Flynn-Law Newsletter

December 2014
Volume 1 Issue 5

Law Offices of Stephen M. Flynn, 71 Stevenson St., Ste. 400, San Francisco, CA 94105
www.smflynn-law.com smflynn@smflynn-law.com 415.655-4430

INSIDE THIS ISSUE

1 Supreme Court to Decide Whether Borrower Can Challenge Assignment of Note and Deed of Trust

1 Supreme Court Holds Architects and Engineers Owe Duty of Care to Subsequent Purchasers

2 Taxation of Covenants Not to Compete

4 Lakes Water System Litigation Now in the Court of Appeal

Supreme Court to Decide Whether Borrower Has Standing to Challenge an Assignment of the Note and Deed of Trust

Mortgage loans are frequently assigned, sold and securitized. As a part of the continuing fallout from the collapse of the real estate market, some borrower have sought to recover damages for "wrongful foreclosure" on the basis the party who commenced the foreclosure had no authority to do so based on the inability of the foreclosing party to establish a chain of ownership to the mortgage loan and deed of trust.

The Supreme Court has granted review in the case of *Yvanova v. New Centry Mortg. Corp.* to address the following issue: "In an action for wrongful foreclosure on a deed of trust securing a home loan, does the borrower have standing to challenge an assignment of the note and deed of trust on the basis of defects allegedly rendering the assignment void."

The Supreme Court, like the Court of Appeal in *Yvanova v. New Centry Mortg. Corp.* (2014) 226 CA4th 495, will almost assuredly hold that the borrower lacks standing to assert a challenge based on an assignment of the note and deed of trust.

California law in this respect has been clear. Civil Code §2924(a)(1) allows the "trustee, mortgagee, or beneficiary, or any of their authorized agents" to file a Notice of Default. In *Gomes v. Countrywide Home*

Please see *Assignment of Note* on page 3

"The Supreme Court in Beacon held that design professionals who provided architectural and engineering services for a condominium project owed a duty to care to the homeowner's association and its members."

Architects and Engineers Owe Duty of Care to Subsequent Homeowners

In *Beacon Residential Community Assn. v. Skidmore, Owings & Merrill LLP* (2014) 59 Cal. 4th 568, the Supreme Court held that design professionals who provided "architectural and engineering services" for a 595 unit condominium project owed a duty of care to the homeowners' association and its members. The case is significant in that is establishes a black-and-white rule with respect to the liability of architects and engineers to subsequent owners with whom they have no privity of contract.

Please see *Duty of Care* on page 2

Taxation of Covenants Not to Compete

The sale of the business – either an asset purchase or a share purchase – is usually a capital event, giving rise to capital income to the seller. In the case of a closely held business, the purchase agreement often includes a covenant not to compete.

Even if executed in connection with the complete sale of a business, a covenant not to compete is taxable as ordinary income under the "substitute for ordinary income doctrine." This is true regardless of whether the covenant to compete is executed as a separate document, or whether it is included in the purchase agreement.

"Even if executed in connection with complete sale of a business, a covenant not to compete is taxable as ordinary income under the substitute for ordinary income doctrine."

The explanation for this treatment was explained by one court as follows: "Compensation paid for refraining from labor [is] taxable income no less than compensation for services to be performed." Thus, the percentage of the purchase price allocable to the covenant not to compete is taxed as ordinary income in the year received.

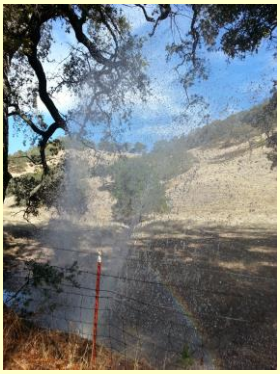
Please see *Covenant Not to Compete* on page 3

Duty of Care, from page 1

"Liability for negligent conduct may only be imposed where there is a duty of care owed by the defendant to the plaintiff or to a class of which the plaintiff is a member" (*J'Aire Corp. v. Gregory* (1979) 24 Cal. 3d 799, 803). Prior to *Beacon*, there was uncertainty as to whether an architect or engineer owed a legal duty of care to subsequent homeowners. As a result, victims of defective construction were forced to rely on a six-factor test first articulated by the Supreme Court in *Biakanja v. Irving* (1958) 49 Cal. 2d 647 to determine the existence of a legal duty. As explained in *Biakanja*:

> The determination of whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, among which are [1] the extent to which the transaction was intended to affect the plaintiff, [2] the foreseeability of harm to him, [3] the degree of certainty that the plaintiff suffered injury, [4] the closeness of the connection between the defendant's conduct and the injury suffered, [5] the moral blame attached to the defendant's conduct, and [6] the policy of preventing future harm.

Most plaintiffs' attorneys agreed that under the *Biakanja* factors, an architect or engineer clearly did owe a duty of care to subsequent homeowners. They were supported in this belief by cases like *Huang v. Garner* (1984) 157 Cal. App. 3d 404, which held that the general contractor and developer owed a duty of care to subsequent purchasers.



The 100-year old Gordon Line, owned and maintained by the City of Vallejo, springs a major leak. The Gordon Line provides water to residents of Napa's Gordon Valley. For more information, see Page 4.

Covenant Not to Compete, from page 2

When the purchase agreement includes a covenant not to compete, the seller should allocate what portion of the purchase price is attributable to the covenant in the purchase agreement. The IRS will generally respect such allocations unless they are "not appropriate." Failure to do so will leave the allocation up to the IRS who may attribute a higher value to the covenant.

From the buyer's perspective, a covenant not to compete is a "Section 197 Intangible" which sometimes allows the buyer to amortize the amount paid over a 15 year period. This treatment is only allowable in the case of an asset sale. The deduction is not available in the case of a sale of stock or partnership interests. Further, the 15 year amortization period must be used, even if (as will ordinarily be the case), the non-compete period is less than 15 years.

Water escaping from a leak in the water lines owned and maintained by the City of Vallejo. This is a different leak than the photo on Page 2. For more information on the Lakes Water System, see Page 4.

Assignment of Note, from page 1

Loans, Inc. (2011) 192 CA4th 1149, 1155, the borrower argued that §2924(a) "by 'necessary implication,' allows for an action to test whether the person initiating the foreclosure has the authority to do so." On demurrer, the court of appeal rejected the argument, reasoning that:

> Section 2924, subdivision (a)(1) states that a 'trustee, mortgagee, or beneficiary, or any of their authorized agents' may initiate the foreclosure process. However, nowhere does the statute provide for a judicial action to determine whether the person initiating the foreclosure process is indeed authorized, and we see no ground for implying such an action. . . . The recognition of the right to bring a lawsuit to determine a nominee's authorization to proceed with foreclosure on behalf of the noteholder would fundamentally undermine the nonjudicial nature of the process and introduce the possibility of lawsuits filed solely for the purpose of delaying valid foreclosures.

Gomes was followed in *Jenkins v. JP Morgan Chase Bank* (2013) 216 CA4th 497. In *Jenkins*, the borrower alleged the "entity who initiated the nonjudicial foreclosure process did not have authority to do so because … the entity was not the owner of the promissory note that was secured by the deed of trust" (*id.* at 512). Following a demurrer, the court held that "like the appellant in *Gomes*, she fails to identify legal authority for such a preemptive action in the statutory provisions setting forth the nonjudicial foreclosure scheme. After our own examination of the nonjudicial foreclosure statutes, we agree with the *Gomes* court that the provisions do not contain express authority for such a preemptive action" (*id.* at 513).

Multiple other cases have reached the exact same result (*Keshtgar v. U.S. Bank.* (2014) 226 CA4th 1201; *Herrera v. Federal Nat. Mortg. Assn.* (2012) 205 CA4th 1495; *Siliga v. Mortgage Electronic Registration Systems, Inc.* (2013) 219 CA4th 75).

Against this weight of authority is the outlier case of *Glaski v. Bank of America* (2013) 218 Cal. App. 4th 1079. In *Glaski*, the court, applying *Texas* law, concluded that a mortgagor could challenge an assignment in the note and deed of trust.

"Glaski has made possible a cottage industry of so-called 'wrongful foreclosure' attorneys who, relying on the questionable authority of Glasksi, have sought to set aside otherwise valid foreclosure sales. These actions have rarely been successful, but they do cause grief for the foreclosing lender."

Duty of Care, from page 2

Nevertheless, defense attorneys frequently filed demurrers and motions for summary judgment or adjudication on the basis no legal duty of care was owed to homeowners with whom the architect or engineer had no contractual relationship. Defense attorneys relied on cases like *Bily v. Arthur Young & Co.* (1992) 3 Cal. 3th 370, which held that an auditor owes no duty of care to its client's investors. Indeed, the trial court in *Beacon,* relying on *Bily*, granted the defendant's demurrer on this exact basis.

The Supreme Court's decision in *Beacon* is not a huge surprise. The *Biakanja* factors strongly support the existence of a legal duty of care between a project architect or engineer and subsequent homeowners. Nevertheless, the case provides much needed certainty. It will reduce law and motion practice and avoid the sometimes inconsistent results which stemmed from the application of the *Biakanja* factors.

Assignment of Note, from page 3

Glaski has been roundly rejected by the California Court of Appeal and the federal district courts in Northern California, but several unpublished federal court cases have followed *Glaski* (*see, e.g., Tamburi v. Suntrust Mortgage Inc.* (N.D. Cal. 2011) WL 6294472; *Sacchi v. Mortgage Electronic Registration Systems, Inc.* (C.D. Cal. 2011) WL 2533029).

Glaski has made possible a cottage industry of so-called "wrongful foreclosure" attorneys who, relying on the questionable authority of *Glasksi*, have sought to set aside otherwise valid foreclosure sales. These actions have rarely been successful, but they do cause grief for the foreclosing lender (and the foreclosed borrower who generally finds themselves with no home *and* significant attorney's fees). Hopefully, the Supreme Court in *Yvanova* will finally put to rest this line of attack and reject *Glaski* as inconsistent with California's comprehensive non-judicial foreclosure scheme.

Lakes Water System Litigation Now In the Court of Appeal

The Lakes Water System Litigation challenges, amongst other things, the exorbitant and discriminatory water rates the City of Vallejo charges the non-resident customers of the "Lakes Water System." The lawsuit also challenges Vallejo's maintenance of the water system (see photos on pages 2 and 3).

Vallejo filed a demurrer to the complaint, which the trial court sustained without leave to amend. Immediately after the trial court's ruling, the Green Valley Landowners' Association appealed.

The case is now in the First Appellate District of the California Court of Appeal. The GVLA will file an opening brief in December 2014 or January 2015. Once filed, the brief will be available on my website at http://www.smflynn-law.com/documents.html.

Recent press, including radio and TV coverage of the Lakes Water System Litigation and associated events can be found here:

http://www.dailyrepublic.com/news/solanocounty/green-valley-water-users-appeal-court-ruling/

http://abc7news.com/science/residents-puzzled-by-recent-water-flow-in-vallejo-creeks-/286992/

http://www.capradio.org/32456

http://www.ktvu.com/videos/news/top-news-videos/lMs/

Law Offices of Stephen M. Flynn
71 Stevenson Street, Suite 400
San Francisco, CA 94105

Phone:
415.655.6631

Website:
www.smflynn-law.com

E-mail:
smflynn@smflynn-law.com