In the Supreme Court of the State of California

ELK HILLS POWER, LLC.,

Plaintiff-Appellant,

v.

CALIFORNIA STATE BOARD OF EQUALIZATION, ET AL.,

Defendant and Respondent.

Case No. S194121

Fourth Appellate District, Division One, Case No. D056943
San Diego County Superior Court,
Case No. 37-2008-00097074-CU-MC-CTL
The Honorable Ronald L. Styn, Judge

ANSWER TO PETITION FOR REVIEW

KAMALA D. HARRIS
Attorney General of California
DAVID S. CHANEY
Chief Assistant Attorney General
PAUL GIFFORD
Senior Assistant Attorney General
FELIX E. LEATHERWOOD
Supervising Deputy Attorney General
LESLIE BRANMAN SMITH
Deputy Attorney General
TIM NADER
Deputy Attorney General
State Bar No. 106093
110 West A Street, Suite 1100
San Diego, CA 92101
P.O. Box 85266
San Diego, CA 92186-5266
Telephone: (619) 645-2210
Fax: (619) 645-2489
Email: Tim.Nader@doj.ca.gov
Attorneys for Defendant and Respondent California Board of Equalization

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page

CASES

STATUTES

CONSTITUTIONAL PROVISIONS

COURT RULES

INTRODUCTION

The Court of Appeal correctly applied this Court's precedent, and the applicable statutes, in holding that petitioner's power plant should be taxed at full value. In so doing, it did not create any new valuation rule, but rather applied this Court's decision in *Roehm v. County of Orange* (1948) 32 Cal.2d 280, which squarely held that, in valuing tangible property for property tax purposes, the assessing entity may consider the value contributed by the presence of intangible assets and rights. (See also *The Michael Todd Company, Inc. v. The County of Los Angeles* (1962) 57 Cal.2d 684 ["market value" for assessment purposes is the value of property when put to "beneficial or productive use"].) *Roehm* and its progeny, as well as Revenue and Taxation Code section 110, subdivision (e), confirm that those intangible assets and rights that are necessary to the use of taxable property are to be taken into consideration in valuing the property at highest and best use for property tax purposes, while those intangibles that are not necessary to the beneficial use of the property are to be excluded. Thus, in the present case, the Court of Appeal applied an existing, well-established principle, albeit to a new type of asset. Accordingly, it is petitioner, not the State, that is seeking to advance a novel rule through this litigation, i.e., to create an unprecedented tax exemption for using an intangible asset to increase pollution. In arguing in favor of review, Elk Hills misconstrues the Court of Appeal's decision below, the relevant statutes, and this Court's precedents. The petition should be denied.

BACKGROUND

Emission Reduction Credits (ERCs) are part of a statutory scheme allowing the issuing, applying, deploying, trading, banking, and/or refunding of interchangeable air pollution credits, among regulatory

authorities and polluting plant operators, to enable a plant owner to suitably operate its power plant, in terms of its selection of the available technology and compliance with regulatory limits on pollution. (Health & Saf. Code, §§ 40709-40913; see also Cal. Code Regs., tit. 17, § 91500 et seq. [regulations implementing § 40709]). As petitioner acknowledges, ERCs are like government permits in that they provide legal, intangible rights, which allow a power plant (or other emission source) to legally operate at specified emission levels. (EHP Petition for Review, at p. 11.)

In this case, it was undisputed Elk Hills deployed five certificates for ERCs it had purchased, from other emission sources, to enable its technology to produce power at the permitted levels. These covered excess pollutants such as nitrogen oxides, volatile organic compounds, and sulfur oxides. Deployment of these ERCs was required to obtain construction and operation permits for the power plant. As long as the plant operates at its current level, it must utilize Elk Hills' deployed ERCs to continue its compliance with state emissions requirements. (Pub. Resources Code, § 25000 et seq; see also Op. at p. 3.) In fact, Elk Hills has admitted that, as applied or deployed in this case, "an ERC is an intangible right that is necessary for the beneficial and productive use of an electric generation plant." (EHP MSJ, I CT 109, lns. 1-3; see Rev. & Tax. Code, § 110, subd. (e).)

The California State Board of Equalization (BOE) is constitutionally mandated by Article XIII, section 19 of the California Constitution to annually value state-assessed property, including petitioner's power plant, on a unitary or going concern basis. (*ITT World Communications, Inc. v. City and County of San Francisco* (1985) 37 Cal.3d 859, 863-865.) In 2004 and 2005, in order to assess the value of Elk Hills' power plant for tax purposes, BOE used the "replacement cost approach". Under this well-established method, the BOE considered the cost of replacing the property

with a substitute property, less accrued depreciation. (See *Watson Cogeneration Co. v. County of Los Angeles* (2002) 98 Cal.App.4th 1066, 1071 (*Watson*).) BOE included a standard estimated replacement cost for the deployed ERCs, as well as other permitting and "soft costs" necessary to use of the property.

From 2006 to 2008, BOE continued to use the replacement cost approach and combined it with another standard valuation method: an income approach utilizing a "capitalized earning ability" or CEA factor. In estimating capitalized earning ability, BOE did not add any increment for the ERCs, but neither did it deduct their value as Elk Hills contended it should have. Instead, the BOE "legitimately took into account the value added by the ERCs," in determining the power plant's assessed value "because without the presence of the deployed ERCs, the power plant cannot operate and function as intended." (See Op. at p. 6.)

I. THE PETITION SHOULD BE STRICKEN BECAUSE IT WAS NOT TIMELY FILED AND SERVED

The Court should strike the petition as untimely. A petition for review "must be *served and* filed within 10 days" after the Court of Appeal's decision is final. (Cal. Rules of Ct., rule 8.500(e), emphasis added.) Because the Court of Appeal filed its opinion on May 10, 2011, that decision became final on June 9, 2011. (*Id.*, rule 8.264(b).) Accordingly, Elk Hills had to file and serve the petition by June 20, 2011. Although Elk Hills filed its petition on June 20, 2011, the proof of service shows service a day later, on June 21, 2011. (See Exhibit A [photocopy of envelope addressed from Plaintiff's attorney Peter Michaels to Deputy Attorney General Brian Wesley with postmark of June 21, 2011 and receipt date

stamp of June 23, 2011].)[1] Accordingly, the petition should be stricken as untimely served.

II. THE COURT SHOULD DENY REVIEW BECAUSE THE COURT OF APPEAL CORRECTLY APPLIED THIS COURT'S PRECEDENT AND ITS OPINION DOES NOT CREATE ANY CONFLICT IN THE LAW

The Court of Appeal correctly applied the applicable statutes and precedent. There is no conflict in the law that merits this Court's intervention. Elk Hills' arguments to the contrary are based on misconstruction of the Court of Appeal's opinion, the relevant statutes, and existing precedent.

A. The Court of Appeal's Decision is a Straightforward Application of Existing Precedent

It has long been established that intangible assets and rights necessary to the beneficial or productive use of the taxable property being assessed should be included in that assessment, while intangibles not necessary to the use of taxable property may not be included. (See, e.g., *Michael Todd v. County of Los Angeles* (1962) 57 Cal.2d 684 [copyright properly considered in assessment as necessary for the "beneficial or productive" use of taxable film at its highest and best use as a master film negative]; *American Sheds v. County of Los Angeles* (1998) 66 Cal.App.4th 384, 392 [permits included in assessment]; *Service America Corp. v. County of San Diego* (1993) 15 Cal.App.4th 1232 [business enterprise value and superior management acumen excluded from assessment]; *Los Angeles SMSA Ltd v. Board of Equalization* (1992) 11 Cal.App.4th 768 [value added by FCC permit properly considered in assessment of cellular telephone plant and

[1] Elk Hills crossed out "June 20" on the proof of service, and replaced it with a handwritten "21." The postmark on the service copy envelope similarly reflects mailing on June 21, 2011. The Attorney General's office did not receive service until June 23, 2011.

system] *GTE Sprint Comm. Corp. v. County of Alameda* (1994) 26 Cal.App.4th 992 [the value of intangible property may be included in the valuation of otherwise taxable tangible property; but remand necessary because the board did not identify or address the alleged exempt intangible assets not necessary to property use, such as trade name, customer base and assembled workforce.])

The Court of Appeal here, faced with a novel type of asset (ERCs), applied the same test California courts have consistently applied for decades. As the ERCs admittedly were necessary to the construction and operation of the power plant being assessed (similar to the FCC permits in *Los Angeles SMSA, supra*), inclusion was appropriate. The Court of Appeal explicitly applied existing precedent:

> Here, as in *LA SMSA, supra,* 11 Cal.App.4th 768, 776, "the crux of the problem" is that Elk Hills cannot demonstrate that the Board misinterpreted the actual or booked ERC costs that were reported by Elk Hills, by impermissibly attributing income and value to them, or incorrectly imposing the tax directly on their value. Instead, those intangible assets were deemed to add to the value of taxable tangible property, because no earnings would be possible without them, due to the regulatory requirement of such " 'possession of intangible rights and privileges that are not themselves regarded as a separate class of taxable property.' " (*Ibid.*, citing *Roehm, supra*, 32 Cal.2d 280, 285; see also *Michael Todd Co. v. County of Los Angeles* (1962) 57 Cal.2d 684, 693-694 [film valued with copyright].)

(Op. at pp. 38-39.) Thus, the Court of Appeal here merely applied an old test to a new asset, ERCs.

B. Elk Hills' Claimed Conflict is Based on its Misconstruction of the Court of Appeal's Opinion

Elk Hills contends, wrongly, that the Court of Appeal created a "new test" for determining when assessment of taxable property should include the assumed presence of an intangible asset that contributes to the taxable

value of the property. The claimed "new test" is the necessity of the intangible asset to the use of the tangible taxable property. But the test applied by the Court of Appeal is neither "new" nor its own invention. Rather, it comes directly from Revenue and Taxation Code section 110, subdivision (e):[2] "Taxable property may be assessed and valued by assuming the presence of intangible assets or rights *necessary to put the taxable property to beneficial or productive use.*" [Emphasis added.] The Court of Appeal did not create a new test but instead, as alluded to above, simply applied a well-established test to a new asset (ERCs).

Elk Hills not only misconstrues the source of the test used in the opinion, but also its application. In determining when intangible assets have contributed to the fair market value of property for assessment purposes, the appellate courts have made an important distinction. First are intangible assets or rights necessary for the beneficial or productive use of the property, such as permits, or the ERCs in this case, which properly may be considered in the value of the property for property taxation purposes. (See, e.g., *American Sheds v. County of Los Angeles, supra,* 66 Cal.App.4th at p. 392-393; Rev. & Tax. Code, § 110, subd. (e).) Such assets, including deployed ERCs, as appellant has admitted, are necessary to the use of the power plant regardless of who owns it and could not be removed from the property without changing its use. Second are intangible assets *not* necessary to use of the property, such as brand name or business enterprise value, which may *not* properly be considered in determining the value of the property for property taxation purposes. (See, e.g., *Service America Corp., supra,* 15 Cal.App.4th 1232). Assets in this category can be removed from the taxable property *without* affecting its highest and best property

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[2] All statutory references are to the Revenue and Taxation Code unless otherwise stated.

use. The statute and well-established case law, including cases on which Elk Hills mistakenly relies, make it clear that this distinction determines whether the assessor should take intangible assets into consideration in determining the fair market value of taxable property.

Elk Hills' failure to grasp the statutory distinction between two different categories of intangible assets – those necessary to the beneficial use of the taxable property and those not necessary to such use – seems to underlie its apocalyptic vision of the ramifications of the Court of Appeal opinion. Elk Hills predicts the opinion will result in tax chaos, judicial meltdown and the catastrophic demise of the tax exemption for intangible property.[3] But, the opinion simply applies to ERCs the same rules that courts have already applied to similar forms of intangible assets that are necessary to the use of the property, such as copyrights (*Michael Todd v. County of Los Angeles* (1962) 57 Cal.2d 684); transferrable development rights (*Mitsui Fudosan v. County of Los Angeles* (1990) 219 Cal.App.3d 525) and FCC permits (*Los Angeles SMSA Ltd v. Board of Equalization* (1992) 11 Cal.App.4th 768), as well as the more commonplace governmental authorizations such as building permits, special use permits, sewer permits, etc. The confusion and explosion of tax litigation predicted

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[3] Elk Hills' forecast of a disastrous outcome emanating from the Court of Appeal's opinion is highly ironic, given that, among the effects of the novel statutory construction it seeks would be the evisceration of the Legislature's intent to help save the planet by creating, through ERCs or "cap and trade," incentives to reduce pollution. (See Op. at p. 39 ["As a policy matter, we find it most unlikely the Legislature intended by its creation of the ERCs' statutory scheme, or by amending the statutes regarding the treatment of intangibles, essentially to provide a unitary tax deduction or tax credit for those power plant operators that cannot operate a plant at state accepted levels of admissions [sic], but that instead must obtain ERCs through purchase or trade, to enable them to commence and continue operations at a higher level of emissions."].)

by Elk Hills has not materialized from *American Sheds, Mitsui Fudosan, Los Angeles SMSA*, *Michael Todd,* or any of the other cases holding that property is taxed at its full value regardless of the fact that part of that value is contributed by the presence of an intangible asset. Those consequences will not follow from the Court of Appeal's opinion in this case, either.[4]

C. Elk Hills' Misconstruction of Statutes Underlies its Claim that the Decision Creates a Conflict

Elk Hills also misconstrues and ignores the applicable statutory language in its effort to create a review-worthy conflict. Specifically, Elk Hills contends section 110, subdivision (d), should be applied without regard to subdivision (e). But section 110, subdivision (d) applies "Except as provided in subdivision (e)." As required by the statute's plain language, the Court of Appeal applied the subdivision (e) exception, for "intangible assets or rights necessary to put the taxable property to beneficial or productive use." Where this exception applies, the statute provides the taxable property may be assessed by "assuming the presence of" the necessary intangible rights for use of the taxable property.

Much of Elk Hill's critique of the Court of Appeal opinion rests on the shaky foundation of claiming that use of the statutory word "necessary" in applying section 110, subdivision (e), is a "new test" invented by the Court of Appeal and is likely to result in chaos and confusion. But this test has been applied by California courts for years without the awful consequences predicted by Elk Hills.

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[4] Three amicus letters likewise misunderstand the issue in this case. Taxation of intangible assets is not at issue here and did not occur here. BOE simply did not add the value of ERCs to the market value of the power plant, as stated by amici. Rather, BOE included as part of the market value of the plant, that portion of value attributable to the presence of the deployed ERCs, as provided by existing statutory and case law.

Elk Hills contends that applying the plain statutory language will henceforth eviscerate the constitutional limitations on taxation of intangible assets. As a threshold point, however, this case does not involve taxation of an intangible asset, but rather assessment of a power plant. Moreover, considering the value-added to the real property by intangible assets necessary to their use (such as ERCs), as the courts have been doing for decades, has not and will not create a runaway taxation problem. In arguing otherwise, Elk Hills ignores that most intangible assets (e.g., commercial paper, professional licenses, banked ERCs) are not related to the use of specific taxable property, and therefore, under existing law as applied by the Court of Appeal, remain outside the property tax valuation process. And it further ignores the fact that not all intangible assets related to use of taxable property meet the "necessary" test; for example, while ERCs are necessary to allow use of property as a pollution-emitting power plant regardless of who owns the plant (and therefore may be considered in the property tax valuation of the overall property), trademarked Golden Arches are not necessary to use of property as a hamburger stand (and therefore any extra value added by the use of the brand and trademark must be excluded from any property valuation). Only by ignoring these facts can Elk Hills argue that the plain meaning of the statutory language must be destroyed in order to save it from constitutional infirmity. The Court of Appeal, however, used these facts in its analysis to reach the correct conclusion that BOE properly assessed the full value of Elk Hills' power plant under section 110, without creating a new tax exemption for use of ERCs. Its decision does not create a conflict.

In light of both the plain language of section 110 and the obvious legislative intent to reduce pollution rather than reward it, Elk Hills seeks refuge in so-called "legislative history" provided by special interest lobbyists. The Court of Appeal properly declined to indulge Elk Hills in

this regard for several reasons. First, doing so would embroil the courts in conflicting accounts of who really "sponsored" the legislation and with what intent.[5] Moreover, consideration of such legislative history is improper where, as here, the plain language of the statute – "necessary to put the taxable property to beneficial or productive use" – requires no construction. (*Lennane v. Franchise Tax Bd.* (1994) 9 Cal.4th 263, 268.) The Court of Appeal's application of the plain language of the statute does not merit this Court's review.

D. The Court of Appeal's Decision Does not Conflict with Existing Case Law

Elk Hills erroneously claims the Court of Appeal opinion creates a conflict in case authority. Elk Hills repeatedly asserts that *Roehm v. County of Orange* (1948) 32 Cal. 2d 280 conflicts with the Court of Appeal's opinion. To so argue, however, Elk Hills incorrectly dismisses a key portion of this Court's holding as "dicta in *Roehm* that has created subsequent confusion." (Petition at p. 18.) But only Elk Hills is confused.

Roehm was clear enough: intangible assets, such as the liquor license at issue in *Roehm*, cannot be separately taxed as property; at the same time, assessable value of taxable property includes the value contributed by intangibles:

> Intangible values, however, that cannot be separately taxed as property may be reflected in the valuation of taxable property. Thus, in determining the value of property, assessing

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[5] The amicus letter of CalTax submitted on Elk Hill's behalf is revealing in that it complains that the intent of *CalTax* (not the Legislature) was not followed by the Court of Appeal's application of the statute. (CalTax amicus letter at p. 7.) As a lobbyist, CalTax's "intent" for sponsoring the 1995 amendments to sections 110 and 212 is absolutely irrelevant, and its proffered interpretation of the law is likewise inconsequential. (See *Martinez v. Regents of University of Calif.* (2010) 50 Cal.4th 1277, 1293.)

> authorities may take into consideration earnings derived therefrom, which may depend upon the possession of intangible rights and privileges that are not themselves regarded as a separate class of taxable property.

(*Roehm v. County of Orange, supra,* 32 Cal.2d at pp. 285.)

The Court of Appeal correctly applied *Roehm* here. There is no conflict between *Roehm* and the decision in this case. This Court should decline Elk Hills' invitation to partially overrule *Roehm* and judicially create a previously-unknown tax exemption for using an intangible asset to increase the production and pollution of taxable property.

In addition, *Roehm*, in fact, establishes the critical distinction missed by Elk Hills between the taxation of an "intangible" and the assessment of the increased property value that may be added to the taxable property by intangible property use rights. (*Am. Sheds v. County of L.A.* (1998) 66 Cal.App.4th 384, 392-395.) Elk Hills incorrectly attempts to draw a comparison between liquor licenses and ERCs. (Petition at p. 18.) However, a liquor license notably differs from ERCs in very significant respects -- principally, in that ERCs are necessary to obtain the permits needed to build and operate a power plant, while a liquor license is not necessary to build real property intended to be used as a liquor store; but, instead, is only needed to sell alcohol at a specific location under the police power. As such, they are completely different from the property rights provided by deployed and applied ERCs to obtain power plant building and use permits to construct the facility. For this reason, unlike building and operating permits, any potential liquor license costs are not properly considered to be part of the replacement cost of real property, despite the fact that there may be an intent to use the space as a liquor store. Stated another way, applied ERCs are different from liquor licenses and other similar business (and not property) licensing rights because deployed

ERCs provide the legal right to build and use a physical power plant similar in effect to the many other governmental authorizations necessary to build and operate a power plant.

Elk Hills similarly misstates the holdings of various other existing appellate authorities to create the misimpression that the Court of Appeal's opinion in this case is in conflict. For example, Elk Hills cites *Michael Todd v. County of Los Angeles* (1962) 57 Cal.2d 684 as "upholding the exemption for intangible copyrights." (Pet. at p. 5.) Actually, this Court in *Michael Todd* applied the same principles of law as those expressed in *Roehm* to arrive at the same conclusion as the Court of Appeal here: although copyrights are not taxable, the value added by this intangible may be reflected in the assessed value of a master film negative whose use depends upon such intangible rights.[6] The Court of Appeal here applied the same principle to ERCs and power plants.

De Luz Homes, Inc. v. County of San Diego (1955) 45 Cal.2d 546, also cited by Elk Hills, actually supports BOE's position. In *De Luz,* this Court affirmed that all taxable property must be taxed in proportion to its full cash value: "In valuing property, the assessor *must adhere to the statutory standard of 'full cash value,'* and must therefore, estimate the price the property would bring on an open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other." (*Id.* at p. 566 [emphasis added].) Elk Hills, however, is seeking to compel the Board to assess its power plant at *less* than "full cash value," by fictitiously assuming that the power plant was operating at a lesser level of

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[6] *Michael Todd, supra* at 696, was, in fact, the source of the "beneficial or productive use" language used by the Legislature in enacting Revenue and Taxation Code section 110, subdivision (e).

productivity than it actually was. In rejecting Elk Hills' position, the Court of Appeal faithfully and correctly applied and followed existing precedent.

Other appellate authorities are also consistent with both this Court's prior decisions and with the Court of Appeal opinion here, and contrary to Elk Hills' novel position. (See, e.g., *Western Title Guaranty Co. v. County of Stanislaus* (1974) 41 Cal.App.3d 733, 776 ["Intangible values. . . that cannot be separately taxed as property may be reflected in the valuation of taxable property"]; *County of Stanislaus v. County of Stanislaus Assessment Appeal Board* (1989) 213 Cal.App.3d 1445, 1454-55 ["Our conclusion that the intangible right to do business is not assessable for ad valorem tax purposes, however, does not mean the value of Post-Newsweek's intangible rights may not be considered in assessing the value of the possessory interests," citing *Roehm, supra, Michael Todd, supra and Western Guaranty Title, supra*]; *Los Angeles SMSA Ltd v. Board of Equalization, supra,* 11 Cal.App.4th 768.)

Elk Hills also relies on cases requiring exclusion of intangible assets *not* necessary to use of taxable property. Such cases are necessarily inapposite here as the ERCs were necessary to construction and operation of the power plant at issue – a fact that Elk Hills admits. There is no inconsistency requiring resolution by this Court.

CONCLUSION

This Court's precedent establishes a rule that, although intangible assets may not be taxed, taxable tangible property including real property should be valued for property tax purposes at full value including any value contributed by the presence of intangible assets or rights, if the intangible assets or rights are necessary for the beneficial or productive use of the real property. The plain language of the relevant statute sets forth the same rule. The Court of Appeal properly applied this rule to the facts and

circumstances in this case and made a decision consistent with both this Court's prior holdings and the statute. Review should be denied.

Dated: July 11, 2011

Respectfully submitted,

KAMALA D. HARRIS
Attorney General of California
DAVID S. CHANEY
Chief Assistant Attorney General
PAUL GIFFORD
Senior Assistant Attorney General
FELIX E. LEATHERWOOD
Supervising Deputy Attorney General
LESLIE BRANMAN SMITH
Deputy Attorney General

TIM NADER
Deputy Attorney General
Attorneys for Defendant and Respondent California Board of Equalization

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CERTIFICATE OF COMPLIANCE

I certify that the attached **ANSWER TO PETITION FOR REVIEW** uses a 13 point Times New Roman font and contains 3,744 words.

Dated: July 11, 2011

KAMALA D. HARRIS
Attorney General of California
LESLIE BRANMAN SMITH
Deputy Attorney General

TIM NADER
Deputy Attorney General
Attorneys for Defendant and Respondent California Board of Equalization

DECLARATION OF SERVICE

Case Name: **Elk Hills Power, LLC v. Board of Equalization**

No.: California Supreme Court, Case No. **S194121**
Fourth Appellate District, Division One **D056943**
San Diego County Superior Court Case No. **37-2008-00097074-CU-MC-CTL**

I declare:

I am employed in the Office of the Attorney General, which is the office of a member of the California State Bar, at which member's direction this service is made. I am 18 years of age or older and not a party to this matter; my business address is 110 West A Street, Suite 1100, P.O. Box 85266, San Diego, CA 92186-5266. I am familiar with the business practice at the Office of the Attorney General for collection and processing of correspondence for mailing with the United States Postal Service. In accordance with that practice, correspondence placed in the internal mail collection system at the Office of the Attorney General is deposited with the United States Postal Service that same day in the ordinary course of business.

On **July 11, 2011**, I served the attached **ANSWER TO PETITION FOR REVIEW** by placing a true copy thereof enclosed in a sealed envelope with postage thereon fully prepaid, in the internal mail system of the Office of the Attorney General, addressed as follows:

Peter W. Michaels, Esq.
Law Office of Peter W. Michaels
6114 La Salle Avenue, Suite 445
Oakland, CA 94611-2802

Jerri S. Bradley
County of Kern Public Defender
1115 Truxtun Avenue, Fourth Floor
Bakersfield, CA 93301

Paul J. Mooney, Esq.
Mooney, Wright & Moore, PLLC
Mesa Financial Plaza, Suite 16000
1201 South Alma School Road
Mesa, AZ 85210-0001

California Court of Appeal
Fourth Appellate District, Division One
750 B Street, Suite 300
San Diego, CA 92101

The Honorable Ronald L. Styn
San Diego Superior Court
330 West Broadway
San Diego, CA 92101

On **July 11, 2011**, I caused (13) copies of the **ANSWER TO PETITION FOR REVIEW** in this case to be delivered to the California Supreme Court at 350 McAllister Street, San Fancisco, CA 94102-4797 by **Overnight Courier Service (Federal Express)**.

I declare under penalty of perjury under the laws of the State of California the foregoing is true and correct and that this declaration was executed on **July 11, 2011**, at San Diego, California.

J. Grand
Declarant

Signature

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