2010 INSIGHTS:

In the remaining weeks of this year, the Daily Journal will be featuring columns written by select contributors touching upon this year's legal developments, lessons learned and what's to come.

Increased Regulatory Activity, a Significant Impact on Businesses

By Leslie Krasny

There has been an increase in regulatory activity over the past year, in many areas of the law, due to proposed or new final regulations and guidelines, different interpretations of existing regulations and heightened enforcement efforts. Although the elections may ultimately affect the degree of regulatory oversight in general, no major change is expected in the near future. Examples of recent developments are summarized below.

Since enactment of the Consumer Product Safety Improvement Act of 2008, the Consumer Product Safety Commission (CPSC) has issued numerous rules and guidelines, with higher civil penalties now in effect. Tracking labels are required on children's products, and advertisements for toys and games must include a choking hazard warning if warranted. Lead limits in paint and surface coatings have been lowered, and new limits on lead in substrate were adopted. Manufacturers of all consumer products must demonstrate compliance with applicable CPSC requirements through a certificate of conformity, which must be based on testing by third-party accredited laboratories for children's products, although in-house testing is permitted for adult products (unless third-party testing is otherwise required in the underlying rule). Phthalate testing must be done, on a component basis, for toys and childcare articles, and there is no inaccessible component part exemption. A scheduled Nov. 17 vote on a proposed final rule implementing a public database on reports of harm was postponed, and will be considered along with an alternative proposal submitted by two commissioners. The deadlines and requirements continue to generate frustration in the business community.

Pursuant to California's Green Chemistry Initiative, the Department of Toxic Substances Control must implement AB1879, which calls for a regulation to identify and prioritize chemicals of concern in consumer products in California, and requires that alternatives be identified or developed. The chemicals of concern list may encourage deselection, in advance of any governmental conclusion regarding a chemical's risk profile, to avoid the onerous obligation of an alternatives assessment. Similarly, the Environmental Protection Agency (EPA) is proposing to create a list for chemicals of concern under the Toxic Substances Control Act, even though it has never used this rulemaking authority since passage of the law in 1976. Other states, including Washington and Maine, have enacted legislation that calls for the identification of toxic chemicals used in children's products. And Canada has implemented a program to review all chemicals on its inventory and restrict or remove from commerce those identified as "toxic." The European Union has begun listing chemicals of concern under its REACH program of chemical management, and the prospect of "authorization" proceedings may also encourage deselection.

Both the Federal Food and Drug Administration (FDA) and the Federal Trade Commission (FTC) are applying more rigorous substantiation standards to health-related claims for food, including dietary supplements, and have stepped up enforcement actions. In September, for example, the FTC filed a complaint against POM Wonderful, alleging false, misleading, or unsubstantiated representations in marketing materials regarding the health effects of POM products. Prior to the FTC complaint, POM had filed a declaratory relief action against the FTC, charging that recent consent agreements with other companies, requiring FDA approval before certain advertising claims could be made, constituted a new standard which exceeded the FTC's statutory authority. On Nov. 16, the Department of Justice filed a motion to dismiss, on multiple grounds.

A novel approach to enforcing the prohibition against misleading fill ("slack fill") of food packages has been carried out by some local District Attorney offices, primarily Sacramento and Yolo. Although both California and the FDA have general regulations on this issue, there are no clear guidelines. Proceeding under Business & Professional Code Sections 17200 and 17500, District Attorneys have obtained settlements against several companies, with civil penalties in the range of $100,000 to $300,000 and injunctions (no cases were litigated). Indeed, it appears that only these California counties believe this is a significant enough concern to warrant enforcement actions; we are unaware of similar cases being brought in other states, although virtually all have comparable state law provisions.

Online and offline privacy and security will continue to garner attention through 2011. The FTC and Department of Commerce are slated to issue important reports that will impact the debate on privacy. Self-regulatory initiatives for online behavioral advertising have been strengthened through a new enforcement program, and Congress is likely to take up new measures. Bills have been introduced to create a national data breach standard to eliminate the confusion created by different models in the 40+ states with data breach laws. And privacy remains important in the courts. The Supreme Court is scheduled to hear a case involving AT&T's claim that the Federal Communications Commission (FCC) was barred from disclosing e-rate information because it would violate the company's privacy rights. An increasing number of challenges address workplace privacy issues, including questions about disciplinary action by companies for employee social networking.

U.S. employers have seen a steep increase in regulatory enforcement audits, fines, and litigation. Examples include the Department of Labor's nationwide "misclassification audit" initiative, targeting employers in the construction, retail sales, janitorial, and landscaping industries for treating "employees" as independent contractors to avoid payment of overtime and inclusion in pension and benefit plans; the Immigration and Customs Enforcement's lead-driven I-9 compliance audits directed at employers allegedly guilty of violations of workplace pay and safety protections in the course of knowingly employing undocumented workers; the Department of Justice's aggressive pursuit of employers for requiring foreign workers to produce more documentation than U.S. workers in the I-9 process; and the Equal Employment Opportunity Commission's systemic discrimination litigation initiative resulting in high-profile pattern or practice class actions challenging employment practices that allegedly have a discriminatory impact upon employees based on religion, national origin, race, or disability. Cautious employers are reviewing internal compliance plans and making revisions, as appropriate, to avoid costly court ordered fines and defense costs.

Many of the nation's leading critical infrastructure companies — electric utilities, oil and gas companies and railroads — are hard-pressed to obtain wireless spectrum necessary to implement new, cutting edge technologies, even when implementation is mandated by statute. Electric utilities need spectrum to develop smart grids and improve supervisory control and distribution automation. Oil and gas companies need spectrum to create digital oil fields of the future, serve refineries and monitor and control pipelines. Railroads need spectrum to build-out positive train control systems. Spectrum is limited, however, and allocated by the FCC on a piecemeal basis largely to cellular carriers and other commercial service providers. Competing demands can go unmet. Meanwhile, there is continuing enforcement of statutory licensing requirements, with actions against companies that assign or transfer control of licenses as part of a merger or acquisition without first obtaining the FCC's consent.

The Federal Motor Carrier Safety Administration is expected to issue, by December, a proposed rule to amend the hours of service regulations regarding commercial motor vehicle (CMV) drivers transporting property on highways in interstate commerce, and must adopt final rules by June 2011. Public interest groups seek changes that would reduce daily CMV driving time, restrict CMV drivers to a shorter work day inclusive of loading and waiting time, limit a CMV driver's total driving time per 7-day work week, increase driver daily off-duty time, and change the restart requirement. Presumably, adoption of the public interest group proposals would cause shipping costs to rise dramatically, contribute to supply chain delays, fuel inflation by causing consumer goods costs to rise, increase truckers' operating costs, and place more vehicles on the road, potentially contributing to more accidents.

During the past year, EPA took significant steps to increase transparency regarding pesticide regulation under the Federal Insecticide, Fungicide and Rodenticide Act, and also established a controversial interpretation (being litigated in federal court), which strengthens its authority to take pesticides off the market outside the formal cancellation process. Regarding transparency, EPA proposed requiring pesticide product labels to list inert ingredients, contrary to the statutory protection for trade secrets or commercial or financial information unless EPA determines that disclosure is necessary to protect against unreasonable risk of injury. Another recent EPA action is the Risk Mitigation Decision for Ten Rodenticides (RMD), requiring changes to certain EPA-registered rodenticides (including cancellation of some registrations). Products not complying with the RMD will be considered "misbranded" starting June 4, 2011, which could expose registrants to enforcement action and substantial penalties.

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Cleaning Up the Mortgage Mess

Jeremiah A. Ho

In preparation for the MPRE (Multistate Professional Responsibility Exam) in law school, I was told in a review course that asking, "What is the morally right thing to do in this or that situation?" was the last effective approach to the exam. Rather, a stealthier approach was to ask, "What can an attorney legally get away with under the confines of any code of conduct?" The advice made sense to me then — as testing the boundaries of restrictions is a lawyering instinct. But the way the advice was phrased, "to get away with it," has always struck discord in my ear. Why were we "getting away with anything?"

The whole mortgage crisis that started in the mid-2000s could be characterized as a journey of trying to "get away with it." The opportunity to securitize mortgage interests and collateralized debt on a vast level was too tempting for financial investors, who strained the regular boundaries of business operations in order to satiate their behemoth appetites. With that strain, the mortgage industry, needless to say, drifted into a dangerous area. The latest installment in this debacle has been the onset of investigations by various state attorneys general to look into the fraudulent foreclosure practices of many lending servicers. At the heart of the issue is the right to foreclose upon a delinquent mortgage and *who*, in every single foreclosure proceeding, actually owns that right if the entire process has been tainted with fraudulent documentation. Often the alarm here is on mortgage notes, which were assigned to trusts when lending institutions pooled mortgages into investment securities. The mad rush to securitize mortgages on a mass scale and to capitalize on the demand for CDOs (collateralized debt obligations) frequently created situations where the banks could not properly manage the documentation of each and every individual mortgage they handled. Then as the rush of foreclosures descended, many of these banks and servicers were robo-signing affidavits and other paperwork, and relying on dubious notarization practices to verify note ownership. Such alleged practices have tainted foreclosure proceedings, placing into question who can actually exercise the right to foreclose when a mortgage becomes delinquent.

This event is the latest example of the mortgage industry's previous endeavors to get away with trying to cater to investors looking for that chunk of collateralized debt in order to expand the industry's own profits — and failing miserably. In hindsight, it appears as if the mortgage industry just couldn't do anything right in response to the housing boom.

With the rise of swift commercial transactions in the modern age, we've seen laws adapt to facilitate the ever-changing landscape of doing business. The Uniform Commercial Code is an illustrative example. Not only was its purpose to standardize common practices across jurisdictions but also to loosen certain traditional contract requirements — consideration in some contract modifications, for example was aimed at making transactions more transparent in the face of modern commerce. In good old real property law, well-known for progress at a snail's pace, legal formalities have always dominated in order to give clarity to rights and liabilities to individual owners, even if it involved people throwing dirt and twigs at each other in order to accomplish livery of seisin. But over time those formalities themselves adapted and changed. In Tudor England, the use of deeds displaced livery of seisin when the importance of documentation became a priority as an indirect result of the Statute of Uses.

With the passage of time, it makes sense that some traditions give way to new practices. This should, however, be done with careful balancing and not at the expense of the integrity of the entire system. What happened in the mortgage crisis has served to push every aspect of creating and enforcing mortgage obligations into suspended uncertainty. This uncertainty — a long-standing theme of the economic downturn — is now inextricably intertwined with the foreclosure process, adding to the lack of public confidence and slowing down the recovery process.

Focusing on the most distressed components, the affected foreclosures themselves, would be taking a myopic view of the situation. This is a systemic problem that affects many parties in the investment and home loan industries and will likely pose a long-term predicament for years to come. The inability to see the larger picture will only prompt the illusion that someone was trying to get away with something smaller. Instead, we should look at the situation holistically.

First: The questionable practices of lending institutions and servicers are not relegated to merely the realm of foreclosure proceedings. It is very possible that, although foreclosure actions have been rightfully pursued against delinquent property owners, such proceedings were accomplished with the presentation of fraudulent evidence *to courts* — the very idea of which harms nationwide judicial integrity. There has also been talk that foreclosure companies, banks, and even law firms involved in foreclosures could be guilty of crimes such as mail and wire fraud, money laundering, conspiracy, and racketeering.

Second: The mess created by dubious practices has raised victimization concerns from current and past homeowners with foreclosure experience. These concerns have or likely will translate to further litigation involving a possible mélange of actions, from lender deceit and fraud to recourse for foreclosures that came too quickly despite a homeowner's good faith attempt to seek mortgage modification, to the sale of foreclosed property under fraudulent practices to innocent third-parties.

Third: What about the investors who acquired those mortgage notes but are now unable to verify their ownership and exercise their right to foreclose? The banks that transferred those notes are now facing possible legal action for failing to inspect collateral files. As a result, there might be legal repercussions for years to come from the true owners of the notes down to the trustees and securitization sponsors who carried out such dubious practices.

Fourth: If cloud title issues exist on mortgages facing foreclosures, surely there are performing mortgages that are affected by questionable documentation practices as well. What does this mean for those homeowners? Does this mean that many homeowners have been paying their loan obligations to the wrong entity? Will there be unjust enrichment issues on the horizon? Of course, this list here is not suggestive. There are other vices and corresponding claims lurking around every corner of this conundrum. Admittedly, on the big-picture angle, the mortgage industry is too big to fail. The housing sector must bounce back as a pivotal piece of the rebound puzzle and a balance must be struck between bailing the banks out and knowing that sloppy deviations from traditional foreclosure practices should never be tolerated when people's homes are involved. No matter how arcane or burdensome the process of verifying title may have been, the lesson here is that it really didn't pay for these large institutions to try to get away with *having it all*. In fact, as some analysts have estimated, foreclosure fraud could cost the mortgage industry at least $1.5 billion per quarter. And this isn't even the long-term figure.

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