POINTS & Authorities®

QUARTERLY NEWSLETTER

BUCHALTER NEMER SPRING 2015

SPRING 2015

"Sorry. I didn't mean to sue the company. I clicked this lawsuit button on my keyboard by mistake."

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Negotiating Strategies for the Successful Sale of Technology Companies

Vicki Dallas

The number of mergers and acquisitions of private technology companies has increased in recent years. Established companies often have a lot of cash, a need to prove to their shareholders the potential for future growth, and inadequate in-house development resources to handle it all. Many times, it is easier to buy rather than build. A target company (Target) may never fully understand all of the dynamics of what makes it attractive to a potential acquirer (Acquirer), but there are tools Target should implement to improve its chances of a successful sale.

Identify the Strategic Reason for the Acquisition

Founder and investor liquidity is usually a motivation, but often not the major reason Target desires to be acquired. Target may require access to complementary products and markets, improved distribution capacity and customer base, access to capital without further dilution to founders and investors, an established infrastructure to accelerate growth, as well as liquidity for founders and investors. Target should also identify what makes it attractive to an Acquirer. Target may have a product line or technology which is unique, or a management team with specific expertise and talent.

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Broker Beware: Are Real Estate Brokers Susceptible to Agent v. Agent Fee Splitting Disputes After *Sanowicz v. Bacal*?

Michael Newhouse

While it is axiomatic in the real estate world that licensed real estate *brokers* may, with very limited exceptions, share commission payments, it has always been less than clear under what circumstances licensed real estate *agents* can share such commissions. In February, California's Second Appellate District weighed in on the issue in *Sanowicz v. Bacal*, 2nd App. Dist., February 26, 2015, and the answer may have significant effect on not only agents sharing commissions, but on their supervising brokers as well.

In *Sanowicz*, plaintiff, a licensed agent, alleged that he had entered into various oral and written "joint venture" agreements with his fellow agent, Bacal, to evenly split commission payments due to either of them. Sanowicz and Bacal allegedly initially entered into these agreements while working under separate brokers, continued to enter into additional agreements while both working for Keller Williams, and further continued this practice while Sanowicz remained at Keller and Bacal moved to

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Points from the President

ADAM BASS

We are delighted to bring you our Spring 2015 issue of *Points and Authorities*.

Opening this issue, Vicki Dallas discusses negotiating strategies for technology companies who are looking to attract potential buyers for the successful sale of their companies.

Turning our attention to the Arizona real estate market, Michael Newhouse addresses agent v agent fee splitting disputes after *Sanowicz v. Baca*, and Nancy Swift offers commercial land lords ways to mitigate damages after a tenant has abandoned the premises.

Jason Goldstein writes about The California Homeowners' Bill of Rights (CHBOR), providing servicers (and owners) with reassurance that the discovery or notification of a violation of the CHBOR does not necessarily mean that liability to a borrower for damage is inevitable.

Bukola Mabadje addresses The Equity Cure Provision which gives borrowers one more alternative where it would otherwise be forced to seek a loan modification, waiver, or worse, acceleration of the debt.

With Spring time comes new growth, and we are especially pleased to announce that we have opened our fifth office in St. Helena/Napa Valley with the addition of two new attorneys—James R. Rose has joined the firm as a Shareholder and Katharine (Trina) Falace has joined as Senior Counsel. Both join Buchalter from the Law Offices of James R. Rose, highly regarded for its broad practice representing wineries, wine brokers and vineyard managers in the Napa Valley.

We hope you enjoy this issue of Points and Authorities, and as always, we welcome your questions, comments and feedback.

Adam Bass
President and Chief Executive Officer

SHAWN BAGDASARIAN
Associate in **Los Angeles**
Bank and Finance
213.891.5116
sbagdasarian@buchalter.com

MICHAEL CASPINO
Shareholder in **Orange County**
Litigation
949.224.6291
mcaspino@buchalter.com

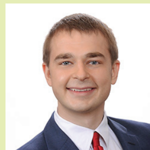
HARRY W.R. CHAMBERLAIN II
Shareholder in **Los Angeles**
Litigation
213.891.5115
hchamberlain@buchalter.com

ROBERT DATO
Of Counsel in **Orange County**
Litigation
949.224.6245
rdato@buchalter.com

KATHARINE FALACE
Senior Counsel in **Napa Valley**
Litigation
707.967.9656
kfalace@buchalter.com

REBECCA FREED
Associate in **San Francisco**
Health Care
415.227.3512
rfreed@buchalter.com

WHANG-KI JOSH JANG
Associate in **Los Angeles**
Bank and Finance
213.891.5290
wjang@buchalter.com



GARRY PADRTA
Associate in **Los Angeles**
Corporate
213.891.5056
gpadrta@buchalter.com

LEE PARISH
Special Counsel in **Orange County**
Bank and Finance
949.224.6298
lparrish@buchalter.com

JAMES ROSE
Shareholder in **Napa Valley**
Litigation
707.967.9656
jrose@buchalter.com

SCOTT SALOMON
Associate in **Los Angeles**
Real Estate
213.891.5022
ssalomon@buchalter.com

J. SCOTT SCHOEFFEL
Special Counsel in **Orange County**
Health Care
949.224.6222
sschoeffel@buchalter.com

KENNY TAMURA
Associate in **Los Angeles**
Real Estate
213.891.5142
ktamura@buchalter.com

The Equity Cure Provision—Saving Debt with Equity

Bukola Mabadeje

For many sponsor backed borrowers, and this would include technology companies which have raised at least one round of financing, the equity cure provides a lifeline which isn't necessarily available to traditional borrowers. The equity cure is a provision in loan documents which permits the borrower to receive into the company, equity capital in most cases, or subordinated intercompany debt in other instances and to apply the proceeds in such a way as to bolster certain financial metrics, with the result that the borrower is able to stave off a loan default. The provision gives the borrower one more alternative where it would otherwise have been forced to seek a loan modification, waiver, forbearance, or worse, acceleration of the debt.

The cash infusion from the issue of equity enables the borrower to boost its cash flow or EBITDA in order to meet financial covenants such as the operating cash flow ratio, debt service coverage ratio, or leverage ratio. These financial covenants which are a key component of cash flow loans provide the lender with periodic snapshots of the borrower's overall financial condition—a must where the lender looks to the borrower's available cash flow for debt servicing and eventual payoff of the debt. For the lender, in addition to injecting the company with much needed cash, the equity cure signals the sponsor company's commitment to the growth of the borrower. Nonetheless, the lender is also keen to ensure that the equity cure isn't misused by the borrower and the sponsor, and so strict conditions are imposed including:

(a) Type of equity—Some equity cure provisions go as far as prescribing the exact type of equity that may be issued by the borrower in obtaining equity proceeds. Most common is the use of common stock as the applicable equity security. Where the borrower is able to negotiate the use of preferred stock, the lender would usually dictate the characteristics of such stock including by providing that any negotiated features of such stock e.g. convertibility, preferential dividends, redemption, maturity etc. are not triggered until a given period after maturity of the loan. This is to ensure that the lender's payment priority is not accidentally tripped by equity which has the elements of debt.

(b) Source of capital—The equity proceeds may come through equity issued directly by the borrower, or may be the proceeds of a capital call carried out by the sponsor, which is then contributed to the borrower. In transactions where the borrower is comprised of a group of related entities, the equity cure provision could limit the equity proceeds to funds provided from outside the loan party group in order to prevent an incidence of round tripping where there is technically no new injection of funds, but simply book entries which have no positive effect on the borrower's financial position.

(c) Timing of injection—The equity capital is required to be received by the company within a cutoff period, which usually matches up with any applicable cure period for the delivery of financial statements under the loan agreement. Such period ranges from 10 to 30 days, with the borrower of course bargaining for more, rather than less time. The lender's interest is to ensure that the funds are received timely enough to meet the covenant requirement. This however does not prevent the borrower from receiving and applying the equity proceeds prior to the applicable compliance test date.

(d) Equity amount—While some lenders limit the amount of equity proceeds to the amount required to cure the default, other lenders only provide that the proceeds should at a minimum, cover the aggregate amount necessary to cure such event of default for such period, in essence permitting the borrower to accept more cash than is actually required to cure the default. The lender would of course prefer to limit the size of the equity cure to the amount required to cure the default such that the borrower does not use the equity cure as a backdoor route to funding the company in such a way as to prevent the lender from applying its default remedies. On the other hand, the borrower would negotiate to freely determine how much equity capital to inject.

(e) Prescribed limits—In addition to capping the dollar amount of the equity cure, the lender could also limit the frequency of the use of equity cure to a prescribed number of times during the term of the loan, or prevent its use for successive test periods. Similar to the cap on the amount

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The California Homeowners' Bill of Rights: The Safe Harbor Provisions

Jason E. Goldstein

The California Homeowners Bill of Rights ("CHBOR") requires servicers (and owners) of loans which are secured by first lien mortgages or deeds of trust recorded against owner-occupied residential real property containing no more than four dwelling units to comply with the requirements of the CHBOR. *Cal. Civ. Code §§* 2920.5(d) and 2924.15(a). The purpose of the CHBOR is to ensure that, "as part of the nonjudicial foreclosure process, borrowers are considered for, and have a meaningful opportunity to obtain, available loss mitigation options, if any, offered by or through the borrower's mortgage servicer, such as loan modifications or other alternatives to foreclosure." *Cal. Civ. Code* § 2923.4(a).

In order to effectuate the purpose of the CHBOR, the California Legislature created certain legal remedies that borrowers may pursue against servicers (and owners) that do not comply with the CHBOR. These remedies include substantial penalties which may be imposed against servicers (and owners) that do not comply with the following portions of the CHBOR: *Cal. Civ. Code §§* 2923.5 and 2923.55 (requirements before recording a notice of default), 2923.6 (conditions for recording a notice of default or sale or conducting a foreclosure sale), 2923.7 (single point of contact), 2924.9 (required written communications), 2924.10 (steps which must be taken after receiving a complete application for a first lien modification), 2924.11 and 2924.18 (obligations after a foreclosure prevention alternative is approved) and 2924.17 (requiring accurate information in foreclosure related documents).

When a borrower discovers a material violation of one of the CHBOR provisions discussed above prior to a trustee's deed upon sale being recorded, that borrower may obtain an injunction stopping the foreclosure process until the servicer (or owner) complies with the CHBOR. *Cal. Civ. Code* § 2924.12(a)(1)-(2) and 2924.19(a)(1)-(2). If the borrower succeeds in obtaining an injunction under the CHBOR, the borrower will recover the attorneys' fees it incurred in obtaining the injunction. *Cal. Civ. Code §§* 2924.12(i) and 2924.19(h). If a violation of the CHBOR is discovered <u>after</u> a trustee's deed upon sale has been recorded, a borrower may recover all actual economic damages the borrower has incurred, which actual damages may be trebled if the violation is deemed intentional, reckless or the result of wilful misconduct. Attorneys' fees and a $50,000 penalty may also be recovered by the borrower. *Cal. Civ. Code §§* 2924.12(b) and (i) and 2924.19(b) and (h).

In light of the draconian penalties inflicted on servicers (and owners) by the California Legislature, it must be noted that the CHBOR, does include certain "safe-harbor" provisions which allow a servicer (or owner) to avoid all potential liability under the CHBOR:

> "A mortgage servicer, mortgagee, beneficiary, or authorized agent shall not be liable for any violation that it has corrected and remedied prior to the recordation of the trustee's deed upon sale, or that has been corrected and remedied by third parties working on its behalf prior to the recordation of the trustee's deed upon sale." *Cal. Civ. Code §§* 2924.12(c) and 2924.19(c).

As discussed above, there are many sections of the CHBOR which, if violated, may result in the entry of an injunction, damages, penalties or attorneys' fees against a servicer (or owner). Accordingly, a detailed analysis of each section of the CHBOR and how violations of each of those sections may be remedied are beyond the scope of this article.

Nevertheless, this article is designed to provide servicers (and owners) with reassurance that the discovery or notification of a violation of the CHBOR does not necessarily mean that liability to a borrower for damages is inevitable. We look forward to serving clients who need assistance with prevention and avoidance of liability under the CHBOR so that the servicer (or owner) can look at the discovery or notification of a violation of the CHBOR as an opportunity to correct the violation which previously occurred in the context of reevaluating its practices and procedures so that the violation does not reoccur. By doing so, the servicer (or owner) will have placed itself in the position where it has no potential for liability under the CHBOR.

Jason Goldstein is a Shareholder in the Litigation and Mortgage Banking Group and his primary office is in Orange County. He specializes in defending lenders from borrower claims and prosecuting escrow and title insurance claims. He can be reached at 949-224-6235 or jgoldstein@ buchalter.com.

An Arizona's Landlord's Duty to Mitigate Damages

Nancy Swift

In Arizona, a commercial landlord has a duty to mitigate its damages after a tenant abandons the premises. This obligation requires the landlord to take reasonable steps to put in place a replacement tenant as soon as possible so that its damages cease to accrue, or at least are decreased. In lawsuits for unpaid rent under commercial leases, such as for shopping center and office buildings, Arizona judges typically will require landlords to elucidate the steps they have taken to mitigate their damages. A landlord cannot simply sit back and watch the unpaid rent accrue month after month, and then ask a Court to enter Judgment for those unpaid amounts. The landlord has to show the Court that it has undertaken "reasonable" efforts to relet the subject premises "at a fair rental". *Stewart Title & Trust of Tucson v. Pribbeno*, 129 Ariz. 15, 16, 628 P.2d 52, 53 (Ct. App. 1981), quoting *Dushoff v. Phoenix Co.*, 22 Ariz.App. 445, 449, 528 P.2d 637, 641 (1974).

What constitute "reasonable" efforts? Not surprisingly, whether the landlord has undertaken reasonable efforts depends on the totality of the circumstances. The circumstances of each specific situation will be important, as will be an economic analysis of the real estate market in your particular area. In the last five years, as the commercial real estate market saw increased vacancies, Arizona judges became more sympathetic to landlords who were unable to find a replacement tenant at a fair rental, and judges loosened the requirements on landlords to show each step they took to market the subject premises.

Case law in Arizona sets out the kinds of activities a landlord should undertake when trying to mitigate its damages. Such activities include posting signs at the premises, holding showings of the specific space (although during the economic downturn Courts understood that there would be minimal showings), listing the property on national databases such as Loop Net and CoStar, sending out email blasts to local and national real estate brokers, and listing the property in trade publications. The cases make clear that the landlord's efforts need not be Herculean. Reasonableness is the standard.

Reasonableness is a relative term. For example, occasionally the tenant's counsel will present evidence that every office building within a one mile radius has "For Lease" signs in the windows, but your building does not. Therefore, the tenant will argue, your efforts are not reasonable because a potential replacement tenant passing by the building cannot tell that your space is available for rent.

One impediment to mitigation that often arises is the case of a defaulting tenant who vacates the premises and leaves the space in a shambles. The landlord will argue that it cannot be expected to market and conduct showings at a location that is unappealing, or that is filled with garbage, through no fault of its own. A landlord may argue that it is not possible to show the subject space for a period of months while the space is refurbished. This can be a compelling argument, but it also can fall flat when the period of time needed to return the space to "marketable" condition becomes unreasonably protracted.

A landlord's duty to take reasonable steps to mitigate its damages does not impose the requirement to take the first tenant who comes along. The landlord should be prepared to provide evidence to demonstrate why a potential tenant was not accepted. The landlord cannot unreasonably reject an otherwise suitable tenant, but is not required to enter into a lease with a tenant who is financially questionable, or incompatible with the tenant mix in the building or shopping center.

For all landlords, as soon as you know a tenant has abandoned the premises, it is essential to list the space, put up "for rent" signs, and start to make the space presentable to prospective replacement tenants. At the end of the day, you do not want your damage award reduced because you failed to take reasonable steps to relet your premises at a fair rental price.

Nancy Swift is Senior Counsel in the Labor & Employment and Litigation Practice Groups in the Scottsdale office. She can be reached at 480.383.1804 or nswift@buchalter.com.

Negotiating Strategies for the Successful Sale of Technology Companies

Vicki Dallas

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An Acquirer is more likely to make an acquisition to gain creative, technical or management talent, acquire key technology, distribution channels or sources of supply; and/or expand or add new product lines. Often, an Acquirer will make an acquisition to get to market more quickly, or to eliminate a competitor.

Identify the Attributes of Target That are Most Valuable and Initiate Internal Due Diligence.

Having proprietary technology is always a competitive advantage, particularly when such technology is a market leader in a fast growing market segment. Strong management teams are key drivers for adding value to Target, as they lend credibility to future growth projections. Target's financial performance and the synergies and growth potential to be created through an acquisition are important factors. Any performance volatility will be a negative factor, along with litigation threats or excessive known or contingent liabilities. Initiating legal and financial due diligence prior to going to market is extremely important so that any problems/issues can be identified and remedied prior to Acquirer commencing its own extensive due diligence.

Due diligence checklists prepared by an Acquirer generally include legal matters (formation, capitalization, management and employees, intellectual property and material contracts), and business matters (financial, industry and market information). The purpose of collecting information from the due diligence process is to address the strengths and weaknesses of Target, enabling an Acquirer to determine the "fit" between Target and Acquirer, and to validate the valuation and allocate risks inherent in the transaction.

Intellectual property (IP) is typically a driving factor in a technology based business. Internal due diligence should include the preparation of a comprehensive list of all IP assets, including patents, patent applications, trademarks, service marks (registered and unregistered), fictitious name filings, internet domain names, software and databases, registered and unregistered copyrights, trade secrets, proprietary know-how, technology or processes, and rights of publicity, each for federal, state and foreign jurisdictions. All IP should be reviewed for filing dates, renewal periods, security interests, validity, enforceability, and freedom to use. Anti-assignment clauses in IP licenses and other contracts that may be triggered on a change in control should be addressed and the process for obtaining any requisite consents should be clarified. Invention assignment and confidentiality agreements need to be reviewed for all employees and consultants that have contributed to the development of the IP. License agreements (which may affect field of use and other restrictions) and other IP-related agreements also need to be reviewed, including research and development agreements, joint venture or other strategic partnership arrangements, co-marketing agreements, manufacturing, supply, distribution agreements, and covenants not to sue.

Identify the Most Advantageous Deal Structure for Target.

The typical forms for structuring acquisitions are stock sales, asset sales or mergers. Transactions can be taxable, or all or partially tax-free depending upon structure. In a stock sale or merger, liabilities are transferred to Acquirer by operation of law, in contrast to an asset sale where only designated and certain "successor" liabilities are assumed by Acquirer. Third party consents must typically be obtained prior to closing an asset acquisition, in contrast to a stock or merger, where third party consents typically are not necessary unless there are changes to the control provisions in contracts. Target's board of directors and shareholders must approve an asset sale if the sale constitutes a sale of all or substantially all of Target's assets. A stock sale requires all selling shareholders to approve the sale. If obtaining 100% selling shareholder approval is not achievable, a merger can be employed establishing certain mutually agreed upon thresholds between Target and Acquirer for shareholder participation. In a merger, shareholders who do not consent and question the adequacy of the deal consideration often have "dissenters rights" or "appraisal rights" under applicable corporate law. It is important to check with tax and legal advisors to determine the best form for the structure of the deal before approaching an Acquirer, so that Target is best equipped to evaluate competing offers.

Identify Negotiating Strategies

Whether Acquirer will prepare a one-sided or a relatively "balanced" first draft of the definitive agreements will depend on negotiating style, perceived deal leverage, other potential bidders in the process, and the intensity of the desire of Acquirer to consummate the transaction. Acquirer

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Negotiating Strategies for the Successful Sale of Technology Companies

Vicki Dallas

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will negotiate for broad representations and warranties (with limited materiality qualifications and limited knowledge qualifiers), joint and several liability for representations and warranties, low caps and baskets for indemnity provisions, and indemnification beyond the applicable escrow or holdback amounts. Acquirer will also look for a minimum target net worth and satisfactory due diligence closing conditions, as well as "no shop" provisions with no (or very limited) fiduciary outs available to Target. Target should attempt to narrow all of these by arguing for more limited or narrow representations which are knowledge based with materiality qualifiers, and incorporating limitations on the survivability of the representations and warranties. Very detailed disclosure schedules should be prepared by Target with a view of protection from indemnification claims, and Target should negotiate for a maximum liability cap for indemnifications claims, baskets (minimum claims which must be met before Acquirer can make any claim), and deductibles (where the Acquirer can only make claims above a certain threshold amount). Target should also consider whether to agree to any no-shop provisions; and, if it does agree, Target should determine the appropriate time period to provide Acquirer with exclusivity to negotiate and complete the transaction.

Planning for the acquisition process up front will enable Target to be proactive in its negotiations with Acquirer. It will also pave the way for a smoother acquisition process resulting in a successful closing that meets the objectives of Target's shareholders.

Vicki Dallas is Co-Chair of the Firm's Corporate Practice Group and a Shareholder in the Orange County office. She can be reached at 949.224.6438 or vdallas@buchalter.com.

The Equity Cure Provision—Saving Debt with Equity

Bukola Mabadeje

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of the equity capital which may be received, this is also to forestall a situation where the borrower uses the equity cure as a prop for its nonperforming business.

(f) Application of proceeds—The cash received must actually be put to use by the company in a way that improves its financial condition and not solely a book entry that serves no purpose. For this reason, one of the most negotiated aspects of the equity cure provision is the application of the proceeds. The borrower would usually prefer to apply the proceeds to cash flow and EBITDA, while the lender's preference is to reduce the amount of the loan by prepaying the loan with the equity proceeds. In any case, even where the proceeds are applied to EBITDA, such proceeds may wind up being applied to reduce the loan where the loan agreement contains excess cash flow provisions.

Bukola Mabadeje is an Associate in the Bank and Finance Practice Group in the San Francisco office. She can be reached at 415.227.3510 or bmabadeje@buchalter.com.

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Broker Beware: Are Real Estate Brokers Susceptible to Agent v. Agent Fee Splitting Disputes After *Sanowicz v. Bacal*?

Michael Newhouse

Continued from page 1

Sotheby's. Principally at issue in the case was a $14 million transaction which began when the parties were at Keller, and closed after Bacal had moved to Sotheby's. The sale resulted in a $210,000 commission to Bacal, paid to him through Sotheby's.

Sanowicz filed suit for fifty-percent of Bacal's commission. Bacal demurred, arguing that under Business & Professions Code section 10137 the alleged agreements were illegal because, without dispute, no broker had signed, nor even consented to, any of the alleged fee sharing agreements. Conversely, Sanowicz argued that there was no such requirement under the statute, and that oral and written fee sharing agreements between *agents* are absolutely enforceable once the supervising *broker* has received the commission at issue—which was the case here. The trial court granted Bacal's demurrer under section 10137, without leave to amend, and Sanowicz appealed.

On appeal, the Court noted that the issue—application of section 10137 to commission sharing by *agents*—appeared to be one of first impression. The court turned to the plain meaning of the statute and the intent of the legislature noting, "…the statute addresses the rules on payment of compensation by brokers to agents—and by agents. It closely limits these activities, but it does not forbid them entirely. In stating that an agent may pay commission to another licensee, the Legislature did not limit the payee to a licensed broker; instead it required that any such payment be made 'through the broker' thus permitting payments to be made to licensed real estate professionals, whether agents or brokers. What the Legislature limited was the manner of payment, requiring that any such payments must be 'through the broker under whom he or she is at the time licensed.'" As such, the Court reversed and remanded, holding that agents could share fees, <u>so long as those fees flowed from commissions already paid to the supervising broker</u>.

While *Sanowicz* is obviously important with respect to agent to agent fee sharing agreements, it also has potentially important impacts on supervising brokers. In fact, in addition to his arguments above, Bacal also argued that Sotheby's, Bacal's supervising broker at the time in question, was an indispensable party to the suit. Rather than rule directly on this contention, the court left the issue for another day stating, "… instead of developing the 'indispensable party' argument, he reargues his contention that section 10137 makes Sanowicz's claim illegal. That is not an argument about whether Sotheby's (or KW) is indispensable."

This technical omission is obviously important to brokers, and their attorneys, because at some point, and likely soon in light of Sanowicz, the courts will be asked to directly consider whether or not brokers are indispensable parties to these types of agent fee sharing disputes. In preparation for that inevitability, brokers would be wise to consult counsel as to whether or not to allow such agent to agent agreements in their office, and if so, to establish clear protocols for their preparation, review and approval.

Michael Newhouse is a Shareholder in the Litigation Practice Group in the Los Angeles office. He can be reached at 213.891.5037 or mnewhouse@buchalter.com.

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BuchalterNemer
1000 Wilshire Boulevard, Suite 1500
Los Angeles, CA 90017-2457

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