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ARTICLE

Moving Up In A Down Market: Rediscovering Equitable Subrogation

By Adam M. Starr*

I. INTRODUCTION

The consequences of lax construction lending practices materialize in a down market. As property values collapse, insolvent developers walk away from partially completed construction projects and unpaid subcontractors are forced to record mechanics' liens against the projects. At that point, a construction lender may belatedly discover that the deeds of trust securing its construction loans are subordinate to mechanics' liens. As a result, both the construction lender and subcontractors are compelled to satisfy their debts from the real property security. The precipitous decline in property values, however, means that there is often not enough equity in the property to satisfy both debts.

Well-advised construction lenders are now rediscovering the remedy of equitable subrogation for preserving and protecting their real property security from intervening mechanics' lien claimants.

The priority of all mechanics' liens on a project generally relates back to the date work commenced on the project. A lender with a deed of trust securing a construction loan can protect its interest against me-

* Adam Starr is an associate in the Walnut Creek office of Miller Starr Regalia.

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chanics' liens by duly recording its deed of trust before construction work commences on the project. In the context of residential subdivision projects, the developer typically obtains an acquisition and development loan to acquire the raw land and begin site improvement work. Later, the developer may borrow additional funds to pay off the acquisition and development loan and to finance vertical construction.

If work commenced on the overall project before the construction lender's deed of trust records, it will be subject to inchoate mechanics' liens, which have not yet materialized or been recorded, but which will be senior to the refinancing lender's deed of trust.[1] Under the doctrine of equitable subrogation, however, a lender who refinanced a senior lien is judicially placed into the priority position of the senior lienholder while junior lienholders (e.g., mechanics' lien claimants) remain in their junior position. In other words, the refinancing lender's deed of trust will be deemed senior, and not subject to an intervening mechanic's lien.

II. ESTABLISHING THE RIGHT TO EQUITABLE SUBROGATION

Subrogation, broadly defined, is the substitution of one person in the place of another, whereby the substituted party succeeds to the rights of the other in relation to the debt or claim.[2] The doctrine arises from the principle that equity gives various rights to one who has satisfied an obligation of another so that he may be reimbursed himself.[3] Under the doctrine of equitable subrogation, a lender who refinances a senior lien (the "subrogee,") without actual knowledge of existing junior liens, is subrogated to the priority position of the existing, senior lienholder (the "subrogor"), while junior liens remain in their junior position even though they are prior in time to the new, subrogated lien.[4] This substitution of the subrogee for the senior lienholder has been called "a sort of assignment by operation of equity."[5] The effect is just as if the senior lienholder, upon receiving performance from the subrogee, made an express assignment to the subrogee of his rights against the original obligor.[6] Because equitable subrogation is based in equity, the doctrine only applies when the subrogee has equities superior to those who will be prejudiced through the application of the doctrine.[7] California courts have applied this doctrine liberally:

> The doctrine of [equitable] subrogation is not a fixed and inflexible rule of law or of equity. It is not static, but is sufficiently elastic to take within its remedy cases of first instance which fairly fall within

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> it. Equity first applied the doctrine strictly and sparingly. It was later liberalized, and its development has been the natural consequence of a call for the application of justice and equity to particular situations. Since the doctrine was first in-grafted on equity jurisprudence, it has been steadily expanding and growing in importance and extent, and is...now broad and expensive and has a very liberal application.[8]

In the context of real property, the elements of equitable subrogation are:

(1) the subrogee advanced money to retire an encumbrance;

(2) at the instance of the property owner or the encumbrancer secured by the property;

(3) under an express or implied understanding that the advance was to be secured by a senior lien on the property;

(4) the subrogee was not a volunteer;[9]

(5) the advance is not already secured by a senior lien;

(6) the subrogee is not chargeable with culpable or inexcusable neglect; and

(7) subrogation will not work an injustice to the rights of others (i.e., the intervening lien claimant is not prejudiced).[10]

Courts typically focus on the last two elements, as the others are relatively straightforward.[11]

A. Culpable And Inexcusable Neglect

As a precondition to the decree of the remedy of equitable subrogation, the subrogee must not be charged with "culpable and inexcusable neglect" in failing to protect the senior priority position of its security interest.[12] "Culpable and inexcusable neglect" requires more than mere negligence. For example, even the failure to search the public records and discover intervening recorded encumbrances does not constitute the type of culpable and inexcusable neglect which justifies the denial of equitable subrogation.[13]

A subrogee has been deemed charged with "culpable and inexcusable neglect" where it failed to take any affirmative steps to ensure its interest would be in a senior position despite having knowledge of facts that should have alerted the subrogee that some affirmative steps should be taken to protect its interest.[14]

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1. *Affirmative steps and the effect of actual knowledge by the subrogee*

Lawyers Title Ins. Corp. v. Feldsher[15] is the seminal case on what may constitute "culpable and inexcusable neglect." In *Feldsher,* an experienced commercial lender had actual knowledge of four deeds of trust recorded against the buyer's property, but the lender mistakenly believed that the proceeds of his loan would be used to pay off (or retire) the second position deed of trust, and that his loan would then exist in place of the second deed of trust.[16] Thereafter, the buyer defaulted on his purchase obligations to the sellers, and the sellers foreclosed under their deed of trust and purchased the property at a trustee's sale, thereby extinguishing the commercial lender's junior deed of trust.[17] The sellers learned of the lender's deed of trust after the trustee's sale.[18]

Plaintiff, a title company, had previously issued a title insurance policy to the lender which erroneously identified the lender's deed of trust as senior to the sellers' deed of trust.[19] The lender sought to recover his loss under the title policy and the title company thereafter sued the sellers, seeking to impose an equitable lien on the property through its payoff of the lender's loss of his security interest in the property.[20]

The court of appeal concluded that the doctrine of equitable subrogation could not be applied under the facts of this case because the lender was charged with inexcusable neglect.[21] In so holding, the court of appeal analyzed the extent of the lender's knowledge—noting the following:

—The lender had both actual and constructive knowledge of the critical facts concerning the sellers' deed of trust, including that the lender's deed of trust would be junior to the sellers' deed of trust unless the sellers executed a subordination agreement.[22]

—The lender was experienced and should have realized that the loan documents did not include a subordination agreement.[23] Nonetheless, the lender continued with the transaction without taking any affirmative steps to ensure his interest would be protected.[24] This "failure demonstrates negligence far more culpable than a mere failure to search records for an intervening lien."[25]

Under such limited circumstances, where the subrogee has actual knowledge of an intervening claim but negligently fails to take adequate precautions to protect its own interests, and where subrogation

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will result in prejudice to the intervening claimant, courts may deny the remedy of equitable subrogation.[26]

2. Actual and imputed knowledge will not always defeat the doctrine

Where there is no prejudice to the intervening lien claimant, the subrogee's actual knowledge of an intervening lien will not defeat the remedy of equitable subrogation.[27] For example, in *Copp v. Millen*[28] the California Supreme Court held that a seller was entitled to foreclose under the deed of trust, despite the fact that she had actual knowledge that new buyer had purchased the property and was in possession of the property at the time the seller made a refinance loan.[29] Prior to advancing the refinance loan, the original buyer was in default, and the seller agreed to refinance to extend the payoff date, believing her priority position would not be prejudiced. The Court held that where the subrogee (here, the seller under the refinance deed of trust) has actual knowledge of the intervening lien claimant (i.e., the new buyer), but where the intervening lien claimant is not prejudiced, equitable subrogation will not be denied.[30] The new buyer's priority position was not materially changed by judicially placing the seller into the priority position of the original mortgage and deed of trust, because the new buyer remained in the same priority position as when he purchased the property (i.e., subject to a first priority deed of trust held by the seller).[31] "Equity will place the parties in their original position."[32] The Court held that the seller was entitled to relief to the extent that equitable subrogation does not prejudice the new buyer.[33]

Likewise, a subrogee is entitled to equitable subrogation and not deemed charged with "culpable and inexcusable neglect" where its *agent* has actual knowledge of an existing recorded junior lien.[34] "[B] y statute, knowledge that is imputed by action of law is *constructive* knowledge, not actual knowledge."[35] Accordingly, the knowledge imputed from a purchaser's agent to the purchaser is merely constructive knowledge, and it is well settled that constructive knowledge does not bar equitable subrogation.[36]

3. Criticism of California's focus on actual knowledge in determining culpable and inexcusable neglect

"The Restatement of Property takes the position that subrogation is available even if the subrogee had actual knowledge of an intervening lien. This can be justified by the fact that knowledge of the lien is irrel-

evant and the intervening lienholder is no worse off after the subrogation."[37] Indeed, if the intervening lienholder is not prejudiced, but is advanced in priority due to the pay off of a senior debt, the lienholder has received a windfall.[38] Consequently, California's focus on whether the subrogee had actual knowledge of an intervening lien has been criticized as irrelevant and unnecessary.[39]

In other words, actual knowledge of an intervening lien should have no effect on the analysis of whether subrogation is permissible because the subrogee is merely standing in the shoes of the discharged senior lienholder, which, regardless of whether the subrogee has actual knowledge of an intervening lienholder, does not by itself, prejudice the junior lienholder. Where an intervening lienholder is prejudiced, regardless of actual knowledge, subrogation will be denied.

B. Subrogation Will Not Work An Injustice To The Rights Of Others

The holder of a junior lien or interest is generally put in no worse situation if a third party who pays off the senior debt is equitably subrogated to the senior lien's priority.[40] The junior lienholder did not rely on the absence of the senior lien when it first extended credit or transferred value, and would receive a windfall if the doctrine were not applied.[41] Accordingly, where subrogation does not change the secured position that the intervening claimant originally bargained for when advancing money in exchange for its real property security, it is not unfairly prejudiced.[42] Likewise, where the intervening claimant is the holder of a recorded mechanic's lien, and where equitable subrogation will not alter the mechanic lien claimant's potential secured position, the lien claimant cannot be unfairly prejudiced.

In *Smith v. State Savings & Loan Assn.*[43] the court of appeal held that a refinance lender was entitled to be equitably subrogated into the priority position of senior deeds of trust, which it retired, and that the holder of the fourth deed of trust, of which it had no actual knowledge, would not be prejudiced.[44] After applying equitable subordination, the holder of the fourth deed of trust remained in the same priority position it held before the refinancing of the senior deeds of trust.[45] If equitable subrogation was denied, however, the holder of the fourth deed of trust would have received a windfall, moving up to a better position than it originally bargained for.

By contrast, in *Feldsher,* the sellers, who bargained for the fourth priority position, were aware that the second and third priority posi-

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tion deed of trusts were due and payable within months.[46] Therefore, the sellers had an expectation that these senior priority deeds of trust were merely temporary at the time they accepted a deed of trust in fourth position.[47] To allow the commercial lender to essentially revive the senior deed of trust when it was on the verge of maturing (which was paid off by the commercial lender's loan proceeds) by equitably subrogating the commercial lender to the second priority position, would run contrary to the sellers' expectations and deprive them of the benefit of their bargain.[48]

When the subrogee loans the debtor more money than is necessary to retire the original debt, and where there exists junior lienholders whose interests are secured by deeds of trusts, allowing the new lender to enforce the entire loan as senior to the junior lienholders will prejudice the junior lienholders.[49] The increased principal will increase the risk of default, resulting in injustice to junior security holders.[50] Consequently, when the subrogee loans the debtor more money than is necessary to retire the original debt, (and where there exists junior lienholders whose interests are secured by deeds of trust), the loan should be bifurcated, whereby the excess amount of the loan should be enforced as a junior lien.[51] Under this scenario, the new lender only may be subrogated up to the amount of the original loan.[52]

Similarly, when the subrogee loans the debtor money on materially different terms than the original loan, and where there exists junior lienholders whose interests are secured by deeds of trusts, it may be inequitable to the junior lienholder to permit the subrogee to equitably subrogate into the first priority position, since the terms of the new loan have an effect on the value of the junior lienholder's security.[53]

III. CASE LAW RE: EQUITABLE SUBROGATION AND INTERVENING MECHANICS' LIEN CLAIMAINTS

Only one California case addresses a lender's right to equitable subrogation where the intervening claimant holds a mechanic's lien. *Parker v. Tout*[54] was decided before the present test for equitable subrogation was articulated, but arises from the same equitable principles, and is instructive. The defendant, a bank, loaned the owner of real property $25,000, which was secured by a first deed of trust. In June 1924, after work commenced on the property, the owner renewed the prior loan (but received additional advances of $2,500 for well work, taxes, and other expenses, totaling $27,500), and recorded a new deed of trust.[55] The second deed of trust was recorded in July 1924, and

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on the same day, the bank recorded a satisfaction of the first deed of trust.[56] The bank searched the records to determine whether any encumbrances had been placed on the property prior to recording the second deed of trust in June 1924, and again prior to reconveying the first trust deed in July 1924.[57]

The California Supreme Court held that the bank was entitled to equitable subrogation because it exercised precautions to protect its rights and it was not negligent or careless in releasing the first deed of trust.[58] Further, the bank had no notice or knowledge of the mechanic's lien when it satisfied its first lien and accepted a renewal note.[59] Accordingly, it was just and equitable to give priority to the bank for at least the amount of the original note.[60]

The decision is arguably ambiguous on an important point: it appears that the Court split the bank's priority, holding that the bank could not maintain priority with respect to the entire $27,500 loan.[61] Instead, it appears that the Court only subrogated the bank into first priority position in the amount of the initial loan of $25,000.[62] The Court bifurcated the bank's priority because the mechanic had notice of the first deed of trust securing the $25,000 promissory note at the time it began work, but it had no notice of the second deed of trust, which secured an increased amount, $27,500.[63] Had the bank been equitably subrogated for the entire $27,500, the mechanic would have been impaired (i.e., prejudiced) by $2,500 (the difference between the first loan ($25,000) and the subsequent loan ($27,500).) "As to the additional money advanced by the bank, and also secured by the second trust deed, the mechanic's lien would seem to be prior in right…."[64] This position is logical – the mechanic bargained for a hypothetical secured position subject to a $25,000 deed of trust held by the bank when it agreed to commence work in 1922. In other words, the mechanic had notice of the first deed of trust in the amount of $25,000 when it commenced work and expected its potential secured position to remain the same.[65] By subrogating the lender to the full amount of the later loan, the mechanic would be prejudiced by $2,500. The court stated: "Justice and equity and well-established precedents compel a decree that the lien of the bank under its deed of trust is superior in right to the mechanic's lien to the extent of the amount of the original note and interest thereon."[66]

Nonetheless, the Court suggested that the mechanic would not be impaired by subrogating the bank for the full amount of the second

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deed of trust because the additional $2,500 went towards improving the land, which is the mechanic's security.[67] The additional money "went to pay taxes and to buy a pump and other equipment for the ranch, all of which increased the security of the lien claimant after the work was commenced."[68] The Court also stated that the second deed of trust "gives to the lien claimants an advantage which they had no right to expect when they commenced their work on the well, for, as we have stated, such advances were used in payment of taxes and to purchase equipment."[69] This rationale is probably incorrect because it eviscerates the power and priority of mechanics' liens. It also runs contrary to the mechanics' expectations when they implicitly agreed and bargained for a potentially secured position junior to the holders of the original deed of trust that existed when the mechanics commenced work on the property. Under this rationale, construction lenders, as subrogees, could argue that when the subrogee loans the debtor more money than is necessary to retire the original debt, and where there exist intervening mechanics' lien claimants, the refinance loan increased the value of the property (i.e., the security), so the intervening mechanic's lien claimant would not be prejudiced if the subrogee is equitably subrogated for the entire amount of the refinance loan. As previously discussed, the loan should be bifurcated, whereby the excess amount of the loan is enforced as a junior lien.[70]

IV. RECOMMENDATIONS: HOW CONSTRUCTION LENDERS CAN SHOW AFFIRMATIVE STEPS TAKEN TO PROTECT THEIR SECURITY INTEREST AND AVOID BEING CHARGED WITH "CULPABLE AND INEXCUSABLE NEGLECT"

The refinancing lender's greatest obstacle to establishing its right to be equitably subrogated into the priority position of the senior lienholder where there is an intervening mechanic's lien claimant will likely be proving that it is not guilty of "culpable and inexcusable neglect" in failing to protect the senior priority position of its security interest. The mere fact that the refinancing lender loaned money at a time when work was being performed at the subject property does not, alone, constitute per se "culpable and inexcusable neglect." The lender can strengthen its claim to equitable subrogation by pointing to affirmative steps that it took to protect its security interest. Merely obtaining a preliminary report in connection with the purchase of a policy of title insurance before making the loan may not be sufficient, as the preliminary report will not show inchoate mechanics' liens. Al-

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though no reported case has considered the issue, it is possible that obtaining a policy of title insurance which provides coverage for mechanics' liens constitutes an affirmative step to protect the refinancing lender's security. Other affirmative steps could include obtaining subordination agreements from contractors and subcontractors, whereby the mechanics agree to subordinate their hypothetical and potential secured positions as a condition to the lender providing the new loan, although the enforceability of such agreements is doubtful.[71] A well-positioned lender also should have obtained conditional and unconditional lien releases before disbursing funds, or have used joint checks when making progress payments. Even undertaking regular construction inspections may provide evidence of affirmative steps taken to protect the refinancing lender's security.

In the context of construction lending, once the refinancing lender is able to prove that it is not deemed guilty of "culpable and inexcusable neglect," the remaining elements for establishing the right to equitable subrogation will not be difficult to satisfy.

NOTES

1. See 10 Miller & Starr, Cal. Real Estate (3d ed. 2001) § 28:5, 23.
2. *Brown v. Rouse*, 125 Cal. 645, 58 P. 267 (1899); *Redington v. Cornwell*, 90 Cal. 49, 27 P. 40 (1891).
3. 13 Witkin, Summary of Cal. Law (10th ed. 2000) § 178, 506.
4. 2 Bernhardt, Cal. Mortgage and Deed of Trust Practice (Cont.Ed.Bar. 2008) § 9.82, 726.
5. *Offer v. Superior Court of City and County of San Francisco*, 194 Cal. 114, 119, 228 P. 11 (1924).
6. 4 Witkin, Cal. Procedure (5th ed. 2008) § 132, 198.
7. See *Simon Newman Co. v. Fink*, 206 Cal. 143, 146, 273 P. 565 (1928); *Katsivalis v. Serrano Reconveyance Co.*, 70 Cal. App. 3d 200, 210, 138 Cal. Rptr. 620 (1st Dist. 1977) ("*Katsivalis*").
8. *In re Johnson's Estate*, 240 Cal. App. 2d 742, 744-45, 50 Cal. Rptr. 147 (2d Dist. 1966).
9. A party who lends money to pay off an encumbrance on property and secures the loan with a deed of trust on the property is not a volunteer for purposes of equitable subrogation. (*Smith v. State Savings & Loan Assn.*, 175 Cal. App. 3d 1092, 1099, 223 Cal. Rptr. 298 (2d Dist. 1985) ("*Smith*") [a third party is not a volunteer when it pays off the senior lien with the understanding that the new lien securing the loan will replace the old lien of the debt that is paid].)
10. *Lawyers Title Ins. Corp. v. Feldsher*, 42 Cal. App. 4th 41, 48, 49 Cal. Rptr. 2d 542 (2d Dist. 1996) ("*Feldsher*"); *Smith, supra,* 175 Cal. App. 3d at 1096; *Katsivalis, supra,* 70 Cal. App. 3d at 210.
11. This article will focus on the last two elements, as the others are self-explanatory, and typically not at issue in the context of construction lending.
12. See, e.g., *Feldsher, supra,* 42 Cal. App. 4th at 53-54; *Parker v. Tout*, 207 Cal. 590, 592, 279 P. 431 (1929); *Simon Newman Co. v. Fink, supra,* 206 Cal. at 146.
13. *Smith, supra*, 175 Cal. App. 3d at 1099.
14. See *Feldsher, supra,* 42 Cal. App. 4th at 53-54.

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15. *Lawyers Title Ins. Corp. v. Feldsher, supra,* 42 Cal. App. 4th 41.
16. *Ibid.*
17. *Id.* at 44.
18. *Ibid.*
19. *Id.* at 44.
20. *Id.* at 44-45.
21. Again, this is one of the elements necessary to establish entitlement to application of the doctrine of equitable subrogation.
22. *Id.* at 52.
23. *Ibid.*
24. *Ibid.*
25. *Ibid.*
26. See *id.* at 50-52.
27. *Copp v. Millen*, 11 Cal. 2d 122, 77 P.2d 1093 (1938).
28. *Ibid.*
29. *Id.* at 125.
30. *Ibid.*
31. *Ibid.*
32. *Ibid.*
33. *Ibid.*
34. *Han v. U.S.*, 944 F.2d 526, 529, 91-2 U.S. Tax Cas. (CCH) P 50486, 68 A.F.T.R.2d 91-5580 (9th Cir. 1991), discussing California law; 5 Miller & Starr, *supra* at § 11:106, 273.
35. *Han v. United States*, *supra,* 944 F.2d 526, citing Civ. Code, § 18.
36. *Ibid.*
37. 3 Dunaway, The Law of Distressed Real Estate (2002) § 40:67, 40-93; see also Rest. 3d Property, § 7.6 comment (e): Under the Restatement "subrogation can be granted even if the payor had actual knowledge of the intervening interest; the payor's notice, actual or constructive, is not necessarily relevant. The question in such cases is whether the payor reasonably expected to get security with a priority equal to the mortgage being paid."
38. *Id.* at § 40:67, 40-93 fn. 2.
39. Lilly, Subrogation of Mortgages in California: A Comparison With The Restatement And Proposals For Change, (2001) 48 UCLA L. Rev. 1633, 1656 to 1657.
40. *Smith, supra,* 175 Cal. App. 4th at 1097.
41. *Ibid*.
42. *Ibid*.
43. *Smith v. State Savings & Loan Assn.*, *supra,* 175 Cal. App. 3d 1092.
44. *Id.* at 1097.
45. *Id.* at 1098.
46. *Feldsher, supra,* 42 Cal. App. 4th at 53.
47. *Ibid*.
48. *Ibid.*
49. *Lennar Northeast Partners v. Buice*, 49 Cal. App. 4th 1576, 1588, 57 Cal. Rptr. 2d 435 (3d Dist. 1996).
50. See *ibid.*
51. See *ibid.*
52. See *ibid*; see also *Parker v. Tout, supra,* 207 Cal. at 591.
53. 4 Miller & Starr, *supra,* at § 11:106, 277.
54. *Parker v. Tout, supra,* 207 Cal. 590.
55. *Id.* at 591-592.
56. *Id.* at 592.

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57. *Ibid.*
58. *Id.* at 592.
59. *Ibid.*
60. *Id.* at 593.
61. *Id.* at 594.
62. *Id.* at 592.
63. *Ibid.*
64. *Id.* at 593.
65. *Id.* at 592.
66. *Id.* at 594.
67. *Id.* at 593.
68. *Ibid*.
69. *Id.* at 594.
70. See *Lennar Northeast Partners v. Buice, supra,* 49 Cal. App. 4th at 1588.
71. Mechanics enjoy protected status in California and attempts to subordinate inchoate mechanics' liens may be construed as an invalid waiver of the mechanics' lien rights, and such subordination agreements will be void and of no effect. (See Civ. Code, § 3262(a).) The statutory forms of release of the lien are the exclusive methods for the waiver of a lien by a mechanic and any purported waiver of lien rights that is not in the statutory form is void and ineffective. (*Capitol Steel Fabricators, Inc. v. Mega Construction Co.*, 58 Cal. App. 4th 1049, 1060, 68 Cal. Rptr. 2d 672 (2d Dist. 1997); Civ. Code, § 3262, subd. (a).)

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