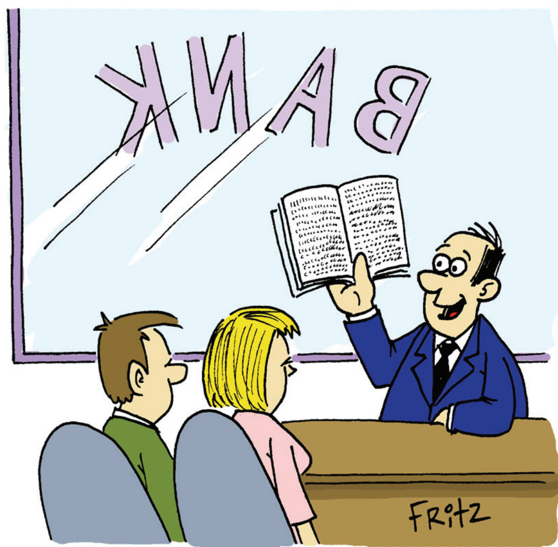
POINTS & authorities®

QUARTERLY NEWSLETTER

BUCHALTER NEMER

WINTER 2012

New Year, New Developments



I WILL NOW READ YOU THE FINE PRINT TO YOUR LOAN DOCUMENTS IN STORYBOOK FORM.

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Banker Beware: Bank Practices under Increased Scrutiny as Dodd-Frank Implementation Begins

Jeffrey B. Kirschenbaum

A new wave of consumer banking litigation and regulatory activity is anticipated as financial institutions introduce new products and increase fees to offset costs and lost revenue attributable to the Dodd-Frank Act. Several major banks have recently settled class action lawsuits for allegedly processing transactions from higher to lowest amount to maximize customer overdraft revenues, and class action attorneys are expected to use these cases as models for future litigation. Banking regulators have also increasingly shown a willingness to take on practices deemed unfair or deceptive to consumers, even if the practices are not prohibited by a particular law. This is a call for financial institutions to proactively review marketing materials, account agreements, and disclosures documents, and to ensure that new products and fees are not targeted at unsophisticated consumers.

In California, private litigants challenging banking operations typically rely on the Unfair Business Practices Act, which prohibits practices that are unlawful, unfair or fraudulent, in addition to common law and false advertising claims. These plaintiffs enjoy a relaxed burden of proof in many respects. For example, under California Business and Professions Code section 17200, to establish that a business practice was fraudulent, plaintiffs need only show that the

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The Lender-Borrower Tangle: Understanding California and Arizona Anti-Deficiency Legislation

Renee M. Shprecher

Rising foreclosure rates in the residential real estate market have prompted underwater borrowers to ask about possible foreclosure strategies—most notably, how to avoid deficiency judgments. Often overlooked, however, are the challenges that lenders face, primarily due to borrowers choosing to strategically default on their mortgage when the amount owing on the loan exceeds the value of their home. These challenges are of particular concern for lenders operating in states like Arizona and California that have enacted strict anti-deficiency laws to mitigate the effects of foreclosure and personal liability. Anti-deficiency legislation insulates the residential borrower from any personal liability on the outstanding debt. This article examines both Arizona's and California's anti-deficiency statutes and presents strategies that may affect a lender's decision to foreclose on residential properties.

There are two types of foreclosure in Arizona and California: the first type is "*judicial*" foreclosure in which a lender files a lawsuit and gets a court order to foreclose on the property, and the second is "*non-judicial*" in which the property is sold by a trustee's sale via a power of sale clause in a deed of trust.

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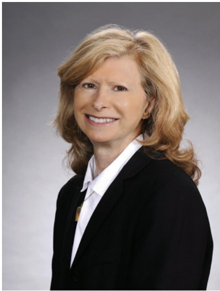
New Faces



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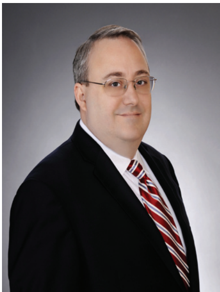

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Points from the President

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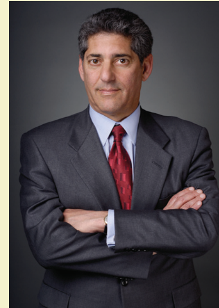

Our 2012 Winter issue of *Points and Authorities* focuses on updates and changes in the law that may impact our clients throughout the coming year.

Two articles of importance to our financial institution clients lead this issue. Jeffrey Kirschenbaum discusses the anticipated rise in regulatory activity and consumer banking litigation in the wake of implementation of the Dodd-Frank Act. Renee Shprecher follows with an analysis of Arizona and California's anti-deficiency statutes and the challenges that lenders face when borrowers with mortgages that exceed the value of their homes choose to default.

If you have a business with a customer database, then you will be interested in Peter Bales' discussion of your obligations should customer personal information become exposed, either inadvertently or through hacking. Next up is Julie Simer's health care industry prognosis for 2012. The only thing certain is its uncertainty.

In breaking news, Amanda Steele and Michael Williamson analyze the impact of the California Supreme Court's fatal blow to the state's redevelopment agencies and the timing for winding down. Wrapping up this issue, Bryan Lazarski's article on independent contractors is a must read if you have them—or think that you might.

However you view it, the year ahead is one of change. We hope that you enjoy this legal peek into 2012, and invite you to contact the authors with any comments or questions that arise.

Sincerely,

Rick Cohen
President and Chief Executive Officer

Who's Hacked You Now?
Changes to California's Security Breach Statute
Peter H. Bales

It seems as though a week does not go by without a company reporting that its customers' personal information was either intentionally hacked or inadvertently exposed. In April 2011, Sony reported that hackers had stolen the names, birth dates, and possibly credit-card numbers of more than a 100 million users of its online videogames. In May 2011, Citigroup discovered that almost 400,000 credit-card accounts were hacked, resulting in $2.7 million in losses. One of the many questions that arises after discovering such a breach is how to notify the affected customers.

In 2003, California became the first state to enact a data security breach notification law. California Civil Code Section 1798.82 requires those who own or license computerized data that includes personal information, to disclose breaches of security to any state resident whose unencrypted personal information was, or is reasonably believed to have been, acquired by an unauthorized person.[1]

"Personal information" means an individual's first name or first initial and last name in combination with any one or more of the following data elements, when either the name or the data elements are not encrypted:
(1) Social Security number;
(2) driver's license number or California identification card number;
(3) account number, credit or debit card number, in combination with any required security code, access code, or password that would permit access to an individual's financial account;
(4) medical information; and
(5) health insurance information.[3, 4]

The disclosure must be made "in the most expedient time possible and without unreasonable delay."[5] Additional time may only be allowed in two instances:
(1) if a law enforcement agency determines that the notification will impede a criminal investigation, and
(2) taking necessary measures to determine the scope of the breach and restore the reasonable integrity of the data system.[6]

The methods of notification, e.g., written, electronic, or substitute notice, are outlined in Civil Code Section 1798.82. It is important to note that a customer injured by a violation of California's notification requirements may institute a civil action to recover damages.[7]

Until recently, there were no requirements for the contents of the notice. However, on August 31, 2011 Governor Brown signed Senate Bill 24 amending the notification law and making important changes that apply to breaches occurring on or after January 1, 2012.

The new law requires that the notice contain specific information regarding the breach, including the following:
(1) a list of the types of personal information that were or are reasonably believed to have been the subject of a breach;
(2) the date, estimated date, or date range of the breach;
(3) whether notification was delayed as a result of a law enforcement investigation;
(4) a general description of the breach incident; and
(5) the toll-free telephone numbers and addresses of the major credit reporting agencies if the breach exposed a social security number or a driver's license or California identification card number.

Another requirement added by Senate Bill 24 is that businesses, in certain circumstances, will need to notify the California attorney general. More specifically, if more than 500 California residents were notified of the breach, the business will be required to electronically submit to the attorney general a sample copy of the security breach notification, excluding any personally identifiable information.

For those California businesses that have customers throughout the country, it is important to be aware of and monitor other state laws regarding breach notifications. With the exception of Alabama, Kentucky, New Mexico, and South Dakota, every state, as well as the District of Columbia, Puerto Rico and the Virgin Islands, have enacted legislation requiring notification of security breaches involving personal information.[8]

Given the unpredictable nature of security breaches, it is essential that companies be prepared ahead of time and have security breach procedures—evaluated by counsel for compliance with the applicable laws—in place so that they can quickly respond in the event of a breach. These new changes to California law provide an opportunity for companies to revisit the policies and procedures currently in place or create such policies and procedures that previously did not exist.

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[1] Civ. Code § 1798.82(a).

[2] "Medical information" means any information regarding an individual's medical history, mental or physical condition, or medical treatment or diagnosis by a health care professional. (Civ. Code §1798.82(f)(2).

[3] "Health insurance information" means an individual's health insurance policy number or subscriber identification number, any unique identifier used by a health insurer to identify the individual, or any information in an individual's application and claims history, including any appeals records. (Civ. Code §1798.82(f)(3).)

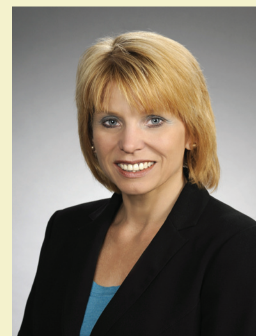
[4] *Civ. Code § 1798.82(e).*

[5] *Civ. Code § 1798.82(a); emphasis added.*

[6] *Civ. Code § 1798.82(c).*

[7] *Civ. Code § 1798.84(b).*

[8] *According to National Conference of State Legislatures.*



Health Care Undergoes Major Surgery in 2012

Julie Simer

It is going to be a busy year in the health care industry. A decision on the constitutionality of the Patient Protection and Affordable Care Act ("Act") is not expected until June, but many of the Act's initiatives will begin before the Supreme Court decides. From implementation of electronic medical records to development of integrated care models, these new initiatives will affect all facets of the industry. Regardless of the outcome of the constitutional decision, these developments will mean major surgery for the health care industry and the many businesses that rely on it.

1. Prognosis for Health Care Reform is Uncertain

No event will have a greater impact on health care delivery in the United States than the Supreme Court's decision on the constitutionality of the Act. The opinion is expected to play a major role in the 2012 elections. Briefs have been filed by the Obama administration in support of the Act, and by Florida and 25 other states in opposition to what they call "Obamacare." Five and one-half hours have been scheduled for the oral arguments, set to begin in March.

2. Birth of Accountable Care Organizations

This year will be the beginning of the Medicare Shared Savings Program ("SSP"). Under this program, entities known as Accountable Care Organizations ("ACOs"), will attempt to coordinate care among health care providers to improve the quality of care for Medicare Fee-For-Service beneficiaries and reduce unnecessary costs. If the ACOs are successful, they will share in some of the savings to the Medicare program. Applications for participation in the program must be submitted by January 20, 2012 for an April 1, 2012 start date and by March 30, 2012 for the July 1, 2012 start date.

For those entities already prepared to implement ACO operations, the administration has established the Pioneer ACO demonstration project. Thirty-two entities have been chosen by the U.S. Department of Health and Human Services ("HHS") to participate in this demonstration project. The Pioneer ACO program is similar to the SSP program, but it is intended for ACOs that are already operational. The first performance period of the Pioneer ACO program began January 1, 2012.

The commercial market is already developing ACO models and will continue to refine the process throughout 2012.

3. Retraction of Sunshine Act Deadline

In December 2011, the Centers for Medicare and Medicaid Services ("CMS") released a proposed rule on implementation of the Physician Payments Sunshine Act, another product of the Act. The proposed rule delayed implementation of the requirement that pharmaceutical and medical device manufacturers report gifts and payments to physicians and teaching hospitals. Reporting was to begin on January 1, 2012, but the proposed rule delays data collection requirements and reporting until a final rule is published, likely to be later this year. Under the proposed rule, payments less than $10 will not have to be reported, unless the total payments to a physician exceed $100 per year. CMS proposes that a report of partial-year data be required by March 30, 2013. Once the data is collected and aggregated by CMS, physicians and teaching hospitals will have a 45-day period to review and comment on the results. CMS proposes that the results be made public by September 30, 2013.

4. Diagnosis of Data Security

Pursuant to a requirement in the Health Information Technology for Clinical Health Act ("HITECH"), the HHS Office of Civil Rights ("OCR") will begin periodic auditing of "covered entities" and "business associates" to ensure compliance with privacy, security, and breach notification standards of the Health Information Portability and Accountability Act of 1996 ("HIPAA"). The OCR intends to audit a wide a range of types and sizes of covered entities: covered individual and organizational providers of health services, health plans of all sizes and functions, and health care clearinghouses will all be considered for an audit. Entities selected for an audit will be informed by the OCR of their selection and asked to provide documentation of their privacy and security compliance efforts. The audits are intended to be a "compliance improvement activity," but for serious compliance issues, the OCR may initiate a "compliance review" to address the problem. The OCR intends to complete the audits in this pilot phase by December 30, 2012.

5. Probe of Provider Advertising by FDA

The U.S. Food and Drug Administration ("FDA") is reaching beyond the medical device and pharmaceutical industry and addressing provider advertising. The FDA recently sent warning letters to health care organizations and to a firm that markets gastric weight loss band devices in California. The FDA claims the ads of these organizations fail to fully explain the risks and complications of the procedures. The FDA's warnings may elicit similar action by state regulators.

6. Bandages for Reimbursement Cuts Continue

A 27 percent reduction in Medicare reimbursement for physicians was scheduled to take place January 1, 2012, but it was deferred for two months by legislation signed by the President in December. The temporary moratorium on the reimbursement cut leaves physicians uncertain of whether the cut will be extended beyond the two-month period.

7. Critical Quality Measurement

A proposed rule published in the Federal Register (76 Fed. Reg. 2454, January 13, 2012) provided guidance on the Medicare Hospital Inpatient Value-Based Purchasing Program. This program provides incentive payments to hospitals based upon their performance on quality measures, such as readmission rates and hospital-acquired conditions. Under the proposed rule, the program will begin in federal fiscal year 2013 and apply to payments for hospital discharges occurring on or after October 1, 2012.

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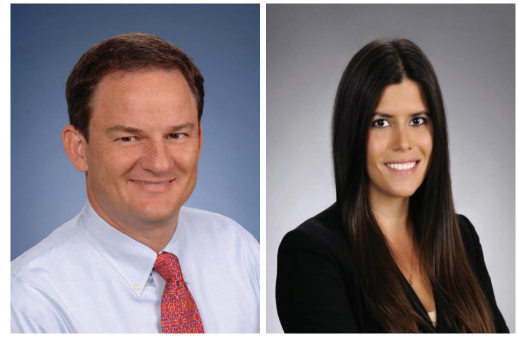

Development Today, Gone Tomorrow: Court Rules to Eliminate California Redevelopment Agencies

Michael A. Williamson and Amanda Steele

The Ruling

As 2011 drew to a close, the California Supreme Court struck a fatal blow for California's redevelopment agencies. In upholding Assembly Bill X1 26 and striking down Assembly Bill X1 27 in *California Redevelopment Association v. Matosantos*, S194861, the Court eliminated all four hundred California redevelopment agencies (RDAs) and started a process to transition all existing projects and obligations to other agencies.

The two laws were part of Governor Brown's budget deficit solution approved in June, 2011. AB X1 26 would eliminate California RDAs by denying them the ability to borrow, acquire property and adopt or amend redevelopment plans, among other things. AB X1 27, however, would then allow RDAs to continue to exist, if the cities and counties that created them "voluntarily" agreed to make payments to benefit State schools and special districts. The total amount of these payments for the 2011-2012 fiscal year would be $1.7 billion, with $400 million to schools and special districts in subsequent budget years.

The Court held that AB X1 26 was "a proper exercise of legislative power vested in the Legislature" under the California Constitution, because that power includes the right to create entities, such as RDAs, to implement State goals. Along with this power to create, the Court concluded, comes the power to dissolve the same entities when the Legislature deems it necessary and proper.

The Court determined that AB X1 27 was invalid under Proposition 22, passed in November, 2010, which prohibits the State from re-directing funds required to be used for local government projects and services to other uses for the State's benefit. Unfortunately for RDAs, the Court determined that Proposition 22 invalidated AB X1 27 in its entirety, leaving no option but elimination of RDAs.

The Implications

Without AB X1 27, RDAs cease to exist as of February 1, 2012. The procedure for implementing this dissolution under AB X1 26 is somewhat convoluted and has consequences for those who have outstanding business with RDAs.

By January 30, 2012, the RDA must prepare a preliminary draft of the initial "recognized obligation payment" schedule (ROP schedule) which projects the dates and amounts of scheduled payments for each "enforceable obligation." After February 1, 2012, a "successor agency" (likely the city or county that created the RDA) will assume responsibility for any enforceable obligations of the RDA under the supervision of an "oversight board" that will eventually be charged with disposing of the RDA's assets.

By March 1, 2012, the successor agency must prepare its own draft ROP schedule. This ROP schedule will cover the period from May 1, 2012 to October 1, 2012. The oversight board, the State Department of Finance, and the State Controller will have the power to review and approve each ROP schedule—promising to make the process drawn out and potentially contentious.

By July 1, 2012, each county's auditor-controller must audit its RDA's assets and required obligations. The audits must be delivered to the State Controller by July 15, 2012. The auditor-controller in each county will then create a redevelopment obligation trust fund (RO Trust Fund), to hold the funds required to meet RDA obligations. Whether these deadlines can be met remains to be seen.

Once this process is completed, the tax-increment funds for enforceable obligations will be placed in the RO Trust Fund, with any remainder distributed to taxing agencies as regular property tax. Typically, but with some variation throughout the State, schools receive 50 percent, counties receive 33 percent, and cities receive 15 percent, with the rest distributed between special districts.

Emergency Legislation

Absent some prompt and effective legislative action, every RDA in California will cease to exist as of February 1, 2012. While many legislators have expressed a desire to "fix" this pending problem, it is expected that any proposal to undo the consequences of the ruling may face an uphill battle from county offices and schools.

Investors, developers, lenders and others who do business with RDAs need to carefully evaluate their existing transactions with any RDA, including keeping abreast of the role of "successor agencies." In particular, ongoing projects and agreements should be reviewed to confirm whether they are "enforceable obligations" and that complete information and documentation for any RDA activities (over the past year in particular) are available in the event it is necessary to enforce the obligations against relevant "successor agencies" or such recourse against RO Trust Funds. It may be necessary to consult with counsel to the extent a dispute arises as to whether an obligation is in fact enforceable against any such agency.

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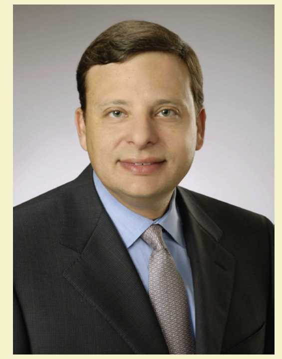

Banker Beware: Bank Practices under Increased Scrutiny as Dodd-Frank Implementation Begins

Jeffrey B. Kirschenbaum

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practice is deceptive based on the likely effect it would have on a hypothetical "reasonable consumer."

In *Gutierrez v. Wells Fargo Bank*,[1] a federal judge applied California law in the action, which challenged the propriety of posting transactions from the highest to the lowest dollar amounts on the ground that this increased overdraft fees. The court found the bank's marketing materials to be misleading, mostly based on statements contained in the bank's new account welcome jacket and in glossy brochures. Disclosures made in the consumer account agreement and in fee schedules (held in pockets inside the new account jacket) were in many instances dismissed as irrelevant by the court, because consumers could not be expected to read the lengthy document, and, even if read, the disclosures were difficult for consumers to understand.

The *Gutierrez* court also concluded that high-to-low sequencing was "a trap" intended to rack up fees "off the backs of the working poor, students, and others without the luxury of ample account balances." Restitution of over $200 million was ordered, in addition to other relief. The case is on appeal before the Ninth Circuit.

Operational practices are receiving increased regulatory scrutiny as well. Presently, federal banking agencies have broad authority under Section 5 of the Federal Trade Commission Act to address banking practices deemed unfair or deceptive to consumers. The Dodd-Frank Act expands regulatory authority in this area by prohibiting "abusive" acts, in addition to unfair and deceptive practices. What constitutes an "abusive" practice remains to be seen; but this rule gives banking regulators even broader powers to address new products and new fee structures.

Like the class action plaintiffs' attorneys, banking regulators are likely to pay closest attention to new products that target lower income consumers and fee structures that most heavily impact customers with low account balances. In 2010, the FDIC issued overdraft program guidance, which became applicable after July 21, 2011. And in 2011, the Office of the Comptroller of the Currency issued proposed guidance similar to the FDIC's. Through this process, the regulators have informed the institutions of their expectation that each bank will actively contact and counsel customers who make excessive use of overdraft programs and limit overdraft fees.

Deposit-related consumer credit products have received similar scrutiny from regulators. These products, which some argue are the equivalent of a traditional payday loan, extend relatively small amounts of credit at a fee of up to 10 percent of the amount borrowed, although the loan typically comes due in 35 days and is repaid from incoming direct deposits. Recently proposed OCC guidance requires national banks and federal thrifts to provide customers with clear and conspicuous disclosures, implement limitations on product use, and monitor customer usage and product revenue.

A new regulatory agency, the Bureau of Consumer Financial Protection, was created by the Dodd-Frank Act. The Bureau, which is nominally part of the Federal Reserve, will have authority to write new standards for a wide array of financial products as well as authority to enforce federal consumer financial protection laws. Although the rule-making process has just begun, when asked about a $5 debit card service fee imposed by a national bank to replace revenue lost due to the interchange rate cap imposed by Dodd-Frank, President Obama stated to ABC News, "This is exactly why we need this Consumer Finance Protection Bureau."

It remains to be seen whether the Bureau deems the lawful imposition of debit card fees to be an "abusive" practice. But recent regulatory guidance and judicial rulings should be a wake-up call for all financial institutions to actively review their marketing materials, account agreements, and fee schedules to ensure that customers are fully informed of the fees that they may be charged. The need for caution is particularly acute for products that are frequently used by unsophisticated consumers, such as overdraft protection and direct-deposit advance programs.

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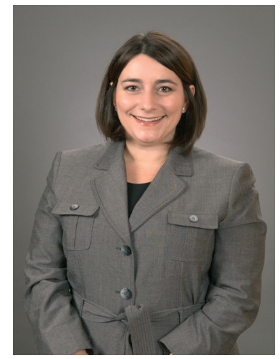
[1] United States District Court for the Northern District of California Case No. 3:07-CV-05932-WHA



The Lender-Borrower Tangle: Understanding California and Arizona Anti-Deficiency Legislation

Renee M. Shprecher

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When faced with a potential foreclosure, the threshold questions to be asked by a lender in either state are:

(i) does the state's anti-deficiency legislation restrict the lender's ability to seek a deficiency judgment for the difference between the outstanding loan balance and the proceeds received by the lender at the sale (or the fair market value of the property), and
(ii) is the underlying loan secured by a mortgage or a deed of trust, and is the debt secured by the loan purchase money or non-purchase money.

If the property does not qualify for anti-deficiency protection, no further discussion is necessary, since the lender can choose under which foreclosure statute it wishes to proceed. In turn, if the property does qualify, the next step is to determine which statute allows the lender to maximize its recovery.

In both Arizona and California, if the property is foreclosed by a trustee's sale, under no circumstances can the foreclosing lender collect a deficiency. On the other hand, if the lender elects to judicially foreclosure on the property, a deficiency *may* be pursued, and the lender *may* be entitled to recover the difference between the loan amount and the actual sale price of the property (or its fair market value). Although the facts and circumstances may vary, the answers to those questions can significantly influence the lender's strategy concerning the method of foreclosure, as well as the method of collecting any deficiency judgment.

Arizona Anti-Deficiency Legislation

In Arizona, Arizona Revised Statutes ("*A.R.S.*") §§ 33-729(A) and 33-814(G) limit a lender's right to seek a deficiency judgment against the borrower after the foreclosure of a residential property if the secured property meets certain qualifications. Regardless of which statute ultimately applies, in order for the borrower to qualify for anti-deficiency protection, the secured property must be "two and one-half acres or less which is limited to and utilized for either a single one-family or a single two-family dwelling." The Arizona courts have held that the use of the residence is irrelevant under A.R.S. §§ 33-729(A) and 33-814(G) by extending the anti-deficiency protection to owners of investment properties as well as homebuilders *so long* as the secured property has been completely constructed, i.e., no vacant land, and is at least occasionally used by either the owner or another party as a single-family dwelling.[1] Interestingly enough, the courts have refused to extend similar protection to speculative builders whose homes are in the process of construction and are not yet occupied, as such homes are not *yet* being "utilized" as dwelling.[2] The courts have similarly refused to extend protection to borrowers who secure multiple single one-family or single two-family dwellings under one blanket deed of trust by holding that the secured property was not being "utilized" either as a single one-family or a single two-family dwelling, but rather as *multiple* single one-family or single two-family dwellings, contrary to the plain meaning of the statute.[3] Provided that the secured property does not qualify for anti-deficiency protection, a lender can shape its foreclosure strategy primarily based on the type and character of the loan.

The application of A.R.S. § 33-729(A), which pertains to both mortgages and deeds of trust that are judicially foreclosed upon, depends on the character of the loan at the time the loan is made. Specifically, under A.R.S. § 33-729(A), if the loan is a purchase money loan, i.e., "*given to secure the payment of the balance of the purchase price, or to secure a loan to pay for all or a portion of the purchase price*," the lender's only recourse is to sell the foreclosed property in an effort to satisfy the outstanding debt. In other words, the lender is barred from collecting a deficiency judgment out of any of the other assets of the borrower thereby eliminating any sort of personal liability for the borrower.

Worth noting is that under A.R.S. § 33-729(A), refinance of an existing purchase money loan does not re-characterize the initial structure of the loan.[4] Therefore, a borrower is still afforded protection under the statute *even if* the borrower refinances the original purchase money loan. Case law in Arizona, however, is unsettled as to whether such protection would be afforded to a borrower if the purpose of the restructure or refinance of the original loan was to "cash out" or pull equity out of the property to buy unrelated home goods or pay off debts.

If, on the other hand, the loan is a non-purchase money loan, i.e., the loan was used for any purpose other than the purchase of the property, such as: an assumption of an existing mortgage,[5] mortgaging one home to purchase another,[6] or a home equity line of credit,[7] the lender could escape protection and pursue a deficiency by judicially foreclosing.

In contrast, under A.R.S. § 33-814(G), which applies *only* to deeds of trust, if the lender elects to foreclose on the property by a trustee's sale, rather than electing to judicially foreclose under A.R.S. § 33-729(A), *regardless* of whether the loan was a purchase money loan or a non-purchase money loan, the lender is thereafter barred from collecting a deficiency judgment against the borrower.

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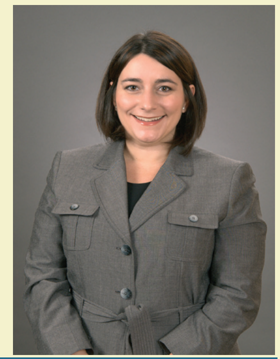

Renee M. Shprecher

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If the secured property does not qualify for anti-deficiency protection under either A.R.S. §§ 33-729(A) and 33-814(G), a lender may obtain a deficiency judgment.

California One Action Rule and Anti-Deficiency Legislation

California's anti-deficiency legislation is similar in nature to that enacted in Arizona in that the manner in which a lender eventually elects to foreclose can determine whether or not a lender can seek a deficiency judgment.

When a borrower defaults, California Code of Civil Procedure ("*C.C.P.*") § 726(a) forces the secured lender to take only "one form of action for recovery of any debt or the enforcement of any right secured by a mortgage upon real property."[8] In other words, the lender is forced to take only one action, whether it elects to judicially foreclose on the property and, unless barred by anti-deficiency legislation, obtain a deficiency judgment, or sue the borrower and/or guarantors for the underlying debt obligation.[9] As a result, the lender must foreclose on the real property *first* prior to collecting on the underlying debt. This requirement is known in California as the "*one action rule*." The obvious benefit to the borrower is that it is only obligated to pay any deficiency that remains after the foreclosure sale (subject to fair value limitations) *provided that* a deficiency judgment is available.

In California, protection for residential borrowers is set forth in two anti-deficiency statutes: *C.C.P. § 580(b)* and *C.C.P. § 580(d)*.

Similar in concept to A.R.S. § 33-729(A), protection under *C.C.P. § 580(b)* depends upon the character of the loan at the time it is made. Specifically, under *C.C.P. § 580(b)*, a lender is barred from collecting a deficiency judgment under a deed of trust for an owner-occupied residential one-to-four dwelling where the loan proceeds were used to secure the payment of the purchase price of the property, i.e., a purchase money loan, or under a loan for any type of property, i.e., owner occupied residential, investment or commercial, financed through seller carry-back financing.[10] In turn, *C.C.P. § 580(d)* limits a lender's right to seek a deficiency against the borrower after the property is foreclosed by a trustee's sale *regardless* of the type of loan *or* the type of property being foreclosed if the sale did not generate enough proceeds to pay the full amount of the debt.[11] There is one significant proviso—580(d) protection only applies to the debt of the foreclosing lender. If the proceeds are insufficient to pay off a subordinate lien, that subordinate creditor may qualify as a "*foreclosed out junior lien holder*" which may enable the creditor to sue the debtor directly for the debt under certain circumstances. Again, worth noting here is that unlike Arizona, a borrower can lose its anti-deficiency protection under *C.C.P. § 580(b)* if it refinances a purchase money loan. In spite of California's anti-deficiency laws, a lender is permitted under certain circumstances, to sue the borrower for damages resulting from fraud; rent skimming; mistake; "bad faith" waste,[12] environment impairment or enforcement of "environmental provision" under C.C.P. *§ 736(a)*.

Conclusion

Anti-deficiency legislation in Arizona and California shields residential borrowers from personal liability at the obvious expense of the lender. Though the application of this legislation differs among the states, when the decision to foreclose is imminent, a lender should keep in mind that there are numerous variables to consider when formulating a foreclosure strategy to maximize its recovery and that no single approach works every time.

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[1] *Northern Arizona Properties v. Pinetop Properties Group,* 151 Ariz. 9, 725 P.2d 501 (App. 1986).

[2] *Mid Kansas Federal Savings and Loan Ass'n of Wichita v. Dynamic Development Corp.,* 167 Ariz. 122, 804 P.2d 1310 (1991).

[3] *PNL Credit L.P. v. Southwest Pacific Investments, Inc.,* 179 Ariz. 259, 877 P.2d 832 (1994).

[4] *A.R.S. § 33-729(A).*

[5] *Southwest Savings and Loan Ass'n v. Ludi,* 122 Ariz. 226, 594 P.2d 92 (1979)

[6] *Cely v. DeConcini, McDonald, Brammer, Yetwin & Lacy, P.C.,* 166 Ariz. 500, 803 P.2d 911 (1990)

[7] *Baker v. Gardner,* 160 Ariz. 98 (1988)

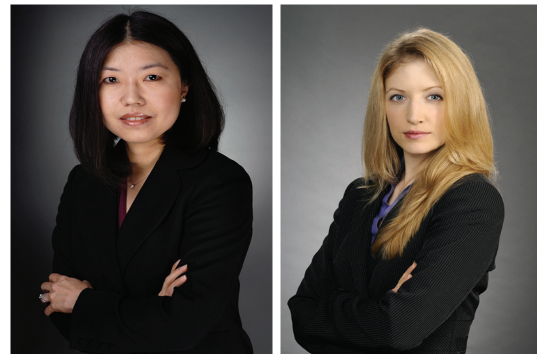
[8] *C.C.P. § 726(a).*

[9] *C.C.P. § 726(a).*

[10] *C.C.P. § 580(b).*

[11] *C.C.P. § 580(d).*

[12] *see, Cornelison v. Kornbluth,* 15 Cal. 3d 590, 542 P.2d. 981 (1975)



How Absolute is the Absolute Priority Rule in Individual Chapter 11 Cases?

Alexandra Rhim and Angella D. Yates

Known as a bedrock principle in chapter 11 cases, the "absolute priority rule" serves as an important protection for creditors. In general terms, it requires senior classes of creditors to be provided for in full before a junior class can receive a distribution under a chapter 11 plan. While this rule continues to apply in business chapter 11 cases, courts are divided on whether it applies to individual chapter 11 debtors. This issue is not a mere consumer matter, but impacts creditors who have made loans to sole proprietorships or have loans guaranteed by such debtors. Given the dichotomy in the courts, creditors should understand how to navigate this issue.

A chapter 11 plan provides a distribution to classes of creditors to satisfy their claims against the debtor. Most creditors will have the right to vote to accept or reject the plan. If a class of creditors does not accept the plan, the debtor must resort to what is known as a "cram down" to confirm nonconsensual treatment of those creditors' claims. The Bankruptcy Code imposes a number of requirements to accomplish a cram down.[1] One of those key requirements is the absolute priority rule.[2] Put simply, unless a plan provides for full payment to a class of creditors holding senior interests, junior interests are prohibited from receiving or retaining any property. Additionally, a plan must satisfy several other statutory elements before it can be confirmed.

Creditors holding unsecured claims have the right to raise the absolute priority rule. A creditor can hold an unsecured claim a number of ways. It can hold a debt that is not secured by any assets. But it can also hold an unsecured deficiency claim to the extent its debt exceeds the collateral value.

Prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), the absolute priority rule precluded individual chapter 11 debtors from retaining prepetition assets unless the plan provided in full for a dissenting class of creditors. Thus, the debtor itself could not retain certain assets and might be unable to continue with its business. To avoid this result (and the higher administrative cost of chapter 11), some individuals seek relief under chapter 13 which does not impose the absolute priority rule. Many individuals who have fairly substantial debt and assets, however, are ineligible for chapter 13 and must resort to chapter 11.

The BAPCPA has spawned the current debate. Section 1129(b)(2)(B)(ii), which codifies the absolute priority rule, was amended to include language describing what assets an individual debtor could retain following plan confirmation. A split exists among the courts due to a difference in interpreting this language.

Some courts interpret the statutory modification to prohibit a debtor from retaining his or her *prepetition* assets, notwithstanding less than full repayment to other creditors (namely, unsecured creditors). In fact, several bankruptcy courts in California have announced that under the growing majority trend, the absolute priority rule continues to apply in individual cases. These courts contend that Congress did not intend to abrogate such a key protection for creditors and that chapter 11 for individuals need not mirror chapter 13. In contrast, other courts posit that a "plain reading" of the applicable code sections and the public policy of promoting rehabilitation support abrogation of the absolute priority rule in individual debtor cases. This divided approach can be observed in the Central District of California among the different judges sitting in the very same courthouse.

Due to the unsettled nature of the issue, creditors face uncertainty. In cases where the presiding bankruptcy judge upholds the absolute priority rule, creditors have a distinct advantage. These creditors will have greater leverage to negotiate an increased distribution through a plan or even prevent plan confirmation if the absolute priority rule is not satisfied. The debtor may also attempt to retain his or her prepetition assets by contributing "new value" to a chapter 11 plan.[3] In this case, creditors could potentially receive a greater distribution equal to such value, which would be unavailable should the bankruptcy judge hold the absolute priority rule inapplicable.

In cases where the presiding judge will not apply the absolute priority rule, creditors may need to employ additional legal strategies to maximize their recovery. Such strategies include establishing that the debtor is unable to satisfy certain other plan confirmation requirements. One of those requirements is that the plan be proposed in good faith.[4] Some courts have suggested that when a nominal distribution is proposed to unsecured creditors while the debtor retains his or her prepetition assets, such plan might not be proposed in good faith and, therefore, is not confirmable. In addition to this requirement, creditors can contest the plan on a number of other grounds, including feasibility or the "best interests of creditors" test (requiring distribution at least equal to liquidation values). The result, however, is that the creditor may face costlier and protracted court proceedings without assurance of success. While most plans are confirmed as a result of negotiations, the spectre of this issue may lead to a reduced recovery for creditors.

Given the number of published decisions by bankruptcy judges and the academic discourse on the subject, it appears the issue is positioned for appellate consideration. In the meantime, creditors should be mindful of this issue when dealing with individual chapter 11 debtors.

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[1] 11 U.S.C. § 1129 sets forth the requirements to confirm a chapter 11 plan.

[2] 11 U.S.C. § 1129(b)(2)(B)(ii) codifies the absolute priority rule.

[3] Although its existence is questioned by some courts, the "new value" exception enables a debtor to retain prepetition assets by contributing money or money's worth to fund a plan.

[4] 11 U.S.C. § 1129(a)(3) requires that a plan be proposed in "good faith and not by any means forbidden by law."

Got Independent Contractors? (Are You Sure?)

Bryan J. Lazarski

As we embark upon 2012, now is an excellent time to evaluate your company's practices with respect to its workforce. In particular, a common issue facing many employers in California, the misclassification of employees as "independent contractors," will be subject to increased penalties under a new California law in 2012, which may warrant action in the new year. Misclassification can have serious ramifications from both an employment and a tax perspective. For several reasons, now may be a good time to correct misclassifications and ring in the new year with a compliant start.

Independent Contractor or Employee? A Quick Self-Examination

The difference between an independent contractor and an employee is a legal distinction that may not always be straightforward or easy to recognize. A dangerous but pervasive myth is that a company can simply agree with a worker that he or she shall be treated as an "independent contractor." This is entirely untrue. Whether a worker qualifies as an independent contractor or an employee is determined by the realities of the relationship between the parties, which cannot be overcome by agreement or contract.

Federal and state enforcement agencies apply a multi-factor analysis to analyze classifications. Ultimately though, the main distinction boils down to whether the employer/principal only has the right to control the result of the work or if it also controls the manner and means of how the work will be done. If it's the latter, the worker is probably an employee.

A quick test to determine whether you may have a misclassified independent contractor in your organization is to take a look at anyone you currently treat as an independent contractor, which includes anyone whose pay you report by IRS Form 1099.

Ask yourself:

- Are they working full-time (or close to full-time) for you?
- Are they expected to work regular hours with you (i.e. a set shift like 9-to-5)?
- Do they work exclusively or almost exclusively at your facilities?
- Do they wear uniforms or use tools or equipment you provide?
- Are they expected to continue their work for your company indefinitely (as opposed to a finite project)?

If you answered "yes" to any of these questions, you may have an employee that has been misclassified as an independent contractor.

Why Act Now?

Unfortunately, identifying misclassified independent contractors is only part of the battle. There are also several things to consider when reclassifying a worker to employee status. Among other things, and depending upon the situation, you may owe back taxes, have liability for unpaid overtime, and be subject to other fines and penalties. If done correctly though, a well-timed, well-executed voluntary reclassification can significantly reduce or eliminate your risk of a much costlier lawsuit (or a class action lawsuit if there are multiple misclassified contractors).

There are two new legal issues that may influence your decision to act now:

1. Increased Penalties in California—The Stakes Are Going Up:

On October 6, 2011, Gov. Jerry Brown signed SB 459 into law, which provides for significantly increased penalties for misclassification, effective January 1, 2012. The new penalties range from $5,000 up to $25,000 in some instances per misclassified worker. There is also a "public shaming" provision of the new law, under which employers who are found to have misclassified workers must post a statement on their company website for a year stating that they violated the law.

In recent years, both federal and state authorities have devoted increased resources to finding and punishing employers who misclassify workers. Because of the penalties and back taxes that authorities can assess for misclassification, seeking out non-compliant employers is a major revenue generator for them, so this increased attention is not likely to go away any time soon. It is also a major revenue generator for the Plaintiff's bar, who frequently file lawsuits to recover on behalf of misclassified workers.

2. Tax relief: From a tax standpoint, generally you must:

(a) withhold income, Social Security and Medicare taxes, and

(b) pay payroll and unemployment taxes on employee wages, which is generally not true for independent contractors. For this reason, any misclassification could lead to years of non-compliance with various tax codes, resulting in back taxes, interest and penalties.

This past September, though, the IRS announced a safe-harbor program for employers who voluntarily reclassify employees. This safe harbor program could significantly reduce federal tax liability for a misclassification, but it also provides the potential for other adverse legal consequences and should be undertaken with caution and in consultation with counsel. Among the potential downsides, applicants for the IRS program should be aware that their company may not be able to avoid penalties from other governmental agencies. For example, the California Employment Development Department is not presently providing any safe harbor for back taxes.

Secondly, applying for the IRS program could potentially be construed as an admission of prior wrongdoing in an action against the company to recover back wages/benefits for the misclassified worker(s). Nevertheless, the federal safe harbor may provide a significant tax incentive to reclassify now while the program lasts, and it warrants analysis if your company is considering reclassifying any of its workers. More information on the IRS program is available here:
http://www.irs.gov/newsroom/article/0,,id=246203,00.html.

If you believe you may have a misclassified independent contractor working for you, you should consult with counsel to discuss a suitable plan of action.

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Health Care Undergoes Major Surgery in 2012

Julie Simer

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8. Progress Noted in Transition to Electronic Health Records
Incentives offered through the Medicare and Medicaid programs are intended to encourage physicians and hospitals to transition to electronic recordkeeping. The incentives can be as much as $44,000 (through Medicare) and $63,750 (through Medicaid) for an individual physician. The incentives are offered in stages, requiring the demonstration of "meaningful use" of the technologies at each stage. Stage one began in 2011 with additional stages to occur in 2012 and beyond. According to the Centers for Disease Control and Prevention, in 2001, 57 percent of all office-based physicians in the United States used an electronic medical record, and 52 percent of physicians intended to apply for meaningful use incentives.

9. Pressure Applied through Medical Loss Ratios
Beginning in 2012, individual and small group health insurers must spend 80 percent of premiums on patient care and quality improvements. Eighty-five percent collected must be spent by large group insurers. If a health plan fails to meet this requirement, it must provide rebates to enrollees. The rebates are to begin in June 2012.

10. Pain of W-2 Reporting Delayed for Small Employers
The Act includes a requirement that the cost of employer-sponsored health insurance coverage be reported on an employee's W-2 tax form. Reporting is optional for small employers for the 2012 tax year, but employers filing 250 or more W-2s will be required to report this information for the 2012 tax year on the W-2s provided to employees in January 2013.

If the Court determines that the individual mandate is unconstitutional, it must then decide whether parts of the Act will stand. Until that decision, however, the health care industry remains under the scalpel. While we do not know whether the outcome for health care will be positive or negative, we do know that it is getting a radical facelift.

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