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BACK

Beyond *Kelo*: THE POLITICAL REACTION & IMPACT ON DEVELOPMENT

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Legal commentators predicted that *Kelo v. City of New London* would be one of the most significant property rights cases heard by the United States Supreme Court in decades. At issue was whether a local government's condemnation of non-blighted private property for purely economic development purposes was constitutional. On June 23, 2005, the court held that, under the right circumstances, economic development can be sustained as a "public use" under the Fifth Amendment, and that, in *Kelo*, the Connecticut city's taking of well-kept private homes to facilitate a comprehensive redevelopment project passed muster.

Few, however, predicted the intensity of the backlash against *Kelo*, which the *Detroit Free Press* termed "an unprecedented uprising to nullify a decision of the highest court of the land." The Chair of the U.S. House of Representatives' Judiciary Committee likened the decision to the infamous *Dred Scott* opinion. Even Connecticut's governor labeled the issues addressed in the case "the 21st century equivalent of the Boston Tea Party: the government taking away the rights and liberties of property owners without giving them a voice." This virulent anti-*Kelo* sentiment has already translated into numerous proposed "remedies" at the state and federal level. Thus, perhaps even more than the holding itself, the legislative and legal developments in the wake of *Kelo* will have profound effects on municipalities, real estate developers, and property owners alike.

POLITICAL REACTION

Kelo has faced bipartisan attack in Congress, uniting rivals such as Rep. Tom DeLay (R-TX) (who called the decision a "travesty") and Rep. Maxine Waters (D-CA) (who denounced *Kelo* as "the most un-American thing that can be done"). The House passed a resolution criticizing the ruling by a 365-33 vote, and several bills aimed at limiting the use of eminent domain are pending in Congress. A Senate subcommittee hearing on one such bill highlighted the strange divisions created by *Kelo*: an NAACP official testified in favor of the legislation, while a representative of the National League of Cities, a traditional NAACP ally, opposed it.

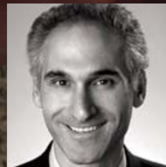
At the state level, reaction to *Kelo* has been even more turbulent. By late July, over half of the nation's state legislatures had bills introduced or pending to clarify or restrict the use of eminent domain. Delaware passed the first post-*Kelo* statute limiting the use of eminent domain on June 30, a mere week after the decision – and Alabama followed suit on August 2. The Texas legislature passed a bill limiting the exercise of eminent domain where it would confer a benefit on a private entity. In Connecticut, where *Kelo* originated, the governor endorsed a moratorium on eminent domain.

These state-based, legislative reactions, while swift, have varied in scope. Delaware's statute restricts the use of eminent domain to "recognized public uses," but does not define those uses. This may be a reference to Justice Sandra Day O'Connor's description in her *Kelo* dissent of the historical class of takings, including streets, schools, and sewers. Alabama's more stringent statute prohibits the use of eminent domain for retail or commercial use, for the purpose of generating tax revenue, or to transfer property to another private use, carving out an

(*KELO* continued on page 6)

I WANT TO HOLD YOUR LAND

JAMES M. RISHWAIN, JR.



DOUGLAS A. PRAW

How many times have you heard lenders say that they are not in the business of owning real estate? Traditionally, lenders have made great efforts to ensure that they did not take on the risks associated with ownership of their borrowers' businesses or assets, even if that meant the economics of the transactions would be less favorable to the lenders. Borrowers, as project owners, bore all the risk of owner liability, and lenders did not want to assume such risks in underwriting loans. Avoiding characterization as owners was difficult enough, but the idea that lenders would *intentionally* assume ownership risks was unthinkable.

Well, as Bob Dylan sings, "…the times they are a-changin'."

In a recent turn of events, lenders are now, under some circumstances, not only willing to take the risk of ownership, they are embracing the idea and marketing the concept to stay competitive in the marketplace.

BRIDGE OVER TROUBLED WATERS

Lender liability results when lenders cross the line from being mere sources of capital for a business to being active participants in that business. For many years, the line was clear. As a result of the decision by the California Supreme Court in *Connor v. Great Western Savings and Loan Association*, 69 Cal. 2d 850 (1968), the line moved much closer to lenders and became blurred. In *Great Western*, homeowners sought damages from the lender, Great Western Savings and Loan Association, for construction defects when the borrower, the developer of a real estate project, built homes with ill-designed foundations that could not withstand the expansion and contraction of adobe soil. The borrowers sought to hold Great Western liable on the grounds that its participation in the real estate development brought it into a joint venture with the developer. Under this joint venture theory, the lender would be held jointly and severally liable for any obligations that the developer might have to third parties, in this case the homeowners who had purchased homes from the developer. The court held that Great Western was so involved in day-to-day operations that it had transcended the line between lender and borrower, and thus was

liable for, among other things, the tort liability and mechanics' lien liability of the developer.

At the time, certain commentators felt that *Great Western* was incorrectly decided and that the court was looking for a deep pocket to remedy the damages suffered by the homeowners. Whether correctly decided or not, however, *Great Western* ushered in an era during which lenders structured their loans with a clear demarcation between lender and borrower so as to avoid any possibility of a claim that lenders were jointly and severally liable for their borrowers' liabilities. The case was of such significance that the California legislature codified the holding in California Civil Code Section 3434. The lenders' traditional role was to insure that loans represented loans and that lenders had no involvement in the ownership of property. Conventional loan documents attempted to provide a clear delineation of the roles of each of the borrowers and lenders, respectively, so that lenders could avoid lender liability. In fact, typical loan agreements would often include a self-serving characterization section that provided that lenders were indeed lenders and not joint venture partners of borrowers. Lenders wanted to avoid taking ownership of any real property unless and until lenders chose to credit bid at foreclosure.

Although no bright line standards exist to establish lender liability, certain guidelines developed following the *Great Western* decision and the enactment of California Civil Code Section 3434, including:

Participation in Day-to-Day Activities: Under conventional loans, lenders are often afforded the right to consent to leases, budgets, construction issues, and many other matters. However, lenders always needed to balance the desire to control certain aspects of the borrowers' operation of property with the risk of chracterization as a participant involved in day-to-day operations.

Sharing in Profits: As a general rule, lenders would be careful when participating in the profits of their borrowers' projects. The extent to which lenders shared in the profits of projects could lead a trier of fact to determine that lenders were not acting merely as lenders, but as owners in the context of real estate secured loans. Take a participating loan as an example. A participating loan has two components: a hard money conventional loan and a participating interest component. Participating interests call for lenders to share in profits from projects upon the sale or refinance of such projects. Sharing profits is certainly one indicia of a joint venture that could have resulted in lender liability.

Sharing in Losses: While participation in profits was allowed to an extent, sharing in losses was not allowed in a traditional analysis. A loan structure where lenders bear responsibility for all or part of the borrowers' losses was an indication of a joint venture.

Intent of Parties: The true intent of the parties is paramount in the interpretation of the parties' roles. While the true intent of the parties may be difficult to glean, lenders often made sure that loan documents explicitly stated that lenders were acting only as sources of funds, and not as owners or joint venturers. For provisions that could be construed as crossing the line from lenders to owners, the theory was that documenting the relationship would assist the courts when interpreting the intent of the parties in entering into the agreements.

CH-CH-CH-CHANGES

As a result of changes in federal accounting guidelines, market forces, the competitive nature of the industry, and the availability of capital, many lenders are now taking title to property directly. While the trend has only recently manifested itself and is still developing, some lending institutions are replacing the classic loans documented by notes and deeds of trust with direct purchases of land by lenders and execution of option agreements with borrowers whereby borrowers acquire property from lenders through incremental take-downs and option payments. The option payments are equivalent in amount to the amortization of the lenders' acquisition price plus a rate of return. If borrowers fail to exercise their options, they are in default and forfeit their rights to the property while remaining liable to lenders for damages. Essentially, the traditional lender/borrower relationship is being converted to an optionor/optionee relationship.

Interestingly enough, the lender liability risks have not changed, just the willingness of lenders to assume those risks. Under the option mechanism, lenders can achieve rates of return in excess of returns for institutional lenders (through products such as participating loans) because lenders are facing the challenges of property ownership and being rewarded for doing so. Indeed, borrowers are paying a premium to have their lenders hold property until such time as the borrowers can acquire the property. The ownership period for lenders can, in some instances, extend over a two- to ten-year period of time, and the premium usually stays constant over that period, which is a hedge against market fluctuations.

> "...the times they are a-changin'."

Under the option model, the intent of the parties is exactly the opposite of past practice: the option agreements are clear that lenders *are* owners of real property. As owners of real property, lenders cannot avoid making day-to-day decisions, and being in the chain of title exposes lenders to risks typically associated with property ownership, such as environmental liability, direct liability to third parties, tax liability, casualty liability, and premises tort liability. While lenders attempt to minimize their liability through borrower indemnities and insurance, the risks are still directly on the lenders. However, lenders are willing to take these risks in consideration for higher returns.

SATISFACTION?

The ownership of property by lenders is a radical change from past practice. While the same lender liability issues are present, the marketplace has changed and demanded that lenders accept greater levels of risk. If the trends continue, then it must be asked: if lenders were lenders, but now lenders are owners, when will lenders be builders?

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BRAC 2005

tough decisions bring unique opportunities

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Now that the political phase of BRAC 2005 is concluding, community leaders in the affected jurisdictions will begin to address the economic impacts of the closed and realigned military installations in their communities. These impacts will create opportunities for real estate development in two ways. First, for communities suffering base closures, land that has been locked up in federal government enclaves for decades will now be available for development. Second, for communities experiencing an influx of military personnel and families, additional housing and commercial development will be needed to service the growing population. In either case, real estate developers have unique opportunities to assist their local communities in adjusting to the BRAC decisions, while at the same time fulfilling their business objectives.

THE PEACE DIVIDEND

The loosening of the Soviet Union's grip over Eastern Europe in the late 1980s marked the beginning of a new era for the United States military establishment. No longer faced with the threat of a direct battle against the Soviet Union, leaders in both political parties looked at the staggering costs of Cold War national defense as a chance to greatly reduce government spending. As a direct result, Congress enacted the Defense Base Closure and Realignment Act of 1990, which created a process for evaluating existing military bases and implementing the realignment or closure of such bases throughout the world. Overseen by the Department of Defense ("DoD") and known as "BRAC," realignments and closures occurred in 1991, 1993, and 1995. The latest round of BRAC was initially approved as part of the DoD's spending authorization legislation for fiscal year 2002.

Officials at the DoD predicted that the BRAC 2005 decisions would be larger than all previous BRAC rounds combined – that up to 20 percent of the military's infrastructure would be closed. Because of the global shifting of military assets, however, those early predictions have not proven correct. While

the BRAC 2005 round is still larger than any single previous BRAC round with respect to closures, BRAC 2005 resulted in a drastic shift in troop strength from overseas back to the United States, prompting some DoD officials to refer to the process as the "Big R, little c" round (*i.e.*, favoring realignment rather than closure).

Whether realignment or closure, the impacts of the BRAC decisions on communities are significant, and the opportunities for developers are equally considerable.

BASE CLOSURES

Base closures, although typically dreaded for their impacts on local communities, are not always as devastating as the public believes. By freeing up significant federal land holdings for development, closed military installations may present significant economic opportunities. In an economically viable urban environment, opening land for development and getting it onto local tax rolls will sometimes far outweigh the economic detriment that resulted from base closures. For instance, Mayor Jerry Brown of Oakland, California, used all of his political savvy in 2003 to expedite a transfer of the Oakland Army Base prior to completion of environmental remediation work because the base was located in the city's commercial and industrial heart.

To soften the economic blow of the base closure process, Congress in 1993 called upon the military services to work with communities to identify and implement means of reutilizing or redeveloping closing installations in such a way as to revitalize communities' economic prosperity. The military services are required to follow the General Services Administration's federal property management regulations, which require that any excess federal property be screened by all other federal agencies to determine whether another agency has a need for the property. In previous BRAC rounds, a number of properties were claimed by Department of Interior ("DOI") agencies, such as the U.S. Fish and Wildlife Service and the National Park Service. The military services, however, were often frustrated by the DOI's reluctance to take administrative control of property prior to completion of all environmental restoration activities. As a result, when the BRAC 2005 closure properties are screened, the military services will insist that any other federal agencies accept the properties "as-is." Based on the prior reluctance of DOI, the "as-is" requirement should reduce the number or properties that are claimed in the federal property screening process.

Normally, base closure properties that are not claimed by other federal agencies will be taken by local redevelopment authorities, which are special purpose entities established by local governments for the sole purpose of managing the base closure properties. A local redevelopment authority ("LRA") will serve as the community's primary development planner and point of contact with the military branch that is disposing of an installation. To the extent possible, developers should be in contact with local government officials even before the LRA is formed. Developers should make governmental planners aware of their interest in BRAC properties, particularly if developers have their own vision for redevelopment. Under the BRAC 2005 legislation, the BRAC commission's decisions are likely to become effective sometime between November 7 and December 22, 2005, which means that redevelopment discussions in communities will begin in earnest very soon. The LRA will be responsible for preparing a redevelopment plan, which it will submit to the responsible military service. It will also work with the DoD's Office of Economic Adjustment to determine whether economic assistance is available for development of the property to the community's best advantage. Developers interested in BRAC property should lobby LRAs to ensure that their interests are incorporated into the base redevelopment plans.

BASE REALIGNMENT

BRAC 2005 decisions will cause a large shift in military personnel to existing facilities. For example, Fort Bliss, Texas, will see a net gain of 11,354 active duty soldiers, doubling its active duty population. In addition, Fort Benning, Georgia, expects to add 9,221 troops, Fort Carson, Colorado, will likely gain approximately 4,178 troops, Fort Sill, Oklahoma, will gain 3,444 troops, and Fort Riley, Kansas, will grow by 2,415 soldiers. BRAC reductions in leased office space in northern Virginia are expected to shift about 12,000 jobs to Fort Belvoir, Virginia, and 5,000 jobs to Fort Meade, Maryland. Other examples include Little Rock Air Force Base with up to 3,898 new positions, Eglin Air Force Base, Florida, which expects 2,218 new personnel, Marine Corps Base Quantico, Virginia, which will see 3,000 new personnel, and the Naval Air Weapons Station, China Lake, California, which may increase by 2,469 personnel.

While good news for local economies, realignment also presents numerous challenges. Infrastructure improvements will likely be required to serve each of the installations with net increases in personnel to accommodate troops, equipment, and command. There will be significant need for housing of military personnel and families. And, of course, an influx of population brings with it a need for additional commercial infrastructure (services, retail, etc.).

The real estate community can provide invaluable support in meeting these needs. Creative approaches, such as public-private ventures similar to the military's privatized housing initiatives, would be one way to meet the requirements (although Congressional approval would be needed for such ventures). However, because the timetables for establishing new facilities and infrastructure will be extremely aggressive, commercial developers should be exploring the ways to meet major military construction requirements as soon as possible.

THE TIME TO ACT IS NOW

BRAC 2005 involved painful decisions, and as with any difficult decisions, there are winners and losers. However, difficult decisions also create opportunities, and the real estate community has immediate opportunities to provide its expertise to both those communities suffering closures and those gaining new residents. The impacts will be swift and significant, so the time to act is now.

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(*KELO* continued from cover page)

exception only for blighted property. Texas's statute exempts numerous specific projects, including the new Dallas Cowboys football stadium. In California, two state senators have crafted a state constitutional amendment requiring the government either to own the property it seizes through condemnation or to guarantee to the public the right to use the property, although local redevelopment officials argue that California's eminent domain law already limits condemnation to blighted areas.

These initiatives may lose momentum as time passes. At the state level, many bills may remain pending indefinitely because most state legislatures are in recess. At the federal level, with hurricane relief and Supreme Court confirmation hearings occupying much attention, *Kelo*-related legislation may be consigned to the back burner. And, noting the risk of overreaching, Senator Patrick Leahy (D-VT) said, "It's been said that tough cases make bad law; it's also true that bad law leads to bad remedies."

IMPACT ON DEVELOPMENT

Putting aside the rhetoric and the legislative developments to date, the true extent of *Kelo*'s impact on specific development projects depends on whom you ask. The Institute for Justice claims that "literally hours afterwards, cities began announcing seizure actions." The *San Francisco Chronicle* documented one such example, as the city of Oakland, California, forced two downtown property owners to vacate only a week after the decision to make way for a city-subsidized apartment complex near a Bay Area Rapid Transit station.

On the other hand, the *Washington Business Journal* observed: "The ruling isn't as sweeping and far-reaching as most people first thought . . . many economic development folks don't think it will change things much at all." For some time, Washington, D.C.'s quasi-public National Capital Revitalization Corporation (NCRC) has threatened to use eminent domain to redevelop a strip mall in southeast D.C. The NCRC viewed *Kelo* as providing "a strong sign of support with regard to our ability to make good on the Skyland development." Yet the landowners actually saw the decision as favoring them because they claim the redevelopment of a single shopping center is not part of a comprehensive development plan, and mirrors the hypothetical circumstances posited by the *Kelo* court to describe the type of taking that would *not* be constitutional. The two sides are now litigating the proposed condemnation.

In Virginia, state officials and observers predict a negligible impact. Virginia courts, like those of numerous other states, recognize "Dillon's Rule," which provides that localities in a state can exercise only the powers which the state constitution or legislature has explicitly granted them. According to the *Washington Business Journal*, a spokesperson for the Virginia attorney general's office said, "There is no proviso in our constitution to use eminent domain for economic development." A local real estate official said the decision "has more relevance in Uzbekistan than Virginia."

In Maryland, several anti-*Kelo* bills have been introduced in the legislature. Yet, the president of the Maryland Senate told a Baltimore newspaper, "I don't know that anyone contemplates using eminent domain for private development and simply to benefit a private enterprise, but we're going to look at the law very carefully, and we will either pass a bill to clarify what Maryland law is or set up a task force to look at how other states are handling this issue." In a state where the high-profile and successful redevelopment of Baltimore's Inner Harbor and downtown Silver Spring was accomplished through the selective use of condemnation, legislators may tread more carefully.

In the end, *Kelo*'s consequences may not be fully felt until individual development projects are litigated and the state supreme courts and federal courts of appeal are asked to interpret the decision. Of particular importance will be the weight afforded to Justice Anthony Kennedy's concurrence (the swing vote in the 5-4 case), in which he acknowledged there may be occasions when property transfers are "suspicious" or the purported benefits are "so trivial or implausible" that they demand heightened judicial scrutiny of the purpose and motive behind the condemnations. As for the court itself, a reversal of *Kelo*, while always a possibility, is unlikely in the short term. Justice John Paul Stevens, who wrote the majority opinion, has defended the decision in recent speeches. Even assuming new Chief Justice John G. Roberts, Jr. and Justice O'Connor's replacement were to vote to overturn *Kelo*, there still would be five votes in its favor. Of course, a third Supreme Court vacancy could change the calculus altogether.

KELO BACKLASH?

The lessons from *Kelo* itself are clear. First, if an economic enhancement project is to be accomplished through the use of eminent domain, the stakeholders must justify that exercise of power through a comprehensive redevelopment plan derived through a deliberative process. Second, *Kelo* preserves a role for lower courts to evaluate challenges to the use of eminent domain for economic development and to strike down pretextual uses of such power. Finally, nothing in the court's decision prevents states from limiting condemnation through legislative action, and as discussed above, many states already have done so or are planning to do so.

What is less certain is whether the current backlash is a fleeting reaction to a perceived unfair court decision or the beginning of a sustained public outcry that will lead to a policy shift across the country. Certainly, a continued reaction will yield numerous legislative "remedies" that may constrict the ability of states and localities to pursue development initiatives or even basic infrastructure improvements. In what may be a perfect example of *Kelo*'s cross-over policy effect, a House committee recently rejected a provision that would have enlarged federal eminent domain powers so that new oil pipelines could be built to back up those damaged during Hurricane Katrina. In this vein, will a *Kelo* backlash stifle other aspects of the Gulf Coast reconstruction? And down the road, will the anti-*Kelo* sentiment threaten the more traditional uses of eminent domain, such as building schools and highways? Ultimately, the success of the *Kelo* backlash may hinge on whether local business communities and their governmental partners can mount organized opposition to such backlash.

For now, while the vote on the ultimate impact of *Kelo* remains undecided, the early returns are in. Suzette Kelo and the other petitioners may have lost their battle in the Supreme Court, but they appear to be winning the war for the hearts and minds of politicians and citizens alike.

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REIT ACQUISITIONS
Potential Pitfalls

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The due diligence phase is vital to any corporate merger or acquisition to ensure that the acquirer receives the benefit of its bargain. The due diligence process in acquisitions by a real estate investment trust - or REIT - is particularly important. Because a REIT is the product of very technical and somewhat nonsensical regulations promulgated by the Internal Revenue Service, the due diligence required is more substantive and, depending on the structure of the company being acquired, significantly more time-consuming. In the acquisition process, there are two common pitfalls that may be encountered. The first pitfall involves the acquisition of a REIT, while the second involves the acquisition of a C corporation by a REIT. Knowing these potential issues will help the acquiring entity determine the feasibility of the purchase.

ACQUIRING REITs

The benefit of a REIT is that it is able to avoid taxation at the corporate level, provided it is in compliance with federal REIT tax guidelines, which, as noted above, are quite complicated. It also gives investors a constant stream of income because the REIT is required to make a certain level of distributions to maintain its REIT status. Therefore, for an investor who is interested in cash flow instead of capital appreciation, it is very important for a REIT to maintain its REIT status.

In a number of recent acquisitions of REITs, it was discovered during the due diligence period that the REITs were not, or at some point in their history, had not been, in compliance with the REIT regulations. Generally, the reason for these discoveries is that the level of review conducted during the acquisition due diligence process is substantially more in-depth than the internal REIT monitoring processes that the target REITs have in place. If there has been a violation of the REIT regulations and the violation terminates an organization's REIT status, there could be a substantial economic impact on the REIT, including the required payment of back taxes and penalties at the corporate level from the date of the violation.

REITs that have failed to comply with the REIT regulations do have the opportunity to obtain relief from the IRS. However, seeking such relief is cumbersome and may delay acquisition of the REIT for up to eight months. In the meantime, the acquisition is vulnerable to certain risks that may prevent the closing. First, market conditions might change, making the transaction less financially attractive. Second, the REIT may not achieve its projections on which the buyer had relied in determining the original purchase price. Finally, the IRS may decide not to grant relief, or, if it does, may require a substantial closing payment to be paid by the non-compliant REIT.

Seeking relief from the IRS has other disadvantages. The IRS has publicly stated that it will not be inclined to grant relief in situations where the determination of noncompliance occurred as a result of due diligence conducted in connection with a potential acquisition transaction. The IRS appears to be frustrated at the fact that REITs, while conducting their ongoing operations, are not placing the level of importance on the internal monitoring procedures necessary to ensure compliance with the REIT guidelines.

As a result, the level of tax due diligence conducted in connection with REIT transactions is substantial and, in general, in excess of the costs associated with non-REIT transactions. Buyers must budget for these costs in their financial models when considering a purchase.

ACQUIRING C CORPORATIONS

A REIT may also acquire a C corporation ("C Corp"). In acquiring a C Corp, the acquiring REIT must determine the amount of undistributed earnings and profits of the target C Corp. Unlike a REIT, a C Corp makes distributions to its owners at the discretion of its board of directors. Therefore, the distributions to the C Corp stockholders can be substantially less than the actual earnings and profits of the C Corp, thereby causing the C Corp to have a large amount of undistributed earnings and profits.

To continue to qualify as a REIT, it must distribute undistributed earnings and profits by the end of the taxable year in which the acquisition takes place. Take, for example, a C Corp that has been in existence for a number of years and, instead of paying large dividends, has chosen to retain the earning and profits and reinvest them in the operations of the company. Depending on the profitability of the C Corp, the amount of earnings and profits could be substantial. Without a requirement in the acquisition agreement that the undistributed earnings and profits be distributed by the C Corp prior to the closing of the transaction, the acquiring REIT would be required to make the distribution, which likely would be in excess of the amount the REIT is required to distribute in order to maintain its REIT status. The increased amount required to be distributed in the first taxable year could result in additional, and potentially prohibitive, acquisition costs.

To address this issue, the acquisition agreement should contain a closing condition that requires all undistributed earnings and profits to be distributed by the C Corp prior to closing. In connection with that requirement, the agreement should require delivery of a letter from the C Corp's accountants certifying that all undistributed earnings and profits have been distributed. Some accountants are hesitant to provide this letter, so it is important for the acquiring REIT to communicate with the accountants early in the transaction to ensure that the expectations of the parties will be met.

DUE DILIGENCE IS CRITICAL

These REIT tax issues can only be addressed through careful drafting, detailed due diligence, and the involvement of REIT tax specialists and accountants early in the acquisition process. These issues should also be a wake-up call to an existing REIT to evaluate whether its current compliance monitoring system is adequate, irrespective of whether the REIT may be participating in an acquisition transaction, either as buyer or seller, in the near future. Since many REITs do not have adequate monitoring systems nothing is more important in a REIT acquisition than a superlative due diligence review.

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RUNAWAY JURY WAIVERS

PREDISPUTE WAIVERS ARE NOT ENFORCEABLE UNDER CALIFORNIA LAW

The California Supreme Court has recently made it official: existing contractual jury waivers - which are routinely found in agreements from commercial transactions to lending to real estate - are no longer enforceable. In *Grafton Partners, LP v. Superior Court (PriceWaterhouseCoopers L.L.P.)*, Case No. S12334, the California Supreme Court held that contractual predispute jury waivers in civil actions are unenforceable under California law. Parties to a contract can use any means or method to settle their disputes, so long as it is based on a statute, but predispute waivers are not currently based on a statute.

Until *Grafton*, California courts had enforced predispute jury waivers under *Trizec Properties, Inc. v. Superior Court*, 229 Cal.App.3d 1616 (Cal.App.2d Dist.) (1991). Subsequent to *Trizec*, parties to commercial and real estate transactions viewed the case as giving assurance that well drafted jury waivers would be enforced.

The *Grafton* court found that *Trizec* was wrongly decided based on the California Constitution and California Code of Civil Procedure Section 631, the latter of which applies only *after* a lawsuit is filed and provides only six methods by which a civil litigant can waive (or be deemed to waive) a jury trial. The *Grafton* court reasoned that the California Constitution requires that the legislature dictate the manner in which the right to a jury trial may be waived, and, to date, it has not articulated any valid forms of waiver other than those listed in C.C.P. Section 631. The court concluded that any method of waiver other than those set forth in C.C.P. Section 631, including contractual predispute jury waivers, is unenforceable.

The *Grafton* court dismissed the concerns of the business community, stating that parties who had relied on the *Trizec* holding will be denied "a benefit that they *never had the right to obtain* — that is, a predispute waiver of the right to a jury trial." Further, the court refused to make its decision prospective. All agreements with jury waiver provisions are subject to the decision.

The court recognized that the majority of jurisdictions allow for jury waivers, but was reluctant to substitute its judgment for that of the legislature because the California Constitution requires that a waiver of the right to jury trial must be prescribed by statute.

There was no dissent to the opinion; however, in a concurring opinion, Justice Ming W. Chin urged the legislature to act. The concurring opinion also pointed out that the majority opinion acknowledged its decision was not consistent with authority in other state and federal jurisdictions. In addition, the court recognized the decision may have far-reaching negative consequences, which were pointed out by the business community and others. While contracting parties may tailor a dispute resolution clause to suit their respective needs, they cannot provide for a process that includes a prospective jury waiver.

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