Managing Liability Risks in Green Construction

By Jeffrey D. Masters and John R. Musitano, Jr.[1]

Green building is more than a trend; it is a fact. According to the United States Green Building Council, the value of green building products and services was more than $7 billion in 2005 and is expected to increase to $12 billion in 2007. Two billion square feet of commercial building space have been LEED-registered or LEED-certified.[1]

In residential construction, the growth of green building has been equally dramatic. A recent survey of local home builders associations indicates that more than 97,000 homes have been certified under voluntary building industry green programs nationally since the mid-1990's.[2] One industry estimate states that by 2010 as much as 10% of residential construction activity in the United States, with a value of $38 billion, will be green, up from 2% and $7.4 billion.[3]

These green building efforts are almost exclusively voluntary. Green products and technologies have not yet been widely incorporated into local building codes for private developments. For example, California Green Builder is a voluntary, standards-driven program under which California production home builders may obtain green certification.[4] Meanwhile, the United States Green Building Council is extending its LEED certification program to homes, with pilot standards expected in late 2007.[5] The National Association of Home Builders currently is seeking comments on its National Green Building Standard for new residential construction and renovation.[6] The Standard is expected to be released in final form in early 2008.

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Driven by increasing consumer and end user demand for environmentally-conscious structures, as well as by emerging state and local climate change regulations, green building represents a major opportunity for builders to do well by doing good. But green building carries with it liability risks and litigation potential. This article discusses these risks, as well as the risk management strategies builders can use to help minimize those risks.

The increased liability exposure derives from two fundamental issues. First, there is as yet no universally-accepted standard for what qualifies as green or sustainable building. Second, there is the risk of heightened expectations on the part of the end user.

For example, buyers of new green residences may believe that green means defect-free. Likewise, they may expect that residences marketed as sustainable will require less maintenance and enjoy a longer useful life than conventionally-constructed residences. Both residential and commercial end users will have expectations about expected energy savings, subjective comfort issues and enhanced indoor air quality.

Buyers disappointed with their green structures will assert numerous familiar legal theories in their efforts to recover damages or other relief. The claims may include both tort and contract theories.

<u>Fraud</u>.

High buyer expectations, aggressive marketing of green building and a lack of uniform green building standards together create a significant danger that builders may face allegations of fraud. In an increasingly competitive housing market, more builders are seeking an advantage over competitors, including by tapping into the growing interest in green products. Some builders believe this will distinguish their homes and may justify higher prices.

Builders should consider the possible consequences of representations to buyers regarding the quality or expected performance of green building techniques or materials. Builders should also understand the developing and likely inaccurate understanding of the public regarding what "green" and "sustainable" mean with respect to construction. Consumers paying more for a green home may expect a higher standard of construction and comfort, products with longer lives and lower required maintenance, and savings on energy costs. They may therefore place higher reliance on such representations by the builder. When performance fails to meet expectations or match the builder's representations, the buyer likely will seek recourse.

As with any other seller of real property, a builder may be liable for fraud if it misrepresents the character or condition of the property, or conceals or fails to disclose defects of which it knew or should have known and which would have affected the buyer's decision to purchase.[7] Buyers may allege claims for negligent misrepresentation or intentional misrepresentation, including claims for deceit or fraud in the inducement.[8] As discussed below, allegations of fraud can also form the basis for state law unfair competition claims.

Builders could face intentional or negligent misrepresentation claims with respect to marketing claims about the green character of the home, such as:

- Advertising that the home is green or sustainable, or certified as such, when it is not;
- Labeling, inaccurately, building components or materials as green;
- Falsely claiming that the home is healthier; or
- Falsely claiming that the home has a lower carbon footprint.

The lack of uniform green definitions and standards may mean that the builder is complying with some standards and not others. Builders often use terms like "green" in marketing without intending any correlation to particular green standards. On the other hand, other builders may specifically market their product before or during construction as certified under one of the various green building standards, with the danger that the certification is not eventually earned. Builders also may claim that that certain elements of the home were built with green building components, which may be incorrect and stem from a misunderstanding of green standards.

Builders may also make inaccurate promises or forecasts regarding the expected performance of the home, such as:

- Claims that the home's materials are more durable;
- Promises of energy savings; or
- Claims of enhanced indoor air quality.

Promises regarding performance can be dangerous, especially when the failure of the home to live up to such promises is quantifiable. For example, buyers may expect, and builders may claim, that the home will have lower utility bills due to the manner of construction. Should the home turn out to have no quantifiable energy savings, potential liability for misrepresentation could be the result. Where the builder has made these claims in standardized marketing materials, such claims could also spur class action litigation. Should the builder have knowledge of and fail to disclose that its green materials or techniques have actually caused the home to be defective – such as in terms of durability – the builder may be liable to the initial buyer as well as to subsequent purchasers.[9]

Buyers must meet a relatively high burden to succeed on their fraud claims. The plaintiff must prove misrepresentation (false representation, concealment, or nondisclosure) regarding their property, the builder's knowledge of the falsity and intent to defraud (i.e., to induce reliance), that reliance by the plaintiff was justifiable and that there is resulting damage.[10] The misrepresentation must involve the suggestion, assertion or suppression of a fact and such fact must be material.[11] With respect to a builder's duty to disclose, a matter is material when it has a significant and measurable effect on the value or desirability of the property.[12]

Courts have found materiality relating to fraud with respect to various facts about a home, its construction, its history and its expected performance. For example, liability for fraud has been found where sellers made false statements regarding the performance and quality of the building and its construction.[13] Courts have also found that material facts may relate to the physical condition of the property, such as known defects, building code violations, and insufficient available water given the intended use.[14] Failing to disclose that a property was not built in compliance with applicable building codes may also constitute fraud.[15] Similarly, buyers will likely argue that representations regarding the green status of their home were material facts securing their assent to the purchase contract. It should also be expected that buyers will view undisclosed added costs, such as potential increased maintenance costs, as material facts which should have been disclosed at the time of purchase.

General representations regarding the home and its performance may be defensible as harmless "puffing." Under California law, generally fraud will not be found where a defendant's statement was one of mere opinion.[16] Nevertheless, claims that the home is “more livable,” “energy efficient,” “environmentally friendly” or “weatherproof” will be argued by the buyer to be statements of fact, not opinion.

Generally, a buyer defrauded by a seller of real estate may recover the difference between the purchase price and the actual value of the property at the time of sale had the truth been known or the defects disclosed (the “out of pocket” measure of damages).[17] The “actual value” of the property purchased is commonly understood to be the market value of that property at the time of the transaction, given the material defects.

Buyers also may seek loss of use damages and lost profits.[18] Apart from damages, fraud claimants may also seek remedies such as rescission and restitution, as well as punitive damages.[19]

Negligence.

Green builders can expect future construction defect suits to include a negligence cause of action. Due to the duty of care owed to the homeowner by parties who were involved in design or construction, homeowners can bring direct negligence claims relating to the green elements of the house against the builder, the architect and all contractors involved.[20] Negligence claims can relate to design, workmanship and/or materials defects. Green building design, materials and construction techniques may be the subject of such actions, if their failure results in damage to the property.

Liability as to an actionable construction defect and resulting damage caused by negligence is usually established through expert testimony on the industry standard of care.[21] One issue relating to negligence claims is that because the use of green building materials and designs is relatively new to residential construction, the applicable standard of care may be elusive. Builders unfamiliar with the new construction methods and products will be forced to rely on the knowledge of their design professionals, general contractor and trades, who themselves may be new to the field. The standard of care for green building may be difficult for builders to gauge until there is more data on the performance of the designs, methods and products.

Builders may also face negligence per se claims, with plaintiffs arguing that the construction violates particular standards or statutes regarding green building. Under negligence per se, breach is presumed if the builder violates a statute, ordinance, or regulation; if the violation injured a plaintiff who is among a class of persons the statute was meant to protect; and if the injury resulted from an occurrence that the statute, ordinance, or regulation was designed to prevent.[22] Expert testimony in a defect case may not be necessary where the claim is for negligence per se, as the violation of the statute or code is used to establish the defect as actionable.[23]

As discussed above, there currently is no uniformity between various green building standards, statutes and local building codes. Even where a builder believes it is meeting certain green criteria, failure to comply with locally-mandated green standards creates a risk of negligence per se claims.

The general measure of damages for defective construction is the cost of repair, or diminution in value (i.e., the difference between the fair market value of the property with and without the defects), whichever is less. Diminution in market value may be recoverable under certain circumstances even where it exceeds the cost of repair.[24]

Breach of Contract.

Buyers may also allege breach of one or more contractual provisions. These could include failure of the builder to deliver promised LEED certification or a similar designation. They could also include failure to meet specified energy efficiency standards. There is also the risk that even absent contractual performance obligations, the buyer could turn the marketing materials against the builder and allege vaguely that the structure fails to qualify as green, sustainable or energy efficient.

The buyer's remedy for breach of contract is damages, typically measured as the cost to repair the defects.[25] In addition, the buyer may recover attorneys' fees, if the contract provides for them.

Breach of Warranty.

Buyers also may assert claims for breach of express or implied warranties. If the builder expressly warrants in a general fashion that the structure is green, sustainable or energy efficient, breach of those warranties may be compensable by damages. The measure of damages generally is the same as for breach of contract. As under a breach of contract theory, the buyer may recover attorneys' fees, if the warranty provides for them.

Under an implied warranty theory, the builder is deemed to have impliedly warranted that the structure was constructed in a good and workmanlike manner and that it is fit for its intended purpose.[26] Implied warranty claims are available only in the new residential construction context.[27] Even in that context, it is an open question whether a court would extend the "good and workmanlike" and "fitness" standards to an otherwise functional green residence.

SB 800 Violations.

It is not yet clear how California's right to repair law, commonly known as SB 800, will apply to green building claims. SB 800 includes more than 40 functionality standards for new residences and for common areas in common interest subdivisions. None of the functionality standards specifically refers to green building components.[28] Yet by its terms, SB 800 applies to every component of the home or common area.[29]

The likely result is that green building claims will be asserted in conjunction with more conventional claims for breach of the functionality standards. For example, if energy efficient windows leak, the buyer will assert a breach of the functionality standard which provides that windows shall not allow water to pass beyond, around or through the window or the window system.[30] Similarly, the green building claim could implicate SB 800 if the claim involves a condition that causes damage (as opposed to a mere "paper defect").[31]

To avoid the constraints of SB 800, claimants may allege bodily injury or fraud or pursue a class action, all of which are outside the scope of SB 800.[32] To the extent SB 800 applies, traditional construction defect theories will be replaced by a claim of breach of the functionality standards.

Violation of Unfair Competition Laws.

A builder's marketing and advertising regarding green building may also subject it to claims by buyers of violations of unfair competition acts, such as Business and Professions Code section 17200 (which prohibits unfair business practices) and Business and Professions Code section 17500 (which prohibits false advertising).

In 2004, Proposition 64 changed the rules applicable to sections 17200, *et seq.* and 17500, requiring that a plaintiff show he or she suffered actual injury and lost money or property as a result of the alleged unfair competition or false advertising. Nevertheless, assuming that such standards are met, a builder can face claims under these statutes.

Business and Professions Code section 17200 defines unfair competition as "any unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue or misleading advertising." The Unfair Business Practices Act (referring to section 17200 and its subsequent sections, and hereinafter the "Act") is considered a strict liability statute; no intent by defendants to deceive or cause damage must be proven.

"Unlawful practices" prohibited by the Act are any practices forbidden by law, whether civil or criminal, federal, state, or municipal, statutory or court made.[33] Common law fraud, or running afoul of emerging statutes and regulations regarding green building, could lead to allegations of unlawful practices.

The terms "unfair" and "fraudulent" are generally defined broadly. To determine if an act is unfair, California courts utilize a balancing test regarding whether the harm of the practice outweighs its benefits.[34] "Fraudulent" practices under the law are broader than common law fraud. The test for what is considered fraudulent is simply that "members of the public are likely to be deceived."[35]

While it is generally settled that damages are unavailable under the Act, plaintiffs may seek injunctive relief preventing further unlawful conduct and restitution.[36] The Act gives courts broad authority to fashion remedies "as may be necessary . . . to prevent the use or employment by any person of any practice which constitutes unfair competition."[37] Restitution is available if the plaintiff can prove that through the unfair business practice, the defendant obtained money from the plaintiff.[38]

Where such allegations relate to green building, buyers will argue that a portion of the builder's profits bear a relationship to the alleged wrong. If the buyer can prove that he or she paid more for the home due to its green label, the buyer may seek to recoup those amounts from the builder. If brought as a class action, the potential damages could be significant.

RISK MITIGATION STRATEGIES.

Builders can manage end users' expectations and decrease their liability exposures by employing a wide range of operational and legal risk mitigation techniques. These include use of clear definitions and performance standards in contracts; enhanced disclosures; minimization of actionable representations; and extra diligence in the builder's design and construction contracting procedures.

In order to maximize the probability of success for their risk management programs, builders must implement a plan which is both *comprehensive* and *integrated*. The green risk management plan should be comprehensive in that it encompasses each stage in the development life cycle, beginning with design and construction contracting, and extending through the use of specialized consulting expertise, construction quality assurance ("QA") observations, protective provisions in contracts, disclosures, and effective customer service for the end user of the structure. The plan must be integrated so that each of its elements supports the others. For example, information the builder learns during the design and specification process likely will translate into material facts that should be disclosed to the buyer.

If the builder intends to market the structure as green, the builder must clearly define what that term means in the context of the transaction. The builder will be best served by referring to an objective standard or by promising only that the structure will be constructed according to then-applicable specific guidelines of a third party organization, such as the United States Green Building Council for the LEED program, or the California Green Builder or NAHB green building programs. In all cases, the as-built condition of the structure must be compliant with such standards or guidelines.

Another approach is to avoid characterizing the structure as green and instead, to provide an inventory of the green components and products used in its construction, together with performance information from the manufacturers (as opposed to the builder). The more subjective and undefined the characterization of the structure, the more risks exist for the builder.

Disclosures can be a powerful risk mitigation tool. For example, the builder can and should disclose that green does not equate to defect-free construction, that sustainable does not mean that less maintenance is required and that no specific level of comfort or energy efficiency has been promised or will necessarily be achieved.

Actionable representations should be minimized or preferably eliminated. For example, the builder should avoid puffing and should scrub subjectivity from its marketing materials. The builder should scrutinize its collateral materials, advertising, website, model units and sales office for risky performance claims and possible misrepresentations. In its disclosures and marketing materials, the builder should be factual and objective.

In commercial construction, contractual maintenance obligations and formal written operations and maintenance ("O&M") manuals have long been standard operating procedures. In the residential setting, construction defect litigation experience teaches that lack of maintenance by homeowners and by homeowners associations ("HOAs") can surface later as alleged construction defects. As a result, some residential builders have adopted a model similar to that used by commercial contractors.

Most residential builders now include mandatory inspection and maintenance obligations in their consumer sales agreements and in the covenants, conditions, and restrictions (CC&Rs) for common interest subdivisions, such as condominium projects. Professionally-prepared homeowner and HOA maintenance manuals are becoming a best practice in the residential construction industry. These contractual inspection and maintenance requirements, as well as maintenance manuals, must be tailored to take account of green building components and features.

Additional or special maintenance requirements (and possible additional costs) should be disclosed and should be addressed in the manuals. Builders should consider having a qualified green building consultant review these contract provisions and manuals for accuracy and adequacy.

HOA governance presents at least two special issues. First, builders must be certain that the HOA operating budgets and assessments will be adequate to take account of green building inspection and maintenance costs. Second, the CC&Rs for the project should contemplate future green modifications to individual units and to common areas in order to avoid unreasonable disapprovals by the HOA or by the architectural review committee.

When undertaking a green project, the builder must candidly self-assess its ability to address properly the myriad unique building issues, as well as the capabilities of its design professionals and subcontractors. Unless the builder has in-house green expertise, the builder will be relying on its design professionals and subcontractors regarding green design, products, technologies and assemblies. As a result, pre-qualification of these parties takes on added importance for green projects.

From a design quality perspective, many builders already engage in peer review of their plans and specifications. This process involves a third party forensic-quality design professional who reviews the proposed plans and specifications with the objectives of assuring code compliance, enhancing constructability by the subcontractors and identifying and deleting "designed in" defects. Peer review is even more critical on green projects because of the varying levels of green experience and expertise among design professionals. This is particularly true regarding selection and specification of green products and components.

There is constant tension between builders and design professionals regarding contractual risk transfer. Builders typically seek enhanced performance standards, broad indemnification and adequate professional liability insurance, maintained during design and construction as well as after completion of the project. In contrast, especially on for-sale residential projects, design professionals resist meaningful contractual risk transfer.

This tension will be heightened in connection with green projects. Design professionals can be expected to seek to exculpate themselves from green design liability by narrowly defining their scope of services and performance standards, diluting indemnification provisions, limiting their professional liability insurance obligations and attempting to include a broad limitation of liability clause.

In contrast, builders will expect design professionals to take responsibility for their green design elements. This responsibility may be reflected in the scope of services, in the performance standards and even in the indemnification provisions. If the builder is seeking LEED certification, for example, it is typical for the architect to assume responsibility for assembling the documentation, performing the inspections and handling the processing necessary to obtain the certification. Alternatively, a qualified LEED-accredited consultant may assume this role.

Green building presents contractual risk transfer and risk management issues with respect to subcontractors, as well. It is critically important that builders evaluate their subcontractors' green building experience. Where appropriate, builders should invest in training for subcontractors who do not yet have such demonstrated expertise.

Risk transfer modifications to the subcontract likely will be necessary. For example, the subcontract should confirm that the performance standards and compliance with laws provisions are broad enough to extend to applicable green building laws, codes and standards. The subcontract warranty and guaranty provisions likewise should extend to green building components and products.

New or unfamiliar components or assemblies should be the subject of special training for the subcontractors. Borrowing again from the commercial construction model, residential builders should consider having mock-ups of the assemblies constructed under the observation of the manufacturer or a qualified green building consultant before undertaking actual construction of the project.

As with any other construction, a builder should also ensure that it has adequate coverage under its commercial general liability policy. While no reported decisions have yet addressed green building liability insurance coverage issues, there is no reason to believe that the available coverage should be any different than in a conventional construction defect claim or suit.

CONCLUSION.

While green building offers unprecedented opportunities for builders, it has a potential dark side: increased liability exposures. But by studying and identifying these exposures, then implementing comprehensive risk mitigation strategies, builders will be positioned to succeed in the new green building environment.

[1] www.usgbc.org, "About USGBC."
[2] www.nahb.org/greenbuilding, "Nearly 100,000 Green Homes Certified Through Market-Driven Green Building Nationwide, says NAHB" (June 6, 2007).
[3] Nation's Building News (NAHB, April 30, 2007).
[4] www.cagreenbuilder.org
[5] www.usgbc.org, "About LEED."
[6] www.nahb.org/greenbuilding, "NAHB To Launch Certification Program" (Nation's Building News Online, week of June 18, 2007); NAHB's Model Green Home Building Guidelines (2005).
[7] 11 Miller & Star, California Real Estate 3d, Defective Construction, § 29:29, p. 157; *See* Snelson v. Ondulando Highlands Corp., 5 Cal. App. 3d 243, 251 (1970).
[8] CIV. CODE §§1572, 1709, 1710.
[9] Greernaert v. Mitchell, 31 Cal. App. 4th 601 (1995).
[10] Engalla v. Permanente Medical Group, Inc., 15 Cal. 4th 951, 974 (1997).
[11] CIV. CODE §§1572, 1710.
[12] Shapiro v. Sutherland, 64 Cal. App. 4th 1534, 1545 (1998).
[13] Grange Co. v. Simmons, 203 Cal. App. 2d 567, 575 (1962); Unger v. Campau, 142 Cal. App. 2d 722, 725 (1956) (seller's representations that building had been completely remodeled were false).
[14] *See* Herzog v. Capital Co., 27 Cal. 2d. 349, 352 (1945); Pearson v. Norton, 230 Cal. App. 2d 1, 8-11 (1964); Green Trees Enterprises, Inc. v. Palm Springs Alpine Estates, Inc., 66 Cal. 2d 782, 785-6 (1967).
[15] *See* Doran v. Milland Dev. Co., 159 Cal. App. 2d 322, 325 (1958).
[16] *See* Hauter v. Zogarts, 14 Cal. 3d 104 (1975) (noting that if a defendant's assertion is merely a statement of opinion or mere "puffing," he will not be held liable for its falsity); *see also* Haskell v. Time, Inc., 857 F. Supp. 1392, 1399 (E.D. Cal. 1994) ("Advertising that amounts to mere 'puffery,'" which are "vague, highly subjective claims," is not actionable in false advertising and unfair business practices claim because "no reasonable consumer relies on puffery.").
[17] CIV. CODE §3343(a); Saunders v. Taylor, 42 Cal. App. 4th 1538, 1542-1543 (1996); Graf v. Sumpter, 207 Cal. App. 2d 391 (1962) (misrepresentation regarding the existence of fill on land which caused the home to settle).
[18] CIV. CODE §3343(a)(2)-(4).
[19] CIV. CODE §§3294, 3343(b)(2).
[20] Sumitomo Bank v. Taurus Developers, Inc., 185 Cal. App. 3d 211, 223 (1986) (builder must use reasonable care toward purchasers); Stewart v. Cox, 55 Cal. 2d 857 (1961) (subcontractor liable to homeowner for defective work); Cooper v. Jevne, 56 Cal. App. 3d 860 (1976) (architect liable to purchasers of allegedly defectively designed condominiums).
[21] Miller v. L.A. County Flood Control Dist., 8 Cal. 3d 689, 703 (1973).
[22] EVID. CODE §669(a); Lua v. Southern Pacific Transp. Co., 6 Cal. App. 4th 1897 (1992).
[23] Huang v. Garner, 157 Cal. App. 3d 404, 415 (1984), disapproved on other grounds, 24 Cal. 4th at 649 (Uniform Building Code establishes standard of care).
[24] Erlich v. Menezes, 21 Cal. 4th 543, 561 (1999). *See also* Glendale Federal Savings & Loan Ass'n v. Marina View Heights Dev. Co., 66 Cal. App. 3d 101 (1977) (cost of repair is proper measure of damages where project was built on plaintiffs' property); Orndorff v. Christiana Community Builders, 217 Cal. App. 3d 683, 687-688, 690-691 (1990).
[25] *See* Shaffer v. Debbas, 17 Cal. App. 4th 33, 46-47 (1993).
[26] *See* Pollard v. Saxe & Yolles Dev. Co., 12 Cal. 3d 374 (1974); Aced v. Hobbs-Sesack Plumbing Co., 55 Cal. 2d 573 (1961).
[27] *See* East Hilton Drive Homeowners Ass'n v. Western Real Estate Exch., 136 Cal. App. 3d 630, 633 (1982).
[28] CIV. CODE §896.
[29] CIV. CODE §897.
[30] CIV. CODE §896(a)(2).
[31] CIV. CODE §897.
[32] CIV. CODE §931.
[33] *See* Podolsky v. First Healthcare Corp., 50 Cal. App. 4th 632, 647 (1996).
[34] *See* Saunders v. Superior Court, 27 Cal. App. 4th 832, 839 (1994).
[35] *See* Committee on Children's Television, Inc. v. General Foods Corp., 35 Cal. 3d 197, 211 (1983); *see also* State Farm Fire & Casualty Co. v. Superior Court, 45 Cal. App. 4th 1093, 1105 (1996).

[36] *See* Korea Supply Co. v. Lockheed Martin Corp., 29 Cal. 4th 1134, 1144 (2003) ("While the scope of conduct covered by the UCL is broad, its remedies are limited. . . . A UCL action is equitable in nature; damages cannot be recovered."); Bank of the West v. Superior Court, 2 Cal. 4th 1254, 1266 (1992) (noting that "damages are not available under section 17203"); *see also* Vikco Ins. Services, Inc. v. Ohio Indem. Co., 70 Cal. App. 4th 55, 67 (1999) ("[t]he Unfair Business Practices Act simply does not provide a means for recovery of . . . damages").
[37] BUS. & PROF. CODE §17203.
[38] Day v. AT&T Corp., 63 Cal. App. 4th 325, 338-340 (1998) ("[S]ection 17203 operates only to return to a person those *measurable amounts* which are *wrongfully taken* by means of an unfair business practice" (italics original)); *see also* Korea Supply Co. v. Lockheed Martin Corp., 29 Cal. 4th 1134, 1149 (2003) (ruling that restitution is limited to either "money or property that defendants took directly from plaintiff" or "money or property in which [plaintiff] has a vested interest").

Cities Suing Subprime Lenders
By: Michael D. Goler and Kevin L. Shepherd

The City of Cleveland, Ohio, filed an unusual lawsuit this past January. Styled City of Cleveland vs Deutsche Bank Trust Company et al, in the Court of Common Pleas (Case No. CV-08-646970), Cuyahoga County, Ohio, the City is seeking damages from a multiplicity of national and international lenders, investment bankers and financial service companies. The City claims these companies created a public nuisance, resulting from actions defendants pursued which the City claims was "proliferating toxic sub-prime mortgages within [Cleveland's] borders, under circumstances that made the resulting spike in foreclosures a foreseeable and inevitable result."

A related but different lawsuit has also now been filed in the federal court in Cleveland. Filed on February 7, 2008 and styled Whittiker v. Deutsche Bank National Trust Co., et al, in the United States District Court for the Northern District of Ohio, Eastern Division (Case No. 08-CV-00300), Cleveland, Ohio, this case seeks class action certification and names Deutsche Bank and three law firms (one in Cleveland and the others in Columbus and Cincinnati) as defendants. Plaintiffs claim that the filing of foreclosures without evidencing duly assigned loan documents (such as the note and mortgage) violates the Fair Debt Collection Practices Act and further allege that the defendants' lack of documentation evidencing assignment of the loans to Deutsche Bank was not mere oversight but fraud. Plaintiffs further allege that Deutsche Bank engaged in business in Ohio without complying with Ohio statutory requirements regarding its activities as a trustee. Finally, Plaintiffs claim that the volume of these allegedly fraudulent foreclosures constitutes a pattern of corrupt activity which would create liability for the Defendants under applicable RICO (i.e, racketeering) statutes.

The claims in the Whittiker action appear to have been sparked by orders by U.S. District Judge Christopher A. Boyko in Cleveland in the fall of 2007 dismissing certain foreclosure actions because the notes and underlying mortgages had not been assigned to or physically transferred to the foreclosing entities and, thus, the plaintiff lenders had failed to prove they were the real parties in interest and true holders of the loans on the properties which they had sought to foreclose. Similar decisions have subsequently been reported from federal courts both in Cleveland and in other jurisdictions (*See* the report by Gretchen Jeffries in the December 2007 issue of *eReport*).

Cleveland has been at the epicenter of what it calls a growing foreclosure crisis. The rampant and growing crush of foreclosures from literally entire neighborhoods, and the City has charged the defendants with, in essence, reckless disregard for what it says was the clear and unavoidable consequence of their sub-prime lending activity, namely, a slew of abandoned and boarded up homes which have become eyesores, possible fire hazards and targets for criminal activity. The City claims that the defendants undertook a pattern of lending which they should have known would, in Cleveland, have this result due to what the City claims was the well-known economic condition of the City.

Answers have not yet been filed by any of the Defendants in the City of Cleveland case or the Whittiker case.

In January 2008, the City of Baltimore filed a multi-million dollar lawsuit against Wells Fargo Bank alleging violations of the federal Fair Housing Act. The lawsuit alleges that the bank intentionally targeted minority communities for unfair and discriminatory lending practices, including unfair pricing, unsuitable products, and discriminatory terms. According to the city, these practices have spawned disproportionately higher foreclosure rates in minority neighborhoods, which has cost the city millions of dollars in damages in the form of declining property values, an increased number of abandoned and vacant homes, increased expenses for police and fire protection, and expenditures for administrative, legal, and social services. The Baltimore lawsuit also seeks punitive damages against the lender.

These will be interesting cases to watch. Many involved in the industry believe there is little likelihood, at least at this stage, of any quick settlements, due in large part to what many say is the possibility of this kind of lawsuit being filed in many other jurisdictions. Stay tuned to this publication for updates on the status and progress of these unusual cases.

The report on the Cleveland case is provided by Michael D. Goler of Miller Goler Faeges LLP, Cleveland, Ohio (www.millergolerfaeges.com), Managing Editor Emeritus of eREPORT and long-time practitioner in commercial real estate transactions and related litigation in Cleveland, Ohio and beyond. Michael has agreed to provide this publication with periodic updates on these unusual and possibly ground-breaking cases.

Kevin L. Shepherd contributed the information on the Baltimore case. He is a member of the firm of Venable LLP (www.venable.com) and a past Chair of the Section.

Balancing Speech and Property Rights

What can retail owners expect as the fundamental elements of our economy and democracy continue to clash?

Robert A. Stout Jr.*

The economic growth and innovation achieved by the United States in the twentieth century including the introduction of the modern automobile; the construction of the interstate highway system; the growth of suburbs and the resulting suburban sprawl impacted American life and forced the law of the land to adapt as well. Sprawl destroyed the sidewalks, mixed used developments and public spaces that are only now coming back into vogue in the planning community. Increasingly, public spaces were privately owned. Attempting to reflect this dynamic change in ownership patterns and social intercourse, the law initially responded by protecting First Amendment speech rights on privately owned property accessible to the public, including privately owned shopping centers. Effectively, strip malls were treated as if they were twentieth century agoras. Toward the later half of the century courts began to recognize the rights of property owners, namely shopping center and mall owners, to restrict speech on their property if they desired. California is a notable exception to this trend.

Private ownership of land and the attendant enjoyment thereof is a structural element of our modern capitalist economy; without it commerce would seize. Similarly, the "freedom of speech" enshrined in the First Amendment to the United States Constitution, as well as in various forms in the Constitutions of our states, is a structural element of our democracy; without it representative democracy would fail. On December 24, 2007, the Supreme Court of California issued a ruling in *Fashion Valley Mall, LLC v. National Labor Relations Board* (69 Cal.Rptr.3d 288) which elevates the right of speech at the potential expense of private property rights, placing the burden on the property owner to ensure that speech rights are not hindered, even by private property rights. The court effectively held that the owner of a mall must permit speech to take place on its premises even if that speech seeks to subvert the intended purpose of the mall. *Id*. at 297.

The legal friction between speech and property dates to the 1946 United States Supreme Court decision of *Marsh v. Alabama* (326 U.S. 501). *Marsh* supports the proposition that the United States Constitution can apply on privately owned land. *Id*. at 502. In *Marsh* the Court found that a company town, "having all the characteristics of any other American town", was required to permit distribution of literature on a company owned sidewalk. *Id.* at 502-503. The Court reasoned that as private property is opened to the public and the public character of the property increases, the constitutional rights of entrants "circumscribe" the owner's property rights. *Id.* at 506.

In 1964, the California Supreme Court expanded the concept of the *Marsh* holding, deciding that a shopping center could not prohibit the picketing of a tenant. *Schwartz-Torrance Investment Corp. v. Bakery & Confectionary Workers' Union* (61 Cal.2d 766).

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This had the effect of treating a shopping center in the same manner the Court treated a company town. The California Court reasoned that the public nature of the center rendered the owner's interest merely "theoretical". *Id.* at 771. In ensuing years, the California Supreme Court issued opinions generally consistent with or expanding upon this approach. The United States Supreme Court also saw fit to continue the trend with its *Food Employees v. Logan Plaza* (391 U.S. 308) decision in 1968. *Logan* allowed the peaceful picketing of a shopping center by nonunion workers, reasoning that a shopping center is the "functional equivalent" of a business district. *Id.* at 318.

The California Supreme Court, in *Diamond v. Bland*, 3 Cal.3d 653 (1970) again saw fit to expand the concept of the then most recent U.S. Supreme Court decision, this time finding that a shopping center could not prohibit free speech activity even if it was unrelated to the business of the center. *Id*. at 663. Within two years the U.S. Supreme Court put the brakes on this trend in *Lloyd Corp. v. Tanner.* 407 U.S. 551 (1972). The Court refused to recognize a First Amendment right to speech in a shopping center when such speech was unrelated to the business of the center. Consequently, in its 1974 reconsideration of *Diamond v. Bland*, the California Supreme Court held that a privately owned shopping center could prohibit speech that was unrelated to the business of the center. 11 Cal.3d 331,332. California, it seemed, was finally willing to embrace the rights of a landowner at the expense of a First Amendment speech right.

The U.S. Supreme Court continued to recognize that there were some limits on speech rights, when juxtaposed with commercial property rights, in its decision in *Hudgens v. NLRB*, 424 U.S. 507 (1976). In *Hudgens* the Court held that that the First Amendment did not guarantee the right to free speech in a shopping mall, overruling its 1968 decision in *Logan.*

The California Court was at a crossroads. It had heeded the Court's 1972 decision in *Lloyd* by not recognizing a right to speech that is unrelated to the business of the shopping center. Would the California Court also backtrack and refuse as protected speech that speech that did not relate to the business of the shopping center? No.

In fact, shaking off its momentary embrace of the status quo in Federal law, (and following a change in the composition of its court), California repudiated its reconsideration of *Diamond* in its decision in *Robins v. Pruneyard Shopping Center* (23 Cal.3d 899)(1979). In Pruneyard, the California Court held that the right to free speech contained in its constitution is broader than the free speech right granted by the First Amendment of the United States Constitution. As such, the court determined that a shopping mall is a public forum in which persons may exercise their right to free speech under the California constitution. *Id.* at 910. California was now squarely back on its previous track, elevating the right to speech on private property and minimizing the right of landowners to control their commercial property.

The subject matter of *Fashion Valley* involved, from a commercial landlord's perspective, a direct assault on the primary purpose of a commercial environment. A union engaged in a labor dispute with the San Diego Union-Tribune (the "Tribune") sought to initiate a boycott of the Robinsons-May department store, a tenant at the mall and an advertiser in the Tribune. To this end, the union distributed leaflets to customers entering the store, advising customers of their grievances and urging them to boycott. The mall had the union members ejected, as the members did not obtain a permit to demonstrate. *Fashion Valley* at 290. In order to obtain a permit, the members would have to agree to abide by certain rules, including a rule which prohibits boycotts. *Id.* at 291. The issue of the validity of the mall rule prohibiting boycotts eventually came before the California Supreme Court.

The California Court reaffirmed its stance that the California Constitution protects the right of free speech in a shopping mall even though the Federal Constitution does not. *Id.* at 296. The court has held that the right to speech must be "reasonably exercised" and may be subject to "time, place, and manner rules". *Robins* at 910. In *Fashion Valley*, the court inquired as to whether the mall policy was a content neutral regulation of time, place or manner or a content based regulation. It found that a blanket prohibition of boycotts was content based and thus subject to strict scrutiny, as it barred speech based on the message contained within the speech. *Fashion Valley* at 299. Had it found the mall policy to be a content neutral regulation of time, place or manner, the court indicated it would have subjected the mall policy to intermediate scrutiny to ensure that it is "(i) narrowly tailored, (ii) serves a significant government interest, and (iii) leaves open ample alternative avenues of communication". *Id*.

The California Court applied the strict scrutiny test used in interpreting the Federal Constitution which requires that a regulation limiting speech must be "necessary to serve a compelling state interest, and narrowly drawn to achieve that end". *Id* at 302. The California Court explicitly found that the Mall's commercial purpose – that of maximizing profits, is "not compelling compared to the union member's right of free expression" *Id.* In California, the right of speech consistently trumps that of private property ownership.

The dissent illustrates that this position is a minority position within the United States. Both the Federal government and state governments have dramatically scaled back the broad powers of speech once granted to individuals in privately owned shopping complexes.

California shopping center owners and tenants are now in a precarious position. It appears as if they must permit speech which could be damaging to their commercial interests. Landlords and tenants have lost a degree of security in the sanctity of their commercial operations. The exposure to liability is real for both parties. Landlords with percentage rent leases are exposed to a potential decline in rentals if a boycott is advocated against a tenant for labor related or political reasons. Query whether tenant has a duty to landlord to mitigate damages from a decreased rental stream in the event of a boycott or other protest of tenant's operations. Conversely, could a tenant have a claim against a landlord for a demonstration aimed at the landlord or other tenants that hinders its business? Property owners may find it advantageous to require a tenant to guarantee a certain level of percentage rent in the event of a boycott, whether based upon previous retail sales or another agreed upon metric. Tenants would be well served to request an abatement of rent if operations are interfered with.

Landlords in California will also struggle to determine what constitutes a content neutral time, place or manner restriction. The court does not delve into a great deal of detail enumerating what may be an appropriate time, place or manner restriction. Query whether the content of the speech at issue really is relevant in crafting a restriction that is a “content neutral” time place or manner restriction. Might one set of restrictions be appropriate for those with general political messages while another regime is better suited for those whose speech is targeted against a particular business? Individuals who wish to target a certain store have a greater interest in being stationed in close proximity to the store, while there may be a wholly suitable alterative location for those with general messages. However, if landlords attempt to craft regulations which attempt to establish time, place and manner restrictions for different types of speech, those regulations must then withstand strict scrutiny. The landlord thus has few options to consider when developing content neutral time, place or manner restrictions.

This ruling creates an ambiguity as to just what type of activity property owners are required to permit on their premises, and in what manner that activity may be conducted. Tenants may request more safeguards than landlords are able to enforce under California law. The landlord who is able to craft appropriate regulations which protect both speech and commerce, may have a commercial advantage in seeking tenants concerned about the integrity of their operations.