by the end of the sixth year, the trademark registration is cancelled.

To renew a federal trademark registration, a registrant must file a renewal application and submit a $400 renewal fee within six months before the registration's expiration or within three months after expiration (with the payment of an additional fee of $100).

An applicant may apply for federal registration in either of the following ways:

If the applicant already has begun using the trademark in commerce,[8] it may apply for a "use" application based on that use. To do so, the applicant must:

Be the first party to use the trademark in commerce; and

Provide the following to the USPTO:

Written application form;

Drawing of the mark;

Required filing fee ($325); and

Three specimens/examples of the mark showing its actual use with each service or good.

If the applicant has not yet begun using the mark in commerce,[8] it may apply for an "intent to use" application based on its bona fide intention to use the mark and thereby reserve the mark. To do so, the applicant must:

Provide the following to the USPTO:

Written application form;

Drawing of the mark; and

Required filing fee ($325).

If the USPTO issues a Notice of Allowance for the mark, within six months after its issuance, the applicant must make use of the mark in commerce and file the following with the USPTO:

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8 For purposes of federal registration, "in commerce" means interstate commerce or commerce between the United States and a foreign nation. Use in commerce must be a bona fide use in the ordinary course of business. Use in promotion or advertising before the product or service is actually marketed does not qualify.

Three specimens/examples of the mark evidencing use;

Required fee ($100); and

An Amendment to Allege Use (if the application has not yet been approved by the USPTO) or a Statement of Use (if the application has been approved).

If the applicant has not used the mark within six months after the issuance of a Notice of Allowance, it must file a Request for an Extension of Time to File a Statement of Use, or the application is abandoned.

Once a mark has been federally registered, the trademark owner may use the ® symbol. Use of this symbol prior to registration is improper and may render future registration invalid. If the ® symbol is used, a trademark registrant is eligible to recover lost profits or other money damages in a trademark infringement action.

Even without a federal registration, anyone who claims a right in a mark may use the ™ symbol to alert the public to its claim in the mark. A party does not have to register the mark to use the ™ symbol. Use of the ™ symbol is not necessary or required, although it does provide notice to the public of a claim in the mark. Such a claim to a mark, however, may not necessarily be valid.

Since enforcement of trademarks registered in the United States is limited to the United States and its territories, the applicant also must apply for and secure trademark registration in foreign countries if enforcement outside the United States will be necessary. Once an application is filed in the United States, international treaties allow six months to file corresponding applications in most foreign countries.

K. Patent Protection

The issuance of a United States "utility" or "design" patent grants the owner the right to prevent others from making, using, selling, or offering to sell a patented invention in the United States, or importing into the United States any patented invention during the term of the patent.

1. Ownership of the Patent

Generally, an inventor owns all rights to his or her invention. With respect to inventions made by an employee, the employer may claim ownership in the invention, depending on the circumstances of its conception and development. To avoid any uncertainty, however, employees should sign an employment agreement that includes a covenant to assign all inventions to the employer.

The term of protection for a utility patent is 20 years from the date the patent application is filed. The term of protection for a design patent is 14 years from the date the patent is granted.

2. What Is Patentable

An invention is entitled to patent protection if it satisfies the following requirements: (1) eligibility and utility, meaning that the invention is useful and falls within statutorily recognized patentable subject matter, *see* 35 U.S.C. § 101 (2002); (2) novelty, meaning that the invention is novel in relation to the prior art, *see* 35 U.S.C. § 102 (2002); (3) non-obviousness, meaning that the invention is not obvious from the prior art to a person of ordinary skill in the art, *see* 35 U.S.C. § 103 (2002); and (4) a specification requirement that: includes a written description of the invention, enables any person skilled in the art to make and use the invention, lays out the best mode contemplated by the inventor for carrying out the invention, and sets forth the distinctiveness of the invention, *see* 35 U.S.C. § 112 (2002).

The basic eligibility requirements are prescribed by federal statute, which states: "Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefor, subject to the conditions and requirements of this title." *See* 35 U.S.C. § 101 (2002). Despite the apparent sweep of the statute, the United States Supreme Court has specifically identified three categories of subject matter that will not receive patent protection: (1) laws of nature, (2) natural phenomena, and (3) abstract ideas. *See Diamond v. Diehr*, 450 U.S. 175 (1981).

One may seek to obtain patent protection on computer software as a "machine," "computer program product," or "process." Similarly, one may obtain patent protection on new and non-obvious business methods, particularly if implemented as a computer-related invention. It should be noted, however, that the question of what is or is not patentable, particularly with respect to computer software, business methods, and computer-related inventions in general, is a difficult one. United States patent counsel should therefore be consulted.

Design patents protect the ornamental design of something. For example, one might seek patent protection for a new design (*e.g.*, sufficiently different from existing designs) of a computer keyboard or mouse.

3. Internal Patent Procedures

A company may wish to appoint a person or persons to develop and coordinate its patent program, which may include the following: setting the company's patent strategy, working with employees who may be developing new inventions to track and document their work and the prior art, evaluating inventions for potential patent protection, coordinating the provision of information to patent counsel, and coordinating with patent counsel the filing of any patents with the USPTO, among other things.

Employees involved in the research and the development of potentially patentable subject matter should document their ideas and activities in a notebook and include: (1) the initial conception of the invention; (2) the conception of any improvements to the invention; and (3) the development history of the invention and any improvements. Employees should include dates for each entry and a clear description of the activities or invention (including drawings, sketches, graphs, etc., as appropriate), and should sign and date each entry. Entries showing inventions and improvements to inventions should be witnessed promptly by two people who are not joint inventors. Entries that do not describe actual inventions or improvements, but merely document the development of the work, may be witnessed less frequently.

Once the concept of the invention has been developed, an invention disclosure form should be completed and provided to the company's patent coordinator or patent counsel, or both. The invention disclosure form should identify the inventors and describe the invention. If possible, the closest prior art (discussed below) should also be disclosed in the invention disclosure form. Submitting the invention disclosure form commences the formal patent process. The patent coordinator, with the assistance of patent counsel, can evaluate the invention and decide whether to seek patent protection. In addition, patent counsel should docket the invention to track filing deadlines.

As stated above, "prior art" is important to the issue of patentability. It is therefore important for an inventor to be aware of and understand, to the extent possible, the state of the art in the field of the invention. Prior art includes, for example, printed publications, existing patents, and items in public use or on sale to the public. Inventors and others involved in the patent application process have a duty to disclose known relevant prior art to the USPTO.

4. Filing the Patent

In the United States, one must file a patent application within one year of the first public use, disclosure, or commercial exploitation of an invention. Moreover, any public use, sale, or offer to sell in the United States or disclosure anywhere in the world prior to filing a patent application could be a complete bar to obtaining a patent in foreign countries. The rules regarding these matters and the deadlines for filing can be very complicated. Patent counsel should be consulted well in advance of any potential deadline.

One may file a "provisional application" to establish an early filing date. The provisional application is simpler than a complete application, but must be followed by a complete application within one year. The provisional application, however, must contain an enabling disclosure of any inventions and limitations that are ultimately claimed in the non-provisional application.

Since enforcement of patents issued in the United States is limited to the borders of the United States, a patent owner may wish to consider filing foreign patent applications if enforcement outside the United States may be necessary. Once an application is filed in the United States, international treaties allow one year to file corresponding applications in most foreign countries.

5. Post-Issuance Matters

Once a patent is issued, some form of enforcement against infringers is usually necessary. One strategy is to notify potential infringers and offer them a license in exchange for royalties.

If it becomes necessary to file a lawsuit against an infringer, the patent owner may obtain an injunction against continued infringing activity, as well as damages. Damages may be based on lost profits caused by the infringing activity or a reasonable royalty. A patent owner may also be awarded treble damages if the infringer is found to have willfully infringed. The patent owner may also seek its costs and attorneys' fees in exceptional circumstances.

It should be noted that, although issued patents are presumed to be valid, a patent may be invalidated in a lawsuit if there are grounds to establish that the patent was somehow wrongfully obtained.

To collect damages in a patent infringement lawsuit, any products covered by the patent(s) must be marked. The device should be marked with the word "patent" or the abbreviation "pat." followed by the patent number. If the device cannot be marked, the package or label should be so marked.

In most countries, periodic maintenance and renewal fees are required to keep a patent in force.

6. Licensing the Patent

A patent owner may be able to generate revenues by licensing patents to others. If the owner obtained a patent but is unable to satisfy the needs of the entire market for the patent, for example, the owner could license the patent to others to fully exploit the value of the patent.

On the other hand, the patent owner may become aware of patents owned by others that the owner may wish to acquire or license.

L. Developing a Patent Portfolio in a Software Company

The development of an effective patent portfolio strategy for a software company, whether large or small, requires a coordinated set of processes that address training, motivation and reward, and efficient application development. Early identification of patentable inventions and providing for application development time in the product development schedule require a commitment from top management, trained and adequately rewarded project managers, and trained and adequately rewarded inventors.

1. The Need for an Effective Software Patent Portfolio

For companies whose products include software, the marketplace itself creates a significant impediment to the patent process. This impediment may be characterized as the "time-to-market squeeze," meaning that the competition today to get a new product into the marketplace has radically changed the way software is produced. The growth of the Internet and the marketing of software through the Internet (through "try-and-buy" processes) have exacerbated the management push to get products to market quickly. This results in software development regimes in which three months from "concept" to "program release" is the goal. This type of shortened development cycle only works if the underlying concepts are well understood, such as "80% is good enough to release version 1.0" or "let's release software to the Internet world of potential customers and let them help debug it while we work on the next release." This type of shortened production schedule puts great pressure on product managers and inventors to release and complete the product. Project managers often do not tolerate activities that interfere with the product development process, such as invention disclosure and assisting in the preparation of a patent application, since their only measure of performance is often whether or not the release schedule was met.

The need for an effective software patent portfolio, however, is apparent. For years, copyright protection was deemed to be enough for software. Several federal cases, however, have made it abundantly clear that methods of operation and functionality can be protected only by patents. *See Apple Computer Inc. v. Microsoft Corp. and Hewlett-Packard Co.*, 35 F.3d 1435 (9th Cir. 1994), *cert. denied*, 513 U.S. 1184 (1995); *Lotus Development Corp. v. Borland International, Inc.*, 49 F.3d 807 (1st Cir. 1995), *aff'd by an equally divided court*, 516 U.S. 233 (1996). These cases and the USPTO's Computer Related Invention Guidelines have led to an explosion of software patents in recent years. It is a necessity for a company to obtain patents on inventions in all strategically important products in order to prevent a competitor from shutting the company out of a strategic area. Some companies receive either entire or significant portions of their net revenues from patent licenses. Most larger software developers seem to be more concerned with the defensive aspects of a patent portfolio. Companies are not immune from attack by software patent holders. They have a need to protect their research and development investments in software even though the products may never be sold or licensed to others. Mission-critical applications with unique and novel systems should have patent coverage to protect the competitive advantage of the developer and to set up a portfolio to use to barter with a potential attacker.

2. Building an Effective Software Patent Portfolio

The size of a patent portfolio depends on the company's strategic products and product development plan. If a company has only a few key products, then only a few patents may be needed to protect them. If a company has a full line of strategic products, however, such as operating systems, server and client software, development tools (compilers, debuggers, test suites, etc.), network systems, and management tools, then it needs a patent portfolio that contains some protection for each of these areas. Strategic development plans must incorporate goals for protecting inventions resulting from the new product development. The company should have enough patent protection in each key area to cover its own technology and possibly should have some patent protection in a strategic area targeted by a competitor. Strategic forecasting of competitor products provides a basis for early patent application in key developing technology areas.

In order to build an effective software patent portfolio, a company needs knowledgeable and committed top management, a project development process that contains mandatory milestones for early invention identification, easy disclosure of inventions, a minimum of five hours per invention application built into the project schedule, developers trained in the invention patent process, and a cadre of patent attorneys (both in-house and outside counsel) who are knowledgeable about both software technology and the invention application development process.

Many companies have invention incentive award programs. These generally contain some form of monetary award for invention disclosure, patent application filing, and patent issue. Such programs vary with each company but generally include small amounts ($100-$300) per disclosure. They also vary from small amounts ($500 per inventor) for application filing and larger amounts ($2,000 per inventor) for patent issuance, to programs more heavily weighted on the patent filing award ($1,000-$2,000 per inventor for filing) and lesser amounts at patent issuance.

The most effective reward system appears to be an award program for disclosure, filing, and issuance of a patent for the inventor coupled with an award or management goal for invention disclosures for project managers and department directors. If the project managers and department directors are not motivated to get inventions disclosed and applications filed, they will not be inclined to allow inventors the time needed to get the disclosures submitted and the applications filed.

However, even more important than the timing or the amount of the rewards may be the accounting treatment of the awards. The award process appears to be most effective if the amounts, when paid to the inventors, are charged to a corporate patent cost account. Charging these costs directly to an operating department causes the costs to quickly become a discretionary expenditure which operating managers will find easy to control. Some companies have charged these amounts to a normal payroll or bonus account in the operating manager's budget. This works effectively in many situations. However, in some cases, astute managers may quickly perceive that they can control these discretionary accounts by filtering the invention disclosure/filing process. This seems to be especially true if the manager's performance has no patent filing—related goals attached. If the project manager's performance is solely tied to putting a product on the market on time and at a set cost, the project manager will not have an incentive to permit the inventors to spend time on the invention disclosure and filing process. The project manager's performance goals, therefore, should include the protection of the new product by the filing of one or more patent applications before the product is publicly released or offered for sale.

3. Training Inventors and Managers

Training on the basics of the patent portfolio process takes at least two forms. One form is the training of top management, department directors, and project managers. The focus of the training is on the need for developing and maintaining the patent portfolio, including intellectual property protection plans in long-range strategic product plans, and adequately setting goals and measurements to determine whether project managers are making patent filings where possible. The company should obtain an executive commitment that a portfolio is necessary and that a reasonable level of funding for the patent process is appropriate.

The other form of training is the training of software developers. The focus must be on patentable subject matter, the identity of the inventors and co-inventors, and the process for submitting a disclosure and completing the application. Training for developers needs to occur frequently and soon after they join the company. It is suggested that part of this training be included in the basic new employee orientation. All software developers should also have a one-to two-hour technical patent law training session at least once a year. Software developer training and the patent award program are two of the essential elements needed to make the patent portfolio program work. The training, understanding, and encouragement of management is also needed to produce a viable on-going patent development process.

The implementation of such award programs, management emphasis and measurement, and dedicated training may result in more invention disclosures than a company can reasonably afford to prosecute. In such a case, the company can establish a patent review committee to review invention disclosures and limit the filing process to those inventions deemed most strategic and most valuable to the company's future. Disclosed inventions deemed not strategically valuable enough to pursue should be formally published so as to constitute prior art that will preclude patenting by another.

4. Hiring Outside Patent Counsel

Outside patent counsel familiar with computer science and software techniques such as object-oriented technology, networks, and advanced operating systems should be hired. Such outside patent counsel will assist with the preparation of the patent application and the filing of the application with the USPTO.

5. Caveats

a) Participation in Standards Setting Organizations

Some engineers may request that their companies permit them to participate in organizations that set intellectual property standards. Such organizations include the Internet Engineering Task Force, the World Wide Web Standards Groups, and various consortia like the Institute of Electrical and Electronics Engineers, RosettaNet, National Institute of Standards and Technology, European Telecommunications Standardization Institute, ATM Forum, WAP Forum, Distributed Management Task Force, Mobile Wireless Internet Forum, and Joint Electron Device Engineering Council. If the engineers so request, the company must take great care to ensure that its engineers do not risk losing protection for any of the company's intellectual property. These organizations generally require a participant to disclose any patents or applications that might relate to the proposed standard with which the participant is involved. In some cases, the organizations require royalty-free licenses to these patents. In recent years, at least two companies, Dell Computer Corporation and Rambus Inc., lost patent rights by their failure to disclose such patents while participating in one of these organizations. Companies are strongly advised to discuss any contemplated participation in such organizations with outside patent counsel before formally agreeing to become a member.

b) Risks of Contributory and Induced Infringement

Software developers today live in a world of ever-increasing numbers of software patents. It is important for these developers to understand that even though they may be producing and selling programs, sub-programs, or parts of a larger system that may have many non-infringing uses, they can still be found to be active inducers of patent infringement if they encourage their customers to use their products in systems that infringe a known patent. Such encouragement may be found in sales literature, licenses, maintenance agreements, and design activities. Similarly, designers and sellers of programs and sub-programs that have insignificant non-infringing uses can be found to be contributory infringers. The mere selling of a component having non-infringing uses does not constitute contributory infringement or active inducement; however, certain acts beyond the mere sale of a component can result in active inducement and liability for infringement. Such acts include: (1) suggesting or advocating a use involving infringement when advertising the product; (2) employing a sales force that actively promotes such uses; or (3) engaging in promotional activities calculated to result in infringement to a greater or lesser degree.

Companies in the components business are well advised to have outside patent counsel discuss these various issues with their marketing and sales groups as well as with their software developers.

CHAPTER 6

EMPLOYMENT

California law has developed to protect the interests of both employers and employees in ways that often differ from the rest of the country. Discussed below are some of the more important legal requirements that are relevant to California employers, as well as certain issues that are important in the hiring and retention of quality employees. The general summaries below, however, are not a complete analysis of the areas discussed, and should not be acted upon without specific legal advice based on particular situations.

A. General Issues

1. Types of Employment and Consulting Relationships

In addition to regular employees, many employers may use the services of temporary employees, independent contractors, or consultants (and employees of independent contractors or consultants).

When an employer hires an employee for a temporary period or for a season, the temporary employee is still an employee of the employer, and the employer is subject to all of the laws discussed below with respect to that temporary employee. As with regular employees, legally mandated benefits, such as workers' compensation insurance and unemployment insurance, must be offered to temporary employees. Optional benefits, such as 401(k) plans, need not be offered to temporary employees.

A true independent contractor or consultant is not considered an employee of the employer. Instead, an individual independent contractor is self-employed, and payments made to the independent contractor are considered contract payments rather than wages. The United States Internal Revenue Service ("IRS") and other governmental agencies have a variety of tests for determining whether a worker is an employee or an independent contractor, which, despite variations among the tests, tend to share the same primary factors. Essentially, workers who are performing the same job and performing under the same supervision as regular employees are usually found to be employees. Additional factors shared by the various tests include the degree of control the employer exercises over the worker's performance, whether the employer retains the right to discharge the worker at will, the length of service, and the method of payment (*e.g.*, is the worker paid hourly or on a project basis).

The consequences of incorrectly classifying a worker as an independent contractor can be far-reaching and expensive (*e.g.*, liability for unpaid payroll taxes and penalties, administrative claims for benefits provided to regular employees, liability for unpaid unemployment insurance and workers' compensation premiums, increased exposure to governmental audits, and potential exposure to employment-related civil suits and administrative claims).

Even if the worker is correctly classified as an independent contractor, the employer may be liable for claims by third parties. For example, the employer can be sued successfully by the employees of the independent contractor where (1) the employer retains control over the safety conditions at the worksite and the employer's exercise of that control affirmatively contributes to the worker's injuries, *see Hooker v. Dep't of Transp.*, 27 Cal. 4th 198 (2002), or (2) the employer negligently furnishes unsafe equipment to the contractor, which then contributes to the worker's injuries. *McKown v. Wal-Mart Stores, Inc.*, 27 Cal. 4th 219 (2002).

As of January 1, 2001, payments to independent contractors must be reported to the California Employment Development Department ("EDD") where (1) the employer is required to file a 1099-MISC form for the services performed by the independent contractor; (2) the payment to the independent contractor is $600 or more or the employer enters into a contract for $600 or more; and (3) the independent contractor is an individual or sole proprietorship. For more information, see the website of the EDD regarding Independent Contractor Reporting.[9]

2. At-Will Employment

The conventional relationship between an employer and an employee hired for an indefinite period of time is called "employment at will." Under this arrangement, either the employer or the employee may terminate the employment relationship at any time, with or without cause, and with or without advance notice. In the absence of a written contract or other evidence indicating that an employee may be terminated only "for cause," employment is generally presumed to be at will. Factors which may indicate that an employee may be terminated only "for cause" include the employee's length of service, the employer's actions or communications reflecting assurances of continued employment, the employer's personnel policies or practices, and the practices of the industry. *Foley v. Interactive Data Corp.*, 47 Cal. 3d 654, 680 (1988) (citing *Pugh v. See's Candies, Inc.*, 116 Cal. App. 3d 311, 327 (1st Dist. 1981)). California Labor Code § 2922 creates the presumption that employment for an unspecified term may be terminated at will by either party.

It is important to remember that even a traditional at will relationship is not absolute, as various laws limit an employer's unfettered right to terminate employees. These laws prevent employers from firing any employee, whether at will or not, for illegal reasons (*e.g.*, discriminatory reasons, whistleblowing, or engaging in certain activities protected by law).

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9 California Employment Development Department: <http://www.edd.ca.gov/>.

3. Required Postings

Every employer is required to post certain notices. The notices that are required depend primarily upon the employer's size. While laws requiring posted notices usually prescribe the posting location, the posting generally must be in a conspicuous location in the workplace where it may easily be seen by employees and, in some instances, by applicants for employment.

A non-exhaustive list of postings required by California law includes:

Workers' Compensation Notice

Notice of Unemployment and Disability Insurance

Harassment or Discrimination in Employment

Family Care and Medical Leave

Pregnancy Disability Leave

Notice of Time Off to Vote

Minimum Wage Order

Applicable Wage Order for the Industry

In general, required notices can be obtained from government agencies free of charge.

4. Employment Records

Every employer is required to maintain certain employee records. As with the notices discussed above, the records that are required depend primarily upon the employer's size.

At a minimum, all employers should have one or more personnel files for each employee, containing any offer letters and agreements signed by the employee, required wage and hour records, and any documents used to determine the employee's qualifications for employment, promotion, additional compensation, termination, or disciplinary action. Medical records, immigration information, and other confidential documents, such as reference checks and investigative files for harassment claims, should be kept separately from an employee's regular personnel file and should be kept confidential.

California employers must allow an employee to inspect his or her personnel file at reasonable times and upon reasonable notice to the employer, and provide the employee with copies of any employment documents that he or she is required to sign.

Several state and federal laws require an employer to retain different types of employment records for particular periods of time. Most of these laws require the records to be retained for a period of four years or less. Some exceptions include information on pension and welfare benefit plans (six years), records of job injuries (five years), and records regarding employee exposure to hazardous substances (30 years).

Record retention requirements generally applicable to California employers include:

Employment Applications	Two years.
I-9 Forms	Three years after hire or one year after termination, whichever is later.
OSHA Records	Under California law, one year for IIPP records (see section B.3 below), five years for occupational injury records, and 30 years for employee exposure and medical records pertaining to employees exposed to toxic substances or harmful physical agents.
Payroll Records	Five years.
Time Cards	Three years.
Personnel Files	Two years under California law, and, for some records, three years under federal law.

5. Government Contractors

A number of laws impose specific requirements on employers who contract with the government or a government-funded agency and on employers who receive grants or other funding from the government. These laws include special equal opportunity laws, affirmative action laws, prevailing wage laws, and drug-free workplace laws. The application of the laws depends on the value of the contract or funding and/or the number of employees in the company.

6. Union Activity

If the employees are unionized, special requirements apply since employers are not allowed to interfere with the employees' right to organize. If the employer is told that the employees have decided to be represented by a union, the employer should obtain legal counsel.

B. Employment Policies and Employee Handbooks

Every employer, regardless of size, should have written employment policies. Written policies can serve many useful purposes, and in some cases they are legally required. However, it is important to remember that under current law, a judge or a jury may arguably have the discretion to find that an employer's policies or handbook constitutes a binding contract, notwithstanding full written disclaimers that a contract was never intended.

The following policies warrant special attention:

1. Nondiscrimination

Under federal law, employers are prohibited from discriminating on the basis of race, color, religion, sex, national origin, veteran status, pregnancy, age, or disability. *See* 42 U.S.C. §§ 2000e *et seq*.; 29 U.S.C. §§ 621 *et seq*.; 42 U.S.C. §§ 12101 *et seq*.; 38 U.S.C. §§ 4211 *et seq*. *Id*., §§ 4301 *et seq*. California law also prohibits employers from discriminating on the basis of ancestry, medical condition, marital status, family care leave status, or sexual orientation. *See* Cal. Gov't Code §§ 12940 *et seq*. Failing to comply with discrimination laws can result in expensive lawsuits or administrative investigations. In general, these laws require that all employees be treated equally without regard to their protected status. In addition, employers may not retaliate against employees who seek to further or enforce employment discrimination laws.

Employers also should be aware of their obligations to make reasonable accommodations for employees where the employees' disabilities or religious beliefs conflict with employment requirements. These obligations, which exist under both federal and state law, are unlike other equal employment opportunity laws in that treating all employees equally will not satisfy the obligations. Instead, employers must take positive steps to reasonably accommodate employees with disabilities and specific religious practices.

2. Harassment

Both state and federal law also prohibit harassment in the workplace against any of the classes of employees protected under federal and state discrimination law. *See, e.g.*, *id.* § 12940(j)(1). Two types of conduct constitute "harassment in the workplace." The most obvious occurs when a supervisor makes a job promotion or benefit dependent on the receipt of sexual favors (often called "quid pro quo" harassment). The other type occurs when an employee has to endure comments, physical contact, physical gestures, or other behavior that creates an offensive atmosphere for that employee (often called "hostile environment" harassment).

An employer is required to take all reasonable steps necessary to prevent the occurrence of either type of harassment, which includes having an appropriate and comprehensive policy against harassment. *Id.* For this reason, a harassment policy is considered one of the few legally required employment policies. In addition, reasonable steps to prevent harassment would also include periodic dissemination of the harassment policy, harassment training (particularly for supervisors), investigations of any complaints, and, when harassment occurs, prompt and effective remedial action. The policy also should explain how an employee can report harassment and how the employer will investigate and respond. As with discrimination, employers cannot retaliate against an employee who complains about harassment.

California law requires employers to disseminate to employees either a sexual harassment information sheet prepared by the Department of Fair Employment & Housing, *see* <www.dfeh.ca.gov/publications/posters.asp>, or a policy containing equivalent information prepared by the employer. For simplicity, most employers choose to include the equivalent information in their policy against harassment.

3. OSHA Injury and Illness Prevention Program

California's Occupational Safety and Health Act ("Cal-OSHA") requires every employer to establish, implement, and maintain a written Injury and Illness Prevention Program ("IIPP"). Cal. Lab. Code § 6401.7. This IIPP process involves designating a person responsible for the program and implementing the six fundamental steps required by Cal-OSHA.

First: The program must include a system for identifying and evaluating potential workplace hazards.

Second: The program must incorporate a code of safe practices which covers the company's entire operation and effectively addresses those identified hazards.

Third: The program must implement a system of scheduled periodic inspections, investigation of incidents, and correction of deficiencies.

Fourth: The program must contain a training program for all employees. The training program should be designed to instruct employees in general safe and healthy work practices and to provide specific instruction with respect to hazards particular to each employee's job assignment.

Fifth: The program must establish a system for communicating with employees on safety matters. This must include encouraging employees to inform the company of hazards in the workplace without fear of retaliation. It must also include a system for ensuring that employees comply with safe work practices, which may include disciplinary action.

Sixth: There are a number of record-keeping requirements.

For small companies, or "non-high hazard employers," or where the risks of injury in the workplace are low — this would include most office environments — Cal-OSHA has developed model policies that make the IIPP process fairly simple. Employers with greater hazards in the workplace will have to spend more time developing their IIPP, will have more record-keeping requirements, and may have other Cal-OSHA requirements for their particular industry. In addition, all employers will need to comply with certain local health and safety regulations.[10]

4. Workplace Violence

California's Division of Occupational Safety and Health also requires employers to take certain steps to prevent workplace violence if there is any risk of violence in the workplace. If there is a known risk of violence in the workplace, employers should take additional steps, including developing an IIPP addressing workplace security.[11]

C. The Hiring Process

The hiring process involves receiving and reviewing applications, interviewing potential candidates, and selecting the employee. Several state and federal laws limit what employers can ask during this process. In addition, federal and state disability

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[10] For more information, and model IIPPs, see Guide to Developing Your Workplace Injury and Illness Prevention Program with checklists for self-inspection, at <www.dir.ca.gov/DOSH/dosh_publications/iipp.html>.

[11] For more information, see Injury & Illness Prevention Model Program for Workplace Security, at <www.dir.ca.gov/dosh/dosh_publications/iipsecurity.html>.

laws require certain affirmative obligations to ensure that disabled persons have a fair opportunity to participate in the hiring process.

1. Applications

The application process generally includes publishing the open position and accepting applications. Discrimination laws prohibit certain questions on the application, and state labor laws prohibit certain questions about a person's arrests and criminal records. *See* Cal. Lab. Code § 432.7.

Disability laws may also require employers to offer alternative application methods. Additionally, some employers (*e.g.*, larger employers and government contractors) are required to request demographic information from applicants, which is written on separate sheets that are maintained in separate files.

2. Interviewing, Reference Checks, and Background Checks

The interviewing process generally involves interviews and reference checks. Federal and state discrimination laws prohibit employers from asking certain questions during the hiring process. Every person who interviews candidates and conducts reference checks should have a working knowledge of the laws that govern employment interviews.

Employers who use outside organizations to conduct background checks must comply with the federal and state credit-reporting laws, which require using several specific forms to obtain the applicant's consent. *See* 15 U.S.C. § 1681; Cal. Civ. Code § 1785.20.5. Under state law, employers using outside organizations must also provide the applicants with a copy of the resulting report. Cal. Civ. Code § 1786.16. Employers who perform "in-house" background checks are required under state law to notify the applicants and to provide the applicant with any information that is developed during the "in-house" investigation. Cal. Civ. Code §§ 1786.16, 1786.53. Employers who perform drug tests must comply with federal and state privacy and disability laws.

3. Immigration

All employers are required to verify that every new hire is either a United States citizen or authorized to work in the United States. 8 U.S.C. § 1324a(a), (b). All employees must complete Employment Eligibility Verification (I-9) Forms and produce required documentation within three days of their hire date. 8 C.F.R. § 274a.2(b)(1)(ii), (iii). A list of acceptable documentation can be found at 8 C.F.R.

§ 274a.2(b)(1)(v). Failure to follow the I-9 process can result in penalties and an audit by the Immigration and Naturalization Service.

Employers cannot discriminate against employees based on their immigration status. *See* 8 U.S.C. § 1324b(a); 42 U.S.C. § 2000e-2; Cal. Gov't Code § 12940(a) (prohibiting discrimination on basis of national origin). Thus, once an employee has satisfied the employer that he or she is eligible to work in the United States, the employee's immigration status should not be used in any other employment decisions.

D. Compensation and Benefits

Many different federal and state laws regulate different forms of compensation and benefits. Each employer should select a compensation scheme that best accomplishes its human resource goals and then have that scheme reviewed for legal compliance.

1. Wages

Most employers — regardless of size — are governed by both federal and state wage and hour laws. Federal and state wage and hour laws differ slightly, and employers must follow both.

The two major requirements in both federal and state wage and hour laws concern: (1) payment of the minimum wage and (2) payment for overtime hours. 29 U.S.C. §§ 201 *et seq.*; *see also* California Wage Orders, at <www.dir.ca.gov/iwc>. Under the minimum wage laws, employers must pay employees an amount that is at least the statutory minimum wage multiplied by the number of hours that the employee worked (as of January 1, 2002, the minimum wage for California is $6.75/hr.). Under the laws governing overtime, employers must pay most employees additional compensation for overtime hours. In California, overtime rates for non-exempt employees (*see* below) apply to all hours worked over eight in a day, unless an alternative work week has been adopted, and all hours worked over 40 hours in one week. Cal. Lab. Code § 510.

Minimum wage and overtime laws are not limited to hourly employees. Employees who are paid in other ways, such as by salary or commission, may also be entitled to minimum wages and overtime pay. The minimum wage and overtime laws apply to all employees, unless an employee falls into one of the "exempt" classifications. *See* 29 U.S.C. § 213; Cal. Wage Order for the relevant industry.

2. Bonuses and Stock Options

Bonuses can improve employee retention and provide extra incentives for reaching certain targets. Employers who provide bonuses (other than gift bonuses like Christmas bonuses) should have a written bonus plan to ensure clarity and legal compliance, and to avoid unintended implied contracts.

Stock option plans and stock purchase plans provide an incentive for increasing the value of the company and can provide the advantages of deferred income. Stock and stock options are regulated by federal and state corporation, securities, and tax laws. Employers who provide stock options or stock purchases should have a written plan and written agreements to ensure legal compliance.

3. Taxes

Employers are required to withhold income tax and social security tax from taxable wages paid to employees. Funds withheld must be deposited in certain depositories accompanied by a Federal Tax Deposit Coupon (IRS Form 8109) or through the Electronics Federal Tax Payment System (EFTPS). An Employer's Quarterly Federal Tax Return (IRS Form 941) must then be filed before the end of the month following each calendar quarter. Willful failure on the part of the employer to collect, account for, and pay withholding taxes will subject the employer to a significant monetary penalty, and in some cases, will impose personal liability on those responsible for remitting the withholding taxes.

Employers also must withhold California income tax from employees' taxable wages. Within 15 days after becoming subject to personal income tax withholding requirements, the employer must register with the EDD. Forms for returns will be automatically mailed to all employers who register with the EDD. A booklet entitled *California Employer's Guide 2003* may be obtained from the EDD, at <www.edd.ca.gov/taxform.htm/>.

Employers must file an Employer's Annual Federal Unemployment (FUTA) Tax Return (IRS Form 940) and pay any balance due on or before January 31 of each year. Details may be found in IRS Circular E, the *Employer's Tax Guide*.

4. Reimbursement for Expenses

California Labor Code § 2802 requires employers to indemnify all necessary expenses and losses incurred by employees in the performance of their job duties. If an employee is sued for conduct within the course and scope of his or her employment, California requires the employer to provide a defense or to indemnify the employee for necessary attorney fees and costs.

5. Mandatory Benefits

Some employee benefits are mandated by law, including workers' compensation, unemployment insurance, and state disability insurance. In addition, under certain circumstances, employers are required to provide unpaid leaves of absence for eligible employees. *See* § 6 *infra* (Mandatory Leaves of Absence).

a) Workers' Compensation

California employers are required to provide workers' compensation benefits for all employee injuries that occur in the course of an employee's employment, regardless of fault. Cal. Lab. Code §§ 3200 *et seq*. This "no fault" system is designed to provide an injured worker with necessary medical care and compensation and/or vocational rehabilitation for on-the-job injuries, while at the same time generally precluding the employee from suing his or her employer for civil damages.

All employers must be either self-insured against workers' compensation liability or insured by an authorized insurer. Should the employer fail to follow the workers' compensation laws, it will be subject to penalties and legal action by the injured employee or the employee's dependents. *Id*. §§ 3707, 3708, 3710.1, 3710.2.

For an overview of the California workers' compensation system, see the Department of Industrial Relations website.[12]

b) Unemployment Insurance

With few exceptions, all California employers are required to contribute a specified percentage of the total dollar amount paid as wages to the unemployment insurance system. The unemployment insurance system is a combined federal/state program that requires the payment of both federal and state taxes.

For more information, see the EDD website at <www.edd.ca.gov/employer.htm/>.

c) Disability Insurance

California employers are also required to provide employees with state disability insurance. Cal. Unemp. Ins. Code §§ 2601 *et seq*. State disability insurance partially compensates employees for loss of earnings due to a sickness or injury (regardless of

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[12] California Department of Industrial Relations: <http://www.dir.ca.gov/DWC/basics.htm/>.

whether it is work-related) that prevents them from performing their customary work. Employees receiving workers' compensation benefits can qualify for some disability insurance payments only if their workers' compensation payments fall below the level of payments they could receive from state disability insurance. The EDD oversees matters concerning disability insurance. For more information, see the EDD website at <www.edd.ca.gov/fleclaimdi.htm/>.

6. Mandatory Leaves of Absence

Several federal and state laws either require or govern leaves of absence, depending upon the reason for the leave. Although these leave laws can be very complicated, application of the laws usually depends on the size of the employer, and some of the more complicated laws do not apply to small employers.

Both federal and California family and medical leave laws require employers with 50 or more employees to provide employees with unpaid family or medical leave of up to 12 weeks in a 12-month period, except where the employee is employed at a work site with less than 50 employees and the total of employees within 75 miles of the work site is less than 50. These laws include several detailed requirements. *See* 29 U.S.C. §§ 2611 *et seq*.; Cal. Gov't Code §§ 12945.2 *et seq*.

Also, California law requires employers of five or more full-time or part-time employees to provide up to four months of unpaid pregnancy leave in addition to any family or medical leave to which an employee may be entitled. Cal. Code Regs. tit. 2, §§ 7291.7 *et seq*.

There are other legally required leaves of absence such as time off for voting, Cal. Elec. Code § 14000, for jury duty, Cal. Lab. Code § 230(a), for appearance as a witness in compliance with a subpoena or other court order in any judicial proceeding, *id*. § 230(b), for military service, 38 U.S.C. §§ 4307 *et seq*., and for attendance at school disciplinary proceedings, Cal. Lab. Code § 230.7. In addition, federal and state disability laws may require the employer to provide disability leave to an employee with a qualified disability.

7. Voluntary Benefits

The benefits listed below are not required by law. However, many employers choose to provide employees with such benefits in order to attract and retain the most qualified workers.

An employer is not required to provide employees with retirement benefits, welfare plans, severance pay, or other voluntary benefits. If an employer does establish such plans, however, they are governed by a federal law called the Employee Retirement Income Security Act ("ERISA"). Under ERISA, employee benefit plans must comply with many procedural requirements.

An employer is not required to provide employees with vacation pay. If an employer elects to provide such benefits, however, the law regulates how these benefits are earned and paid. California law treats earned vacation as wages that are protected by California wage laws. Accordingly, employers may not implement a "use it or lose it" policy in which employees lose earned vacation that is not taken within a specified period of time. Upon termination of employment, all accrued but unused vacation must be paid to the employee. *See Suastez v. Plastic Dress-up Co.*, 31 Cal. 3d 774 (1982) (holding that vacation time is a form of deferred compensation and thus is vested as earned).

Although it is extremely common to do so, employers are not required to give employees paid holidays. Indeed, except in cases where accommodation of religious holidays might be required, employers are not even required to give employees time off *without pay* during holidays.

Employees are not required to offer paid sick leave to employees. In contrast to vacation pay, traditional sick leave, *e.g.*, where its use is restricted exclusively to dealing with the employee's own illness, is not treated like wages, and an employee may forfeit unused sick leave at the end of a specified period of time. Upon termination, the employer has no obligation to pay out unused sick leave.

Many employers choose to combine vacation, sick leave, personal days, and floating holidays into a single "paid time off" or "PTO" policy. Because the PTO may be taken whenever the employee chooses, California law treats the entire PTO amount as tantamount to vacation pay. Accordingly, as with vacation, all accrued but unused PTO must be paid to employees upon termination.

Paid leaves of absence, such as paid maternity or paternity leave, are not required by law.

E. Termination of Employment

1. Pay

All wages earned and unpaid at the time of discharge, including pay for any accrued vacation time, are due and payable immediately upon the termination of employment, except that an employer is allowed 72 hours in which to make such payments when an employee has resigned without advance notice. Cal. Lab. Code §§ 201, 202. Failure to pay all unpaid wages upon termination can be very costly. In addition to back wages, employers may also be liable for penalties, interest, and attorneys' fees. *Id*. § 203.

2. Severance Agreements/Releases

Generally, employers are not required to provide severance pay, unless they have agreed to do so. If the employer wants to offer severance to an employee, the employer may ask the employee to sign a release in exchange for the severance, in which the employee waives all legal claims the employee may have against the employer. If an employer seeks a release, the employee must be provided consideration in addition to any payments the employee was already entitled to receive. State and federal law place many restrictions on releases, including specific statutory requirements for waivers of age discrimination claims. *See, e.g.*, 29 U.S.C. § 626(f) (additional specific requirements for waiver of claims under the Age Discrimination in Employment Act, as amended by the Older Workers Benefit Protection Act).

3. Unemployment Insurance and the EDD

Under California law, employers are required to provide employees who are discharged, laid off, or placed on a leave of absence with Pamphlet 2320 from the EDD entitled *For Your Benefit*. The pamphlets may be obtained from the EDD. In addition, an employer must provide written notice regarding the employee's change in status. This notice must include: (1) the name of the employer; (2) the name of the employee; (3) the social security number of the employee; (4) whether the action was a discharge, a layoff, a leave of absence, or a change in status from employee to independent contractor; and (5) the date of the action. The EDD pamphlet and written notice regarding employment status are not required for employees who voluntarily resign their employment. As a general rule, employees who voluntarily resign will not be entitled to collect unemployment insurance benefits.

4. COBRA Requirements

The Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA") requires employers to provide notification to employees of their COBRA rights at the time of a "qualifying event" such as a resignation or an involuntary termination of employment. COBRA applies to employers with more than 20 employees. Employers with fewer than 20 employees must comply with certain obligations under a similar state law called Cal-COBRA.

5. HIPP Notice

In addition to COBRA notice, the State of California Health Insurance Premium Payment ("HIPP") Program requires a notice to discharged employees regarding Medi-Cal and health insurance. A copy of the required HIPP notice may be obtained directly from the state agency.[13]

[13] California Department of Health Services: <http://www.dhs.ca.gov/>.

CHAPTER 7

IMMIGRATION

Awareness of the employment-based nonimmigrant and immigrant visa classifications is essential for all United States employers seeking to hire and employ foreign workers in the United States. This chapter summarizes some of the various temporary and permanent visa options that are available to foreigners who wish to work and/or conduct business in the United States.

A. Nonimmigrant Visa Categories

Nonimmigrant visas are available to individuals who seek to enter the United States on a temporary basis. Subject to some exceptions, nonimmigrant visa holders must, upon entry into the United States, intend to return to the country of their last residence or their nationality upon the conclusion of their temporary stay in the United States.

The basic nonimmigrant visa categories available to foreign nationals include the B-1 visa for business visitors, the H-1B visa for professionals and members of "specialty occupations," the L-1 visa for intracompany transferees, the E-1 and E-2 visas for treaty traders and investors, and the O-1 and P-1 visas for qualifying artists, athletes, scientists, business persons, and entertainers. The North American Free Trade Agreement ("NAFTA") provides Canadian and Mexican nationals with four additional business visa options. Foreign students who are enrolled in full-time programs at a United States college or university can engage in part- and full-time "practical training" with a United States employer.

1. The B-1 Visa and Visa Waiver for Business: Business Visitors

The B-1 visitor's visa and Visa Waiver for Business are available to individuals traveling to the United States to engage in brief, "acceptable" business-related activities, such as job training, meetings, conferences, and consultations.[14] Because the B-1 visa and Visa Waiver for Business do not permit employment in the United States, the foreign national cannot receive compensation in the United States and must be acting on behalf of his or her foreign employer. Under the United States Citizen and Immigration Service ("USCIS") (formerly the Immigration and Naturalization Service ("INS")) and the United States Department of State's "work for hire" test, an activity is deemed "work" in the United States (and a B-1 visa should not be issued) if the foreign national's proposed activity would normally be performed by a local worker in the United States. In such a case, the foreign worker should instead apply for a temporary work visa.

A business visitor may be admitted to the United States for an initial period of six months. Since 9/11, however, the period of admission is often more closely limited

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[14] The Visa Waiver is limited to persons from certain countries as established by regulation. The rules defining acceptable business activities are the same for both the B-1 visa and the Visa Waiver for Business.

to the documented need to be in the United States. While extensions of stay are available through application to USCIS, most business visitors are granted a period of stay sufficient to accomplish the specific activities described in the visa application.

NAFTA also contains a business visitor category. While Canadian nationals may enter the United States as business visitors without first obtaining a visa or prior USCIS authorization, Mexicans nationals must first obtain a visa. Both Canadian and Mexican nationals must demonstrate upon entry that they will not work in the United States.

An alien making frequent visits to the United States should be particularly aware of "acceptable" business-related activities in the United States. If characterization of the foreign worker's duties is unclear, he or she should apply for a visa that provides work authorization in the United States.

2. The H-1B Visa: Workers in Professional and Specialty Occupations

The H-1B visa category is widely used by foreign professionals to come to the United States and temporarily engage in professional or "specialty" occupations that typically require a minimum of a bachelor's degree or its equivalent. Artists, athletes, and fashion models of distinguished merit or ability, as well as individuals working on certain United States Department of Defense projects, are also eligible for H-1B visas.

In order to qualify for an H-1B visa, the employee must obtain a job offer from a United States employer, as defined by regulation, and a formal employer-employee relationship must exist. For "specialty" occupations, the employer must show that a bachelor's degree is a minimum requirement for the position and that the employee has an appropriate degree in a relevant field.

An H-1B petition may be approved for an initial period of up to three years and can be extended for an additional three-year period. Except in certain circumstances, after six years of continuous H-1B status, the alien must spend one year outside the United States before re-entering on an H-1B visa.

Spouses and children (under 21) of the principal H-1B employee may obtain H-4 status to accompany the H-1B worker to the United States. Dependent children are permitted to attend school. However, employment is not permitted for H-4 visa holders.

The "dual intent" doctrine applies to H-1B visa holders and their families. Dual intent removes the foreign-residences-abroad requirement and permits the H-1B visa holder to pursue United States permanent residence status while remaining in the United States on an H-1B visa.

a) Labor Condition Application

Before applying for an H-1B visa, an employer must generally first obtain a certified Labor Condition Application ("LCA") from the United States Department of Labor ("DOL"). The LCA requires the employer to state whether it is H-1B dependent or H-1B non-dependent. H-1B dependent employers are employers with more than 50 employees which have a workforce of which more than 15% are H-1B employees. The numbers differ slightly for smaller employers. Employers must also attest to several issues related to working conditions, post the LCA at the place of employment for a period of 10 days, and give a copy of the certified LCA to the intended employee at the inception of employment.

In the LCA, an employer must identify both the actual wage to be paid to the employee and the "prevailing wage" for the occupational classification in the geographical area of the intended employment. Although the most common sources of "prevailing wage" information are published surveys conducted within two years prior to the filing of the LCA, an employer may alternatively request a binding prevailing wage determination from the California State Employment Security Agency ("SESA"). If the DOL finds that an employer is not paying the proper wage, the employer may be subject to serious penalties, including payment of back wages (based on the difference between the actual wage and prevailing wage) and a restriction on hiring foreign workers for one year.

Once the LCA is certified, the employer may file the H-1B application and supporting documentation with the USCIS. While normal USCIS processing of H-1B petitions may take months, employers can pay an extra $1,000 for "premium processing," through which they will either obtain a decision from the USCIS within 15 days or receive a full refund of the premium processing fee.

b) Changes in the Terms of H-1B Employment

Employers must inform the USCIS of any material change in the conditions of employment, including the termination of an H-1B employee. If an H-1B employee is terminated prior to the expiration date of his or her authorized stay, the sponsoring employer is responsible for the reasonable cost of the alien's transportation back to his or her last place of foreign residence. In contrast, if the employee quits or works until the expiration date of his or her stay, the employer has no responsibility to pay for the return transportation.

c) The H-1B "Cap," H-1B "Portability," and Fee Increases

The Immigration and Nationality Act limits the number of H-1B visas available within a specific USCIS fiscal year. The H-1B "cap" is set at 65,000 for fiscal year 2005. Exempt from this cap are employees of nonprofit research institutions, government research organizations, and higher education institutions, as well as employees seeking extensions of their H-1B stay and/or changes of their H-1B employers. In the last few years, the available 65,000 H-1B visas have been quickly exhausted, months before the end of the fiscal year. In response, Congress enacted legislation which will allow an additional 20,000 H-1B visas to be issued this fiscal year and each subsequent fiscal year to aliens who have earned a master's degree or higher from a United States institution. H-1B nonimmigrants who have already been counted toward the cap in the six years prior to the filing of a new petition are not counted towards the cap unless they are eligible for a full six years of H-1B stay.

An H-1B employee may begin working for a new H-1B employer at the time a "change of H-1B employer" petition is filed, rather than waiting for the new petition to be approved. The new H-1B petition must be nonfrivolous, the employee must not have worked in the United States without authorization, and the employee must be in lawful immigration status at the time the new petition is filed. If the new petition is denied, work authorization ceases immediately, and the employee may have to depart the United States.

The base filing fee for an H-1B petition is $185. There is an additional fee of $1,500 or $750, depending on the size of the employer and a separate $500 Fraud Prevention and Detection Fee. Nonprofit research institutions, higher education institutions, and government research organizations are exempt from the $1,500/$750 fee. As previously mentioned, "premium processing" currently costs an additional $1,000.

3. The L-1 Visa: Intra-Company Transferees

The L-1A and L-1B intra-company transferee visas are available to individuals who will temporarily work in the United States in an executive, managerial, or "specialized knowledge" capacity. Generally, a United States company can petition for a foreign worker if, in the three years immediately preceding the L-1 filing, the alien spent one continuous year of employment abroad with a foreign parent, affiliate, or subsidiary of the United States company.

An L-1 visa petition can also be filed by a company that seeks to establish a new United States subsidiary, branch, or affiliate. Supporting documentation must include evidence of the relationship between the foreign and United States companies, a current, valid office lease, and evidence that, within one year, the new operation will be able to support an executive or managerial position.

For existing United States offices and companies, an initial L-1 petition is granted for three years with extensions available for two-year increments. An initial L-1 application for a new office will be granted for one year with the possibility of extension. L-1A "managers and executives" may remain in the United States for seven years, and L-1B "specialized knowledge workers" may remain in the United States for five years. Like H-1B visa holders, "dual intent" is permitted for L-1 visa holders, and they may simultaneously pursue permanent residency while retaining their valid nonimmigrant status. Similar to the H-1B visa category, dependent family members may accompany the L-1 visa holder and are given L-2 status. L-2 spouses can request USCIS authorization to work in the United States.[15] Employers submitting an L petition must pay a $185 base fee and the $500 Fraud Prevention and Detection Fee Premium processing is also available for an additional $1,000.00

4. The E Visa Category: Treaty Investors and Treaty Traders

The E visa category is available to nationals from countries with which the United States has entered into certain trade and/or investment treaties. E-1 visas are available to qualified foreign nationals engaged in trade between their home "treaty" country and the United States. E-2 visas are available to qualified foreign nationals who enter to oversee "substantial investments" in the United States.

E visa applications are submitted to a United States Consulate abroad. Processing may take several weeks depending upon the consulate. E visas are generally issued for a period of up to five years and allow for multiple entries into the United States. Upon entry into the United States, an E visa holder is generally issued an initial period of stay up to two years, which can be extended by traveling abroad or by applying to the USCIS prior to the expiration of the alien's authorized stay. Spouses and children under the age of 21 are granted the same visa status as the principal applicant. E-2 dependent spouses can request USCIS authorization to work in the United States.

In order to qualify for an E-1 visa, the following requirements must be met: (1) nationals of the specific treaty country must hold at least 50% of the outstanding shares of the proposed United States employer; (2) over 50% of the trade conducted by the United States employer must be with the treaty country of the *trader's* nationality; and (3) the individual assigned to the United States employer must be a national of the specific treaty country. Two classes of employees can enter the United States on E-1 status: (1) those serving in a high-level managerial or executive

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15 <http://uscis.gov/graphics/formsfee/forms/>.

capacity with supervisorial responsibility and (2) those serving in a “non-supervisory capacity” and possessing “specific qualifications that will make his or her service essential to the efficient operation” of the enterprise.

The E-2 visa enables treaty nationals to come to the United States to develop and direct the operations of a United States enterprise in which they or their fellow nationals have made or are about to make “substantial investment.” The following criteria apply to the E-2 visa: (1) the applicant must be a national of a “treaty” country; (2) treaty nationals must have invested, or be actively involved in the process of investing, a “substantial amount” (*e.g.*, an actual, at-risk investment of at least 50% of the value of the enterprise, including leverage financing) of capital in a real operating commercial enterprise in the United States; (3) the treaty nationals must have at least a 50% interest in the business; (4) the investment tends to expand existing job opportunities; and (5) the investment has not been made solely for the purpose of earning a living. Two classes of employees are eligible for E-2 status: (1) those serving in an executive or high-level managerial capacity with supervisorial responsibilities and (2) those providing an essential skill or specialized technical capacity and who are required to establish the enterprise (start-up), train or supervise persons serving in technical positions (such as manufacturing, maintenance, or repair technicians), or continuously monitor and develop product improvement and quality control.

5. The North American Free Trade Agreement (“NAFTA”)

NAFTA creates four nonimmigrant visa categories for Canadian and Mexican professionals seeking to enter the United States to engage in professional activities: NAFTA professionals, temporary visitors for business, intra-company transferees, and treaty traders and investors. Qualifications for the last three categories are similar to those described above for the B-1, L, and E visa categories.

The most commonly used category under NAFTA for obtaining work authorization is the NAFTA professional, otherwise known as a TN. A TN applicant must show that he or she meets the qualifications for one of the professions in the Treaty Schedule (which includes 63 professional activities) and that she or he will engage in activities for a United States employer at a professional level. Although most of the categories require a bachelor's degree or a technical license, certain professions, such as that of management consultant, require only work experience in the field in which the professional activity is sought. The TN employee may not be self-employed in the United States. If he or she is a majority owner or controls the operation of a United States company, he or she does not qualify for TN status.

Canadian professionals do not require USCIS pre-approval for TN status and may apply for TN admission directly at a United States port of entry. Mexicans must first obtain a visa before entering the United States.

TN status is valid for one year and may be renewed each year. Renewals for management consultants can be difficult as they may only be admitted to work on discrete projects with a defined ending date. Although there is no limit on the number of renewals available to a TN applicant, TN applicants must demonstrate nonimmigrant intent. Therefore, TNs wishing to obtain legal resident status in the United States are advised to change their status to H-1B before applying for an immigrant visa.

6. The O and P Visas: Aliens of Extraordinary Ability

The O-1 visa category is available for aliens of "extraordinary" ability in the sciences, arts, education, business, or athletics. O-2 visas are used for certain aliens accompanying or assisting O-1 aliens. The O-1 visa category can be extremely useful for individuals without professional degrees.

Depending on the profession, the USCIS applies three separate standards to O-1 adjudications: (1) the highest, "extraordinary ability" standard, which applies to aliens who have risen "to the very top of their field" in the sciences, education, business, and athletics; (2) an intermediate standard that applies to aliens of extraordinary achievement in the motion picture or TV industries; and (3) a less rigorous standard that applies to individuals in the arts.

The P visa category includes the P-1, P-2, P-3, and P-4 classifications. P-1 visas are generally available to internationally known athletes who compete individually or as part of a team at an internationally recognized level. P-2 visas are available for artists performing under the auspices of a reciprocal exchange program. P-3 visas are designed for "culturally unique" entertainers. These three classifications include accompanying personnel. The P-4 category is for the dependents of aliens in the foregoing categories.

7. Employment of Foreign Students

Generally, foreign students (F-1) and exchange visitors (J-1) (*e.g.*, students attending a full-time program at a United States university or college) are able to work for a United States employer in practical or academic training that is directly related to the student's course of study.

For F-1 students, two types of practical training exist: curricular practical training and optional practical training. Curricular practical training must be an integral part of the established curriculum and authorized by a Designated School Official. The student need not obtain prior USCIS approval. Students who receive one year or more of curricular practical training may not undertake optional practical training.

Optional practical training requires prior USCIS approval, is granted for a maximum 12-month period, and must be completed within 14 months of completion of the educational program.

J-1 exchange visitors are often granted up to 18 months of post-completion academic training and do not require separate employment authorization from the INS.

At the end of the authorized period of training, the foreign student is no longer authorized to work in the United States. It is not possible to extend the period of training. If an employer wishes to continue to employ the student beyond the authorized period, the employer must file a petition to change the student's status to another nonimmigrant visa category (*e.g.*, H-1B visa).

B. Changing to Permanent Resident Status

There are many ways to seek permission for the alien to work and live in the United States on a permanent basis. Most employment-based immigrant visa categories require a "permanent" job offer in the United States. The employer generally files an immigrant visa petition on behalf of the employee. Once the immigrant visa is approved, the employee can seek lawful permanent residency via adjustment of status in the United States or processing through a United States embassy or consulate abroad.

The job offer must typically remain valid throughout the immigration process. However, an employee whose adjustment of status application has been pending for more than 180 days can now change jobs or employers without invalidating the underlying immigrant visa petition, as long as the new job is in the same job classification as the position identified in the immigrant visa petition.

Sponsoring an employee for a permanent position does not create a "binding" employment relationship. The at-will employment doctrine remains in effect, and the employer may terminate the employee based on established policies and applicable legal restrictions. Similarly, after the employee obtains the "green card," he or she may quit and seek employment elsewhere. Frequently, employers who sponsor an employee for an immigrant visa include incentives and/or disincentives in the employment contract to prevent the employee from leaving the employer after obtaining his or her "green card."

1. Labor Certification and Immigrant Visa Processing

Unless a foreign national can be considered a "priority worker" or "special immigrant," an employer must obtain an approved labor certification from the DOL before seeking an immigrant visa for the alien. Labor certification requires that an employer show that there are no qualified and available workers to fill the position.

a) The Labor Certification Process

The DOL has recently implemented its long anticipated PERM process for labor certification. The DOL states that the PERM program, which went into effect on March 28, 2005 "will improve services to [its] various stakeholders." Applications filed before March 28, 2005 will continue to be processed under the old rules at Backlog Elimination Centers. New applications under PERM are filed at the appropriate National Processing Center after the employer conducts requisite recruiting for the position and obtains a prevailing wage determination from the relevant State Workforce Agency. The DOL may deny an application if it determines that a United States worker was qualified for the job, the wage offered was too low, the requirements were too restrictive, or the employer did not conduct adequate recruitment.

Under both PERM and its predecessors, once the labor certification is approved, the employer submits an immigrant visa petition to the USCIS, along with evidence that the alien is qualified for the position and that the employer has the ability to pay the wage offered. The alien cannot rely on experience gained through the petitioning employer to establish that he or she is qualified for the job. In general, the immigrant visa process takes less than one year. Once the immigrant visa petition is approved, the alien must wait for a visa to become available in order to complete the immigration process. Visas are available based on the date the PERM labor certification application is filed. This date is known as the alien's priority date. If the priority date is current, the alien may apply for lawful permanent residency immediately upon receipt of the approved immigrant visa or, if already in the U.S., may apply concurrently with the submission of the immigrant petition to adjust status to that of legal permanent resident.

b) Priority Workers and Special Immigrants

Certain foreign nationals are exempt from the labor certification process. "Priority workers" include multinational executives and managers, outstanding researchers and professors, aliens with advanced degrees or exceptional ability whose employment is in the national interest, and aliens of extraordinary ability in the arts, sciences, athletics, education, or business. "Special immigrants" include religious workers, aliens who invest $1,000,000 in a commercial enterprise, and visa lottery winners. Where no labor certification is required, the priority date is the date the immigrant visa petition is filed with the USCIS.

c) Multinational Executives and Managers

Aliens employed by a foreign entity in a managerial or executive capacity for one continuous year may apply for lawful permanent resident ("LPR") status in the multinational executive category. Frequently, such employees are already in the United States in either L-1A or E visa status. This category requires the submission of documentary evidence to demonstrate the alien's qualifications as a manager or executive, as well as the ongoing commercial activity of the United States entity. The USCIS places considerable emphasis on the number of workers employed by the United States entity and the nature of the job duties to be performed by the manager or executive.

d) Outstanding Professors and Researchers

Professors and researchers must establish at least three years of research experience and that they are considered among the "very top" of their field. Relevant evidence includes the alien's professional publications, awards, invitations to conferences, and support letters from notable institutions and/or experts in the alien's scientific or academic field.

e) National Interest Waivers

Aliens who possess advanced degrees, or who are determined to have exceptional ability in the sciences, arts, or business, and who are employed in a position that is of national interest are exempt from the labor certification requirement. This immigrant visa category includes a wide range of scientific, artistic, and business-related fields. Substantial documentary evidence must be submitted that demonstrates the alien's experience and qualifications and that the position results in a benefit to the United States as a whole, and not merely to a limited geographic region.

f) Aliens of Extraordinary Ability in the Sciences, Arts, Education, Business, or Athletics

Aliens included in this category are those who are determined to be in "that small percentage who have risen to the very top" of their field of endeavor. Again, this immigrant visa category covers a wide range of professions and, in all cases, involves highly accomplished individuals. Unlike virtually all employment-based immigrant visa categories, aliens in this category do not require a job offer and may file a petition on their own behalf.

g) Immigrant Investor Visa Category

An alien who invests $1 million (or $500,000 in a region with high unemployment or a rural area) in a new commercial enterprise that will create at least 10 full-time jobs may file an immigrant visa petition on his or her own behalf. The alien must establish that the investment is "at risk" and that the investment is derived from a "legitimate" source. Obtaining approval of an immigrant visa in this category is frequently based on whether the investment is found to be a permissible equity investment or an impermissible debt obligation.

h) Visa Lottery

For the past several years, certain nationals have been eligible to apply for an immigrant visa through the diversity lottery program. Fifty-five thousand visas are available for winners of the lottery. However, the USCIS picks over 100,000 names, and each winner must complete the immigration process in order to qualify for a green card under the lottery program. An applicant for the lottery must have a high school diploma or its equivalent and, within five years of applying, at least two years of work experience in an occupation requiring at least two years of training or experience.

CHAPTER 8

LITIGATION AND ALTERNATIVE DISPUTE RESOLUTION

This chapter is aimed at providing a basic overview of the dispute resolution process in both the federal and the state courts. It will begin by describing the basic stages of litigation, from the initial pleadings through jury selection, trial, and the different forms of available relief for the prevailing party. It will also focus on certain aspects of the dispute resolution process in the U.S. that make it unique, including extensive party-initiated pre-trial discovery, the use of juries to adjudicate the facts in civil trials, and the availability of punitive damages.

The unique operation of the judicial system in the United States can be a source of anxiety for foreign businesses and lawyers. However, an understanding of the basic structures and procedures with which to navigate the legal system should help foreign businesses and lawyers discover the aspects of the United States system that can provide them with a competitive advantage, as well as the aspects that might be adverse to them. This chapter will conclude with an overview of the use of alternative dispute resolution ("ADR") in state and federal courts, including information on ADR providers and ADR procedures unique to California.

A. The Law in the United States

There are two forms of law in the United States: (1) statutory law, which consists of laws made by the United States Congress and state legislatures; and (2) common law, which consists of laws made by judges. Federal statutory laws become codified upon passage by the United States Congress and will be enforced by courts across the country. State statutory laws become codified upon passage by a state legislature and will be enforced within the state. Common law is made up of case law — the decisions of judges become law through the doctrine of *stare decisis*.[16] When a lawyer in the United States needs to determine the current status of the law on a particular issue, he or she cannot simply look to an established code or statute to find the answer. Rather, lawyers practicing in the United States must look to a combination of statutory and case law. This may mean that the answer to a seemingly basic question such as "What is the law on this issue?" may actually require extensive research in order for a lawyer to provide an accurate and adequate response.

B. The Trial Process

1. Establishing Jurisdiction

Before a litigant can initiate any litigation in a state or federal court, it must be determined whether the court has jurisdiction to preside over the case. There are

[16] *Stare decisis* is Latin for "let the decision stand." The reliance that courts in the United States put on previously decided cases in deciding new cases is known as *stare decisis*. *Stare decisis* does not prevent a court from overruling its own previously decided cases and in effect creating new law. However, the doctrine of *stare decisis* and the reliance on precedent does discourage rapid changes in the law that might undermine the stability of the law and the ability of people to rely on the law as it has been interpreted before.

three basic types of jurisdiction: (1) jurisdiction over the person; (2) jurisdiction over the subject matter; and (3) jurisdiction to render the particular judgment sought. The constitution or the legislation of the state or federal government establishes the jurisdiction of the courts.

A court's jurisdiction over the person or parties in the litigation is the court's authority to bind its decision on parties, or resolve claims disputed, in the lawsuit. For state courts, personal jurisdiction, the court's authority over actual persons involved in the lawsuit, generally extends to residents of the state plus persons or businesses conducting business in the state. In federal courts, it extends to persons or entities violating federal law. Territorial jurisdiction is the court's power to bind the parties to the action, and determines the scope of federal and state court power.

Subject matter jurisdiction is the court's authority to decide certain types of lawsuits. State courts have general jurisdiction, meaning that they can hear any controversy except those prohibited by state law. (Some states, for example, deny subject matter jurisdiction for a case that does not involve state citizens and did not take place in the state). Some issues are specifically allocated to the exclusive jurisdiction of the federal courts (such as bankruptcy issues). Federal courts have limited jurisdiction in that they can only hear cases that fall within the scope defined by both the United States Constitution in Article III, § 2, and Congressional statutes.

2. Pleadings: Complaint, Answer, Motions to Test the Complaint

After establishing jurisdiction, the pleading is the beginning stage of a lawsuit in which parties formally submit their claims and defenses. Pleadings generally include the relevant facts and the remedy sought. The pleadings provide notice to the defendant as to the fact that an action has been initiated as well as to the nature of the allegations. The plaintiff files a complaint stating the issue(s) in controversy, known as the cause of action. The defendant then files an answer stating any defenses or denials. The defendant may also submit a counterclaim initiating a separate cause of action against the plaintiff. In state court, pleadings are generally governed by state procedural rules. In federal court, pleadings are generally governed by the Federal Rules of Civil Procedure. *See* Fed. R. Civ. P. 27-37.

3. Discovery in the United States

The United States has the most liberal party-initiated pre-trial discovery rules in the world. Unlike civil law countries, where discovery (particularly pre-trial discovery) is restricted, the United States system allows parties to access information from both documents and witnesses before the trial begins. This liberal discovery policy may be perceived as intrusive and disruptive in allowing parties to sift through and collect a vast amount of information from witnesses and documentary sources. Under the Federal Rules of Civil Procedure, parties have the right to request any information that is relevant to the case. The information need not be admissible — indeed, it need not meet the materiality standard.

Although the discovery process in the United States has been heavily criticized, and is certainly subject to abuse, it can be used to uncover important facts before the trial. Foreign clients and attorneys can certainly use the liberal discovery policies to gain strategic advantages in the litigation process. Furthermore, if a court concludes that an attorney is abusing discovery to intimidate or harass the opposing party or to substantially delay the proceedings, the Federal Rules of Civil Procedure provide that the court may sanction the offending party. Many states have taken steps to further rein in liberal discovery practices. For example, California enacted the Discovery Act of 1986 to clarify the earlier California Civil Discovery Act as well as to address some of the discovery abuses that occurred under the former discovery rules. The Discovery Act of 1986 included a non-exclusive list of discovery abuses that were subject to sanctions. California now limits the use of interrogatories and depositions. *See* Cal. Civ. Proc. Code §§ 2030(c)(1), 2025(t).

A litigant uses several tools in the discovery stage of litigation. A litigant can seek an affidavit, a sworn statement in writing made under oath or on affirmation before an authorized magistrate or officer. A deposition is a statement made under oath by a party or witness in response to oral examination or written questions and recorded by an authorized officer. In discovery, an affidavit can be used to preserve the testimony of a witness who is likely to become unavailable for trial, or to impeach the testimony of a witness at trial. Depositions are distinguished from affidavits by the requirement that notice and an opportunity to cross-examine the deponent must be given to the other party.

An interrogatory is a written question directed by one party to another regarding information that is within the scope of discovery. Interrogatories are frequently used by litigants in civil litigation matters. An interrogatory may be objected to and does not have to be answered if the court determines that it is excessive or burdensome. An interrogatory may also be submitted by a judge to a jury when the court asks for a general verdict and wants to know the basis of the decision, or when the court requires the jury to return a special verdict.

In order to obtain documents from the other party in discovery, the litigants must issue formal document requests that conform to various local and state or federal rules. For example, the California Code of Civil Procedure requires that requests describe each item with reasonable particularity from the perspective of the responding party. *See id*. § 2031(c)(1).

4. The Jury System

The United States is not unique in its use of jury trials for civil cases. However, its use of juries is much more pervasive than in other countries. For example, in some countries, judges determine damages, not juries. Even in countries that do allow jury trials in civil cases, their use is much more limited than in the United States. Attorneys practicing primarily in other countries may be interested to learn that United States courts have considered the question of abolishing juries altogether or using so-called professional jurors for especially complex litigation such as patent cases, but have also expressed concerns over the parties' Seventh Amendment right to a jury trial.

Despite the criticism, juries are still widely utilized, and courts continue to uphold the right to a jury trial. Indeed, one of the strongest decisions supporting juries despite the complex nature of a case was handed down by the Ninth Circuit (of which California is a part). The Ninth Circuit overturned a lower court and disagreed with the basic premise that a judge could do a better job of deciding complex issues than jurors and questioned how one could draw a comprehensible line between cases that are too complex for juries and cases that are not. *In re U.S. Financial Securities Litigation*, 609 F.2d 411 (9th Cir. 1979). The Ninth Circuit indicated that it would be better for a judge to use his or her oversight powers to direct the proceedings by appointing a special master to aid jurors during trial or to invoke procedural checks to grant a new trial or issue a judgment notwithstanding the verdict. *Id.* at 432.

The right to a jury trial in a civil suit in federal court is guaranteed by the Seventh Amendment[17] to the United States Constitution, and most state constitutions also afford such a right, at least for some cases. In the federal system, the Jury Act calls for random selection of citizens' names from voter records. Some courts supplement voter lists with such sources as lists of licensed drivers or tax rolls. In California, all United States citizens who are over the age of 18, a resident of the county that issued the jury summons, and able to understand the English language are eligible to serve on a jury in the state of California. Of these people, only convicted felons, meaning anyone who has been found guilty of a serious crime, cannot serve.[18]

The jury selection process in California begins with the judge requesting a panel of prospective jurors to be sent to the courtroom from the jury assembly room so that the jury selection process can begin. The clerk calls 12 or more jurors to the

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[17] Note that a jury trial is not available in some civil cases.

[18] California Courts, The Judicial Branch of California website, The Jury, *available at* <www.courtinfo.ca.gov/jury>.

courtroom, where the judge and the attorneys ask jurors questions to determine if the jurors are free of bias and impartial. This process is called voir dire. A trial jury generally consists of 12 persons; however, in civil actions and misdemeanor cases, a jury may consist of fewer than 12 persons when the parties to the action so agree in open court. *See* Cal. Const., art. I, § 16; Cal. Civ. Proc. Code § 220.

The law allows the judge and the lawyers to excuse individual jurors from service for various reasons. If a lawyer wants to have a juror excused, he or she must use a "challenge" to excuse the juror. Challenges can be for cause, or they may be peremptory. There are a number of reasons why a juror can be challenged "for cause." For example, a juror who is related to or employed by one of the parties in the case may be excused for cause. There is no limit to the number of "for cause" challenges that may be used. Peremptory challenges can be used without giving a reason — each side may ask the judge to excuse particular jurors. The California state legislature has limited the number of peremptory challenges to 10 for criminal cases and 6 for civil cases.

After the closing arguments of the trial (or immediately before the closing arguments), the judge will explain the law that applies to the case before the jurors. The jurors must then apply the law to the facts as they heard them in arriving at their verdict. The standard of proof that is applied depends on whether the case is a civil or criminal matter. In a civil case, a party suing another has to prove its case by a preponderance of the evidence or on a balance of probability. A higher standard is required for criminal cases, and the defendant must be proved guilt beyond a reasonable doubt in order to sustain a guilty charge.

The jury will then deliberate and vote on a verdict. In a civil case, three-fourths of a jury must agree in order to reach a verdict. A judge, in his or her discretion, may dismiss a jury if it cannot arrive at a verdict within a reasonable time and notifies the judge that it cannot reach a verdict. If this situation occurs, the judge declares a mistrial, and the case will go to a new trial with a new jury. The jury's verdict does not take effect until the judge enters a judgment on the decision — the judge must order that the verdict be filed in public records.

5. Remedies and the Unique Nature of Punitive Damages in the U.S.

A litigant can seek (and a jury can award) a number of different forms of remedies to enforce a right or obtain redress for a wrong. Examples of remedies include damages, restitution, specific performance, or an injunction. These forms of redress are likely to be familiar to most attorneys practicing outside the United States. However, one form of damages, punitive damages, is a form of damages most other countries do not recognize. Even among the few other countries that do permit punitive damages, the United States legal system appears to produce more and larger punitive damage awards.

However, recent massive awards of punitive damages in the United States have brought punitive damages under attack by practitioners, business leaders, and judges. The now-famous McDonald's coffee spill case resulted in a jury award of $2.9 million in punitive damages after a woman spilled hot coffee on herself while holding it between her knees and attempting to open it. The trial judge reduced the punitive damage award to $480,000, but the impact of the initial jury verdict on public opinion was great. *Liebeck v. McDonald's Restaurants*, No. CV-930-02149, 1994 WL 360309, at *1 (N.M. Dist. Ct. Apr. 18, 1994). In *Pennzoil v. Texaco*, 481 U.S. 1, 4 (1987), a jury initially awarded nearly $11 billion against Texaco, which included almost $3 billion in punitive damages.

Not only the size of punitive damage awards, but also their apparent lack of uniformity or predictability, can be unsettling to foreign corporations. The United States Supreme Court has consistently refused to adopt any strict formula for computing punitive damages awards in federal courts.

Nevertheless, there are limits imposed by judicial review as well as the United States Constitution's guarantee of due process. In an attempt to provide businesses with a better sense of the type of actions that would justify a large punitive damages award, the United States Supreme Court established three guideposts to determining the acceptable level of punitive damages: (1) the degree of reprehensibility of the defendant's conduct; (2) the relationship between the punitive award and the actual or potential harm suffered by the plaintiff; and (3) the similarities and distinctions between the punitive award and comparable civil or criminal sanctions. *See BMW of North Am. v. Gore*, 517 U.S. 559, 574-75 (1996).

Companies doing business in the United States and in California in particular should be encouraged by the fact that both federal and state courts have firmly established that punitive damages are subject to the sort of judicial review that would enable a judge to apply the three guideposts described above or other criteria to determine whether a punitive damage award is too high.

6. The Appellate Process

If one party feels that an error of law has been made during the trial, and the trial judge refuses to grant a post-trial motion for a new trial, then the dissatisfied party may appeal to a higher court. Typical grounds for appeal include the wrongful admission of evidence by the judge, the refusal by the judge to admit evidence that should have been allowed, or failure by the judge to give proper jury instructions. An appeal is not a retrial or a new trial of the case but a review of the legal decisions of the lower court. Appellate courts do not usually consider new witnesses or new evidence, and generally accept the trial court's or jury's findings of fact.

C. Alternative Dispute Resolution

Alternative Dispute Resolution ("ADR") refers to any means of settling disputes outside the courtroom. ADR typically includes arbitration, private judging, mediation, early neutral evaluation, and conciliation. With federal and state courts facing an increasing backlog of cases, and litigants facing rising costs of litigation and time delays, more states have begun experimenting with ADR programs. Some of these programs are voluntary; others are mandatory. Federal and state laws support the increased usage of ADR. For example, Title 9 of the United States Code establishes federal law supporting arbitration, one form of ADR. Most states also acknowledge the growing importance of ADR. For example, in California, section 465 of the California Business and Professions Code encourages greater use of alternatives to the courts, such as mediation, conciliation, and arbitration. *See* Cal. Bus. & Prof. Code § 465(b).

1. Arbitration and Mediation

The two most common forms of ADR are arbitration and mediation. The biggest provider of arbitration services is the American Arbitration Association ("AAA").[19] With arbitrations, both parties have to agree that the best way to resolve a dispute will be through arbitration and that they will accept the decision of the arbitrator as a binding one. Arbitration is generally a simplified version of a trial, where a neutral adjudicator (the arbitrator) reviews evidence, hears arguments, and makes a decision to resolve the dispute. Arbitration agreements may provide for the submission of an existing dispute (submission agreements) or future dispute (predispute agreements) to arbitration. Both state and federal law explicitly provide that written arbitration agreements are valid, enforceable, and irrevocable, except on grounds that exist for the revocation of any contract. *See* Cal. Civ. Proc. Code § 1281; 9 U.S.C.A. § 2. The California Arbitration Act applies to all agreements for arbitration. *See* Cal. Civ. Proc. Code §§ 1280-1294.2. Selecting the arbitrator can be a contentious issue: either both sides agree on one arbitrator, or each side selects one arbitrator and the two elect the third to comprise a panel.

The Federal Arbitration Act preempts state law when it comes to arbitration for contracts involving interstate or foreign commerce or maritime transactions that

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[19] For more information on American Arbitration Association services and providers, see their website at <www.adr.org>.

provide for the settlement of controversies by arbitration. *See* 9 U.S.C.A. §§ 1-14. Unless specifically provided otherwise in the arbitration agreement, contractual arbitration awards are treated as final and binding. Judicial review is very difficult to obtain, and court involvement in contractual arbitration proceedings is limited to very specific circumstances, such as compelling arbitration when a party to an arbitration agreement refuses to arbitrate voluntarily, staying court proceedings of issues that are subject to an arbitration agreement, and appointing an arbitrator when the parties cannot agree on a method of appointment. *See* State of California Task Force on the Quality of Justice, Subcommittee on Alternative Dispute Resolution and the Judicial System, *Report on Alternative Dispute Resolution* (Aug. 1999).

In mediation, a neutral adjudicator (the mediator) assists the parties in reaching their own mutually acceptable resolution. A mediator helps parties reach their own resolution of a dispute — the mediator does not decide how to resolve the dispute. Unlike arbitration, there is no statutory scheme that establishes the enforceability of agreements to use mediation or settlement agreements reached in mediation. While there are statutes that mandate the use of mediation in certain circumstances, the main statutory provisions regarding mediation establish the confidentiality of the process. *See* Cal. Evid. Code §§ 1115 *et seq*. Mediation is intended to be a cooperative process, and may be particularly useful for companies that intend to do business with each other in the future. JAMS/Endispute is the largest provider of mediation services. Typically, JAMS/Endispute offers panels of retired judges compensated by the hour to serve as mediators of disputes.

Another form of private ADR is private judging. In California, when parties select to use private judging, they agree to have their case adjudicated by a neutral person compensated by the parties and appointed by the court either as a temporary judge pursuant to Article VI, § 21, of the California Constitution or as a referee pursuant to California Code of Civil Procedure section 638. Article VI, § 21, of the California Constitution allows parties to stipulate to having their case tried by a temporary judge on a privately compensated basis. In a similar fashion, California Code of Civil Procedure section 638 permits parties on a consensual basis to have a privately compensated referee try issues in their case. The person selected as either a temporary judge or a referee is appointed by the public court and hears the matter and renders a decision in almost the same manner as a judge in the public court system would. Private judging differs from other forms of ADR in that the decision of the privately compensated temporary judge is entered as the decision of the public court, and the parties have the same appellate rights as they would with any public court decision. *See* State of California Task Force on the Quality of Justice, Subcommittee on Alternative Dispute Resolution and the Judicial System, *Report on Alternative Dispute Resolution* (Aug. 1999) at 31.

2. Court-Ordered ADR

A judge may order the parties to submit to ADR process. California Code of Civil Procedure § 638 establishes when and how a court can refer a case (or parts of a case) to a "referee." This section provides for voluntary referees, and is one of the bases through which private judging takes place in California. Section 639 of the California Code of Civil Procedure allows courts to order *nonconsensual* referees in specific circumstances.

Judicial arbitration is a mandatory non-binding arbitration program established by statute. *See* Cal. Civ. Proc. Code §§ 1141.10 *et seq*. The statute states that superior courts with 10 or more judges, or 18 or more judges in a county in which there is no municipal court, must submit to arbitration most civil cases other than limited civil cases, in which the amount in controversy is $50,000 or less. *See id.* § 1141.11.

Other superior courts may adopt a similar program. To determine if one is in a jurisdiction with such a provision, one must read the local court rules. As of August 1999, judicial arbitration programs were required in 16 superior courts, including San Francisco and Los Angeles. The Subcommittee on Alternative Dispute Resolution determined through a review of local court rules that superior courts in 28 other counties have also voluntarily adopted judicial arbitration programs. *See* State of California Task Force on the Quality of Justice, Subcommittee on Alternative Dispute Resolution and the Judicial System, *Report on Alternative Dispute Resolution* (Aug. 1999) at 60. In any court with a judicial arbitration program, parties may stipulate to submit any civil case to the program, regardless of the amount in controversy. Cases in which the plaintiff chooses arbitration and agrees that the arbitration award will not exceed $50,000 are also subject to arbitration. *See* Cal. Civ. Proc. Code § 1141.12.

Unless the parties stipulate that a non-attorney may serve as arbitrator, the arbitrators in judicial arbitration programs must be retired judges, or retired court commissioners who were licensed to practice law before appointment as a commissioner, or members of the California State Bar. *See id.* § 1141.18. The awards made in judicial arbitration are final and become the judgment of the court unless a trial *de novo* is requested. Any party may choose to have a trial *de novo* within 30 days of the filing of the award by the clerk. *See id.* § 1141. However, if the party who requested the trial does not obtain a more favorable judgment at trial, that party must pay the costs of the arbitration as well as certain of the other party's litigation costs. *See id.* § 1141.21.

3. Advantages and Disadvantages of ADR

Proponents of ADR claim that one of its advantages is the faster resolution of disputes. The simplified procedures and earlier resolutions ADR can offer can also save money on court costs, fees for attorneys and expert witnesses, and other litigation costs such as discovery, motions, court conferences, and witness preparation. Some proponents of ADR also assert that it can provide greater satisfaction overall for all parties involved in the dispute resolution process. ADR can be flexible, allowing the parties to select the process that is best for them. ADR processes can also be cooperative and permit more participation than in a typical court case. Parties may feel more invested in the process and have more control over the outcome than they would in the courtroom.

However, ADR may not be the appropriate option for every dispute; the decision not to use the traditional litigation route has disadvantages as well. In processes like binding arbitration, parties usually give up most court protections, including procedural protections, a decision by a judge or jury under established rules of evidence, and the ability to appeal an unfavorable decision. Furthermore, in ADR, the procedures and time that allow a party to learn about the other side's case are non-existent. Private ADR can be expensive, and if the dispute is not resolved, the parties may have to invest time and money in both ADR and a lawsuit. Parties who are engaged in ADR, but who may have to resort to a lawsuit, must also be aware that while they are involved in ADR processes, the statute of limitations on their court case still applies, and time continues to run. Many practitioners and legal observers are also alarmed at the growing ADR phenomenon because ADR proceedings and settlements are secret. No legal precedent is established, and the legal system as a whole may suffer.

CHAPTER 9

REAL ESTATE LAW

Real estate law in California includes important common law principles as well as extensive statutory requirements. This chapter provides an overview of real estate law in California, organized around the broad topics of the purchase and sale, financing, and leasing of real estate. This chapter primarily relates to commercial real estate transactions, with occasional references to special legal requirements applicable only to residential real estate.

This chapter provides basic information about the various legal issues involved in buying, selling, leasing, or financing commercial real estate, and as such it should be treated as an introduction to the subject, not an exhaustive treatise on California real estate law. Because of the generality of this material, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice taking into consideration all of the facts of the transaction.

A. Transfer of Real Estate

1. Disclosure Obligations of Sellers of Commercial Property

a) Common Law Duty

Sellers of commercial property have a duty to disclose all known material information about the property to prospective buyers, although their disclosure obligations are not as detailed and stringent as those imposed by statute on sellers of residential property. A seller of commercial property has a legal obligation to voluntarily disclose facts that materially affect the value or desirability of the property, that are known or accessible only to the seller, and that the seller should know cannot be discovered by the buyer. Generally, a matter is "material" if the buyer would not have entered into the contract had he or she known the facts.

An "as-is" clause in a sales contract will not relieve the seller of the duty to disclose material facts affecting the property which fall within the disclosure parameters described above, or to deliver a Natural Hazards Disclosure Statement (see discussion below) applicable to the property. However, an "as-is" clause otherwise puts the buyer on notice that the property is being sold subject to all defects and conditions of the property, whether or not actually known to or discovered by the buyer.

b) Natural Hazards Disclosure Requirements

In addition, a seller must notify the buyer of specified natural hazards that may affect the property. If the property is within an earthquake fault zone, a seismic hazard zone, a special flood hazard area, an area of potential flooding, or a wildland fire hazard area, this fact must be disclosed on a Natural Hazard Disclosure Statement.

Earthquake fault zones and the broader seismic hazard zones are identified on maps prepared by the California Division of Mines and Geology, and sent to local jurisdictions. Flood hazard areas are shown on maps prepared by the Federal Emergency Management Agency ("FEMA"), while areas of potential flooding (in the event of dam failure) are to be shown on maps prepared by the State Department of Water Resources. Similarly, wildland fire hazard zones are to be identified on maps prepared by state agencies with input from local governments. Disclosure is required only if the seller or the seller's real estate agent has actual knowledge that the property is within a delineated zone or area, *or* if the relevant map has been provided to the applicable local jurisdiction and notices have been posted in designated public offices indicating the location of the map. Certain limited exceptions to this disclosure obligation have been carved out by statute.

Since this law went into effect in the 1990s, private companies have sprung up to prepare natural hazard disclosure reports for a nominal fee. Although sellers often use these reports for disclosure purposes, they remain liable for any errors contained in such reports.

c) Environmental Disclosure Requirements

California has also enacted laws concerning disclosure of environmental hazards which supplement the common law duty discussed above.

The Hazardous Substance Account Act, Cal. Health & Safety Code § 25359.7, requires property owners to notify buyers and lessees in writing, prior to a purchase or lease transaction, of any material releases of hazardous substances that the seller knows, or has reasonable cause to believe, have come to be located on or beneath the property. Such disclosure might include any knowledge the seller has of historic uses of the property which could have involved the release of hazardous substances, as well as releases arising out of the seller's operations on the property. If the seller knowingly and intentionally fails to disclose a material environmental hazard to the buyer or lessee of which the seller had actual knowledge, the seller may also be subject to civil penalties.

The Hazardous Waste Control Law, Cal. Health & Safety Code §§ 25202.5, 25220-25241, requires all property owners within 2,000 feet of a significant deposit of any hazardous substance to seek a determination concerning the status of their property as "hazardous waste property," "border zone property," or "buffer zone property" prior to any subdivision or development of their property. Property so designated is subject to strict limitations on permissible development. Notice of this designation, in the form of a deed restriction, must be recorded against the property in some cases.

California has other hazardous substances liability statutes that apply to property owners. (*See* Chapter 10, Land Use, Zoning and Property Development Laws, for a more detailed discussion.) A seller with knowledge of any violation of such laws must disclose that fact, whether or not a particular law includes a specific disclosure requirement in the context of a sales transaction.

d) Investigation and Seller Liability

Physical defects or hazardous substances problems are not always readily discoverable through visual inspection or even inspection by an independent consultant. The law is not entirely clear on when a problem will be deemed sufficiently "obvious" for purposes of placing some responsibility on a buyer to discern it during its due diligence. For this reason, the level of "reasonable inquiry" required of the buyer and the limitation on the scope of knowledge of the seller are important considerations in negotiation of the purchase and sale contract.

B. The Purchase and Sale Agreement

1. Letter of Intent

An offer to purchase commercial property often begins with a letter of intent, signed by the parties or their agents, which spells out the key business terms of the transaction, including purchase price, major contingencies and conditions, and proposed closing date. It is important to include language expressly stating that the letter of intent is an expression of the parties' understanding of the basic or principal terms of the proposed transaction, but is not a binding agreement and is not intended to create legal rights and obligations between seller and buyer. Such legal rights and obligations come into existence with the mutual execution of a purchase and sale agreement by the parties. The purchase and sale agreement is usually negotiated by the attorneys for the seller and the buyer.

2. Some Typical Contract Terms

a) Property Inspection; Closing Conditions

The purchase of a commercial property typically involves the purchase of personal property and various intangible rights as well as the purchase of the real estate, including such items as business equipment and inventory, leases and other contract rights, warranties, trade names, architectural plans and drawings, permits, development rights, and other land entitlements. The agreement will generally provide for a due diligence period during which the buyer will review such items, as well as the physical condition of the property and other information relevant to the property and the specific transaction. The buyer's acceptance of the property, upon completion of its due diligence, will be a condition of closing. In some cases, the agreement is signed only after the buyer's due diligence has been completed.

If the agreement involves development property, the buyer's property review is likely to emphasize environmental conditions, and governmental requirements under environmental, zoning, and land use laws. If the agreement gives the buyer the right to make a physical inspection of the property, or conduct any environmental testing on the property, a separate access agreement is recommended which provides for such matters as insurance, notice, scope of the inspection and nature of testing to be permitted, restrictions on the dissemination of test results, and indemnification of the seller for liabilities arising out of entry on the property by the buyer and its agents.

The agreement should also include, as a closing condition, the buyer's acceptance of matters disclosed in a title report (or seller's willingness and ability to remove title defects). Other conditions, such as the availability of financing, may be negotiated depending upon the particular facts of the transaction.

b) Escrow; Deposit

The use of a title company or its affiliate as escrow holder is the customary procedure for transacting the sale of real estate. The purchase agreement should specify the escrow holder, and escrow is opened upon the buyer's delivery of an earnest money deposit into escrow. The purchase agreement will also specify whether the initial deposit is to be increased before closing, the procedure for the release of the deposit, the terms on which it becomes non-refundable, and details regarding the payment of interest earned on the deposit, if any. If the deposit is to be retained by the seller as liquidated damages upon default by the buyer, this contract term must comply with California Civil Code §§ 1671, 1675-1681. Although some purchase agreements are set up to serve as joint escrow instructions by the parties, typically the parties' attorneys prepare and deliver separate escrow instructions.

c) Representations and Warranties

The representations and warranties section of the agreement is typically heavily negotiated, although the outcome is generally determined by the relative bargaining power of the parties. The parties typically represent to each other that they are duly organized and in good standing, that the agreement constitutes a legally binding obligation, and that the persons executing the agreement on behalf of the parties are authorized to do so. In addition, a seller may be asked to represent that performance of the agreement will not constitute a default under any other agreement to which the seller is a party, that the property is not the subject of any legal proceeding or any known violation of any building code or zoning law, and that the seller has delivered to the buyer accurate copies of specified documents regarding the property.

A buyer may also seek to obtain more extensive seller representations relating to the physical condition or operating performance or characteristics of the property, such as the absence of significant construction defects, the status of leases affecting the property, the absence of litigation, and the like. Sellers typically resist providing these representations, and the relative bargaining positions of the parties, together with the ability to obtain the relevant information from other sources (including tenant estoppel certificates), will heavily influence the final outcome of these negotiations.

When representations are made based on "seller's knowledge," sellers often seek to limit any duty to investigate the existence of the factual conditions underlying the representations by defining the term "seller's knowledge" to mean the *actual* knowledge of identified officers of the company who were directly involved in the management of the property. Sellers also commonly attempt to limit representations regarding environmental laws to specific investigations and environmental studies delivered to the buyer, and require the buyer to confirm receipt of all such environmental materials and acknowledge all specific disclosures made by the seller. In an "as-is" sale, a seller will usually attempt to include an acknowledgment by the buyer stating that the buyer is relying on its own due diligence, and not any representation of the seller, regarding the property's compliance with all environmental laws.

d) Buyer's Release

Many sellers attempt to include a provision in the agreement in which the buyer agrees to release the seller from any post-closing liabilities arising from environmental problems or physical defects overlooked by the buyer during the due diligence period. These provisions are typically negotiated, and certain limitations on the scope of such releases are relatively common. In California, unless expressly waived by the buyer, a release is limited to matters within the contemplation of the parties at the time the release is executed. Cal. Civ. Code §§ 1541-1543.

3. Title Insurance

In California, the buyer virtually always obtains title insurance. Because the standard coverage policy (referred to as a "CLTA" form) generally insures matters of record only, institutional buyers usually opt for extended coverage (referred to as an "ALTA" form) which insures against various off-record risks and ordinarily requires a survey. In a transaction financed by an institutional lender, an ALTA Lender's Policy is usually issued to insure the lender. In addition to the title insurance policy, title insurance companies offer various endorsements for an additional charge. Commercial buyers and lenders typically request selective endorsements to protect against particular risks discovered or anticipated in the title and property review process.

Every title insurance company must file with the California Insurance Commissioner the title insurance company's schedule of rates and forms of title policies, which must be available for view by the public. Competitive pressure keeps rates somewhat comparable; however, sometimes lower rates can be negotiated. In addition, a title company can provide a bulk rate for subdividers, and a short-rate premium when there will be an additional transaction regarding the same property occurring within a short period of time. Certain services can be provided without charge, including giving information regarding the names of record owners or the legal description of a parcel of property, furnishing a copy of a recorded deed, plat, or map, and furnishing descriptions of property characteristics. Although a title company may charge a fee to provide a preliminary report, the fee is generally credited against the premium subsequently paid for the policy.

The allocation of title insurance premiums is negotiable between buyer and seller, although the parties usually follow the prevailing custom of the county in which the property is located. Escrow charges are also negotiable, but the prevailing custom statewide is for the parties to split the escrow charges.

4. Taxes

a) Transfer Taxes

Each California county charges a documentary transfer tax of at least $1.10 per $1,000 of property net value transferred after deducting existing encumbrances. Some charge a higher rate, and, in addition, some California cities charge an additional transfer tax. For example, the City of Berkeley charges $15.00 per $1,000. The documentary transfer tax is levied against the seller. The parties may agree to have the buyer pay all or part of the tax, but the most common outcome is for the seller to assume liability for payment of the tax, and the negotiated purchase price will generally reflect this assumption. Many institutional buyers opt to record the deed separately from the statement of documentary transfer tax so as to prevent disclosing the purchase price in the public records.

b) Withholding Requirements

California law imposes withholding requirements on certain real estate transactions, similar to the requirements under the federal Foreign Investment and Real Property Tax Act (FIRPTA). Under California law, 3 % of the gross sales price of real estate must be withheld from an individual seller who is not a California resident at the time of the transfer of title, or from a corporation, limited liability company, or other business entity that is neither organized under the laws of California, nor qualified to do business in California by the California Secretary of State's Office. California Franchise Tax Form 597-W is completed by a seller claiming exemption from withholding, and deposited into escrow with the other closing documents.

c) Real Property Taxes

All California counties impose an annual *ad valorem* tax on real property within the county. California's unique property tax system is set forth in Article XIIIA of the California Constitution, which was enacted in 1978 as a ballot measure commonly known as Proposition 13. Under this provision, the maximum amount of *ad valorem* tax cannot exceed 1% of the full cash value of the property, although additional special assessments and special district taxes can also be included in the property tax bill. The full cash value is the property's value as shown on the 1975-76 property tax bill, or alternatively, the appraised value of the realty when purchased or newly constructed or when a change in ownership has occurred. A change of ownership is deemed to occur not only upon a sale of the property, but also upon the transfer (in a single transaction or related series of transfers) of a controlling or substantial interest in a corporation, partnership, or other entity holding title to the property. In the case of property where there is no new construction nor change in ownership, the full cash value may be increased annually by an inflation factor of no more than 2%. The full cash value may also be decreased if it can be demonstrated that the property has declined sufficiently in value.

The county assessor is responsible for appraising property to determine its full cash value as of the date of purchase (usually determined to be the sales price). This full cash value becomes the property's base year value, and the buyer pays an *ad valorem* tax of 1% of that base year value in the year of purchase. In succeeding years, that base year value may be increased by no more than 2%.

d) No Mortgage Tax

There is no mortgage recording or similar tax levied on indebtedness secured by real estate in California.

5. Deeds

a) Grant Deeds

California Civil Code § 1092 sets forth a simple form of deed (called a "grant deed" because it uses the term "grant" as the word for conveyance), which is the document most commonly used to transfer title to real property in California, and is the rough equivalent of a so-called "special warranty deed" or "bargain and sale deed with covenants against grantor's acts" used in a number of other states. A grant deed that conveys a fee simple estate carries with it only two *implied* covenants (unless the deed includes an express exception): (i) that the grantor has not conveyed the same estate, or any right, title, or interest therein, to any person other than the grantee; and (ii) that the estate conveyed is, at the time of execution of the grant deed, free from any encumbrance done, made, or suffered by the grantor or his or her agent. There is no covenant that the grantor has good title to the property, nor any implied warranty of the quality of the property. For this reason, grant deeds frequently contain language making the grant subject to all existing liens and encumbrances of record.

b) Warranty Deeds

Warranty deeds are rarely used in California because of the common use of title insurance. In addition to the implied covenants in a grant deed, a warranty deed expressly warrants the title to the property and the quiet possession of the property to the grantee.

c) Quitclaim Deeds

The quitclaim deed is commonly used in California to transfer the grantor's "right, title, and interest" in the described property. This form of deed transfers whatever interest the grantor may have in the property, whether legal or equitable, and does not contain any implied covenant or warranty of title.

d) Recording; Priority System

Although it is not legally required that a duly executed and delivered deed be recorded to transfer title, recordation of a deed in the public records is prima facie evidence of the validity of the transfer, and is necessary to give constructive notice to subsequent parties who deal with the property. It also establishes the date and time the buyer's interest in the property is created for purposes of establishing the priority of competing interests in the property, because California's rules of priority generally follow the "first in time, first in right" (race-notice) system.

A deed cannot be recorded without an attached certificate of acknowledgement signed by a notary or other appropriate officer. California law prescribes a form certificate for an acknowledgement taken within the state. *Id*. § 1189. If the acknowledgement is taken out of state, it must be either in substantial compliance with the California statutory form, or in the form prescribed by the laws of the state where it is taken if it does not require the notary to determine or certify that the person signing the document holds a particular representative capacity or other determination or certification not allowed by California law. California Civil Code § 1183 sets forth special requirements for acknowledgments made outside the United States.

6. Adverse Possession

The acquisition of title to real property by adverse possession in California requires that the possession must be hostile, actual, open, notorious, exclusive, and continuous for the statutory period, which is generally five years. In addition, the possessor must pay all of the real estate taxes assessed on the property during the statutory five-year period of continuous possession.

The taxes to be paid must be validly levied and assessed on the property. A person may have his or her name added to the assessment roll for a particular parcel of property by providing the assessor with a declaration that he or she is currently in possession of the property and intends to be assessed in order to perfect a claim by adverse possession. California Rev. & Tax. Code § 610. An adverse claimant must also redeem any delinquent taxes owing for prior years. Determining whether the tax requirement is satisfied can be particularly difficult in cases involving property located on a boundary because taxes are usually not separately assessed against the disputed area. For example, even if a building encroaches over the property line, the building owner would fail to meet the tax requirement if his or her assessment did not include the area of encroachment. In such a case, the claimant would have to show that the assessor's description of the property was erroneous (*e.g.*, it did not agree with the property descriptions contained in the respective deeds), or that the assessor intended to assess the disputed area to the claimant.

The five-year period begins when the possession of an adverse possessor invades the rights of the property owner in a way that is sufficient for an action by the owner to remove the possessor as a trespasser. A conveyance of the property by the true owner does not interrupt the continuity of a possessor's occupation.

Although occupation that is commenced with the consent of the owner does not meet the requirement of being adverse, permission or consent given by the owner *after* the possession has begun may not be enough to interrupt the continuity of occupation. At this point, the owner should either record a notice in the statutory form, Cal. Civ. Code § 1008, or file an action for ejectment or quiet title, at any time before the adverse possessor has satisfied all of the requirements to acquire title. The commencement of an action interrupts the five-year period even if a judgment is not obtained until after the five years have expired. Property owned by any public or governmental entity is not subject to adverse possession.

7. Laws Unique to California Affecting Title to Real Property

a) Destroyed Land Records Relief Law

This law, also called the McEnerney Act (the "Act"), Cal. Civ. Proc. Code §§ 751.01 *et seq.*, was enacted by a special session of the California Legislature in response to the 1906 earthquake and the ensuing fire in San Francisco. The Act provides that whenever land records are lost as a result of a fire, flood, earthquake, or other disaster at the recorder's office in the county where the property is located, the owner can bring a quiet title action to establish title and correct the land records. The Act sets forth a specific judicial procedure which must be followed, culminating in the recording of a certified copy of the judgment in the land records of the affected county.

b) Cullen Earthquake Act

A different kind of quiet title action is appropriate when the boundaries of land are disturbed by earth movements (such as slides, subsidence, or lateral or vertical displacements caused by man or an earthquake or other natural disaster) so that the lands are in a location different from their location prior to the disaster. A quiet title action to reestablish boundaries may be brought by the county or city in which the affected lands are located, as well as by the property owner or other person having an interest in or lien upon the affected land if granted permission by the court to bring the action and if the county is made a party to the action. (The procedural requirements are detailed in California Code of Civil Procedure §§ 751.50 *et seq.*) The court will render a judgment that includes the approval of an official map covering the affected property as a substitute for previously filed plat maps that have been rendered inaccurate by the disaster. A certified copy of the judgment is then recorded in the land records of the affected county.

C. Ways of Holding Title to Real Property

1. Individuals; Cotenancies

There are several ways in which more than one person may hold title to the same property in California:

a) Joint Tenancy

Joint Tenancy is an estate owned jointly in undivided equal shares by two or more persons. The primary characteristic of joint tenancy is right of survivorship. The creation of a joint tenancy must be by an express written declaration. A joint tenancy cannot be terminated by will. The surviving joint tenants acquire the entire estate by operation of law, thus bypassing probate.

b) Tenancy in Common

Tenancy in Common is the "residual" form of ownership for multiple interests in real property. When two or more persons acquire real property and do not expressly take title as joint tenants, for partnership purposes, or as community property, their interests are deemed a tenancy in common. There is no right of survivorship, and the interests need not be equal.

c) Community Property

Community Property is a form of ownership available only to spouses in a valid marriage. Prior to July 1, 2000, married persons could hold title to property as *joint tenants* or *tenants in common* or as *community property*. While joint tenancy has the advantage of by-passing probate, holding title as community property may have certain tax advantages in the case of appreciated property. The law was recently changed to permit married persons to hold title as *community property with the right of survivorship*, thereby combining the probate avoidance advantage of joint tenancy and the tax advantage of community property.

Because California is a community property state, if property is deemed "community property" under California law, the respective interests of the spouses in the community property during the continuance of the marriage are equal, absent a written marital agreement to the contrary. Married persons can also hold property as separate property, so long as they comply with California community property law. Both spouses must execute any instrument by which community property is sold, conveyed, encumbered, or leased for longer than one year. A buyer of property from a married seller claiming that the property is separate property should obtain a waiver or a quit claim deed from the other spouse in order to avoid the risk that the other spouse will attempt to void the transaction at a later date.

d) Other

Other forms of ownership with cotenancy characteristics have been created by statute, including *condominium* ownership, in which individuals own their own separate interests in their units and an undivided interest in common areas shared with other owners, and *cooperative housing corporations*, in which residents own shares of stock in a corporation and are entitled to possession of a unit in the building owned by the corporation. Condominiums and cooperative housing corporations are governed by the Davis-Stirling Act. Cal. Civ. Code §§ 1350-1370.

2. Business Entities

a) General Partnerships

Partnerships are associations of two or more persons to conduct a business for profit. In contrast to a limited partnership, which must file a certificate of limited partnership with the Secretary of State, a general partnership may exist without similar formalities. A statement of partnership authority may be filed with the Secretary of State, but this is not mandatory. The receipt of a share of the profits of a business is prima facie evidence that the recipient is a partner in the business. Title to real property is acquired in the name of the partnership by a transfer instrument that expressly names the partnership as the transferee, *or* names one or more partners as transferee in his or her capacity as a partner and indicates the name of the partnership. Partnership property is held by the partners as tenants in partnership, and their partnership interests are personal property.

A deed in the name of the partnership as grantor conveying partnership property in the ordinary course of the partnership business is generally effective so long as it is executed by any partner, even if the partner's authority is not in writing, unless the grantee has knowledge that the partner has no authority. However, a buyer of partnership property should obtain a properly executed statement of partnership authority that names the partner(s) authorized to execute the deed. As a practical matter, a title company will often require that the statement of partnership authority be recorded before insuring any conveyance or encumbrance of partnership property. The same principles that apply to general partnerships also govern the authority of a joint venturer to bind the joint venture.

Under federal income tax law, partnerships (both general and limited partnerships), as well as limited liability companies (LLCs) (discussed below), are considered to be "pass-through" entities, so that income and related taxes attributable to partnership or LLC business operations are levied directly on the partners or LLC members as distinguished from the partnership or LLC entity itself.

b) Limited Partnerships

Limited Partnerships formed to hold real estate record a copy of their certificate of limited partnership certified by the Secretary of State in the recorder's office of the county in which the partnership property is located. A general partner of a limited partnership has the same power to convey partnership property as a general partner in a general partnership with no limited partners. Often all general partners named in the certificate of limited partnership will sign a deed conveying partnership property. If all general partners do not sign the deed, a title company will require satisfactory documentary evidence that the signing general partner has the authority to bind the limited partnership before insuring any conveyance or encumbrance of partnership property.

c) Limited Liability Companies

Limited Liability Companies are becoming a common business form used by real estate investors to hold title to property, and are generally subject to provisions comparable to those applicable to partnerships. In order to form an LLC, one or more persons file articles of organization with, and on a form prescribed by, the Secretary of State and, either before or after the filing of articles of organization, the members enter into an operating agreement. Single-member LLCs are permitted in California. If there is more than one member, the business of the company may be conducted by a manager, who is the agent for the company. Unlike the certificate of limited partnership which must name all the general partners, an LLC's articles of organization need only state whether the company has no, one, or more than one manager, or is a single-member LLC. A manager's execution of any deed, mortgage, or deed of trust in the name of the company binds the company unless the other party to the transaction has actual knowledge that the manager does not have authority. Where the business of a company is not operated by a manager, as would generally be the case only for small enterprises, every member of the company is an agent for the company. Therefore, a party to a transaction with an LLC (and a title company insuring a conveyance or encumbrance of company property) will require satisfactory evidence of the authority of the manager or member signing documents on behalf of the company.

d) Corporations

Corporations convey corporate property pursuant to procedures set forth in the corporation's bylaws as well as statutory requirements. A deed must be executed by an officer or officers duly authorized by the board of directors to convey property on behalf of the corporation, or by an agent other than the enumerated officer(s) given such authority by resolution of the board of directors. A title company will ordinarily require a copy of the board resolution giving the officer authority to convey the property before it will insure the corporation's transfer of title. In most cases, any deed that transfers all or substantially all of the corporation's assets must be approved by the shareholders.

Except for real estate investment trusts, which are formed as corporations but enjoy special pass-through tax characteristics and treatment under income tax laws, corporations are less frequently used as the principal vehicle for holding real estate assets because of "double taxation" concerns; specifically, the corporation's net income is first taxed at the corporate level, and then any dividends derived from that corporate income that are paid to stockholders are also separately taxed in the hands of such recipients.

D. Financing Real Estate Acquisitions

1. Deeds of Trust

a) Form

For all practical purposes, mortgages and deeds of trust serve the same function in California, but the deed of trust is the more generally accepted security device. Unless otherwise indicated, this discussion applies to both security instruments, but the deed of trust terminology is used.

No particular form is required for the creation of a deed of trust. Lenders that are not financial institutions may commonly use the form of deed of trust prepared by title companies. However, for real estate loans funded by institutional lenders, the deed of trust is generally prepared by the lending institution or the lender's attorney. A large number of standard provisions are expected to be included. For example, most deeds of trust restrict transfers and further encumbrances of the real property security, although the precise wording of such restrictions as well as the scope of permitted transfers/encumbrances is typically negotiated in significant detail.

A deed of trust typically secures a loan evidenced by a promissory note. Certain provisions in the note which are not standard will also be covered in the deed of trust or alternatively in another related transaction document such as a loan agreement. For example, a deed of trust must indicate on its face if it secures a shared appreciation loan, if it secures future advances, or if the loan provides for a variable interest rate. It is also generally recommended that a deed of trust so indicate if the note includes an acceleration clause (making the entire loan balance due on default, sale, further encumbrance, or other stated event), or various other special terms specific to the transaction.

b) Perfection of Security Interest

A security interest in real property is perfected by recording the deed of trust in the office of the county recorder in the county in which the property is located. In California, the collateral secured by a deed of trust typically includes some personal property in addition to the real property. For example, the deed of trust will grant the lender a security interest in such items as fixtures attached to the real property security as well as various associated personal property and equipment and, in some instances, certain cash or reserve funds and accounts arising out of the borrower's ownership and operation of the property. In order to perfect a security interest in most types of personal property collateral, the lender must file a financing statement with the Secretary of State, in strict compliance with the procedures set forth in the California Uniform Commercial Code. In addition, for certain types of personal property collateral, such as deposit accounts and letter of credit proceeds, additional steps must be taken to perfect the lender's security interest.

c) Mechanics' Liens

Persons who furnish labor or supply materials for any construction project generally fall within the protection of California's mechanics' lien law, and as a result have a lien on the property as security for payment for their work on the project. Mechanics' liens are prior to any deed of trust or other encumbrance recorded against the property subsequent to the commencement of the construction work. Priority of mechanics' liens dates from the "commencement of work," which may involve only the construction of visible site improvements or the delivery of construction materials to the site, even though there may be no record of any mechanics' lien in the county recorder's office. Further, the priority of *all* mechanics' liens on a construction project "relates back" to the commencement of work, and all the mechanics' liens have equal priority among themselves. Mechanics' liens are thus a statutory exception to the state's general priority system.

In practice, this means that if a deed of trust securing a construction loan is recorded after the commencement of work, such as the delivery of lumber for foundation forms to the job site, the deed of trust is junior to the lumber supplier's lien as well as to all other mechanics' liens on the property associated with labor or materials provided *after* the date the deed of trust was recorded. Because of this "relation-back" principle, lenders, particularly construction lenders, typically require title insurance coverage that indemnifies them against unrecorded mechanics' liens.

Enforcement of a mechanics' lien requires strict compliance with a detailed statutory scheme. For example, a claimant must file a claim of lien within prescribed time limits, and commence suit to foreclose the action within a certain time period after the filing of the claim. Failure to comply with the statutory time limits nullifies the claim.

2. Usury Law; Exemptions

California's Usury Law is intended to protect the public from paying an excessively high price to borrow money. In general, unless an exemption applies, or the terms of the transaction are governed by the law of another jurisdiction, the permitted maximum interest rate is the greater of ten percent per annum or five percent over the federal discount rate in effect at a specified time prior to the date the loan was made or committed. The Usury Law applies both to unsecured loans and to loans secured by real or personal property, regardless of the amount of the loan. However, certain classes of lenders (as opposed to types of loans) are exempt, and thus not subject to the interest limitations of the Usury Law. These include various institutional lenders that are regulated by other state or federal agencies, including most banks and qualified savings associations, credit unions, mortgage bankers, insurance companies, certain pension and retirement funds, licensed broker-dealers, the Veterans' Administration and the Federal Housing Administration, and loans made to students, faculty, and staff by colleges and universities.

Another important exemption is for certain loans to substantial business entities for business purposes. This exemption is available for (1) loans made to or guaranteed by companies affiliated with the borrower that have total assets in excess of \$2,000,000, or (2) loans in an amount exceeding \$300,000 where the parties have a preexisting personal or business relationship or have the necessary business and financial experience to protect their own interests. Cal. Corp. Code § 25118. In addition, certain types of loans secured by real property are also exempt, including loans that are made or arranged by a licensed real estate broker, and shared appreciation loans (with respect to the contingent deferred interest component of such loans).

Violation of the Usury Law carries stiff penalties, including potential criminal and civil liability as well as forfeiture of interest on the loan, and in some instances treble damages of three times the interest collected in the year before the borrower brought suit under the Usury Law.

3. Foreclosure by Power of Sale

a) Nonjudicial Foreclosure ("Trustee's Sale")

Deeds of trust in California virtually always include a contractual provision granting to the trustee the express power to conduct a public foreclosure sale as an alternative and cumulative remedy to judicial foreclosure. California statutes provide a comprehensive framework for foreclosure pursuant to a power of sale granted in a deed of trust. This private power of sale is generally preferred by creditors because it is less expensive, quicker, and more efficient than a judicial foreclosure and because, as discussed below, a nonjudicial foreclosure sale is final and eliminates any post-sale right of redemption.

b) Notice of Default

A foreclosure under power of sale is commenced by recording a notice of default in the county in which the encumbered property is located. This notice serves various important purposes, the most important of which is to notify the debtor, as well as junior lienors and other interested persons, of the nature of the default. Because of the importance of this notice, strict compliance with the statutory requirements is critical so as to avoid the risk that a subsequent foreclosure sale will be found to be invalid. *See* Cal. Civ. Code § 2924. A copy of the notice, indicating the recording date, must be mailed to the debtor, and to all other persons who have recorded requests for notice of default, within 10 business days of the recording date.

c) Presale Reinstatement and Right of Redemption

After the recordation of a notice of default, a statutory three-month period must expire before the lender can take the next step of scheduling the foreclosure sale by recording and posting a notice of sale. The debtor and specified other persons with an interest in the encumbered property have a statutory right to reinstate the loan, that is, to pay the unaccelerated balance due, at any time after the recordation of the notice of default up to five business days prior to the date of the actual foreclosure sale. They also have the codified common-law right to redeem the property from the security interest by paying the full amount due under the secured note to the foreclosing creditor at any time before the property is sold at a foreclosure sale. This right is referred to as "equitable redemption," as contrasted with "statutory redemption," which is only available in California after a judicial foreclosure sale (discussed below).

d) Trustee's Sale

The required notice of sale may be given at any time after the expiration of the three-month period following the recordation of the notice of default, but no less than 20 days before the date of the sale. The statute further requires that the notice be published in a newspaper of general circulation, posted in a conspicuous place on the property, and mailed to all persons having an interest in the property, including state tax authorities. As with the notice of default, the form of notice of sale must strictly comply with detailed statutory requirements.

The sale must be held in the county in which the property is located, at the date and time specified in the notice (unless postponed pursuant to prescribed procedures), and conducted by an authorized person. The sale must be conducted by auction, and the property sold to the highest bidder. The sale becomes final upon acceptance of the final bid, the lien is extinguished, and the debtor has no further right of redemption.

e) Purchaser's Title to Property

The purchaser at a foreclosure sale receives title free and clear of any interest of the debtor, or any lien or other interest that was junior in priority to the deed of trust (with certain limited exceptions for federal tax liens). The purchaser's title is junior, however, to any lien or encumbrance that had priority over the deed of trust that was foreclosed.

f) Trustee, Beneficiary, and Trustor Obligations to Disclose Defects Prior to Foreclosure Sale

In a trustee's sale, neither the trustee nor the lender (beneficiary) who sells the property has the same disclosure obligations as a seller in a voluntary (nonforeclosure) sale of real property. Neither the trustee nor the lender has a duty to inspect the property, and as a practical matter they usually lack sufficient access to the property to discover physical defects. Further, foreclosure sales are expressly excluded from the transfer disclosure statements required in most residential sales. However, a lender who has knowledge of material defects in the property has a common law duty to disclose these facts to an innocent buyer.

The debtor (trustor) whose property is sold in foreclosure does *not* have a duty to disclose defects to the purchaser; however, a debtor who built improvements on the property may be liable to the purchaser for damages caused by negligent construction of the improvements.

g) Receiverships

Where the security for a real estate loan is income-producing property, the lender will often seek the appointment of a receiver for the property concurrently with the commencement of either judicial or nonjudicial foreclosure proceedings. Although there is no absolute statutory right to the appointment of a receiver in California merely because a loan is in default, California statutes and judicial precedent both permit the appointment of a receiver in a wide variety of situations, *see*, *in particular*, Cal. Civ. Proc. Code § 564, and courts commonly are prepared to appoint receivers where the borrower is in substantial monetary default of its loan obligations and there is a threat of damage or injury to the property, misapplication of rents by the borrower, or other potential loss or impairment of security value. Most commonly, receivers are appointed pending completion of foreclosure proceedings, and it is customary to seek a final accounting and distribution of the net proceeds received during the period of the receivership promptly following completion of the foreclosure sale.

4. Judicial Foreclosure

a) General Comparisons with Foreclosure by Power of Sale

A deed of trust, as well as a mortgage, may be foreclosed by judicial proceedings at any time after a default has occurred in performance of the secured obligation, as an alternative to a foreclosure by power of sale. For reasons discussed above, the vast majority of foreclosures, residential or nonresidential, are nonjudicial. Even when a judicial foreclosure action is filed, it is rare for it to go to judgment. Instead, the secured creditor generally elects to utilize a nonjudicial (trustee's) sale.

A number of the principles applicable to nonjudicial foreclosure are equally applicable to judicial foreclosure. These include, for example, the rules governing the nature of the default warranting foreclosure and the title received by the purchaser in relation to other interests and liens. However, certain debtor protection laws (discussed below) operate differently in the context of a judicial foreclosure as compared with a foreclosure by power of sale.

Judicial foreclosure proceedings are commenced by filing a complaint in the county in which the encumbered property, or some part of it, is situated. When a single obligation is secured by two noncontiguous parcels of property in two different counties by two separate security instruments, the action may be commenced in either county. Jurisdiction lies in the county where the property is located, even though the debtor resides in a different county and a personal deficiency judgment is sought against him or her. A foreclosure action may be brought by the beneficiary or trustee of a deed of trust, the mortgagee of a mortgage with or without a power of sale, or a successor in interest of any of these. In a foreclosure action by the beneficiary of a trust deed, the trustee is a proper, but not a necessary, party.

b) Parties to Foreclosure Action

The complaint must name all parties who have a record interest in the property at the time the action is filed, *and* whose interest will be affected by the foreclosure decree. (Thus, a senior lienor need not be joined since his or her interest will not be affected by the foreclosure of the junior lien.) The decree does not have any effect on any interest or lien that appears in the public records at the time the action is filed unless the person holding the interest or lien is named as a defendant in the proceedings. This includes the United States and the state of California when there is a subordinate federal or state tax lien or other claim on the property. The original debtor must be joined unless the debtor has conveyed his or her interest in the encumbered property. After the debtor transfers the property, it is not necessary to join the debtor as a defendant unless the creditor is seeking a deficiency judgment against him or her.

c) Elements of the Complaint

The precise contents and format of the judicial foreclosure complaint are beyond the scope of this overview, and foreclosing lenders should consult experienced counsel when instituting a judicial foreclosure action. In general, however, a complaint for judicial foreclosure should contain a full description of the obligation that has been breached, as well as the security for that obligation. In addition, the status of the plaintiff should be pleaded along with a description of the nature, character, timing, and amount of the alleged default. Other elements of a proper complaint, as prescribed by applicable statutes and court rules, should be included, as well as a request for award of attorneys' fees and other expenses if so provided in the security instrument or other loan documents.

d) Lis Pendens

On filing the complaint in a foreclosure action, a notice of pendency of action (lis pendens) is typically recorded in each county in which the property or part of it is located. The recordation gives notice of the proceedings to all persons who subsequently acquire an interest in or a lien on the encumbered premises, and all such persons take subject to any foreclosure judgment rendered. If notice is not recorded, a subsequent purchaser or encumbrancer for value who has no notice of the proceedings is not bound by any judicial decree that may be rendered.

e) Presale Reinstatement and Right of Redemption

The debtor, junior lienors, and their successors have the same right to reinstate the debt after default as in a foreclosure by power of sale, except that the right of reinstatement continues in the judicial foreclosure proceeding until a decree of foreclosure is rendered, and on payment or tender of payment the plaintiff must terminate the foreclosure proceedings. The five-day presale reinstatement period imposed on debtors in a nonjudicial foreclosure does not apply. Debtors also have the right of equity of redemption, exercised by paying the full amount due to the foreclosing creditor at any time before the judicial sale. In addition to these rights common to nonjudicial foreclosure, debtors have a statutory right to redeem property being judicially foreclosed, subject to prescribed time limits, after a judicial sale.

f) Foreclosure Decree

The foreclosure decree will typically establish the creditor's right to the collection of the unpaid debt and provide for the sale of the security property, with the proceeds to be applied to the payment of the secured obligation. The foreclosure decree must establish the amount of the secured indebtedness and, unless a deficiency is waived or is prohibited because the debt is a purchase-money obligation (*see* discussion of antideficiency laws below), it must also determine the personal liability of any defendant. When a deficiency is waived or prohibited, the decree must state affirmatively that there is no personal liability of any defendant for a deficiency. The decree may also establish the relative priority of any lien claimants who are joined as parties to the action in order that any surplus sales proceeds can be paid to the junior lienors in the order of their priority, and after they are satisfied, to the debtor. Generally, if the entire secured obligation is not due, only so much of the property may be sold as is necessary to pay the amount then due, although the court may subsequently, on the plaintiff's motion, order more to be sold as often as more of the debt becomes due. If, however, the property cannot be sold in portions without injury to the parties, the court may direct sale of the entire property, and application of the proceeds to the entire debt, in its initial foreclosure decree.

5. Foreclosure for Mixed Collateral

When the security for a loan includes both real property and personal property, enforcement of the personal property lien is generally governed by the California Uniform Commercial Code, unless the creditor elects to conduct a so-called "unified sale" of both the real and the personal property security. The lender may foreclose the security in any order, and the amount realized on the foreclosure of the first security is applied toward payment of the debt. If the real property and the personal property are closely related, such as elements of a going business, the lender will usually decide to proceed with a unified sale. Under this option, the lender must comply with the procedural requirements applicable to the foreclosure of a deed of trust for both the real and the personal property. When there is a unified sale, the antideficiency limitations applicable to real property foreclosures (discussed below) will apply.

6. Special Debtor Protection Laws in California

a) Antideficiency Laws

During the depression of the 1930s the California Legislature enacted debtor protection legislation in response to widespread foreclosure sales. Although part of this emergency legislation was temporary and is no longer in effect, significant restrictions on deficiency judgments continue to provide important protection for debtors. Moreover, these protections may not be waived by debtors, on public policy grounds.

Antideficiency protections differ depending upon whether foreclosure is by power of sale or judicial foreclosure.

The amount of any deficiency following a judicial foreclosure sale is limited to the difference between the unpaid balance of the debt and the fair value of the property (subject to legal fair value limitations). In addition, for a certain time period after the sale, the debtor has a statutory right of redemption, which is the right to repurchase the property by paying the amount prescribed by statute, which is generally equal to the sales price plus interest, plus certain costs incurred during the redemption period such as taxes, assessments, insurance, and maintenance costs, less an offset for rents and profits received during the redemption period. The statutory redemption period is three months after the date of the sale when there is no deficiency liability, but one year after the sale if the sale proceeds are not sufficient to satisfy the debt plus interest and costs. When the foreclosure is conducted by trustee's sale, the debtor does not have the right of statutory redemption, *but*, as protection for the debtor, the creditor may *not* obtain a deficiency judgment. It is fair to say that the existence of a post-foreclosure sale redemption right is commonly believed to severely restrict the marketability of the property, and largely for that reason most institutional lenders prefer to realize on their collateral by using nonjudicial foreclosure proceedings, at least in the absence of a need to seek a deficiency judgment against the borrower.

b) Special Antideficiency Limitations for Purchase Money Mortgages and Deeds of Trust

When the debt is secured by a purchase money mortgage, the creditor is prohibited from obtaining a deficiency judgment *regardless* of the method of foreclosure. The standard purchase money mortgage involves a purchase of property where the seller takes a note from the buyer secured by a mortgage or deed of trust on the property purchased for all or part of the purchase price. In this form of transaction, the prohibition against a deficiency judgment applies, regardless of the size of the debt, the nature of the property, or whether or not the property is residential. The California Supreme Court has expressly stated that residential and investment property are not to be distinguished.

Certain third-party loans made to finance the purchase of real property are also subject to antideficiency limitations: the loan must be used for paying all or part of the purchase price, and be secured by the property purchased, and the property must be residential, for use by no more than four families, and occupied by the purchaser. However, a new loan by a different lender, other than the former seller, that refinances the prior purchase money loan is no longer a purchase money instrument.

c) One Form of Action Rule

The one form of action rule applies to liens on real property located in California. The rule requires that the creditor seeking to recover a debt secured by a deed of trust must foreclose the security prior to taking any other action against the debtor. In addition, the creditor must exhaust *all* of the security by foreclosure proceedings, and can only recover a personal judgment against the debtor by obtaining a deficiency judgment after a *judicial* foreclosure sale. Therefore, if the proceeds from a *nonjudicial* foreclosure sale are insufficient, the antideficiency statutes generally bar the creditor from recovering a personal judgment against the debtor.

The application of this rule is the subject of much California case law. For example, the situation is more complicated when the debt is secured by both real property and personal property; when the real property security for the debt is located both in California and in one or more additional states; when the property is environmentally impaired; or when the security instrument becomes valueless after the loan transaction has been completed. In addition, the question of what constitutes an "action" for purposes of triggering the rule has also spawned much litigation. This question is critical because a creditor who violates the one-action rule without the consent of the debtor, even unwittingly, loses the right to enforce the lien to recover the debt. The violation generally does not discharge the debt, however, and in most instances the creditor may pursue recovery of the debt as an unsecured creditor.

d) Liability of Guarantor

A guarantor generally has a right of reimbursement against the debtor if the guarantor performs under its guaranty and pays the creditor following a debtor default. Special rules apply, however, where the debt that is guaranteed is secured by real property. While in general a guarantor does not enjoy the direct benefit of the California one-action and antideficiency laws, it is important for a creditor of a guaranteed debt to comply with statutory and judicial requirements relating to waiver by the guarantor of protections that might otherwise be available to the guarantor in the event of a creditor's election to enforce its foreclosure and other remedies following a loan default. Most institutional lenders use forms requiring that the guarantor waive its statutory and common law suretyship defenses, including a waiver by the guarantor of the lender's obligation under the one form of action rule to foreclose on the security before seeking recovery from the guarantor, and a waiver of any right to claim the protections of the antideficiency rules. (California Civil Code section 2856 includes suggested waiver language.) Such waivers by guarantors are not held to be against public policy, and thus are generally enforceable, although in relying on such waivers creditors must proceed carefully to avoid inadvertent loss of rights against the guarantor.

e) Additional Protections for Certain Residential Property

The laws discussed above are noteworthy because they apply to all loans secured by real property in California. In addition, loans secured by residential property containing four or fewer units are heavily regulated under extensive debtor protector legislation. That regulatory scheme, however, is beyond the scope of this discussion.

E. Leasing

1. Residential Leases

California has an extensive statutory scheme concerning the rights and obligations of residential landlords and tenants. For example, numerous fair housing statutes under state law supplement federal fair housing laws. The Unruh Civil Rights Act, Cal. Civ. Code § 51, specifically prohibits discrimination because of sex, race, color, religion, ancestry, national origin, disability, or age (with certain exceptions for senior citizen housing). The California Fair Employment and Housing Act, Cal. Gov't Code § 12955, prohibits specific discriminatory practices based on race, color, religion, sex, marital status, national origin, ancestry, familial status, or disability in the sale or rental of housing. California laws protecting persons with disabilities also impose specific obligations on residential landlords. Cal. Civ. Code § 54.1.

In addition, numerous statutes protect the rights of residential tenants in general. For example, certain waivers in a lease would be invalid on public policy grounds, such as waivers of the tenant's rights regarding security deposits, of restrictions on the landlord's right of access to the premises, of the tenant's statutory remedies against the landlord, of legal notice and hearing requirements, or of procedural rights of the tenant in litigation. Commercial leases, however, are primarily a matter of contract law (except as required by the Statute of Frauds, which provides that contracts relating to real property must be in writing to be enforceable). Unless expressly stated otherwise, this overview will be limited to commercial leasing situations.

2. Types of Commercial Leases

Commercial leases cover different types of properties, including industrial, office, and retail properties, and some lease terms will be dictated by the type of property. In addition, certain lease terms will apply only to shopping center leases, or to leases for multi-tenant buildings. A lease may be a "gross lease" (generally, tenant pays a monthly rent that covers both the base rental rate for the leased premises plus the cost of building utilities, building property taxes, and other building services incurred during a designated "base year," and in addition the tenant pays its *pro rata* share of increases in utility and other services and taxes following the base year), or a "net lease" (tenant pays its base rental rate, plus its allocated share of utilities, taxes, insurance, maintenance, and all other operating costs, so that the aggregate rent received by the landlord is effectively net of the costs of operation of the property). At times, leases contain features that combine certain gross lease and net lease elements, and due to the many possible allocations of financial responsibilities and risks between landlords and tenants, there can be a vast number of variations between a "pure" gross lease and a "pure" net lease. Generally, however, in California, commercial leases of retail and industrial space tend to be in net lease form, particularly leases for a single-tenant commercial or industrial building, while office leases tend to be documented in a pure or modified gross lease format.

3. Lease Negotiations

a) General Considerations

Although all lease terms should be negotiable, the relative leverage of landlord and tenant is heavily determined by market conditions (most importantly, the vacancy rate in a particular area), and the relative financial size of the parties. Large commercial leases are usually negotiated by the parties' attorneys, based on the landlord's form, although a sophisticated tenant will often negotiate many business terms before turning negotiations over to its attorney. Small tenants, less likely to seek legal advice, are typically handed the landlord's standard lease form, which will be one-sided, containing unreasonable risks and hidden costs. However, even small tenants (or their attorneys) may be able to negotiate some changes to make the lease more balanced, especially under favorable market conditions.

b) Role of Landlord's Lender

The landlord's mortgage lender has considerable interest in the lease because lenders look to the lease to determine whether the landlord's income under the lease is sufficient to enable the landlord to meet its loan obligations. Leases also serve as collateral because lenders often require landlords to assign tenant leases to the lender as security for the loan. Therefore, a lender will want the lease to include substantial landlord protections in the event that the lender has to assume the lease in foreclosure. An assignment of rents made in connection with a loan secured by real property is deemed to create a present security interest in existing and future rents of that property, effective upon the execution and delivery of the assignment by the assignor. The assignment of rents is typically part of the deed of trust but may also appear in a separate document, and in any event will be recorded in the records of the county recorder in the county in which the property is located. Upon such recordation, the assignment will be perfected as against competing claimants to the rents.

c) Landlord's Disclosure Duties

The common law duty of sellers to disclose any known material fact to buyers has not been extended to landlords under California law. This does not mean, however, that landlords have no duty to disclose material facts in instances where a failure to disclose would be fraudulent. Certain environmental statutes do impose the same disclosure obligations on landlords as on sellers. For example, property owners must notify prospective tenants in writing of any material releases of hazardous substance that have come to be located on or beneath the property. Tenants are likewise obligated to give notice to their landlord within a reasonable time after discovery of such a release. The Asbestos Notification Law, which appears in California Health & Safety Code §§ 25915 *et seq.*, applies to both landlords and tenants, and requires that notice be given to employees, contractors, and other persons providing services on a property, of the presence of asbestos on that property. In addition, both landlords and tenants are required to post notices containing "Proposition 65" warnings about the presence of certain chemicals on the premises.

A commercial landlord has no duty to deliver the premises to the tenant in any particular condition. It is common practice in California, however, to include language in a lease whereby the tenant acknowledges that the landlord has made no representation or warranty with respect to the condition of the premises or its suitability for the tenant's use. However, a tenant may attempt to negotiate a limited representation by the landlord that the tenant's proposed use of the premises does not violate any existing zoning or other local land use law or entitlement.

4. Assignment and Sublease by Tenant

California law specifically provides that a commercial lease may restrict assignment or sublease by the tenant, subject to certain limitations. A lease may include a clause requiring the consent of the landlord for assignment or sublease by the tenant. Unless the lease expressly provides that the landlord may withhold consent in its sole discretion, the landlord may not unreasonably withhold its consent to a proposed assignment or sublease. Whether the landlord's withholding of consent is reasonable is a question of fact to be determined by an examination of the circumstances of the proposed transfer. In addition, in any event, a landlord's discretion in withholding consent must be exercised in accordance with the covenant of good faith and fair dealing which applies to all contracts under California law.

To minimize their exposure to liability for bad faith or unreasonableness, landlords often set forth in the lease specific standards for approving (or disapproving) a proposed transfer, and the steps a tenant must take to secure approval. Further, such clauses often provide that either if the tenant fails to follow the set procedure, or if the proposed assignee or subtenant fails to meet the standards set forth in the lease, any denial of consent will be considered reasonable, and the prohibited transfer will be void and will constitute a default under the lease.

California law also provides that any ambiguity in a restriction on transfer in a lease shall be construed in favor of transferability. However, commercial leases typically contain a "recapture" right, under which the landlord might terminate the leasehold upon the tenant's request for permission to assign or sublet, or be entitled to any "excess" rent collected by the tenant from the assignee or subtenant over the rent owed by the tenant under the lease. The California Supreme Court has held that such a recapture provision is not an unreasonable restraint on alienation or a prohibited restriction on transfer.

Finally, the parties may agree to a lease provision giving the landlord the right to withhold consent to a proposed assignment or sublease in the landlord's sole discretion. However, under the provisions of California statutes, such a restriction will limit the landlord's remedies in the event of a tenant default (*e.g.*, the landlord will not be permitted to continue the lease in effect and recover the rent for the remainder of the lease term. (*See* discussion below of landlord's remedies for tenant default.)

5. Landlord's Remedies on Tenant's Default

a) Alternative Remedies

Under California law, the following basic alternative remedies are available to a landlord upon a tenant's default:

Unlawful Detainer Proceeding

Terminate the lease and recover possession of the premises through the appropriate statutory procedures.

Continuation of Lease

Elect not to terminate the lease; instead, permit the tenant to retain possession of the premises, and sue to collect damages for the tenant's breach or recover the delinquent rent. Under this alternative, the tenant remains liable for the rent due under the lease.

b) Notice

The parties to a commercial lease can modify the statutory notice and right to cure requirements for unlawful detainer actions, to allow the landlord to terminate the lease upon notice without permitting the tenant to cure the default. In a residential lease such waivers would be unenforceable on public policy grounds.

A three-day notice of default is required for an unlawful detainer action to recover the premises. The notice may state a reasonable estimate of the amount of rent or other charges due; if the amount demanded is an estimate, the notice must clearly identify the demand as an estimate. A notice that does not include a reasonable estimate of the amount due is defective.

c) Recovery of Damages in an Unlawful Detainer Proceeding

In an unlawful detainer proceeding, the measure of damages is determined by statute. The amount of damages the landlord can recover is limited to the following:

- The "worth at the time of the award" of the unpaid rent or other charges equivalent to rent, such as taxes and insurance premiums earned prior to the time of termination, with interest; plus

- The "worth at the time of the award" of the amount of rent that would have been earned from the date of termination to the date of the award less the amount the tenant proves could reasonably have been mitigated by the landlord, plus interest; plus

- The "worth at the time of the award" of the amount of rent that would have been earned for the balance of the lease term from the date of the award less the amount the tenant proves could reasonably have been mitigated by the landlord; plus

- Any other amount necessary to compensate the landlord for the detriment that was proximately caused by the tenant's failure to perform the obligations under the lease or that in the ordinary course of events would be likely to result from the breach.

The amount of damages recoverable under paragraphs (a) and (b) above is computed using an interest rate that is typically defined in the lease (subject to legal limitations). The "worth at the time of the award" of the amount referred to in paragraph (c) is computed by discounting such amount at the discount rate of the Federal Reserve Bank of San Francisco at the time of award plus one percent.

d) Recovery of Damages with Continuation of Lease

Even if a tenant has breached the lease and abandoned the premises, the lease continues in effect if the landlord does not terminate the tenant's right of possession. The landlord may enforce all rights and remedies under the lease, including the right to recover rent as it becomes due, but only if the lease (1) gives the tenant the right to assign the lease or sublet the premises, subject only to the landlord's consent, not to be unreasonably withheld; and (2) expressly provides that the landlord has the right to continue the lease in the event of the tenant's default, while permitting the tenant to mitigate its damages by assignment or sublease. (Leases typically describe this remedy with reference to the applicable statute, California Civil Code § 1951.4.)

6. Tenant's Remedies

The remedies available to a tenant upon a breach of the lease by the landlord are general contract remedies, as modified by the parties during lease negotiations. It is customary in California for landlords to insist that their liability under the lease be limited to the landlord's equity in the building or project in which the premises are located. Institutional landlords also may require that their tenants agree that the landlord's obligations under the lease are not personal obligations of the individual partners, directors, officers, or shareholders of the business entity holding title to the property, in order to further protect their personal assets in case of an action for breach of lease.

CHAPTER 10

LAND USE, ZONING, AND PROPERTY DEVELOPMENT LAWS

This chapter addresses the primary areas of California law that control the use and development of land, buildings, and facilities. It also refers to certain federal laws that affect the development of real property. Land use regulation in California is complex, as it is composed of an interlocking and sometimes overlapping combination of federal, state, and local planning, zoning, environmental, and constitutional restrictions. There are often special laws that may apply to a proposed use or development of property. Environmental regulation, in particular, is closely interwoven with certain land use activities. Numerous environmental rules, regulations, and statutes apply to the operation of certain facilities, such as air and water discharge permits, hazardous material handling and disposal permits, and pesticide regulations. This summary does not attempt to address the full environmental regulatory scheme, except to the extent that those regulations affect issues of land use. For a more comprehensive discussion of the impact of environmental laws on California businesses, please see Chapter 11, *Environmental Regulatory Scheme*.

In addition, there are often special laws that may be applicable to a particular proposed use of property. For example, there are specific federal and state laws and regulations that govern mining activities or airport operations. Other laws might apply because a proposed activity takes place in a particular geographic region that has been accorded special significance or regulatory protection, such as the California coastline or San Francisco Bay. In many cases, special regional or local governmental entities may be established to protect these resources, and these agencies may impose their own rules and regulations restricting the use or development of property within their jurisdiction.

It is important for foreign business persons and lawyers to understand California's land use laws when acquiring and/or developing property or when changing the use of property, because these laws may impose substantive and procedural restrictions on a given parcel of property and may therefore significantly impact property values. Moreover, because these regulations and procedural requirements often vest government agencies with the discretion to approve or disapprove a particular project, or to impose conditions on the project, an understanding of the general framework of the land use regulatory scheme is useful when considering the amount of time that securing such approvals may take, and the potential risk that approval might not be granted. This chapter presents only a general overview of the restrictions and regulations that may affect land use and development in California. Each parcel of property, and the proposed use of that property, presents its own facts and circumstances with its own substantive and procedural requirements. California counsel should always be consulted in order to ensure that the proposed land use meets all applicable legal and regulatory requirements.

A. The Police Power: A Broad Basis for Land Use Regulation

Federal, state, and local legislative bodies base all land use regulations on the legal authority vested in them by the police power. This power allows governing bodies to enact regulations that are designed to protect the public health, safety, and welfare. Regulations enacted under the police power must be reasonably related to the protection of public welfare.

Courts have upheld land use regulations adopted for many purposes, and generally will not inquire as to the wisdom of the purposes or the means chosen so long as the restrictions are not clearly arbitrary and no constitutional rights are violated. However, the police power is limited by the United States Constitution; therefore in some circumstances, equal protection and due process limitations may circumscribe the government's land use power.

The Fifth Amendment to the United States Constitution declares that private property shall not be taken for public use without just compensation. The primary application of this principle has involved incidents where the government has physically taken or destroyed property (*e.g.*, to build a dam or a road) or has taken some other physical action interfering with the use of private property. The clearest type of "taking" occurs when the government encroaches upon or occupies private land for its own proposed use. However, in the land use area, where zoning laws may prohibit certain uses of property, it is more difficult to determine when a regulatory taking has occurred. The United States Supreme Court has repeatedly stated that each case must be decided in the context of a fact-specific inquiry. In general, a mere diminution in property value is not likely to prove a taking; rather, there must be an actual deprivation of economically viable uses. While property may be regulated to a certain extent, if a regulation denies all economically beneficial or productive use of land, compensation will be required under the Fifth Amendment. *See Palazzolo v. Rhode Island*, 536 U.S. 606 (2001).

B. General Planning and Zoning Law

In California, land use restrictions are enforced primarily by local governments, and state law specifically requires local governments to undertake a number of actions in that regard. *See generally* Cal. Gov't Code §§ 65000-67980. Those actions include the development of general plans and zoning ordinances for development that are consistent with applicable state land use laws and policies.

1. General Plans: The "Constitution" for Local Land Use Planning

A general plan is a comprehensive, long-term planning document for the development of a city or county. *Id.* § 65300. The courts have described general plans as a "constitution" for development. State law requires each city to adopt a comprehensive, long-term general plan for the physical development of city land, as well as land outside the city's boundaries. Each city or county government, including chartered cities, must adopt a general plan. *Id.* § 65300. After adoption, a general plan may be amended by the legislative body of that city or county, such as the city council or board of supervisors, if the legislative body deems amendment to be in the public interest. *Id.* § 65358(a).

a) Required Elements

The plan must contain a number of specific elements, including a land use element designating the general location and extent of allowable uses, a circulation element delineating existing and proposed transportation routes, a housing element, a conservation element, an open space element, a noise element, and a safety element. *Id.* §§ 65300-65307. Various other code sections provide detail as to some of those elements. *See*, *e.g.*, *id.* §§ 65563 *et seq.* (open space lands). The housing element requirements are especially stringent, requiring that the housing element be updated every five years. *Id.* §§ 65580 *et seq.*

Another component of land use planning is the identification, by the city or county, of particular private property that may be necessary for possible public use in the future (*e.g.*, property that may be needed for possible roadway expansion). In general, the mere identification of property for possible government use in the future does not constitute a "taking" of private property that requires the government to pay compensation to the private landowner. However, unreasonable pre-condemnation conduct by a local government intended to drive down the price of land to be acquired by the government may constitute "inverse condemnation" and may result in the payment of damages to the landowner.

It should be recognized that in California, the laws applicable to charter cities often differ significantly from the laws applicable to cities and counties, in particular with respect to general planning. While this chapter highlights many of the instances where the law regarding general planning differs from city/county to charter city, other differences may exist. It is important to exercise caution and to review carefully the statutory provisions applicable to charter cities when a matter involves the general plan of a charter city.

b) Application to Different Jurisdiction

General plans must cover all of the land within the jurisdiction of the adopting entity and may also cover any land outside the adopting entity's boundaries that the municipality determines bears relation to its planning. *Id.* § 65300. A general plan that contains provisions affecting areas outside the adopting agency's boundaries should be prepared so that the appropriate legislative body of any city or county affected by that general plan may adopt individual elements of the plan. *Id.* § 65301(a).

c) The Consistency Requirement

California law requires not only that general plans be internally consistent, but that general plans also be consistent with state policy. This section will highlight some of these consistency requirements.

A general plan and its elements must be an integrated, internally consistent and compatible statement of policies for the adopting agency. *Id.* § 65300.5. For example, a zoning ordinance that authorizes various land uses must be consistent with the objectives, policies, general land uses, and programs specified in a general plan. *See id.* § 65860. If a city or county passes a zoning ordinance that is inconsistent with the general plan for that city or county, a reviewing court would likely invalidate the adoption of the zoning ordinance. It should be noted, however, that most charter cities are exempt from the zoning consistency requirement. *See id.* § 65803.

Because general plans are the overarching scheme of development for a given city or county, all development approvals within that city or county must be consistent with the general plan, including subdivision maps and conditional use permits. *See id.* §§ 65860, 66418, 66473.5, 66474. There is some uncertainty, however, as to whether or not building permits must be consistent with the general plan. *See Elysian Heights Residents Assn. Inc. v. City of Los Angeles*, 182 Cal. App. 3d 21 (1986) (holding that building permits need not be consistent with the general plan); *but see Verdugo Woodlands Homeowners Ass'n v. City of Glendale*, 179 Cal. App. 3d 696 (1986) (implying that building permits must be consistent with general plan in cities and counties but not in charter cities).

d) Compliance with CEQA (Environmental Review)

The city or county government is required to prepare an environmental impact report ("EIR") pursuant to the California Environmental Quality Act ("CEQA"), Cal.

Pub. Res. Code §§ 21000 *et seq.*, prior to adopting or amending any general plan or element that may have a significant effect upon the environment. Cal. Code Regs. tit. 14, § 15378(a)(1). CEQA is applicable to most if not *all* development activities in California, and is discussed in more detail in Section C below.

e) Judicial Review of the Adequacy of General Plans

If the adequacy of a general plan is challenged, a court will examine the contents of the general plan to determine whether it complies with the standards imposed by state law. The courts have reviewed, among other things, whether the plan contains each of the required elements, whether each individual element adequately addresses the requirements of state law, and whether the plan is internally consistent. The absence of an adequate general plan can result in bans on certain project approvals, such as building permits, subdivision map approvals, and zoning changes. *See* Cal. Gov't Code § 65755(a); *Save El Toro Assn. v. Days*, 74 Cal. App. 3d 64 (1977) (city may not approve subdivision map if it has not adopted valid open space plan). State law imposes specific statutes of limitation that restrict the time during which a lawsuit can be filed challenging the adoption or amendment of a general plan or its elements. It should be noted that if a challenger attacks the adequacy of a general plan, that challenger often simultaneously alleges that the EIR prepared for adoption of that general plan is inadequate.

2. Zoning

As noted above, a city's zoning ordinance is a key component of its general plan. Zoning is the means by which the city determines permissible land uses and activities in a given geographic area. "Zoning is a separation of the municipality into districts, and the regulation of buildings and structures, according to their construction, and the nature and extent of their use, and the nature and extent of the uses of land." *O'Loane v. O'Rourke*, 231 Cal. App. 2d 774, 780 (1965).

Zoning is normally reflected in one or more maps of a community, setting forth the types of uses allowed in different districts, such as agricultural, commercial, residential, or industrial. Within each category, a city may further define the permissible uses of land. For example, residential zoning may be subdivided into high-density residential (apartment buildings or condominiums), low-density residential (small apartment buildings or duplexes), and single family residential. Precise zoning regulation is commonplace, including several divisions of single family residential depending on the density of lots per acre. The same is true of the other types of zones, such as commercial, which in turn may allow a particular type of commercial use, such as offices but not shopping centers. Density restrictions, such as the number of square feet of office space or the number of buildings per acre of land, and height limitations are also common.

As noted above, zoning must be consistent with, and implement the policies of, a city or county's general plan. Cal. Gov't Code § 65860. Actions to enforce this requirement must be brought within 90 days of an amendment to a zoning ordinance. *Id.; see Lee v. City of Monterey Park*, 173 Cal. App. 3d 798 (1985). However, general plans are broader than zoning ordinances and include many elements not addressed in an ordinary zoning ordinance. Moreover, whereas local governments are explicitly required by state law to adopt general plans, local governments may choose to leave land unzoned, at least as long as they may otherwise enforce the provisions of the general plan. It should also be noted that, in general, the state's zoning statute does not apply to charter cities, unless a charter city expressly adopts the state's zoning law. *Cal. Gov't Code* § 65803.

As with general plans, an EIR is required under CEQA for enactment or amendment of zoning ordinances that may have a significant effect on the environment. Cal. Pub. Res. Code § 21080(a). Indeed, many land use entitlements granted under zoning ordinances will require CEQA review. Therefore, all such entitlements should be reviewed for compliance with CEQA.

In the past, zones were frequently "inclusive," meaning that the specific permitted type of use and any lower intensity use would be allowed, with the intensity of use progressing from agricultural to residential to commercial to industrial. *See*, *e.g.*, *Lockard v. City of Los Angeles*, 33 Cal. 2d 453, 456 (1949). For example, houses could be built in commercial districts, and all uses were permissible in industrial districts. Most zoning today is exclusive since inclusive zoning led to incompatible land uses that the zoning laws were created to prevent (*e.g.*, industrial and residential uses allowed on adjacent parcels of property). Although zoning laws today permit only one general type of use per zone, the blending of land uses may still be allowed within general zones such that single family houses may be permitted in high-density residential zones.

a) Variances

Variances permit a property owner to petition a city to authorize activities or structures that might otherwise be prohibited under the city's zoning ordinance. Zoning classifies entire sections of a jurisdiction for specific uses, even though particular parcels of property may, for reasons of geography or otherwise, be unsuited to the uses permitted by the zoning. Variances from the terms of the zoning ordinances may be granted when, because of special circumstances applicable to the property (including size, shape, topography, location, or surroundings), the strict application of the zoning ordinance deprives such property of privileges enjoyed by other property in the vicinity and under identical zoning classification. Cal. Gov't Code § 65906. Variances allow minor deviations from the zoning ordinance (*e.g.*, lot size or building size). They do not authorize a property use or activity that is prohibited by the zoning ordinance. Variances must be consistent with the applicable general plan and zoning ordinance. A variance will not be granted which authorizes a use or activity not otherwise expressly authorized by the zoning regulation governing the property. *Id.*

b) Conditional Use Permits

Conditional use permits allow uses of land in given zones after review and approval of the specific project by the planning commission or other governing body. These permits provide the government with the ability to consider the unique impacts of specific projects on specific locations.[20] In issuing a conditional use permit, the government entity must determine that the proposed use "is desirable for the public convenience and is not detrimental to the public welfare." *Malibu Mountains Recreation, Inc. v. County of Los Angeles*, 67 Cal. App. 4th 359 (1999).

The uses for which a property owner may obtain a conditional use permit are often expressly stated in the applicable zoning ordinance. In general, a zoning ordinance will list those uses permitted or allowed in a given geographic area. The ordinance may then indicate what other specific uses the city will consider authorizing in that area. For example, a city may grant a conditional use permit to allow a day care center in a residential zone. The owner of land in such a zone thus knows that residential use will be permitted, assuming it complies with whatever engineering and safety standards are imposed, but that a day care center is a possibility without a full-scale rezoning so long as a specific discretionary permit is obtained.

c) Planned Unit Developments

Planned unit developments ("PUDs") are specific development projects for which the local government typically adopts project-specific regulations, permitting a given number of units on a particular site. PUDs typically have a land ownership pattern that differs from the traditional lot and block subdivision. Units are clustered more densely than normally allowed but are surrounded by land owned in common or by a homeowners' association so that the overall density is no greater than a typical subdivision. Such developments can have benefits in more efficient construction and land use and the preservation of more open space. PUDs sometimes permit mixed uses (*e.g.*, commercial and residential) as well as mixed densities. Some local

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[20] *See Tustin Heights Assn. v. Bd. of Supervisors*, 170 Cal. App. 2d 619 (1959); *Stoddard v. Edelman*, 4 Cal. App. 3d 544 (1970).

governments have dealt with such proposals through the creation of a so-called "floating zone," which is a land use district not actually applicable to any parcel until requested by a potential developer. The courts have generally upheld the PUD concept against challenges based on the state zoning statutes. *See*, *e.g.*, *Orinda Homeowners Comm. v. Board of Supervisors*, 11 Cal. App. 3d 768 (1970). State law also authorizes, either explicitly or implicitly, a number of other types of zones, such as flood plain zones, historic districts, "special study zones," seismic safety zones, and airport zones.[21]

3. Subdivision of Land

One way in which local governments affect the physical use of land in California (particularly undeveloped land) is through the review and approval of proposals to subdivide land for future sale. This review is mandated by the Subdivision Map Act. Cal. Gov't Code §§ 66410 *et seq*. This section highlights the primary issues often raised by the Subdivision Map Act.

A landowner/developer that wishes to subdivide its land must obtain permission to create separate parcels that will be legally recognized. In order to do so, the landowner must obtain approval to subdivide its land and must file "maps" showing the proposed subdivision. Under the Subdivision Map Act, tentative and final subdivision maps are generally required for subdivisions creating five or more parcels. *Id.* §§ 66426, 66499.30. Parcel maps are generally required for divisions of property into fewer than five parcels, although this requirement may be waived by local ordinance, provided that there is a finding that each division of land will meet a number of the standards established by state law and the local ordinance for subdivisions requiring a formal map. *Id.* § 66428. At the time of the subdivision, the local agency's approval of the subdivision may be conditioned upon the imposition of conditions restricting the use of the resulting parcels or subdivision.

There are several general plan consistency requirements for subdivision approvals. A local government cannot approve a subdivision map unless the local legislative body makes findings that the proposed subdivision (together with its design and improvements) is consistent with the general plan and with applicable specific plans. *Id*. § 66473.5. Consistency findings cannot be made unless the local government has adopted the general plan and the proposed subdivision or land use is compatible with the objectives, policies, and all the mandatory elements of the general plan. *Id*. § 66473.5; *Save El Toro Assn. v. Days*, 74 Cal. App. 3d 64 (1977) (city may not approve subdivision map if it has not adopted mandatory general plan elements and open space plan).

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[21] *See*, *e.g.*, Cal. Pub. Res. Code §§ 2621-2630; Cal. Gov't Code §§ 50485 *et seq.*; *Turner v. County of Del Norte*, 24 Cal. App. 3d 311 (1972); *Bohannan v. City of San Diego*, 30 Cal. App. 3d 416 (1973).

A local legislative body must deny approval of a proposed subdivision (tentative map) if it makes *any* of these findings:

- The proposed map is not consistent with the general plan and its mandatory elements or with specific plans;
- The design or improvements of the proposed subdivision are not consistent with the general plan;
- The site is not physically suitable for the proposed development or the proposed density of the development;
- The design or improvements of the proposed subdivision development are likely to cause substantial environmental damage or substantially and unavoidably injure fish or wildlife or their habitat;[22]
- The design or type of improvements is likely to cause serious public health problems; or
- The design of the proposed subdivision will conflict with public easements for access or use of the property.

Cal. Gov't Code § 66474; *Carmel Valley View Ltd. v. Bd. of Supervisors*, 58 Cal. App. 3d 817 (1976) (written findings describing grounds for approval or disapproval of subdivision map required).

Subdivision approval requires public access to streams, rivers, lakes, and reservoirs owned entirely or in part by public entities. Subdivisions in rural areas involving the sale of unimproved lots ("land projects" as defined in Cal. Bus. & Prof. Code § 11000.5) may not be approved by local government unless the local government has adopted a specific plan for the area and finds that the proposed project is consistent with the specific plan. Cal. Gov't Code § 66474.5. Lot divisions and revisions to acreage (lot line adjustments), as well as subdivisions are generally subject to the requirements of CEQA. In reviewing a proposed subdivision development, the local agency must make a determination whether waste water discharges from the subdivision into a sewer system would result in violation of state water discharge standards. *Id.* § 66474.6.

Local governments may require subdivision developers to dedicate land (or pay fees in lieu of dedication) for park and recreational needs. *Id.* § 66477; *Associated Home*

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[22] Local governments have the discretion, however, to approve projects affecting fish, wildlife, or the environment if an EIR is prepared under CEQA and a finding is made that one or more factors specified in the statute make mitigation measures infeasible. Cal. Gov't Code § 66474.01. *See also* discussion in Section D.5 below.

Builders v. City of Walnut Creek, 4 Cal. 3d 633 (1971) (upholding parkland dedication as condition of entitlements). Dedication requirements are also specifically authorized for streets (Cal. Gov't Code § 66475), bike paths (*id.* § 66475.1), local transit facilities (*id.* § 66475.2), schools (*id.* § 66478), and public access to river and stream banks and the coastline (*id.* §§ 66478.1 *et seq.*). Judicial review of subdivision development approvals, or to determine the reasonableness, legality, or validity of any condition attached to such an approval, must be sought within 90 days of approval. Cal. Gov't Code § 66499.37.

4. Protection Against Subsequent Regulation: Vested Rights

In general, a property developer must comply with land use regulations even if they are enacted or amended after preparation for a project has begun. However, some courts have found, on the basis of either the constitutional takings doctrine or governmental estoppel, that it would be unfair for the government to enforce new requirements on a project that is already underway. In order to facilitate orderly development, in light of the uncertainties in the constitutional takings and estoppel cases, California has adopted statutes to protect landowners against some subsequent laws and regulations. In such instances, the developer is said to have a "vested right" to complete the project under the prior laws or regulations.

a) Vested Rights

In California, if a property owner has obtained a building permit for a project and performed substantial work and incurred substantial liabilities in good-faith reliance upon that building permit, the property owner acquires a vested right to complete construction in accordance with the terms of the permit. Once a landowner has such a vested right, the local government cannot prohibit the construction authorized by the permit by simply changing its zoning laws. *Avco Community Developers, Inc. v. South Coast Reg'l Comm'n*, 17 Cal. 3d 785, 790-91 (1976); *City of West Hollywood v. Beverly Towers, Inc.*, 52 Cal. 3d 1184 (1991). However, permits must be obtained for <u>all</u> phases of a project, construction commenced, and substantial liabilities incurred in good-faith reliance on those permits before the <u>entire</u> project will be protected.

There are several exceptions to this general rule. For example, if the building permit is invalid, no vested rights are acquired. In addition, a developer cannot claim a vested right to an existing zoning ordinance – a municipality may change its zoning, and unless a permit has been issued authorizing construction, a landowner has no right to the benefits conferred on a property by virtue of a zoning ordinance.

b) Development Agreements

California's property development agreement statute, Cal. Gov't Code §§ 65864-65869.5, gives a city or county express authorization to enter into a development agreement with a developer for any agreed-upon length of time. Under the statute, the terms and conditions of a development agreement are negotiable. Therefore, a development agreement can commit the developer and the city to certain requirements, such as the issuance of entitlements or permits to the developer upon reaching certain milestones in the development project. Depending on the project, the statute requires that, unless otherwise provided by the agreement, the applicable rules, regulations, and policies shall be those in force and effect at the time the agreement is executed. *Id*. § 65866. An agency is not, however, precluded from applying subsequently enacted regulations that do not conflict with those regulations applicable to the property. Because the terms of a development agreement can often extend beyond 25 years, it can be particularly beneficial for long-term and phased projects, as the developer will have established, by agreement, the rules and procedures applicable to its project, despite any future changes in law. If a development agreement has been entered into, its provisions should be carefully reviewed for compliance with the statute and the local development agreement-enabling ordinance.

It should be noted that a development agreement is a legislative act of a municipality and must be approved by ordinance. As explained in Section D below, the ordinance may be subject to voter referendum if a challenge to the development agreement is filed in a timely manner. *Id*. § 65867.5.

c) Vesting Tentative Maps

One major variation from the narrow vested rights rule is a California statute allowing developers to "lock in" certain rights at the time that a "vested tentative map" application is approved. *See id*. §§ 66498.1-66498.9. Approval of a vesting tentative map constitutes a "vested right" to proceed with development in substantial compliance with the local ordinances, policies, and standards in effect at the time the application for the vesting tentative map is deemed complete. *Bright Development v. City of Tracy*, 20 Cal. App. 4th 783, 788 (1993). These vested rights may extend out for substantial periods of time beyond the filing of a final map. This law is applicable to commercial and industrial as well as residential subdivisions.

5. Dedications and Improvements Required as Part of Development

Developers have long been required to install and dedicate to public entities certain improvements necessary to service the specific development, *e.g.*, roads, sewers, and utility lines. These dedications do not, however, respond to the more generalized demands imposed by increases in population and density, such as roads outside the subdivision, parks, and libraries. In recognition of this fact, local governments now typically require developers either to provide more general improvements or to pay specific sums to offset the impact of their projects on the community as a whole. *See, e.g.*, *Russ Bldg. Partnership v. City and County of San Francisco*, 188 Cal. App. 3d 977 (1987) (upholding transit fees imposed on developers of new office buildings). To prevent abuses by local government, California now authorizes and regulates the scope of such requirements by statute. Cal. Gov't Code §§ 66475 *et seq*. The courts have generally upheld such requirements, provided that there is a reasonable relationship ("nexus") between the required dedication and the impact. *Id.* § 65909; *Nollan v. California Coastal Comm'n*, 483 U.S. 825 (1987) (holding that a specific dedication was not sufficiently tied to the impact of the project in question to be sustained without payment of compensation). In addition, the required dedication must be "roughly proportionate" to the impact of the development. *Dolan v. City of Tigard*, 512 U.S. 374 (1994).[23]

6. Special Planning and Zoning Laws for Specific Uses and Areas

a) Airports and Airport Land Use Planning Areas

Airport land use planning is governed by the State Aeronautics Act (Cal. Pub. Util. Code §§ 21670 *et seq*.). Under the Aeronautics Act, every county in which a commercial airport is located must establish an airport land use commission. The airport land use commission must adopt a comprehensive land use plan for the area surrounding the airport. In formulating a land use plan, the commission may develop height restrictions on buildings, specify use of land, and determine building standards, including soundproofing of areas adjacent to airports, within the planning area. *Id.* § 21675(a). Thereafter, all land use approvals within the geographic area covered by the airport land use plan must be consistent with that plan.

In addition, California Government Code section 50485 governs zoning within airport approach hazard areas. This statute is an additional source of authority for special regulation of areas surrounding airports. When conducting due diligence for purposes of acquiring or developing property located in the vicinity of an airport, one

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[23] *But see San Mateo County Coastal Landowner's Ass'n v. City of San Mateo*, 38 Cal. App. 4th 523 (1995) (holding that *Dolan* is applicable to specific exactions only, and not general zoning ordinances); *Del Monte Dunes v. City of Monterey*, 920 F.2d 1496 (9th Cir. 1990) (holding that the heightened scrutiny called for in *Dolan* does not apply to general denials of development permits).

should determine whether an airport land use plan or other special regulation affects the proposed use or otherwise applies to the property.

b) Agricultural Land

Agricultural land is often in short supply, despite the fact that agriculture is one of California's main industries. As California continues to grow, there is increasing pressure to develop agricultural land to accommodate expanding urban and suburban areas. In addition to increased land prices for urban uses, one of the pressures encouraging premature conversion of agricultural land is the property tax structure which, in general, taxes land based on its value if sold rather than its value in its current use. Agricultural land near urban areas often has a theoretical value (*e.g.*, a value if it were to be sold for its most financially profitable use) far in excess of its value for agricultural uses. Therefore, taxes on such land could be very high in relation to farming profits. The California Legislature enacted the Williamson Act, Cal. Gov't Code §§ 51200 *et seq*., to address this problem and encourage the preservation of agricultural lands.

Under the Williamson Act, cities and counties may establish agricultural preserves. *Id*. § 51230. Owners of land within such preserves may apply to the local government to enter into contracts limiting the use of the land to agriculture and other compatible uses. *Id*. §§ 51238, 51241-51243. Such contracts must be for an initial term of no less than 10 years. *Id*. § 51244. The contract term is extended one year on each anniversary date unless either party gives notice of a desire not to renew. *Id*. §§ 51244-51246.

Land subject to a Williamson Act contract is taxed in accordance with its value as restricted by the contract. *Id*. § 51252. Cancellation of a contract other than by the non-renewal method (which involves a 10-year waiting period) generally involves payment of a substantial penalty and also requires specific findings concerning, among other things, the public interest and the availability of land not under a Williamson Act contract for the proposed use. *Id*. §§ 51280-51286; *Sierra Club v. City of Hayward*, 28 Cal. 3d 840 (1981); *Lewis v. City of Hayward*, 177 Cal. App. 3d 103 (1986); *see also Honey Springs v. Board of Supervisors*, 157 Cal. App. 3d 1122 (1984); *Dorcich v. Johnson*, 110 Cal. App. 3d 487 (1980). The Subdivision Map Act requires that land subject to Williamson Act contracts may not be subdivided into lots smaller than necessary to sustain agricultural use. Cal. Gov't Code § 66474.4.

If a particular parcel of property is subject to a Williamson Act contract, subsequent purchasers of that property may find themselves bound by the restrictions placed on the property under that contract. Prior to purchasing property governed by a

Williamson Act contract, it is prudent to review the terms and the provisions of the contract, and to ascertain the feasibility of canceling that contract. A landowner may petition a city or county for cancellation of a Williamson Act contract as to all or part of the land subject to the contract. *Id.* § 51282. Cancellation of a contract requires payment of a substantial penalty and requires the local agency to make certain findings pursuant to California Government Code section 51282(b) or 51282(c).

c) Coastal Zones

The coastal zone, usually subject to the jurisdiction of the California Coastal Commission (the "Coastal Commission"), generally includes the area extending inland from the state's outer limit of jurisdiction to a line 1,000 yards from the mean high-tide line of the Pacific Ocean.[24] Under the California Coastal Act (the "Coastal Act"), all local governments lying in whole or in part within the coastal zone have to prepare and submit to the Commission a Local Coastal Program ("LCP") for certification by the Commission. Cal. Pub. Res. Code §§ 30500 *et seq*. Like the general plan, the LCP strives to ensure planned, comprehensive development within the coastal zone, with a view to preserving the "overall quality of the coastal zone environment and its natural and artificial resources." *Id.* § 30001.5.

The LCP consists of a local government's land use plans, zoning ordinances, zoning district maps, and other implementing actions. After its adoption, the LCP becomes a part of the local government's general plan and is vested with the same "constitutional" authority as the general plan. *Id.* §§ 30003, 30108.55, 30500. A certified LCP and all implementing ordinances may be amended by the local government, but no such amendment may take effect until it has been certified by the Coastal Commission.

The Coastal Act requires a landowner to obtain a coastal development permit from the local planning agency for any proposed development within the coastal zone. Until an LCP is adopted by the local government and certified by the Coastal Commission, the Coastal Commission has concurrent jurisdiction with the local government for granting development permits in the coastal zone. *Id.* § 30600(b)-(d). After the LCP is certified, the authority to issue coastal development permits is held solely by the local government. *Id.* §§ 30519, 30600(d).

d) Surface Mining and Reclamation Act

If a property or proposed use includes surface mining or mineral extraction, the Surface Mining and Reclamation Act of 1975, *id.* §§ 2761 *et seq*., may be applicable. This statute requires local agencies adopting general plans or specific plans to take

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[24] The coastal zone does not include areas covered by San Francisco Bay Conservation and Development Commission jurisdiction. Cal. Pub. Res. Code § 30103.

into account surface mining operations. The statute also requires that an applicable general plan be consistent with the policies of the statute. In conducting a due diligence investigation, one must determine if any surface mining areas have been designated next to or near the proposed property, as certain restrictions may apply to future uses of that property.

e) Daycare and Health Facilities

California's Planning and Zoning Law contains a number of particular requirements relating to daycare and health facilities. These provisions place certain limits upon zoning requirements for mental health and/or daycare facilities, and require compliance with certain code provisions applicable to similar types of facilities. *See*, *e.g.*, Cal. Health & Safety Code §§ 1566.3 *et seq.* (zoning of "community care facilities"). The California Health and Safety Code contains specific statutory requirements applicable to the zoning of residential care facilities for the elderly, alcoholism recovery facilities, developmentally disabled habilitative facilities, and congregate living health facilities. Family daycare homes are governed by the "California Child Daycare Facilities Act," *id.* §§ 1596.70 *et seq.*, which prohibits cities from regulating small family daycare homes (6 children or under), and limits city restriction of large family daycare homes (6 to 12 children). If a proposed land use would include a daycare or other health-related facility, it is necessary to determine whether any statutory restrictions apply to that proposed use.

f) Solid Waste Sites

Activities relating to the siting, expansion, and operation of solid waste management facilities, including landfills, incinerators, and transfer stations, are governed by the Integrated Waste Management Act, Cal. Pub. Res. Code §§ 40000 *et seq*. This statute sets forth the general requirements for the adoption of integrated waste management plans by counties, and source reduction and recycling requirements for both cities and counties. *Id*. §§ 41790 *et seq*. In conducting a due diligence investigation in connection with the acquisition or development of property, one must determine whether any active or inactive solid waste management or recycling facilities are located on or near the property, as certain restrictions may apply to future uses of that property.

7. Regional and Local Agencies

Land use planning is traditionally the province of local governments; however, land use decisions have an impact far beyond local boundaries. Therefore, the California Legislature has provided for a number of regional and local agencies to oversee all planning and development activities within certain geographic areas. Developers and property owners may need to obtain permits or other approvals from such regional or local agencies in order to engage in certain activities relating to the use and development of land. The requirements of these local agencies apply to such activities in addition to any applicable local government regulations.

a) Redevelopment Agencies

Under the Community Redevelopment Law, Cal. Health & Safety Code §§ 33000 *et seq*., cities and counties are authorized to form redevelopment agencies and to adopt redevelopment plans if new development may provide an economic stimulus and improve the overall character of a given neighborhood or city. Under the Community Redevelopment Law, state funding is available to rehabilitate redevelopment areas, which are defined as "blighted areas which constitute physical and economic liabilities, requiring redevelopment in the interest of the health, safety, and general welfare of the people of these communities and of the state." *Id*. § 33030. In general, the Community Redevelopment Law is utilized in situations where the blight is such that it constitutes a real hindrance to the development of the city and cannot be eliminated or improved without public assistance. If property to be acquired is located within a redevelopment area, the restrictions and requirements of the redevelopment plan should be reviewed and the local redevelopment agency consulted.

A determination of blight is a prerequisite to invoking redevelopment. To qualify as a blighted area, the area in question must meet certain statutorily defined criteria for economic and physical conditions that cause blight. *Id*. In recent years, the test for blight has become tougher, and the courts closely scrutinize determination of blight made by local redevelopment agencies. *Friends of Mammoth v. Town of Mammoth Lakes Redevelopment Agency*, 82 Cal. App. 4th 511 (2000); *Beach-Courchesne v. City of Diamond Bar*, 80 Cal. App. 4th 388 (2000). Examples of blight might include areas in which buildings are unsafe for persons to live or work in or areas in which incompatible uses prevent the economic viability or development of a parcel. One use of the Community Redevelopment Law is to promote the redevelopment of sites that have been contaminated with hazardous substances as a result of the prior use of the property. Upon cleanup of the contamination, the statute provides certain immunities from state law for the local redevelopment agency as well as persons who enter into an agreement with the local agency to redevelop the property, subsequent purchasers, and persons who provide financing to one of these entities or persons. Cal. Health & Safety Code § 33459.3.

b) Local Agency Formation Commissions and Annexations

If the property needs to be annexed to a city or special district, the mandates of the Cortese/Knox Local Government Reorganization Act, Cal. Gov't Code §§ 56000 *et seq*. (the "Cortese/Knox Act"), must be followed. The Cortese/Knox Act governs all types of boundary changes, including annexations, detachments, district formations, city incorporations, consolidations, and mergers. Most local agency boundary changes are subject to approval by the Local Agency Formation Commission ("LAFCO") of each county. *Id*. § 56325. LAFCOs have broad legislative powers to approve or disapprove boundary changes and to adopt spheres of influence for each city, county service area, or special district in the county, with the exception of school districts, community college districts, special assessment districts, improvement districts, and Mello-Roos Act Community Facilities Districts. *Id*. §§ 53311, 56375.

If the property is located in an unincorporated area, it is prudent to determine whether any petitions for incorporation are being circulated. If a boundary change has already been completed, developers may want to determine if the statute of limitations for challenging the validity of the boundary change has run. The statute of limitations is 60 days from the date of completion of the boundary change. *Id*. § 56103.

c) Special Regional Agencies

Property subject to the jurisdiction of a special regional agency, such as the San Francisco Bay Conservation and Development Commission ("BCDC"), the Tahoe Regional Planning Agency, the Sacramento Regional Area Planning Commission, and the Santa Monica Mountain Conservancy, may have additional limitations upon development. For example, BCDC is a state regional planning agency authorized to issue or deny permits for any proposed project that involves placing fill in, extracting materials from, or making any substantial change in the use of, any water, land, or structure in or on San Francisco Bay or within 100 yards of the shoreline of the bay. *Id*. §§ 66604, 66610. There are also a number of regional agencies dedicated to transportation issues in large metropolitan areas, such as the San Diego Association of Governments and the San Francisco Bay Area's Metropolitan Transportation Commission. Prospective landowners should be aware that if their land is within the jurisdiction of such a regional state agency, that agency's regulations may impose additional requirements on, or perhaps restrict, the further development of the property.

d) Special Districts

Water districts, fire districts, and other special districts generally do not have land use authority in California, although such districts occasionally play an important part in the development and land use process. In some instances, district policies regarding water and sewer hookups may affect development. It is important to investigate the presence of such policies. In addition, these special districts will play a role in the LAFCO consideration of boundary changes relating to that district.

C. The California Environmental Quality Act

The California Environmental Quality Act ("CEQA"), Cal. Pub. Res. Code §§ 21000 *et seq*., was enacted in 1970 to require public agencies to consider the environmental implications of their decisions. CEQA imposes a detailed and demanding environmental review process upon most public and private development activities. The mandates of CEQA encompass not only public projects, but also activities of private persons seeking discretionary approval for a "project" from a public agency. Under CEQA, "project" is defined as:

> An activity which may cause either a direct physical change in the environment, or a reasonably foreseeable indirect physical change in the environment, and which is any of the following:
>
> (a) An activity directly undertaken by any public agency.
>
> (b) An activity undertaken by a person which is supported, in whole or in part, through contracts, grants, subsidies, loans, or other forms of assistance from one or more public agencies.
>
> (c) An activity that involves the issuance to a person of a lease, permit, license, certificate, or other entitlement for use by one or more public agencies.

Id. § 21065. Accordingly, "projects" that are subject to CEQA include not only land use entitlements issued to private persons, but also the enactment and amendment of zoning ordinances, the issuance of zoning variances and conditional use permits, and the approval of tentative subdivision maps by public agencies. *Id.* § 21080(a). CEQA does not apply to projects that are either categorically or statutorily exempt from its provisions. *See id.* § 21080; Cal. Code Regs. tit. 14, §§ 15250-15332.

CEQA and its implementing regulations (the "CEQA Guidelines"), codified at California Code of Regulations title 14, sections 15000 *et seq*., require that an environmental impact report ("EIR") be prepared for all projects that may have a "significant" environmental effect. Cal. Pub. Res. Code §§ 21100, 21151. CEQA contains explicit directives to public agencies on the determination of a significant effect. *See, e.g.*, *id.* § 21083; Cal. Code Regs. tit. 14, § 15064. All such determinations must be based on substantial evidence in the record. Cal. Pub. Res. Code § 21082.2(a). For projects in which a public agency determines that no substantial evidence exists to show that the project may have a significant effect on the environment, a Negative Declaration may be prepared. *Id.* § 21080(c). Both EIRs and Negative Declarations are prepared by the public agency having principal responsibility for carrying out or approving the project (the "lead agency"). *Id.* § 21067. If the lead agency determines that the project will not have any possible significant effect on the environment, then no further action will be required under CEQA. Cal. Code Regs. tit. 14, § 15061(b)(3).

CEQA contains numerous procedural and substantive requirements, and its application has become more complex due to case law and legislation that has tended to favor greater environmental disclosure and protection. Because of CEQA's complexity, if the environmental review process outlined in the statute and regulations has not been adhered to with precision, a lead agency's decision to approve a project can be challenged for failing to properly consider and/or mitigate the environmental impacts associated with that project. For this reason, careful attention must be paid to this aspect of the land use due diligence process. Accordingly, it is equally important to determine whether there has been CEQA compliance for all prior discretionary project approvals, and whether the applicable statutes of limitation have run within which to challenge a public agency's CEQA determination.

1. Exemptions from CEQA

A number of specific categorical or statutory exemptions from the requirements of CEQA exist for certain types of projects. *See* Cal. Pub. Res. Code §§ 21080, 21171, 21172; Cal. Code Regs. tit. 14, Art. 17-19, § 15061(b); *see also* Cal. Gov't Code § 65457. It is not always easy to determine the projects that will be exempt; therefore, caution should be exercised when applying an exemption to a particular project.

If the project is exempt from CEQA, a Notice of Exemption will be filed and posted pursuant to California Public Resources Code sections 21108(b), (c) or 21152(b), (c) after the project is approved. If the Notice of Exemption is filed, the statute of limitations is 35 days for filing a lawsuit challenging the public agency's decision that the project is not subject to the provisions of CEQA. Cal. Pub. Res. Code § 21167(d).

If a Notice of Exemption is not filed, the statute of limitations for a legal challenge to the project is 180 days. *Id.* § 21167(a).

2. Initial Study

If the project is not exempt from CEQA, an "initial study" must be prepared pursuant to CEQA Guidelines section 15063. The purposes of the initial study are to determine whether or not the project may have a significant effect on the environment and whether an EIR or Negative Declaration should be prepared. The courts have tended to disfavor the simple "checklist type" of initial studies often used by public agencies, preferring at least some analysis of the potential effects of a project. *See Sundstrom v. County of Mendocino*, 202 Cal. App. 3d 296 (1988). The lead agency must consult with all other public agencies with jurisdiction over natural resources that will be affected by the project and those which have discretionary approval power over the project (*e.g.*, all trustee and responsible agencies), and with the Office of Public Research ("OPR"), to obtain their comments as to whether to prepare an EIR or Negative Declaration. Cal. Pub. Res. Code § 21080.3(a).

3. Negative Declaration

a) Preparation

If the initial study determines that an EIR is not required, a Negative Declaration may be prepared. CEQA Guidelines section 15070(b) also authorizes a lead agency to prepare a so-called "mitigated negative declaration," which allows a project applicant to avoid the preparation of an EIR even if the initial study identifies potentially significant environmental effects. A mitigated Negative Declaration may be issued if the applicant agrees to revisions in the project that will "avoid the effects or mitigate the effects to a point where clearly no significant effects would occur." Cal. Pub. Res. Code § 21080(c)(2). In other words, the mitigated Negative Declaration must contain a list of measures that have been included in the project and that would avoid potentially significant effects. Cal. Code Regs. tit. 14, § 15071(e).

b) Public Notice and Comment

The lead agency must give proper public notice of its intention to adopt a Negative Declaration pursuant to Cal. Pub. Res. Code § 21092. CEQA gives no clear guidelines on when this must occur, only that notice must be given within a reasonable period of time prior to the adoption of the Negative Declaration. Notice must be given to all organizations and individuals who have previously requested such notice and to all responsible and trustee agencies with discretionary approval power or jurisdiction over natural resources that will be affected by the project. Cal. Code Regs. tit. 14, §§ 15073(b), 15073(c). Notice must be given by publication, posting, or mailing, and must state that the Negative Declaration is available for public review and comment. The lead agency must allow sufficient time for members of the public and responsible agencies to respond to the proposed Negative Declaration before it is approved. *Id.* § 15073(a).

c) Reporting Program

The local agency must adopt a reporting or monitoring program to ensure compliance with a project's conditions of approval. CEQA requires that when a public agency adopts a mitigated negative declaration pursuant to Cal. Pub. Res. Code § 21080(c)(2), or makes findings pursuant to Cal. Pub. Res. Code § 21081(a), that public agency must adopt a reporting or monitoring program for the changes to the projects that are made conditions of project approval in order to mitigate or avoid significant environmental effects. Cal. Pub. Res. Code § 21081.6. This mitigation monitoring program must be designed to ensure compliance with the conditions of approval for the project.

d) Project Approval

The lead agency must approve and certify the Negative Declaration within 105 days from the date the application for the project was accepted as complete, *id.* § 21100.2 or 21151.5, and must approve the project within six months after this date. Cal. Gov't Code § 65950. Within five working days of the date on which the project was approved, the lead agency must file and post a Notice of Determination pursuant to Cal. Pub. Res. Code §§ 21108(a), 21108(c), 21152(a). Once a Notice of Determination is filed, there is a 30-day statute of limitations for filing a lawsuit challenging the lead agency's decision to prepare a Negative Declaration. *Id*. § 21167(b). If the agency does not file a Notice of Determination, the statute of limitations is 180 days from the date of project approval. *Id.* § 21167(a).

4. Environmental Impact Report

a) Notice of Preparation

If the initial study determines that the project may have a significant effect on the environment, an EIR is required. The first step in the EIR process is for the lead agency to issue a Notice of Preparation informing the public and other relevant agencies that an EIR will be prepared. The purpose of an EIR is to provide state and local agencies and the general public with detailed information on the potentially significant environmental effects that a proposed project is likely to have and to list ways in which the significant environmental effects may be minimized and indicate alternatives to the project.

b) Contents of an EIR

The EIR must describe both the project and the environmental setting in which the project will be located. The EIR must consider and analyze the environmental impact of the project on the environment. In particular, the EIR must identify any significant environmental effects of the proposed project, including any such effects that cannot be avoided if the project were implemented and any significant irreversible environmental changes that would result from implementation of the project. The EIR must also address any mitigation measures that are proposed by the project applicant to minimize the significant environmental effects of the project, as well as any feasible alternatives to the proposed project. For example, the EIR must contain a discussion of alternative project sites in addition to alternatives to the project itself. *Citizens of Goleta Valley v. Board of Supervisors*, 197 Cal. App. 3d 1167 (1988). The lead agency is responsible for ensuring that the EIR meets all the substantive and procedural requirements imposed under CEQA. *See* Cal. Code Regs. tit. 14, §§ 15120 *et seq*.

c) Notice of Completion and Public Review

Once a draft EIR has been prepared, the lead agency must file a Notice of Completion with the State Office of Planning and Research pursuant to Cal. Pub. Res. Code § 21161, and give public notice of availability of the draft EIR pursuant to Cal. Pub. Res. Code § 21092. The lead agency must allow sufficient time for public agency and general public review of the EIR. This review must not be less than 30 days nor greater than 90 days. CEQA Guidelines, Cal. Code Regs. tit. 14, § 15087(c). During this period, the public may submit comments to the lead agency regarding the contents and conclusions of the EIR.

d) Final EIR

The lead agency must properly prepare a final EIR, ensuring that it responds to all public comments received on the draft EIR and incorporates these into the final EIR. CEQA Guidelines §§ 15088, 15089. If the comments raise significant new information that must be added to the EIR, it may be necessary to revise the EIR and recirculate the revised draft for public and agency comment. Recirculation is necessary if the agency determines that (1) a new significant impact would result from the project or a new mitigation measure is proposed to be implemented; or

(2) a substantial increase in the severity of an environmental impact would result unless mitigated to insignificance; or (3) a feasible alternative or mitigation measure considerably different from those previously analyzed would lessen the project's environmental impact; or (4) the EIR is grossly deficient and conclusory in nature. Cal. Pub. Res. Code § 15088.5.

e) Findings

The lead agency must make the proper findings for each significant effect identified in the EIR pursuant to California Public Resources Code section 21081 and CEQA Guidelines section 15091 such that:

(1) changes or alterations have been or will be incorporated into the project which will mitigate or avoid the significant environmental effects identified in the EIR, and/or

(2) such changes or alterations are within the jurisdiction of another public agency and have been adopted by such other agency, and/or

(3) specific economic, social, or other considerations make infeasible the mitigation measures of project alternatives identified in the EIR.

The agency's findings cannot be mere recitations of the statutory language, nor can they be "boilerplate" environmental findings.[25] All findings must be supported by substantial evidence in the record and recite specific facts upon which the findings are based. Cal. Pub. Res. Code § 21081.5.

f) Statement of Overriding Considerations

In the event that a finding was made that it is not feasible to mitigate a significant effect of the project, the lead agency must adopt a Statement of Overriding Considerations for each significant effect that has not been substantially mitigated. Cal. Code Regs. tit. 14, § 15093.

g) Project Approval

The lead agency must approve (or disapprove) the project within one year after the date on which the application for the project is deemed complete. Cal. Gov't Code § 65950. If not, the project could be deemed approved pursuant to California Government Code § 65956(b). The lead agency must file and post a Notice of

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[25] *See, e.g.*, *Topanga Assn. for a Scenic Community v. County of Los Angeles*, 11 Cal. 3d 506 (1974); *City of Carmel v. Board of Supervisors*, 71 Cal. App. 3d 84 (1977); *Atherton v. Board of Supervisors*, 146 Cal. App. 3d 346 (1983).

Determination on the approval within five working days after the project is approved. Cal. Pub. Res. Code §§ 21108(a), 21108(c), 21152(a), 21152(c).

Once the Notice of Determination is filed, there is a 30-day statute of limitations for filing a lawsuit challenging the agency's decision to approve the project. *Id.* § 21167(c). If the agency does not file a Notice of Determination, the statute of limitations is 180 days. *Id.* § 21167(a).

5. Supplemental EIRs

The lead agency must prepare a subsequent or supplemental EIR if:

- subsequent changes are proposed in the project that will require important revisions to the prior EIR or Negative Declaration, or
- significant impacts are revealed that were not previously considered, or substantial changes have occurred in the circumstances under which the project was undertaken, or
- new information of substantial importance becomes available.

Id. § 21166; Cal. Code Regs. tit. 14, §§ 15162, 15163.

D. Initiative and Referendum: Voter Adoption or Rejection of Land Use Controls

1. Introduction

The powers of initiative and referendum are established by the California Constitution. *See* Cal. Const., art. III, §§ 8-11. These provisions give California voters the ability to enact new legislation (initiative) at the city, county, or state level, or invalidate previously enacted legislation (referendum), at the city or county level, thus allowing the people to bypass and to override the Legislature. The conceptual basis for both initiative and referendum is the principle that the people have reserved for themselves the right to exercise their inherent legislative power. The right of initiative and referendum applies only to legislative acts, including all legislative acts relating to land use, such as the enactment of general plans, specific plans, and zoning ordinances. Initiative and referendum powers do not apply to adjudicative or administrative acts, such as subdivision map approval or the granting of a variance or use permit. *Yost v. Thomas*, 36 Cal. 3d 561 (1984); *Arnel Dev. Co. v. City of Costa Mesa*, 28 Cal. 3d 511 (1980). However, the provisions of the California Constitution which grant the electors of each city or county the authority to exercise the powers of initiative and referendum do <u>not</u> apply to charter cities. Cal. Const., art. II, § 11. Of course, a city charter may itself adopt provisions granting the power of initiative and referendum to its citizens, and many charter cities have, in fact, adopted such charter provisions.

As noted above, the initiative process may be used to adopt local ordinances or statewide legislation. The procedures for initiative petitions are set forth in California Elections Code §§ 9100 *et seq*. (counties), and §§ 9200 *et seq*. (cities). The referendum process is one by which the electorate can, by vote of the people, repeal local statutes or ordinances adopted by the legislative body of a city or county before those laws become effective. *See* Cal. Elec. Code §§ 9236 *et seq*. In order to exercise the power of referendum, a referendum petition must be filed within 30 days of adoption of the ordinance or resolution by the local agency. *Id*. § 9236.

There are certain constitutional limits on the powers of initiative and referendum. Specifically, an initiative may embrace only one subject, *see* Cal. Const., art. III, § 8(d), and a referendum may not be used to reject interim urgency ordinances adopted pursuant to California Government Code section 65858, statutes calling elections, or statutes providing for tax levies or appropriations "for usual current expenses." Cal. Const., art. II, § 9(a); *see* also Cal. Elec. Code § 4050(b). The courts have placed further limitations on the powers of initiative and referendum. Generally, the power of the voters to adopt an ordinance by initiative is no greater than the power of the city council to adopt ordinances. Accordingly, an initiative may not violate the California or United States Constitution, *see Hawn v. County of Ventura*, 73 Cal. App. 3d 1009 (1977), conflict with general law, *see Galvin v. Board of Supervisors*, 195 Cal. 686 (1925), address a matter of statewide concern, *see Committee of Seven Thousand v. Superior Court*, 45 Cal. 3d 491 (1988), impair an essential governmental function, *see Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129 (1976), or invade a duty imposed solely on the city council as an agent of the state, *see Simpson v. Hite*, 36 Cal. 2d 125 (1950).

As applied to the land use field, if an initiative or referendum conflicts with the general plan, it is invalid when passed. *De Bottari v. City Council of Norco*, 171 Cal. App. 3d 1204 (1985). Moreover, if an initiative or referendum constitutes an arbitrary and discriminatory regulation that does not bear a substantial and reasonable relationship to the public welfare or is in excess of the police power, it will not be upheld by the courts. *Arnel Dev. Co. v. City of Costa Mesa*, 126 Cal. App. 3d 330 (1981). The primacy of the local general plans over initiatives was confirmed in *Lesher Communications, Inc. v. City of Walnut Creek*, 52 Cal. 3d 531 (1990).

2. Pending Initiatives

Developers and those acquiring property in California may want to determine if there are any growth-control or other related initiative petitions being circulated in the city or county where the property is located that could adversely impact the planned development of the property. Specifically, has any notice of intent to circulate a petition been filed and published, or has a proposed initiative been submitted to the city or county clerk for preparation of a ballot title and summary by the city attorney? *See* Cal. Elec. Code §§ 9100, 9104 (counties) *and* §§ 9200, 9203 (cities). If so, the next step is to inquire whether any of these petitions qualified for the ballot. *See id.* §§ 9107-9115 (signature requirements for initiative petitions in cities); *id.* §§ 9203-9218 (counties). The text of the proposed initiative must be legally valid, *e.g.*, the measure must be consistent with the general plan, and the electorate must have the authority to enact the measure. In addition, the initiative petition must meet all the requirements set forth in the California Elections Code. *See, e.g.*, *id.* §§ 9100-9115 (counties); *id.* §§ 9200-9218 (cities). The test for determining whether an initiative or referendum petition will be invalidated for failure to comply with these sections is whether the defect frustrates the purpose of, and does not substantially comply with, the California Elections Code requirements.[26]

3. Referendum Petitions

As noted above, the electorate can challenge and repeal local legislation, including the adoption of general plans or zoning ordinances, through the power of referendum. When referendum petitions are circulated that will affect the property being acquired, it is prudent for developers to determine whether the petitions meet all of the requirements specified in the Elections Code, as discussed in the above section. For example, developers can ascertain whether the measure will cause an inconsistency with the general plan as in *de Bottari v. City Council of Norco*, 171 Cal. App. 3d 1204 (1985). Further, when acquiring property, purchasers will want to find out if any referendum petitions have qualified for the ballot that may limit the development potential for that property. *See* Cal. Elec. Code § 9237.

4. Growth Management Ordinances

If no petition is currently pending, a growth management or similar ordinance may have already been passed into law, either by initiative or by the legislative body of the city or county. The requirements of such an ordinance must bear a reasonable relationship to the welfare of those whom the ordinance significantly affects. Also, it must meet the test first articulated in *Associated Home Builders Etc., Inc. v. City of Livermore*, 18 Cal. 3d 582 (1976): Does the ordinance represent a reasonable

[26] *See D'Agostino v. Superior Court*, 33 Cal. App. 4th 107, 116 (1995); *Assembly v. Deukmejian*, 30 Cal. 3d 638 (1982); *Chase v. Brooks*, 187 Cal. App. 3d 657 (1986).

accommodation of competing regional interests? The measure must also be consistent with the general plan. Moreover, another avenue of inquiry is the statute of limitations for challenging the ordinance. The statute of limitations for challenging an initiative ordinance is 90 days from adoption of the ordinance, the same as that for challenging an ordinance enacted by the legislative body. *See* Cal. Gov't Code § 65009(c); *Garat v. City of Riverside*, 2 Cal. App. 4th 259 (1991) (challenge to adequacy of charter city's general plan held to be timely, where actions were filed within 120 days (later amended to be 90-day statute of limitations) of adoption of initiative measure amending general plan).

E. Environmental Regulations Related to Land Use and Development

1. Endangered Species

The Federal Endangered Species Act ("ESA"), 16 U.S.C. §§ 1531 *et seq*., is administered by the United States Fish and Wildlife Service ("FWS") and the National Marine Fisheries Service ("NMFS"). Under the ESA, all federal agencies are required to protect endangered and threatened plant and animal species and to preserve their critical habitat. Federal agencies must utilize their authority to conserve listed species and to make sure that their actions do not jeopardize the continued existence of listed species.

Private landowners may also be affected by the ESA, as the presence of a protected species or its critical habitat may severely curtail the range of permissible land uses or activities for that property. Section 9 of the ESA prohibits any person from "taking" any member of an endangered species. 16 U.S.C. § 1538. The ESA defines "take" as meaning "to harass, harm, pursue, hunt, shoot, wound, kill, trap, capture, or attempt to engage in any such conduct." *Id*. § 1532(19). However, the ESA includes provisions allowing for "incidental" takings of protected species resulting from such activities as construction of homes, roads, and other facilities. *Id*. § 1539. In order to obtain permission to engage in an activity that could result in such an incidental taking, it is necessary to obtain an incidental take permit from the FWS. Failure to obtain the necessary permit could result in the imposition of severe penalties if an activity harms or takes a protected species. To be eligible for an incidental take permit, a party must submit a Habitat Conservation Plan to the FWS pursuant to the requirements of 16 U.S.C. § 1539(a)(2).

The FWS has enacted a "No Surprises Policy" which is intended to ensure that no additional land use restrictions or financial burdens will be applied to landowners who prepare a habitat conservation plan. The No Surprises Policy assures landowners that they will incur no additional mitigation requirements beyond those they agreed to in their Habitat Conservation Plans, even if circumstances change.

In addition, if a proposed project could adversely affect plant or animal species listed under the California Endangered Species Act ("CESA"), or could adversely impact the critical habitat of such species, it is necessary to obtain an incidental take permit from the California Department of Fish and Game ("DFG"). To obtain a CESA incidental take statement, one must submit an application to DFG identifying the project, its location, an analysis of whether and to what extent the project could result in the taking of species to be covered by the permit, an analysis of whether issuance of the incidental take permit would jeopardize the continued existence of a species, and proposed mitigation and monitoring measures. Cal. Code Regs. tit. 14, § 783.2.

2. Wetlands

The term "waters of the United States" is broadly defined, and includes rivers, coastal waters, lakes, ponds, mudflats, wetlands, sloughs, vernal pools, and any tributaries of such waters, the use, degradation, or destruction of which could affect interstate commerce. 33 C.F.R. § 328.3(a); 40 C.F.R. § 122.3. Any person proposing to locate a structure in navigable waters, or to excavate or discharge dredged or fill material, is required to obtain a permit to do so from the U.S. Army Corps of Engineers (the "Corps"). 33 C.F.R. § 323.

The Corps's authority to regulate activities in waters of the United States stems from several statutes. For example, section 404 of the Federal Water Pollution Control Act, 33 U.S.C. §§ 1251 *et seq.*, (commonly known as the Clean Water Act ("CWA")) authorizes the Corps to control the placement of dredged or fill material in waters of the United States. *See id.* § 1344. In addition, section 10 of the Rivers and Harbors Act, *see id.* §§ 401 *et seq.*, requires that anyone proposing to erect structures in navigable waters of the United States (including construction, excavation, or deposition of materials in, over, or under such waters, or any work that would affect the course, location, condition, or capacity of those waters) must obtain a permit from the Corps. *Id.* § 403.

In approving an application for a project that involves the discharge of dredge or fill material into waters of the United States, the Corps may require the applicant to comply with certain mitigation measures that are designed to minimize the potential adverse impacts of the proposed project. The Corps must be satisfied that discharge of dredge or fill material will not have an "unacceptable adverse impact either

[27] It should be noted that, in addition to complying with the Corps's permit requirements, an applicant will be required to obtain a section 401(c) certification from the Regional Water Quality Control Board, indicating that the proposed project will be located, designed, constructed, and operated in compliance with applicable state water quality standards. *See* Cal. Code Regs. tit. 23, §§ 3800 *et seq.*

individually or in combination with known and/or probable impacts of other activities affecting the ecosystems of concern." 40 C.F.R. § 230.1(c).[27] While the Corps is generally the lead agency with regard to determining when a section 404 permit is required and for issuing that permit, the U.S. Environmental Protection Agency ("EPA") also has the authority to review and veto section 404 permits issued by the Corps.

Until recently, even isolated wetlands or water bodies were subject to the Corps's jurisdiction, and any dredge or fill activities in or on such water bodies required a section 404 permit from the Corps. However, in January 2001, the United States Supreme Court issued a decision that limits the authority of the federal government to regulate the disturbance of wetlands and other waters under section 404.

In *Solid Waste Agency of North Cook County v. U.S. Army Corps of Engineers*, 531 U.S. 159 (2001) ("*SWANCC*"), the Supreme Court struck down a Corps policy to exercise CWA jurisdiction over intrastate, isolated, non-navigable bodies of water if those waters are or would be used by migratory birds. This policy, commonly known as the "Migratory Bird Rule," had been employed by the Corps as a test to determine whether the use or disturbance of intrastate, isolated non-navigable waters would have an effect on interstate commerce, a prerequisite to federal regulation under the United States Constitution. In *SWANCC*, the Supreme Court held that the Migratory Bird Rule was illegal because Congress intended section 404 of the CWA to govern only *navigable* waters.

The Supreme Court's ruling in *SWANCC* is ostensibly narrow, as the Supreme Court refused to address whether the Commerce Clause allows federal jurisdiction over isolated waters based upon migratory bird use. Instead, the Supreme Court held that the CWA itself prohibited application of the Migratory Bird Rule because the CWA explicitly applies only to navigable waters, whereas the Migratory Bird Rule was used by the Corps to extend jurisdiction over non-navigable, intrastate, isolated waters. Thus, with regard to wetlands that are subject to Corps jurisdiction, the Supreme Court held that a water body must nonetheless bear *some* connection to open, navigable waters (*e.g.*, lakes, rivers, streams) in order to be covered by section 404. Thus, the decision would allow certain wetlands and other water bodies that do not have some hydrological connection to an open water body to be filled without a permit from the Corps.

Not surprisingly, state and federal agencies have reacted quickly to the Supreme Court's challenges to regulatory authority under *SWANCC*. On January 19, 2001, 10 days after the *SWANCC* decision, the Corps and EPA issued a joint memorandum identifying the aspects of the regulatory definition of "waters of the United States" affected by *SWANCC* ("Joint Memorandum"). The Joint Memorandum states that, although *SWANCC* discussed federal CWA jurisdiction in broad terms, its holding was limited to invalidating the Corps's application of 33 C.F.R. § 328.3(a)(3), as clarified and applied to the ponds at issue pursuant to the Migratory Bird Rule. In other words, the Joint Memorandum takes the position that *SWANCC* did not affect the scope of section 328.3(a)(3) itself.

Although the full impact of the *SWANCC* decision is yet to be felt, greater regulation of isolated wetlands can be expected at the state and local levels. Additionally, federal and state resource agencies (*e.g.*, United States Fish and Wildlife Service and California Department of Fish & Game) will likely attempt to exert jurisdiction over isolated waters based on wildlife and ecological concerns in order to fill the regulatory gap. While these agencies use their authority to regulate isolated wetlands, we can also expect to witness future litigation involving the substantial nexus standard, the need for hydrological connections, and the scope of the Corps's authority generally as the Corps attempts to modify its regulations to broaden its authority beyond traditional definitions of navigability and adjacency.

As a result of the *SWANCC* decision, landowners and developers must now consider a variety of factual questions in determining whether a section 404 permit is required for the disturbance of wetlands and other waters (*e.g.*, Is it navigable? If not, is it "adjacent" to or a "tributary" of a navigable water? What hydrologic or other connections exist between a particular wetland and other, navigable waters?). These questions will spawn new disputes between the federal government and the regulated public and, undoubtedly, additional litigation. As a precautionary measure, it is advisable for landowners and developers that wish to fill a wetland or other isolated water body to consult with the Corps where it is unclear whether a given fill is subject to section 404 jurisdiction.

3. Storm Water Discharges

Persons engaging in construction activities[28] that disturb five acres or more of land must have a Storm Water General Permit and a Storm Water Pollution Prevention Plan ("SWPPP") under the United States Environmental Protection Agency ("EPA") regulations that implement the Clean Water Act. The EPA's storm water discharge regulations are codified at 40 C.F.R. § 122.26. These regulations affect a vast array of developments and construction projects in California and across the country. In recent months, the EPA has stepped up its enforcement of these storm water requirements, particularly in California, imposing monetary penalties on developers

[28] Construction activity includes clearing, grading, and disturbances to the ground such as stockpiling or excavation.

who fail to comply with the regulations. As a result, developers and construction site operators must ensure that they are in compliance with the EPA's storm water regulations.

The Storm Water General Permit authorizes the discharge of storm water to surface waters from construction activities that result in the disturbance of five or more acres of land. It prohibits the discharge of materials other than storm water and authorized non-storm water discharges and prohibits all discharges that contain a hazardous substance in excess of reportable quantities established in federal regulations at 40 CFR § 117.3 or 40 CFR § 302.4, unless a separate National Pollution Discharge Elimination System ("NPDES") permit has been issued to regulate those discharges. The operator of the storm water discharge is responsible for obtaining the NPDES permit. Operators can include landowners, developers, general contractors, or individual contractors.[29]

Construction activity that results in soil disturbances of less than five acres may still be subject to a General Permit if the construction activity is part of a larger common plan of development that encompasses five or more acres of soil disturbance or if there is significant water quality impairment resulting from the activity. In general, "construction activity" does not include routine maintenance to maintain original line and grade, hydraulic capacity, or original purpose of the facility, nor does it include emergency construction activities required to protect public health and safety. However, developers should confirm with the local Regional Water Quality Control Board whether a particular routine maintenance activity is subject to the General Permit.

The SWPPP has two major objectives: (1) to help identify the sources of sediment and other pollutants that affect the quality of storm water discharges; and (2) to describe, and ensure the implementation of, best management practices ("BMPs") to reduce or eliminate sediment and other pollutants in storm water as well as non-storm water discharges. The SWPPP also includes BMPs that address source control and, if necessary, address pollutant control. In general, a SWPPP must include descriptions of BMPs for erosion and sediment controls, BMPs for construction waste handling and disposal, and proposed post-construction controls, including descriptions of local post-construction erosion and sediment control requirements.

[29] In addition, landowners should be aware that NPDES permits are also necessary for certain discharges to water after construction activities have taken place. For example, if the land is developed into an industrial facility that will have water discharges, NPDES permits may be necessary both for the development of that property, as explained above, and for the operation of the facility located on the property. This summary does not address the environmental regulatory scheme applicable to industrial operations.

4. Air Quality Regulation

Air quality districts in California may require developers proposing large development projects to obtain "authority to construct" or similar permits before construction activities begin. As their name implies, "authority to construct" approvals apply only to air emissions during the construction phase, such as emissions from construction equipment. Depending on the nature of the proposed project, if the project will have air emissions after construction, it may also be necessary for the owner or operator of that facility to obtain an operating permit from the local or regional air quality management district.

In addition, developers may be required to adopt mitigation measures if their construction project would adversely impact air quality. These regulations have generally been patterned after model rules circulated by the State Air Resources Board as a guide to implementing requirements of the California Clean Air Act of 1988.

Additional information regarding the California Clean Air Act and the implementation of the federal Clean Air Act in California is available in Chapter 11, *Environmental Regulatory Scheme*.

CHAPTER 11

ENVIRONMENTAL REGULATORY SCHEME

This chapter provides an overview of the primary environmental laws and regulations that affect persons and entities doing business in California. There are three sources of environmental law that apply to persons conducting business in California: federal, state, and local. In large part, the regulatory scheme for environmental protection in the United States has been created by the federal government, which has established a detailed series of laws and regulations to control pollution of land, air, and water, protect human health and safety, and prevent harm to natural resources. California's environmental regulatory scheme is widely recognized as one of the most strict and comprehensive in the United States. In addition to establishing stringent emission limitations that go beyond the minimums required under federal law, numerous state and local laws govern issues that have not been addressed by federal law. As a result, the environmental regulatory scheme in California is complex, involving federal, state, regional, and local authorities. In many cases, special regional or local governmental entities have been created to protect significant environmental resources that are located within a particular geographic region, such as the San Francisco Bay area. These entities may impose their own rules and regulations governing activities within their jurisdiction. Those who do business in, or with companies located in, California must therefore diligently investigate the environmental ramifications of their actions, and it is important to determine what laws might apply to business activities prior to commencing such activities. Failure to comply with environmental laws and regulations could result in significant litigation expenses, liabilities, statutory penalties, and in some cases, criminal sanctions.

This chapter does not attempt to address the entire spectrum of environmental laws and regulations in California. It is critical to appreciate the complexity and substantial impact of environmental laws on businesses operating in California, and accordingly, it is always prudent to consult counsel with regard to specific environmental matters to ensure that the proposed business activity meets all applicable requirements and is conducted in accordance with law.[30]

A. Federal Law

Numerous federal statutes regulate virtually every facility or business operation that manufactures, uses, generates, handles, emits, transports, or disposes of substances that could harm the environment, cause pollution, create odors, noise, or eyesores, or have other effects on human health or the environment. The coverage of these statutes is not discrete — a given activity, property, or condition may be regulated under several separate federal statutory authorities, as well as several overlapping state and local provisions. Often, these laws are not enforced uniformly; different

[30] It should be noted that this summary does not address all laws and regulations governing the use and development of land, buildings, and facilities. For additional information on California's land use laws, see chapter 10, *Land Use, Zoning, and Property Development Laws*.

agencies, even at the same level of government, may apply different mandates to the same activities.

The United States Environmental Protection Agency ("U.S. EPA") has regulatory oversight and enforcement authority under most of the federal environmental statutes. The U.S. EPA is divided into 11 geographical regions, and California is located in U.S. EPA Region 9, which is known for its active and innovative role in implementing and enforcing environmental laws.[31] For example, U.S. EPA Region 9 has adopted a program to encourage citizens, such as environmental groups, to take an active role in protecting local watersheds by encouraging citizen-based water quality monitoring programs. Another example of the innovative approach the U.S. EPA has taken in California involves the San Francisco Bay Delta watershed, where Region 9 is working with a consortium of over 20 state and federal agencies to improve water quality in the San Francisco Bay. The U.S. EPA has also created innovative programs to improve air quality in southern California and to improve water quality in California's Lake Tahoe.

Many federal environmental statutes also provide for delegation of implementation and primary enforcement responsibility to states such as California, including the Clean Water Act, the Clean Air Act, and the Resource Conservation and Recovery Act. In such cases, the U.S. EPA maintains a supervisory role and has final enforcement authority with respect to these statutes. Even where states have not been delegated authority to implement federal programs, federal law may allow them to implement their own additional laws.

The federal courts have been granted jurisdiction over matters involving federal environmental law, such as disputes regarding the interpretation and application of such laws. Certain federal statutes provide for original jurisdiction in the United States courts of appeals, but United States District Courts also have jurisdiction to decide certain matters that arise within their geographic areas, such as enforcement actions. In California, the United States Court of Appeals for the Ninth Circuit adjudicates appeals from the federal district courts. Other than the United States Court of Appeals for the District of Columbia, the Ninth Circuit has probably been the most active with respect to issuing controversial and far-reaching environmental decisions.

The following is a summary of some of the major federal environmental statutes that apply in California:

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[31] In addition to California, Region 9 includes the states of Arizona, Nevada, and Hawaii.

1. Hazardous Substances and Wastes

Congress has enacted a complex series of laws and regulations to ensure that hazardous materials are properly handled and disposed of. The Resource Conservation and Recovery Act ("RCRA"), 42 U.S.C. §§ 6901 *et seq.*, provides for regulation of hazardous waste "from cradle to grave" (*i.e.*, from generation to disposal), and establishes facility permitting and waste management requirements applicable to persons that generate, treat, store, transport, or dispose of hazardous wastes. Under RCRA, the federal government is empowered to order such action as is deemed necessary and to impose fines for past or present violations when the handling, storage, treatment, transportation, or disposal of solid or hazardous waste may present an imminent and substantial endangerment to health or the environment. *Id.* §§ 6928, 6973. Citizen suits are also authorized under certain circumstances. *Id.* § 6972. RCRA imposes substantial penalties for violations of its requirements, and liability can extend to owners and operators of affected businesses and properties. California has received authorization under RCRA to implement its own hazardous waste regulatory program in lieu of the federal RCRA program and does so via the California Department of Toxic Substances Control ("DTSC"). *Id.* § 6926; 57 Federal Register 32726 (July 23, 1992).

The Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), 42 U.S.C. §§ 9601 *et seq.*, commonly known as Superfund, was enacted to address contaminated sites and provides broad federal authority to respond directly to releases or threatened releases of hazardous substances that may endanger public health or the environment. CERCLA authorizes the government and private parties that respond to a release or threat of release of a hazardous substance to recover the costs of cleanup from responsible parties.[32] In addition to costs of cleanup, responsible parties are liable for damages to natural resources. CERCLA defines responsible parties to include: (1) the current owner or operator of the property; (2) prior owners and operators who owned the property when any disposal occurred; (3) persons who arranged for disposal of hazardous substances; and (4) the transporter who selected the location of hazardous substance treatment or disposal at the site on which it was released. *Id.* § 9607(a). Liability under CERCLA is joint and several, meaning that a single party may be held responsible for the entire cleanup even if that party made only minor contributions to the total release of hazardous material. The statute therefore does not require that all responsible parties be sought in connection with the cleanup, and reimbursement for cleanup costs may be sought against whatever liable party the government or other plaintiff can find. *Id.* §§ 9604, 9606, 9607, 9613(f). It is important to stress that CERCLA liability is not based on fault or knowledge; liability may apply to an owner who had no knowledge of the

[32] The United States Congress created a fund of money for CERCLA cleanups (the "Superfund"); however, the U.S. EPA will first attempt to recover cleanup costs from responsible parties before spending federal money from this fund.

existence of the release or of the hazard it poses. CERCLA also allows the states to impose additional liability and requirements, and California has its own state program for governing the cleanup of hazardous substances, which applies in addition to CERCLA. *Id.* § 9614.

The Emergency Planning and Community Right-to-Know Act, or SARA Title III, *id.* §§ 11001 *et seq.*, establishes detailed planning, notification, and reporting requirements for regulated materials. This statute is perhaps the most comprehensive of the "right-to-know" laws that require companies to disclose to individuals information concerning chemicals located in their communities or workplace, and that provide for emergency preparedness to react to environmental accidents. SARA Title III comprises multiple chemical reporting and information requirements applicable to regulated entities. Required reports may include information on permitted or accidental chemical releases, or the manufacture, processing, storage, and use of chemicals. The information collected is available to the public, subject to some trade secret protection. *See* 40 C.F.R. Part 350. Both CERCLA and SARA Title III require reporting of certain releases to governmental authorities. *See* 42 U.S.C. §§ 9603, 11004. Under CERCLA, releases of hazardous substances in excess of the reportable quantity ("RQ") must be reported to the National Response Center. SARA Title III requires that releases of extremely hazardous substances or hazardous substances in excess of a CERCLA RQ that result in exposure to persons outside the facility's boundaries be reported to the community emergency coordinator and the state emergency response commission. In California, releases would be reported to the appropriate county Office of Emergency Services and the State Office of Emergency Services.

2. Air Pollution

The Clean Air Act ("CAA"), *id.* §§ 7401 *et seq.*, was enacted in 1970 and forms the basis for controlling air pollution nationwide. The CAA regulates air emissions from both stationary and mobile sources. This law authorizes the U.S. EPA to establish national ambient air quality standards and to set maximum levels of air pollutants from pollutant sources. *Id.* § 7409. The CAA also empowers the U.S. EPA to set emissions standards for new air pollution sources. As required by the CAA, U.S. EPA regulations establish standards of performance for various categories of industry that require facilities to control air emissions using the best available technology. *Id.* § 7411. The CAA also provides for permitting of certain stationary sources. *Id.* §§ 7661 *et seq*. The individual states are delegated responsibility, subject to U.S. EPA oversight, to enforce and monitor air pollutant sources within the state. Accordingly, California has its own Clean Air Act wherein the California Air Resources Board and local air quality management districts are responsible for implementing the applicable federal CAA requirements.

3. Water Pollution

The Federal Water Pollution Control Act, 33 U.S.C. §§ 1251 *et seq.*, commonly known as the Clean Water Act ("CWA"), regulates the discharge of pollutants to waters of the United States. The CWA empowers the U.S. EPA to set effluent standards on an industry basis as well as water quality standards for all contaminants in surface waters. *Id.* § 1311. Facilities whose operations involve discharges to water are required to obtain permits prior to discharging any constituents of concern. *Id.* The CWA also contains certain government cleanup and cost-recovery provisions allowing the government to sue past or present owners or operators for costs resulting from the discharge, or threat of a discharge, of oil or hazardous substances into or upon waters of the United States. *Id.* §§ 1321(f), 1321(g). The CWA also requires reporting of certain releases to waters of the United States. *Id.* § 1321.

Under the CWA, the U.S. EPA delegates most of its permitting and enforcement responsibilities to the states while maintaining oversight authority. *Id.* § 1251. In California, the responsibility for implementing the CWA is delegated to the State Water Resources Control Board and nine regional water quality control boards. The CWA also allows citizens, such as environmental group members, to bring lawsuits against business and government agencies under certain circumstances for violations of certain of its provisions. *Id.* § 1365.

B. State Law

As discussed above, California has been delegated substantial responsibility for implementing federal environmental laws, including those laws regulating discharges to air, water, and land. In addition, California has its own environmental laws and regulations. While the basic regulatory scheme for environmental protection is created in large part by the federal government, often California's own environmental laws will reach further or impose more stringent requirements than federal law. In many cases, California's environmental laws may be the most stringent in the nation. Some of these laws are unique to the state of California, such as "Proposition 65."

1. Responsible Agencies

The California Environmental Protection Agency ("CalEPA") is the umbrella agency responsible for enforcing environmental laws in California. Most environmental regulatory and enforcement activities are carried out by the specialized agencies under its jurisdiction. The California Air Resources Board oversees all air pollution control efforts in California, as well as the activities of 35 local air pollution control districts. The Department of Toxic Substances Control, which has four regional field offices, is responsible for regulating hazardous waste management activities and facilities and overseeing the cleanup of hazardous waste sites. The State Water Resources Control Board and its nine Regional Water Quality Control Boards ("RWQCBs") oversee all water pollution control efforts in California, including protecting surface water and groundwater from discharges to land and water, issuing permits for discharges of both waste and storm water, regulating underground storage tanks, and certifying that other federally issued permits, such as permits to dredge and fill wetlands, are in compliance with California's water quality standards. The Integrated Waste Management Board and its corresponding Local Enforcement Agencies are responsible for managing all of the solid waste generated in California. The Office of Environmental Health Hazard Assessment provides scientific information and recommendations to other agencies regarding the risks posed by hazardous substances. All of these agencies play a significant role in enforcing environmental laws in California and are often provided authority from the State Legislature allowing them to set forth their own environmental guidelines and policies with which businesses must comply.

2. Hazardous Substances and Waste

a) Treatment, Storage, and Disposal of Hazardous Waste

California's Hazardous Waste Control Law ("HWCL"), Cal. Health & Safety Code §§ 25100 *et seq.*, establishes regulations and incentives to ensure that businesses practice safe generation, handling, storage, transportation, treatment, recycling, and disposal of hazardous waste. California's state hazardous waste program is authorized by the U.S. EPA to operate in lieu of most of the federal RCRA program. The HWCL regulates not only all wastes that are classified as hazardous under RCRA, but also "non-RCRA" hazardous wastes that pose a substantial present or potential hazard to human health or the environment. *Id.* §§ 25117(b), 25141. In some cases, the HWCL also imposes additional or more stringent requirements than RCRA. For example, generators of waste oil and relatively small quantities of other hazardous substances are subject to more regulation under the HWCL than under RCRA. *See id.* §§ 25250-25250.25; 40 C.F.R. 264.1030-1079, 265.1030-1079. Thus, the HWCL is broader and more stringent than RCRA.

Businesses can be held liable for administrative, civil, and/or criminal penalties for violations of the HWCL. The HWCL also provides for damages for the costs and expenses of restoring, rehabilitating, replacing, or acquiring the equivalent of any natural resource injured, degraded, destroyed, or lost as a result of the disposal of hazardous waste. *Id.* §§ 25181, 25182, 25189, 25189.1.

b) Abandoned Hazardous Substances

California's Hazardous Substance Account Act ("California's Superfund"), *id.* §§ 25300 *et seq.*, is the basic state law governing the cleanup of sites contaminated with hazardous substances. California's Superfund mirrors CERCLA in many respects but differs in others. For example, the list of hazardous substances in California is broader than that in CERCLA, and joint and several liability is not always authorized. California's Superfund also limits retroactivity to 1982, provides for victim compensation, and subjects to treble damages those who are liable for failure without sufficient cause to respond to an order. It also provides for local cleanup authority and private site management.

California's Superfund imposes strict liability on any person who owns or operates a facility or owned or operated a facility at the time of disposal of hazardous wastes. *Id.* § 25323.5 (citing CERCLA, 42 U.S.C. § 9607(a)). If the DTSC determines that a release, or threatened release, of a hazardous substance may cause an *imminent or substantial endangerment* to the public health or welfare or to the environment, it has three options: (1) order any responsible party to take appropriate removal or remedial action; (2) take or contract for any necessary removal or remedial action; or (3) request the Attorney General to secure such relief in the courts as may be necessary to abate the danger or threat. *Id.* § 25358.3(a)(1)-(3).

Under California's Superfund, businesses can be held liable for costs or expenditures incurred in responding to hazardous substance releases. *Id.* § 25360. Such costs can include costs expended to restore, rehabilitate, replace, or acquire the equivalent of any natural resource injured, degraded, destroyed, or lost as a result of the release of a hazardous substance. *Id.* § 25352. Authority under California's Superfund, the state's Water Code, and local agency requirements often means overlapping federal, state, and local jurisdiction over site cleanup. At many smaller sites where the state oversees the cleanup, the course of cleanup can vary considerably depending on which agency takes the lead. California has a procedure for designating a lead agency to ensure that all requirements are met. *Id.* §§ 25260 *et seq*.

c) Emergency Response Provisions

California has adopted several statutes, including the Hazardous Materials Release Response Plans and Inventory, *id.* §§ 25500 *et seq.*, which implement emergency response measures to respond to the release or threatened release of hazardous materials. These statutes require businesses handling a specified minimum amount of hazardous materials to develop emergency response plans for responding to any releases, or threatened releases, of such materials. Owners and operators of certain stationary sources, including buildings, structures, or equipment from which an accidental release of a regulated substance may occur, must also submit risk management plans. The statute also requires immediate notification to state and local emergency response agencies of certain releases or threatened releases of hazardous materials.

d) Release Reporting Provisions and Disclosure Requirements

In addition, other California laws and regulations may require businesses to report to various governmental agencies releases or threatened releases of hazardous materials or pollutants into the environment, depending on the nature, amount, and circumstances of the release. These release reporting provisions are not uniform, and often releases need to be reported under more than one provision and to more than one agency. Accordingly, persons doing business in California and handling hazardous materials must exercise diligence to ensure all applicable reporting obligations are met.

e) Oil and Hazardous Substance Spill Prevention and Response

California has several statutes that govern oil and hazardous substance spill prevention and response. California's Oil Spill Prevention and Response Act ("OSPRA"), Cal. Gov't Code §§ 8574.1-8670.72, empowers the California Department of Fish and Game to compel cleanup and removal of certain spills. OSPRA broadly imposes liability on the parties or businesses responsible for causing oil to enter or threaten to enter state waters. *Id.* § 8670.3(q). Under OSPRA, liability applies without regard to fault for all cleanup, response, and removal costs and for damages from any injury caused by an oil spill to the marine environment. *Id.* § 8670.56.5.

3. Air Pollution

The California Clean Air Act ("CCAA"), Cal. Health & Safety Code §§ 39000 *et seq.*, establishes a comprehensive state air pollution control program to fulfill the requirements of the federal CAA as well as to establish, attain, and maintain the state's own air quality goals. In general, matters of planning, permitting, emissions limitation, and enforcement are subject to extensive federal requirements as well as to U.S. EPA oversight to ensure compliance with those requirements. Knowledge of the federal CAA is therefore useful and in many cases essential to an understanding of the substance and operation of California's air regulatory program.

Under the CCAA, the California Air Resources Board ("CARB") and the local air quality districts share responsibility for improving air quality. CARB establishes standards of ambient air quality and regulates vehicular air pollution, whereas the local air quality districts have the primary authority, subject to oversight from CARB, to regulate nonvehicular sources of pollution. The Bay Area Air Quality Management District ("BAAQMD") and the South Coast Air Quality Management District ("SCAQMD") are two of the most active air quality districts and have the most stringent regulations in California. The CARB regulations for vehicle emissions, and the district regulations for stationary sources, provide for comprehensive regulation and permitting of sources that may go beyond the regulatory requirements in the federal CAA or those required by other states. Therefore, it is very important to consult the rules of the relevant agency regarding potential regulatory requirements. The CCAA also provides for administrative, civil, and criminal penalties for violations.

4. Water Pollution

California's Porter-Cologne Water Quality Control Act ("Porter-Cologne Act"), Cal. Water Code §§ 13000 *et seq.*, regulates the discharge of pollutants to state waters, which are defined to include both surface and groundwater. In this respect, California law is more expansive than the federal CWA, which, in most cases, does not regulate discharges to groundwater. The State Water Resources Control Board has the ultimate responsibility for enforcing the Porter-Cologne Act; however, there are nine Regional Water Quality Control Boards ("Regional Boards") that also oversee water regulation on a regional and local level.

Regional Boards set forth water quality standards and objectives and regulate all pollutant or nuisance discharges that may affect either surface water or groundwater. Facilities proposing to discharge wastes into state waters must file in advance a report of such proposed discharge with the appropriate Regional Board and, generally, no discharge can take place until a set of "Waste Discharge Requirements" and/or a federal National Pollutant Discharge Elimination System/CWA permit is issued by the Regional Board. *Id.* § 13260. The Regional Boards do not uniformly apply the rules and regulations, and therefore, businesses should check the requirements of the appropriate Regional Board before undertaking any significant project.

Under the Porter-Cologne Act, the Regional Boards have the authority to order any person who has caused or permitted (or threatened to cause or permit) any waste to be discharged or deposited where it might reach state waters, to clean up or abate the discharge. *Id.* § 13304. Such wastes include, in addition to hazardous substances, all other waste substances (liquid, solid, or gaseous) from any producing, manufacturing, or processing operation. *Id.* § 13050(d). Current owners of property where such discharges have occurred may be subject to Regional Board orders even though a past owner or operator was solely responsible for the presence of the waste in the environment.

5. Consumer Products

a) Warning Disclosures

California has gone far beyond other states in the enactment, by voter initiative,[33] of a far-reaching disclosure statute commonly known as "Proposition 65" or the Safe Drinking Water and Toxic Enforcement Act of 1986, Cal. Health & Safety Code §§ 25249.5 *et seq*. In addition to providing certain protections to drinking water resources, the statute requires businesses to provide warnings before exposing any individual (via products, the environment, or the workplace) to a lengthy list of chemicals specifically identified by the Governor of California as carcinogens or reproductive toxicants. *Id*. § 25249.6. Exposure to any amount of a listed chemical triggers Proposition 65's warning requirement, and if a failure to warn is alleged, the burden of proof is placed on "any person in the course of doing business" to establish that the amount of exposure poses "no significant risk" or "no observable reproductive effect" according to strict guidelines set out by the state in regulations. *Id*. §§ 25249.10, 25249.22; Cal. Code Regs. tit. 22, §§ 12701 *et seq*.

Proposition 65's warning requirement applies to all businesses with 10 or more employees in the chain of commerce involved in the exposure, including manufacturers, distributors, or retailers located outside California who sell or distribute products in the state. Local restaurants, bars, drugstores, and even corporations that provide alcoholic beverages at business functions or allow smoking in their offices are also covered by the requirement. The broad terms of the statute, the expansive list of over 600 chemicals covered, and the stringent standards promulgated to date have resulted in many warnings being provided throughout the state. Regulations issued by the Office of Environmental Health Hazard Assessment have established means to provide a warning by use of signs, labels, newspaper ads, and other methods. *See* Cal. Code Regs. tit. 22, §§ 12601 *et seq*. Proposition 65 may be enforced by public prosecutors or, if certain procedural prerequisites are not met,

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[33] Voter initiatives are discussed in more detail in Chapter 10, *Land Use, Zoning, and Property Development Laws*.

by any individual claiming to act in the public interest. It provides for injunctive relief and for civil penalties of up to $2,500 per day per violation. When private citizens are successful in proving an unlawful exposure has occurred, they receive 25% of fines collected as a reward. Cal. Health & Safety Code § 25192. Plaintiff's attorneys' fees may also be recovered pursuant to Cal. Civ. Proc. Code § 1021.5.

b) Environmental Advertising and Labeling Requirements

California has numerous laws that regulate the environmental aspects of product packaging, advertising, and labeling. These laws provide that manufacturers and distributors of products must follow strict guidelines regarding any representations that their products are not harmful to, or are beneficial to, the environment. Definitions are provided for frequently used advertising and labeling phrases, such as "ecologically sound," "environmentally safe," "recyclable," "biodegradable," etc., to ensure that use of such terms does not mislead consumers. Any businesses that use a defined term must maintain, and make available to the public, records providing, among other things: (1) why a particular representation is true; (2) any significant adverse environmental impacts directly associated with the production, distribution, use, and disposal of the product; and (3) any measures taken to reduce such impacts. *See* Cal. Bus. & Prof. Code §§ 17580-17581. Thus, prior to making any such claims in California, it is prudent for businesses to carefully review the specific provisions and implications of these requirements.

6. Other Regulations

a) Occupational Safety and Health Regulations

California has received authorization to implement its own occupational safety and health ("Cal/OSHA") program in lieu of the federal program. The Division of Occupational Safety and Health is responsible for enforcing California laws and regulations pertaining to workplace safety and health and for providing assistance to employers and workers with workplace safety and health issues. The Cal/OSHA program provides on-site assistance, high-hazard consultation and special emphasis programs, and educational materials on workplace safety and health topics, including hazardous materials in the workplace. While the Cal/OSHA program mirrors the federal OSHA program in most respects, there are also a number of provisions that are unique to California.

b) Asbestos Notification Law

California has a variety of its own requirements with regard to asbestos notification. For example, owners of all buildings built before 1979 are required to disclose certain information if they know that asbestos-containing construction material ("ACCM") (*i.e.*, material that contains greater than 0.1% asbestos by weight) is present. Cal. Health & Safety Code §§ 2915 *et seq*. The notice must be given to the owner's employees, and other "owners" with whom the owner has a contract. "Owner" is broadly defined to include an owner, lessee, sublessee, or agent of the owner. In general, the notice must include information on the location of the ACCM, the results of any surveys, handling restrictions, potential health risks, and a summary of bulk sampling results. The owner must provide notice within 15 days of first learning of the presence of ACCM, and annually thereafter. An owner who knowingly or intentionally fails to provide the notice is subject to a fine of up to $1,000 or one year in jail, or both. Additional state asbestos-related requirements apply to workplace exposures and to residential properties. Asbestos is also listed under the state's Proposition 65.

c) Underground/Above-ground Storage Tank Regulation

California has adopted a program for regulating underground storage tanks ("USTs"), but has not yet been delegated authority to implement its program in lieu of the federal UST program. This program applies to the storage of hazardous materials and petroleum in USTs. California also has adopted the Above-ground Petroleum Storage Act ("APSA"), which regulates the storage of petroleum products in certain tanks. *Id.* §§ 25270 *et seq*.

In California, the UST regulations are promulgated by the SWRCB and implemented by the local Certified Unified Program Agency ("CUPA") that has been certified by CalEPA. No person can own or operate a UST unless a permit has been issued by the CUPA. Each UST must have a monitoring system to detect leaks or other unauthorized releases. In the event of a release requiring corrective action, a UST owner or operator may apply to the UST Cleanup Fund for reimbursement of up to $1 million in cleanup costs. Claims are paid based on a priority system, with the highest priority given to residential tank owners and small businesses.

d) Corporate Criminal Liability

The Corporate Criminal Liability Act, Cal. Penal Code § 387, imposes substantial criminal liability on corporations and business managers who fail to notify company employees and Cal/OSHA of "serious concealed dangers" associated with the company's products or business practices. The law makes it a crime whenever a corporation or manager (1) has actual knowledge of a serious concealed danger associated with a product or business practice and (2) knowingly fails within 15 days (or immediately if there is imminent risk of great bodily harm or death) to notify OSHA and affected employees. Penalties for violations can range up to $25,000 and three years in prison for individual managers and up to $1,000,000 for corporations.

e) Land Use Restrictions

Use of property on which hazardous waste has been deposited, and of property within 2,000 feet of such land, may be restricted under certain circumstances. Under the so-called "Border Zone Statute," upon the request of the owner, lessor, or lessee, DTSC may determine that the use of a property constitutes a significant existing or potential hazard to public health or safety, and may designate the property as "hazardous waste property" or "border zone property." Hazardous waste property may only be used for certain industrial or manufacturing activities. Border zone property may not be used for residential, hospital, school, or daycare facilities unless it can be shown there is no potential risk to public health or safety. For undesignated property, DTSC also may recommend land use restrictions to the appropriate local agency. Upon request, DTSC may grant a variance to permit other uses of the property. Cal. Health & Safety Code §§ 25220 et seq.

Other California statutes may also permit deed restrictions to limit the use of property that is contaminated. Such deed restrictions may permit subdivision of the property to separate hazardous from nonhazardous areas. Id. § 25232(a)(2). Deed restrictions may run with the land and affect title to the property. See Cal. Civ. Code § 1471.

C. Local Law

Local jurisdictions often have environmental regulations in addition to those required by federal or state law. For example, in most California cities and counties, the local jurisdictions adopt both the Uniform Building Code and the Uniform Fire Code. In addition, the requirements under these codes may differ in each of these jurisdictions as the city or county may have adopted changes to the codes or the local jurisdiction may have adopted hazardous material ordinances that go beyond the uniform code requirements. Local jurisdictions also manage programs for the regulation of underground storage tanks, as well as the use and storage of hazardous materials. Again, the specific requirements in many jurisdictions are specific to the implementing agency. When proposing a new project, it is advisable to check with the appropriate local agencies to determine what requirements might be applicable to the proposed project.

D. California Legislation

Each year, the California Senate and Assembly enact legislation affecting California's environmental regulatory scheme. While many bills make only minor changes to existing law, often bills may have significant effects. For example, in a recent legislative session, the Senate enacted the California Land Environmental Restoration and Reuse Act, which allows local agencies to either order or directly undertake the investigation and cleanup of certain real estate properties. Under this new law, owners and tenants can be required to provide local agencies with specified information regarding whether a hazardous materials release may be present on the property. Based on that information, the local agency may then determine that the property is or may be affected by a hazardous materials release, or the threat of a release, and can issue a notice requiring the owner or tenant to conduct environmental assessments, investigations, and cleanup.

CHAPTER 12

ANTITRUST AND TRADE REGULATION

A. Federal Antitrust Law

The antitrust laws of the United States are reflected primarily in five federal statutes: the Sherman Antitrust Act of 1940 (the "Sherman Act"), the Clayton Act of 1914 (the "Clayton Act"), the Robinson-Patman Act of 1936 (the "Robinson-Patman Act"), the Federal Trade Commission Act (the "Federal Trade Commission Act"), and the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "Hart-Scott-Rodino Act").

1. The Sherman Antitrust Act of 1940

The Sherman Act is divided into two primary sections. Section 1 prohibits contracts, combinations, and conspiracies made in restraint of trade. Section 2 prohibits unilateral and combined conduct that monopolizes or attempts to monopolize trade. Under the Sherman Act, some restraints are "per se" unlawful (primarily "horizontal" agreements — agreements between competitors — to fix prices, divide geographic or product markets, restrict outputs, or otherwise restrain trade). Other restraints are subject to analysis under the "rule of reason" (typically, "vertical" arrangements, such as restrictions placed on a distributor by a manufacturer). Restraints subject to the "per se" rule are never permitted, while those governed by the "rule of reason" test will be evaluated on a case-by-case basis to determine if the restraint is reasonable.

2. The Clayton Act of 1914

The Clayton Act prohibits certain specific anticompetitive activities. For example, the Clayton Act prohibits some corporate mergers, exclusive dealing contracts, and agreements under which one product is sold subject to the requirement that the purchaser also buy another product from the seller (known as a "tying" arrangement).

3. The Robinson-Patman Act of 1936

The Robinson-Patman Act prohibits a seller from discriminating (or inducing others to discriminate) among competing purchasers in the price charged for commodities "of like grade and quality." While the Robinson-Patman Act focuses on price discrimination, it also addresses other concerns such as discriminatory advertising allowances or the discriminatory provision of services to competing customers.

4. The Federal Trade Commission Act

The Federal Trade Commission Act declares unlawful "unfair methods of competition" and "unfair or deceptive acts or practices."

5. The Hart-Scott-Rodino Antitrust Improvements Act of 1976

The Hart-Scott-Rodino Act requires that, under certain circumstances, a company proposing to merge with or acquire another company must give prior notice of the proposed acquisition to the United States Federal Trade Commission (the "FTC") and the United States Department of Justice (the "Justice Department"). Failure to give prior notice may result in very substantial fines.

Private individuals and corporations may bring lawsuits under the Sherman Act, the Clayton Act, and the Robinson-Patman Act. Remedies may include injunctive relief, treble damages, and attorney fees. The government may enforce the Sherman Act through criminal prosecutions and civil suits. In addition, the government may enforce the Clayton Act and the Robinson-Patman Act through the FTC or the Justice Department. Only the government can enforce the Federal Trade Commission Act and the Hart-Scott-Rodino Act.

B. California Antitrust Law

California's main antitrust laws are reflected in the Cartwright Act, the Unfair Practices Act, and the Unfair Competition Law.

1. The Cartwright Act

The Cartwright Act (the "Cartwright Act") generally prohibits any "trust," which is defined as "a combination of capital, skill or acts by two or more persons" for the purpose of restraining trade and injuring the business or property of another. The Cartwright Act also prohibits "[e]very contract combination . . . or conspiracy in restraint of trade or commerce," and specifies certain types of prohibited joint conduct, such as combining to restrict output or increase prices, combining to control prices to the public or consumer (*e.g.*, resale price maintenance and vertical price fixing), and fixing prices horizontally (between competitors) by the setting of minimum prices, maximum prices, or prices at any given level. The Cartwright Act specifies certain acts that are illegal "per se" and applies the "rule of reason" to others. The Cartwright Act applies to restraints of trade in markets for services as well as commodities.

a) Price Fixing, Market Division, and Concerted Refusals to Deal

The principal restraint of trade cases under the Cartwright Act involve price fixing, market divisions, and concerted refusals to deal (group boycotts). There are also a number of cases under the Cartwright Act that address vertical restrictions such as exclusive dealing, resale price maintenance, and tying arrangements.

Horizontal price fixing agreements or conspiracies are per se violations of the Cartwright Act. Horizontal price fixing involves price fixing among competitors. Collaboration among competitors to fix bids is a good example of this. Horizontal allocations of customers, territories, or product markets also are per se violations of the Cartwright Act's prohibitions against trusts.

Vertical price fixing (or "resale price maintenance") involves an agreement between a manufacturer and its distributor which has the purpose of controlling the price at which the distributor resells the product. Such vertical agreements that set an actual or minimum resale price are unlawful per se. It is unclear under California law whether a vertical agreement that sets a maximum resale price will be evaluated under the per se rule or, as is now true under federal law, under the rule of reason. Vertical restraints other than price fixing generally are examined under the rule of reason.

A group boycott involves an agreement to refuse to deal or stop dealing with a third party in order to coerce that entity to behave in a particular manner or to eliminate competition. An illegal group boycott must involve concerted activity. Courts have generally distinguished between "horizontal" boycotts directed at a competitor, which are illegal per se, and "vertical" boycotts, which are evaluated under the rule of reason. Courts also have sometimes distinguished between practices directly aimed at coercing third parties and eliminating competitors and indirect boycotts (which are usually vertical arrangements) that result in refusals to deal only as a byproduct of providing other benefits to the parties to the agreement. The former type of restraint is per se illegal, and the latter is judged under the rule of reason.

b) Discrimination

California also has a unique prohibition on exclusionary discrimination in business transactions where the discrimination is based on sex, religion, race, creed, color, national origin, ancestry, or location of business. In addition, California law prohibits exclusionary discrimination in issuing letters of credit and in contracts for goods and services.

c) Monopolization

No California statute deals expressly with monopolization. Single-firm monopolization generally is held not to be a violation of the Cartwright Act, but combinations to monopolize do fall under the statute. Monopolization may also constitute an unfair business practice under the Unfair Competition Law (*see* discussion below).

d) Tying and Exclusive Dealing

A tying arrangement is one in which a seller makes product A (the tying product) available to a buyer only if the buyer purchases product B (the tied product). Tying arrangements are generally evaluated under the rule of reason, but some older California cases apply the per se rule to these arrangements. The Cartwright Act prohibits tying arrangements that "substantially lessen competition or tend to create a monopoly in any line of trade or commerce." The elements of a tying violation are (1) the existence of two products and (2) either (a) the seller's possession of sufficient economic power in the market for the tying product to allow the seller to coerce purchases of the tied product or (b) the restraint of a substantial amount of commerce in the tied product.

To prove the existence of two products, a plaintiff must demonstrate that the products are separate and distinct. Factors in this inquiry include: (1) whether competitors offer to sell the products or services separately or only as a unit; (2) whether the combined product or service is composed of varying assortments of component parts; (3) whether buyers are, or can be, charged separately for the allegedly separate products or services; and (4) whether the defendant ever sells or offers to sell the products or services separately. Courts have held a plaintiff in a tying claim must prove both elements (1) and (4) and either of elements (2) and (3).

Exclusive dealing arrangements involve a seller's requiring that a buyer not deal with a competitor of the seller if the buyer wishes to deal with the seller. Such arrangements have been held to fall under the rule of reason. Exclusive dealing may also be implicated by refusals to deal.

e) Mergers

Mergers and acquisitions are not prohibited by the Cartwright Act.

f) Remedies

Standing

Before a plaintiff can bring a lawsuit, he or she must have standing, which means that the plaintiff must demonstrate a sufficient stake in the controversy. The criteria for standing involve an evaluation of the relationship between the alleged harm to the plaintiff and the alleged wrongdoing by the defendant. Under the Cartwright Act, the plaintiff must prove: (1) that he or she was damaged; (2) that the damages resulted from the defendant's violation of the Cartwright Act; and (3) that the damages may be computed on some reasonable basis, if not with precision. As under federal law, the plaintiff must have suffered "antitrust injury" — injury caused by conduct the antitrust laws were intended to prevent. Unlike federal antitrust law, indirect purchasers have standing to sue under the Cartwright Act.

Treble Damages

A successful plaintiff may recover treble damages plus reasonable attorney's fees and the costs of suit.

Treble damages may be recovered by a private party, by the state, by public agencies, or by the Attorney General of California as *parens patriae* (*see* discussion below) on behalf of natural persons residing in the state.

Public Damages Actions

The Attorney General of California may bring a civil damages action on behalf of the state based on violations of either the California antitrust acts or their federal counterparts. A county district attorney may bring a civil damages action on behalf of the county.

Parens Patriae Actions

The Attorney General of California can bring a civil action in the name of the people of California, as *parens patriae* on behalf of natural persons residing within the state. Treble damages are recoverable in *parens patriae* actions. In assessing damages to the class of plaintiffs involved in the civil action, the court must compute the total monetary relief and then subtract from that total those portions attributable to business entities, as distinguished from natural persons. The total amount may be based on a reasonable estimate and need not be computed with absolute certainty.

Forfeiture of Corporate Rights

Corporations found in violation of the Act are subject to forfeiture of their corporate rights. Foreign corporations may have their privilege to do business in the state revoked.

Public Injunctions

In civil actions brought by the Attorney General of California, the court may grant both prohibitory and mandatory injunctions and other restraints that may be reasonably necessary to deter a defendant from future violations, and "to restore and preserve fair competition in the trade or commerce affected by the violation." Cal. Bus. & Prof. Code § 16754.5.

Criminal Penalties

Criminal penalties may be imposed on those conspiring against trade and also on agents, officers, and employees of the business who carry out the conspiracy. A corporation that violates the Cartwright Act is subject to a fine not more than $1,000,000. An individual who violates the Cartwright Act is subject to not more than $250,000 in fines, three years in prison, or both. Both individuals and corporations may be alternatively fined up to twice the amount gained or lost as a result of the violation.

Private Injunctive Relief

Injunctive relief is available to private parties whenever damages are inadequate or to prevent a multiplicity of judicial proceedings. Preliminary injunctions against per se illegal activities are expressly provided for in the Cartwright Act.

Void Contracts, Arbitration

Any contract that violates the Cartwright Act is void and unenforceable; thus, alleged violations of the Act can be asserted as a defense to contract claims. Claims under the Cartwright Act are now subject to arbitration.

Prejudgment Interest

A court can award interest on actual damages obtained in state antitrust proceedings. Such interest is awarded at the rate of 10% per annum for the period beginning on the date of service of the complaint setting forth a claim for a violation of the Cartwright Act and ending on the date of judgment, or for any shorter period if the court finds that the award of interest for that period is just under the circumstances.

There are three considerations for a court in determining whether to award interest: (1) whether a party made motions or asserted claims or defenses so lacking in merit as to show that the party acted intentionally for delay or otherwise acted in bad faith; (2) whether in the course of the action, a party violated any applicable rule, statute, or court order providing for sanctions for dilatory behavior or otherwise providing for expeditious proceedings; and (3) whether a party engaged in conduct primarily for the purpose of delaying the litigation or increasing the cost of the litigation.

g) Exemptions

The following are exempt from the Cartwright Act's coverage: labor; municipalities; political subdivisions of the state; agricultural and fish cooperative associations; electric service areas designated by the California Public Utilities Commission; National Football League rules regarding player contracts; lobbying and other similar joint efforts to obtain legislative or executive action; creation of exclusive service areas for emergency medical services; and motor carriers who elect to comply with federal regulations dealing with uniform rules, joint line rates or routes, mileage guides, and pooling.

2. The Unfair Practices Act

The Unfair Practices Act (the "UPA") prohibits locality discrimination, sales below cost, loss leading, anticompetitive gifts, warranty services below cost, secret rebates, and discriminatory and secret services. The UPA covers virtually all trade in commodities or services, tangible or intangible, that are not expressly exempt from its coverage. Such practices may also be actionable under the Cartwright Act and the Unfair Competition Law.

The UPA forbids any person "to use any threat, intimidation, or boycott" and forbids any vendor or an agent of a vendor "to solicit" any violation of the UPA or "to participate or collude" with any other such person in such a violation.

a) Locality Discrimination

Locality discrimination consists of selling a product at a lower price in one locality as compared with other localities. The UPA can be violated only by a seller with two or more business locations. In addition, the price discrimination must involve harm to "primary line" competition, that is, competition at the seller-manufacturer level where the seller-manufacturer lowers its price to retailers in a particular location but not in other locations in order to cause competing sellers to lose business in that particular location.

There are a number of defenses to an allegation of illegal locality discrimination. A seller may meet in good faith a competitive, legal price. Locality differentials may be justified by a difference in the grade and quality of articles delivered to the respective localities. Price differentials may reflect differences in the cost of manufacture, sale, or delivery of articles shipped to different locations, or differences in the actual cost of transportation of a product from its point of production, manufacture, or shipment to its destination. The UPA also permits sellers to make a functional classification of any customer or broker, jobber (middleman), wholesaler, or retailer and to establish a differential in price for any article or product as between any customers in different functional classifications. Finally, the UPA does not prohibit sales made in good faith at a reduced price to close out stocks of seasonal, obsolete, perishable, damaged, or deteriorated articles, provided notice of the sale is made to the public. The items must be segregated from regular stock and must have a legible marking of the reasons for the sale.

b) Secret Rebates and Secret and Discriminatory Services

There are three elements to a violation of this section of the UPA: (1) a secret rebate or payment, or discriminatory extension of services, privileges, or other benefits; (2) injury to a competitor; and (3) the tendency of such action to destroy competition. Secret rebates as well as secret and discriminatory services or other benefits are per se offenses when accompanied by the latter two elements. Secret rebates made to meet competition do not violate the UPA's prohibitions. This section of the UPA extends to both primary and secondary line discrimination ("secondary line" discrimination is discrimination that causes harm to competition at the buyer level).

c) Sales Below Cost, Anticompetitive Gifts, and Loss Leading

The UPA prohibits vendors from selling an article below cost or giving away an article where the vendor's purpose is to injure competitors or to destroy competition. In order to prove a below-cost sale, both the sale itself and the anticompetitive purpose must be proven.

The UPA defines "loss leaders" as articles sold at less than cost (1) where the purpose is to induce, promote, or encourage the purchase of other merchandise, or (2) where the effect is a tendency or capacity to mislead or deceive purchasers or prospective purchasers, or (3) where the effect is to divert trade from or otherwise injure competitors. Loss leaders, as opposed to below-cost sales, are prohibited not only if an anticompetitive purpose exists, but for other reasons as well, such as to promote the sale of other merchandise or to mislead or deceive prospective purchasers.

In order to prove an illegal sale below cost, plaintiff must prove that the below-cost sale was made by defendant with the intent to injure competitors or destroy competition. Defendant's predatory intent can be presumed from the fact of the below-cost sale together with proof of the sale's injurious effect, which may mean simply the loss of sales by the plaintiff. A defendant may attempt to rebut the presumption by introducing evidence of a proper business purpose of its below-cost pricing (*i.e.*, a purpose other than to injure competition).

California law defines "cost" as average total cost, rather than marginal or average variable cost as under federal law. Assuming the other elements of a violation are proven (see above), once the plaintiff demonstrates that the defendant has priced below average total cost, the defendant then has the burden of negating the inference of illegal intent or of establishing an affirmative defense. In establishing the cost of an article, the sales or replacement cost of the article in "normal channels of trade" is used as a measuring standard. These are sales, other than closeout sales, which might occur in bankruptcies, going-out-of-business sales, or sales of damaged or deteriorated goods.

d) Remedies

Damages

A plaintiff who has proven actual damages can recover treble damages plus reasonable attorney's fees and the costs of suit. A plaintiff that successfully obtains treble damages cannot also obtain punitive damages.

Injunctive Relief

Courts have the power to issue both preliminary and permanent injunctions directed toward future violations of the UPA by a defendant. The courts may also impose any other appropriate restraints, in each case without requiring plaintiff to post bond. The injunction must cover all products sold by defendant in violation of the UPA, even if the alleged violation pertains to fewer products. Injunctions will only issue upon a clear demonstration of a violation of the UPA.

Liability under the UPA extends not only to the corporation found to be in violation, but also to its officers, agents, and employees who assisted in the violation.

Criminal Penalties

Violation of the UPA is a misdemeanor. Each violation is punishable by a fine of no less than $100 nor more than $1,000, or by a fine and imprisonment of up to six months.

Void Contracts

Any contract, express or implied, made by a person or corporation that violates the UPA is void and unenforceable.

e) Exemptions

The UPA's exemptions include motion picture films; products or services furnished by any public utility corporation whose rates are set by the California Public Utilities Commission; products or services furnished by a publicly owned utility whose rates would have been set by the California Public Utilities Commission if the utility were privately owned; sales of discontinued, perishable, or damaged goods; court-ordered sales; and sales made in good faith to meet a competitor's legal prices.

3. Unfair Competition Law

The Unfair Competition Law (the "UCL") prohibits any "unlawful, unfair or fraudulent business practice." The UCL has been amended to provide that a single violative act can constitute a "practice."

The UCL has been given an extremely broad construction by the California courts. In addition to conduct that is "unlawful" because it violates the Cartwright Act or the UPA, the UCL also encompasses unlawful conduct under any law, state or federal, whether related to antitrust or unfair trade practices or not. Compliance with the underlying statute which forms the basis of an unlawful practice is a complete defense. Any defense permitted by the underlying law is available.

The prohibition against fraudulent business practices has been widely applied to deceptive trade practices. The basic test to determine whether a deceptive practice exists is whether the public is likely to be deceived. Even full disclosure does not constitute a defense to fraudulent business practices under the UCL.

The UCL encompasses fraudulent advertising practices as well. The UCL's prohibitions mirror California Business and Professions Code § 17500 prohibiting false or misleading advertising in connection with the sale or disposition of property or services. Under both statutes, a violation is established if members of the public are likely to be deceived. The UCL affords protection against the probability or likelihood, as well as the actuality, of deception or confusion. Neither statute requires proof of actual deception, public reliance upon the advertising to the public's detriment, actual damages, intent to deceive, or actual falseness of the advertising.

The UCL also prohibits unfair business practices, even where these practices are held not to be unlawful under the Cartwright Act, the UPA, or any other statute. Where the plaintiff is a competitor of the defendant claiming competitive harm, an unfair business practice requires proof of conduct that threatens an incipient violation of an antitrust law, a violation of the policy or spirit of an antitrust law if the effects are comparable to or the same as the effects from an actual violation of the law, or conduct that otherwise significantly threatens or harms competition. Where a UCL claim is brought by a consumer, however, the standard of "unfairness" in much more open-ended (the applicable standard where a consumer brings an antitrust-type "unfairness" claim remains an open question).

a) Remedies

Any unlawful business practice, including violations of laws for which there is no direct private right of action, may be redressed by a private action under the UCL. It is not necessary that the predicate law provide for private civil enforcement.

Injunctive Relief

A court has broad discretion to fashion an appropriate remedy for violation of the statute, including injunction, appointment of a receiver, and issuance of other orders to prevent future violations by defendant. The court may also issue any such orders "as may be necessary to restore to any person in interest any money or property, real or personal, which may have been acquired by means of . . . unfair competition." Cal. Bus. & Prof. Code § 17203.

Injunctive and restitutionary actions under the UCL can be brought by private persons acting individually, or as representatives of the general public even without certification of a plaintiff class. Actions may also be brought by the Attorney General of California or the county district attorney.

Civil Penalties

In any unfair competition action brought by the Attorney General or county district attorney, a defendant may be assessed civil penalties of no more than $2,500 per violation. The statute permits additional penalties when the violations are perpetrated against senior citizens or the disabled.

Violation of an injunction against unfair competition results in a penalty of no more than $6,000 per violation.

The factors that the court takes into account in determining the amount of the penalty include the extent of the harm caused by the violation, the nature of the conduct, the length of time it was carried out, and the financial condition of the defendant.

In imposing penalties for price-fixing activities, the court must consider the following: (1) the number of persons directly affected by each unfair act; (2) the degree of harm and acts of harassment involved; and (3) the nature and extent of the public injury.

Damages

The California Supreme Court has held that damages, including punitive damages, are not available under the UCL. As noted above, however, restitution is available under the UCL.

b) Exemptions

There are no express exemptions from the UCL. However, the general wording of some of the Cartwright Act exemptions may afford some shelter from jurisdiction under the UCL, specifically the Cartwright Act's labor exemption.

CHAPTER 13

RESOURCE LISTING

The agencies of California's government concerned with doing business in the state include the following:

A. Overview of California

The **Federal Court System Website** <www.uscourts.gov> provides links to the various district and appellate courts in the United States in addition to general United States Courts information. Access to the local rules for the United States District Court, Northern District of California, is available at <www.cand.uscourts.gov.>

The **California Courts Website** <www.courtinfo.ca.gov> was established by the state of California to provide information on the California court system. Most courts in California have posted their local rules online. These rules can be accessed through the California Courts main website at <www.courtinfo.ca.gov/courts.>

- The California Courts' Judicial Branch of California Website for Trial Courts is available at <www.courtinfo.ca.gov/courts/trial/about.htm;>
- The California Courts' Judicial Branch of California Website for courts of appeal is available at <www.courtinfo.ca.gov/courts/courtsofappeal/about.htm;> and
- The California Courts' Judicial Branch of California Website for its Supreme Court is available at <www.courtinfo.ca.gov/courts/supreme/about.htm.>

The **Federal Deposit Insurance Corporation** ("FDIC") <www.fdic.gov> *Federal Deposit Insurance Corporation, 550 17th Street, NW, Washington, DC 20429-9990, (202) 736-0000,* is an independent agency of the United States government whose mission is to maintain the stability of and public confidence in the nation's financial system. The FDIC insures deposits with qualified financial institutions up to specified limits and promotes safe and sound banking practices. The FDIC performs the routine compliance, trust, and safety examinations of all domestic and foreign financial institutions to ensure that standards are met.

The **Department of Financial Institutions** ("DFI") <www.dfi.ca.gov> *Department of Financial Institutions, 111 Pine Street, Suite 1100, San Francisco, CA 94111-5613, (415) 263-8500,* is responsible for regulating the safety and soundness of California's state-chartered financial institutions. The DFI licenses and regulates state-licensed banks, state-licensed savings and loan associations, state-licensed credit unions, state-licensed industrial banks, state-licensed offices of foreign banks, trust companies, business and industrial development corporations, issuers of traveler's checks and payment instruments (money orders), and transmitters of money abroad.

The **Pacific Exchange** (“PCX”) <www.pacificex.com> *Pacific Exchange, 115 Sansome Street, San Francisco, CA 94104, (415) 393-4000*, is the third-largest stock options exchange in the world, with trading floors in two cities — San Francisco and Los Angeles. The PCX is a marketplace where individual and institutional investors, professional broker-dealers, and registered member firms meet to buy and sell more than 1,800 stocks, bonds, and other securities issued by publicly traded companies, as well as options on more than 800 stocks.

The PCX trades the most active stocks and bonds listed on the New York Stock Exchange (“NYSE”) <www.nyse.com> and American Stock Exchanges (“ASE”) <www.amex.com> as well as many growth companies. The average individual retail order sent to the Pacific is for 500 shares, with every order filled at the best price available in the National Association of Securities Dealers Automated Quotations (“Nasdaq”) system
<www.nasdaq.com.>

B. Types of Business Entities

The **Office of the Secretary of State** <www.ss.ca.gov> *California Secretary of State’s Office, 1500 11th Street, 6th Floor, Sacramento, CA 95814, (1-916) 657-5448*, through its Corporations Section, is responsible for examining, processing, filing, and maintaining documents related to the existence and structure of California domestic corporations and foreign (out-of-state or -country) corporations qualified to transact business in California. The Corporations Section also responds to inquiries relating to status or other information concerning corporations of record, and provides copies of corporate documents upon request. The Secretary of State serves as a non-regulatory custodian of corporate records filed with this office. In addition, the Section is responsible for accepting and processing substituted service of process.

The Secretary of State maintains a website to assist persons wishing to create a business entity in California at <www.ss.ca.gov/business/default.htm> and, included on the Secretary of State’s website at <www.ss.ca.gov/business/resources.htm> *California Secretary of State’s Office, International Business Relations Program, 1500 11th Street, 6th Floor, Sacramento, CA 95814, (1-916) 653-3631*, is a checklist in English and Spanish for persons planning to start a business in California.

The Office of the Secretary of State includes the International Business Relations Program (“IBRP”) <www.ss.ca.gov/business/ibrp/ibrp.htm> designed to assist the international business community by educating and assisting foreign corporations in the various filing processes and procedures required in California’s business world.

The **California Franchise Tax Board** <www.ftb.ca.gov> is the department that collects state personal income taxes and bank and corporation taxes for the state of California. Questions regarding franchise tax requirements can be answered by calling (1-800) 852-5711.

The **United States Internal Revenue Service** ("IRS") <www.irs.gov> *(1-800) 829-1040*, is the nation's tax collection agency and administers the Internal Revenue Code enacted by Congress. Its mission is to provide America's taxpayers with top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all. A written operating agreement may need to be submitted to the IRS for federal tax purposes if the corporation requests a ruling from the IRS on a particular tax issue.

The **State of California, Department of Consumer Affairs** <www.dca.ca.gov>, *State of California Department of Consumer Affairs, 400 R Street, Sacramento, CA 95814, (1-800) 952-5210*, promotes and protects the interests of California consumers by licensing and regulating 2.3 million professionals, including doctors, dentists, contractors, and auto-repair technicians. The Department should be consulted on whether the proposed business falls within the ambit of any state-licensing agency.

The **State Board of Equalization** <www.boe.ca.gov>, *California State Board of Equalization, P.O. Box 942879, Sacramento, CA 94279-0090, (1-800) 400-7115*, is responsible for the administration of the state's sales and use, fuel, alcohol, tobacco, and other taxes, and for the collection of fees that fund specific state programs. The Board also plays a significant role in California property tax assessment and administration. It also acts as the appellate body for franchise tax and personal income tax appeals.

C. Intellectual Property Rights

The **United States Patent and Trademark Office** ("USPTO") <www.uspto.gov>, *(1-800) 786-9199*, administers patent and trademark laws as they relate to the granting of patents for utility inventions, designs, and plants and the issuing of trademark registrations. The USPTO examines applications for patents to determine if the applicants are entitled to patents, and grants the patents when they are so entitled. It examines applications for trademark registration to determine if the applicants are entitled to register their trademarks, and issues trademark registrations.

D. Employment

The **United States Internal Revenue Service** ("IRS") <www.irs.gov> *(1-800) 829-1040,* is the nation's tax collection agency and administers the Internal Revenue Code enacted by Congress. Its mission is to provide America's taxpayers with top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all. A written operating agreement may need to be submitted to the IRS for federal tax purposes if the corporation requests a ruling from the IRS on a particular tax issue.

The **California Employment Development Department** ("EDD") <www.edd.ca.gov> *Employment Development Department, 800 Capitol Mall, MIC 83, Sacramento, CA 95814, (1-800) 758-0398,* promotes California's economic growth by providing services to keep employers, employees, and job seekers competitive. A booklet entitled *Employer's Tax Guide for the Withholding, Payment, and Reporting of California Income Tax* may be obtained from the EDD's website. The website also provides information regarding Independent Contractor Reporting. Information on unemployment insurance is available at <www.edd.ca.gov/employer.htm> and information on disability insurance is available at <www.edd.ca.gov/fleclaimdi.htm.>

The **State of California, Department of Fair Employment & Housing** <www.dfeh.ca.gov> *Department of Fair Employment and Housing, San Francisco District Office, 455 Golden Gate Avenue, Suite 7600, San Francisco, CA 94102-6073, (415) 703-4175,* protects the people of California from unlawful discrimination in employment, housing, and public accommodations and from the perpetration of acts of hate violence. The Department prepares the sexual harassment information sheet that California law requires employers to disseminate to employees, which is available at <www.dfeh.ca.gov/publications/posters.asp.>

The **California Division of Occupational Safety and Health** ("DOSH") <www.dir.ca.gov/dosh/dosh/> *Division of Occupational Safety and Health, 455 Golden Gate Avenue, 10th Floor, San Francisco, CA 94102, (415) 703-5100,* protects workers and the public from safety hazards by enforcing California's occupational and public safety laws and provides information and consultative assistance to employers, workers, and the public about workplace and public safety matters.

For information on the Injury and Illness Prevention Program ("IIPP"), see Guide to Developing Your Workplace Injury and Illness Prevention Program with checklists for self-inspection at <www.dir.ca.gov/dosh/dosh_publications/iipp.html.>

For information on developing an IIPP addressing workplace security, see Injury and Illness Prevention Model Program for Workplace Security at <www.dir.ca.gov/dosh/dosh_publications/iipsecurity.html.>

The **California Industrial Welfare Commission** <www.dir.ca.gov/iwc> *Industrial Welfare Commission, 770 L Street, Suite 1170, Sacramento, CA 95814, (1-916) 322-0167,* takes formal action by instituting industry-wide and occupation-wide wage orders. See Cal. Wage Orders for information on federal and state wage and hour laws available on the website.

The **California Division of Worker's Compensation** <www.dir.ca.gov/DWC> *Division of Worker's Compensation, 455 Golden Gate Ave., 9th Floor, San Francisco, CA 94102-3660, (415) 703-4600,* minimizes the adverse impact of work-related injuries on California employees and employers. An overview of the California worker's compensation system is available at <www.dir.ca.gov/DWC/basics.htm.>

E. Immigration

The **Immigration and Naturalization Service** ("INS") <www.ins.usdoj.gov/graphics> <www.immigration.gov> is a federal agency within the United States Department of Justice that administers the nation's immigration laws. The website provides information on the B-1 Visa and Visa Waiver for Business.

The **United States Department of Labor** <www.dol.gov> *United States Department of Labor, Frances Perkins Building, 200 Constitution Avenue, NW, Washington, DC 20210, (1-866) 4-USA-DOL,* fosters and promotes the welfare of the job seekers, wage earners, and retirees of the United States by improving their working conditions, advancing their opportunities for profitable employment, protecting their retirement and health care benefits, helping employers find workers, strengthening free collective bargaining, and tracking changes in employment, prices, and other national economic measurements. The Department administers a variety of federal labor laws, including those that guarantee workers' rights to safe and healthful working conditions; a minimum hourly wage and overtime pay; freedom from employment discrimination; unemployment insurance; and other income support. A Labor Condition Application ("LCA") can be obtained from the Department.

F. Litigation and Alternative Dispute Resolution

The **California Courts Website** <www.courtinfo.ca.gov> was established by the state of California to provide information on the California court system. The California

Courts' Judicial Branch of California Website for the Jury is available at <www.courtinfo.ca.gov/jury.>

The **American Arbitration Association** ("AAA") <www.adr.org> *American Arbitration Association, 335 Madison Avenue, Floor 10, New York, NY 10017-4605, (212) 716-5800*, is the world's leading provider of conflict management and dispute resolution services, including mediation, arbitration, fact-finding, partnering, dispute review boards, and other related alternative dispute resolution processes.

G. Miscellaneous

The **Business, Transportation & Housing Agency** ("BT&H") <www.bth.ca.gov> *Business, Transportation & Housing Agency, 980 9th Street, Suite 2450, Sacramento, CA 95814-2719, (1-916) 323-5400*, regulates the offer and sale of securities in or from California, business franchising, and the banking and financial industries.

The **Technology, Trade and Commerce Agency** <www.commerce.ca.gov> *California Technology, Trade and Commerce Agency, Sacramento Regional Office, 801 K Street, Suite 912, Sacramento, CA 95814, (1-916) 322-5665*, serves as the state's principal catalyst for innovation, investment, and economic opportunity. The Agency's goal is to continually create jobs and increase economic investment for Californians, both domestically and in the international business arena.

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