California Constitutional Debt Limits and Municipal Lease Financing

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I. Introduction

Debt limits are statutory or constitutional constraints on discretionary borrowing by governments. Specifically, debt limits apply where the government has pledged its full faith and credit, supported by the government’s power to tax within its jurisdiction, for financial obligations. This Paper examines how the debt limits prescribed by the California Constitution affect certain municipal business transactions.

This discussion begins with a brief introduction to the constitutional debt limits applicable to cities as well as the recognized exceptions to the rule. The analysis focuses on municipal lease financing arrangements, which is the most difficult and most frequently raised debt limit issue city attorneys are likely to encounter, and provides an examination of lease provisions that may affect whether the particular transaction falls within the constraints of local government debt limits.

A) Local Debt Limits Generally

Section 18 of article XVI of the California Constitution (“Section 18”) provides in pertinent part:

(a) No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the voters of the public entity voting at an election to be held for that purpose, except that with respect to any such public entity which is authorized to incur indebtedness for public school purposes, any proposition for the incurrence of indebtedness in the form of general obligation bonds for the purpose of repairing, reconstructing or replacing public school buildings determined, in the manner prescribed by law, to be structurally unsafe for school use, shall be adopted upon the approval of a majority of the voters of the public entity voting on the proposition at such election; nor unless before or at the time of incurring such indebtedness provision shall be made for the collection of an annual tax sufficient to pay the interest on such indebtedness as it falls due, and to provide for a sinking fund for the payment of the principal thereof, on or before maturity, which shall not exceed forty years from the time of contracting the indebtedness.1
This constitutional debt limit was created to mandate fiscal responsibility in public borrowing at a time when the State of California was rapidly developing and local governments were under pressure to expand railroads and fund other infrastructure projects. The resultant constitutional provision requires certain local governments to obtain approval by two-thirds of its voters to encumber public funds beyond the current fiscal year.

The law “is designed to afford the people who are required to pay the cost of providing . . . objects of public convenience and welfare an opportunity to express their approval or disapproval of a long-term indebtedness.” The California Supreme Court provided an early reading of the constitutional limit, stating:

[E]ach year’s income and revenue must pay each year’s indebtedness and liability, and that no indebtedness or liability incurred in any one year shall be paid out of the income or revenue of any future year. The system previously prevailing in some of the municipalities of the State by which liabilities and indebtedness were incurred by them far in excess of their income and revenue for the year in which the same were contracted, thus creating a floating indebtedness which had to be paid out of the income and revenue of future years, and which, in turn, necessitated the carrying forward of other indebtedness, was a fruitful source of municipal extravagance . . . . It was to put a stop to all of that, that the constitutional provision in question was adopted.”

Accordingly, the limitation is more aptly described as a balanced budget requirement or a pay-as-you-go mandate. This broad purpose reaches beyond traditional bond financing and includes any financial arrangement where the obligation to pay exceeds the local government’s present annual revenue. Hence, the voter approval requirements set forth in Section 18 are not exclusive to traditional debt arrangements, but must be considered anytime a city receives property, equipment, or services in one year the cost of which if agrees to pay over several subsequent years from revenues the city has not yet received. Thus, a city can purchase property or equipment on time if the funds for the purchase are appropriated and set-aside in the year the purchase agreement is signed, but cannot do so if the payments will be made from future revenues.

B) Exceptions to the Rule

By its terms, Section 18 applies only to the governmental entities named therein (basically, cities, counties and school districts) and only to obligations, which extend beyond a fiscal year. Section 18, for example, does not apply to redevelopment agencies. In addition, the courts have recognized several exceptions to accommodate the tension between a need for local government borrowing and for enforcing fiscal responsibility. The three major exceptions to the constitutional debt limit are (1) the special fund doctrine, (2) obligations imposed by law, and (3) lease obligations.
1) Special Fund Doctrine

First, the common law special fund doctrine provides that debt limits and the consequential voter approval do not apply to obligations that the local government pays from a special fund. This doctrine exempts certain obligations that are not legally enforceable against the local government’s general fund or its tax revenues. “The rationale . . . is that where the local government’s ‘credit [is] not involved in the incurring of the indebtedness’ [citation omitted] and the debt will not effect an increase in property taxes or threaten foreclosure upon government property, the debt is outside the scope of [Section 18].” The California Supreme Court narrowly construes this exception only to apply to special fund revenues that do not constitute revenues that would otherwise be paid into the local government’s general fund. Water rate payments used to fund the construction of water facilities would be one example of a special fund.

2) Obligations Imposed by Law

Second, the constitutional debt limit is not applicable to an obligation imposed by law. The California Supreme Court held that the debt limits only apply to discretionary borrowing. For example, obligations such as tort damages or state and federal mandates may exceed current revenues; yet, local governments are not required to obtain voter approval to finance such obligations. This exception developed because local governments cannot refuse to pay obligations mandated by law, therefore voters’ approval or disapproval cannot affect [the required expenditure].

3) Current Expenses and Lease Agreements

Lastly, as relevant here, certain property or equipment leases and service contracts are not subject to the voter approval requirements mandated by the Section 18 debt limit. This line of exceptions evolved from an early California Supreme Court case that held a contract for services was effectively a current expense and not debt because an annual obligation to pay for services only arose after the city received the services. Similarly, the California Supreme Court later held that a lease agreement, which makes annual rent payments contingent on the use of the property during the rental period, is not a debt for the purposes of Section 18. The Court seems willing to permit this exception because contracts for property, equipment and services promote efficiencies through improved budgeting, as well as allow local governments to negotiate and secure the best price.

II. Leases and Lease-Purchase Agreements

More recently, the Court has applied the “current expense” principle to exclude from the Section 18 debt limit certain agreements where the local government enters a lease-purchase contract to pay for capital and equipment beyond the current fiscal year. This exception is termed the “Offner-Dean” exception for the seminal cases that authorized lease arrangements for financing public needs.
A) History

In *City of Los Angeles v. Offner*, the California Supreme Court upheld an agreement where the City leased land to a contractor for ten years at one dollar per month. In return, the contractor agreed to construct an incinerator for the City’s use. The parties signed another lease agreement in which the contractor leased the newly constructed incinerator to the City for the same period. The contractor retained title to the incinerator during the lease term. The City, however, had the option to purchase the incinerator at its appraised value at the end of the lease term. The Court found that the arrangement did not fall within the requirements of Section 18 because the lease payments represented the fair rental value for use of the incinerator, the option to purchase represented the value of the incinerator, and the City was not compelled to exercise its option to purchase the incinerator. As a result, the agreement did not encumber future revenues and was not debt within the meaning of Section 18.

In *Dean v. Kuchel*, the California Supreme Court approved a financing plan similar to the *Offner* lease. The agreement was distinguishable, however, because title to the land and improvements automatically vested in the State at the end of the lease term without any additional payment. The Court found that the automatic vesting provision was a distinction without difference. The Court explained that the “determinative inquiry for purposes of the Constitution is not the extent to which the agreement resembles an installment purchase contract, but whether the payments in future years are contingent [such that] liability for each installment of the purchase price was contingent on receipt of some additional, contemporaneous consideration.” Subsequently, the Court has applied the *Offner-Dean* exception where the parties sign a lease with an option to buy. The lease, however, cannot contain an acceleration clause rendering rent payments due at any one time.

The Court provided further guidance for structuring lease-purchase agreements in *County of Sacramento v. Assessment Appeals Board*, a tax case where the Court examined whether an agreement for data processing equipment was a sale or lease. The Court examined the specific terms of the agreement to determine whether “every separate payment is supported by its own consideration and is not simply an aliquot part of total indebtedness, and that such separate payment falls within the budgetary allotment for that year or budgetary period.” Although the issue before the Court related to the tax treatment of the equipment, the Court has since cited the *County of Sacramento* analysis in deciding whether an agreement falls within the limits of Section 18.

Finally, in *Rider v. City of San Diego*, the California Supreme Court recently affirmed early case law regarding lease-purchase agreements. The Court cited with approval the *Offner* and *Dean* decisions to uphold “multiyear contracts in which the local government agrees to pay in each successive year for land, goods, or services provided during that year.”

B) How Section 18 Affects Municipal Leases

As the above cases suggest, not all lease contracts will satisfy the *Offner-Dean* requirements. For a lease to be valid, the Court must find that the agreement obligates current revenues and the payments in future years are contingent on receipt of some additional,
contemporaneous consideration. On the other hand, if the court finds “the installment payments are to be made over a period of years and are to be paid out of the ordinary revenue and income of a city, where each installment is not in payment of the consideration furnished that year, and the total amount of said installments when coupled with the other expenditures exceeds the yearly income, [the agreement is] violative of the constitutional provision in question unless approved by a popular vote.”36 Basically, the lease cannot be a conditional or installment sales agreement disguised as a lease.

When the Court determines that the agreement is a conditional sale rather than a lease agreement, thus violating the constitutional debt limit, the contract is void.37 The Court is willing to enforce such harsh consequences because “all are presumed to know the law, and . . . whoever deals with a municipality is bound to know the extent of its powers. Those who contract with it, or furnish it supplies, do so with reference to the law, and must see that [the debt limit] is not exceeded.”38 Therefore, local governments and private parties must structure their transactions with the requirements of Section 18 in mind.

III. Checklist

The following provides a checklist of the most critical issues a court will consider in determining whether or not an agreement constitutes a valid lease or a conditional sales agreement that violates Section 18. Additionally, sample language taken from various municipal lease agreements follows each provision.

In most cases, none of these issues will be solely determinative. A court generally will look at the transaction in its totality.

A) Provisions That Weigh In Favor of a Lease Agreement

The Court has found one or some combination of the following provisions conclusive in exempting a transaction from Section 18 requirements.

1) Budget and Appropriation: Rental payments are a separate annual obligation, with the payments due after the period when the City adopts its budget.39

Example: Section X1. Budget and Appropriation. Lessee shall take such action as may be necessary to include all lease purchase payments in its annual budget and annually to appropriate an amount necessary to make such lease purchase payments. During the term of this Lease, Lessee will furnish to the Lessor, if so requested, copies of each proposed budget of Lessee within thirty (30) days after it is filed and of each final budget of the Lessee within thirty (30) days after it is printed.

Section X2. Current Expense. Lessor and Lessee understand and intend that the obligation of Lessee to pay lease purchase payments hereunder shall constitute a current expense of Lessee and shall not in any way be construed to be a debt of Lessee in contravention of any applicable constitutional or statutory limitations.
or requirements concerning the creation of indebtedness by Lessee, nor shall anything contained herein constitute a pledge of the general tax revenues, funds or monies of Lessee.

2) **Non Appropriation:** Payments are contingent upon appropriations. Such a provision (like the one described in item 5, below) has the effect of reducing the term of the obligation to one year.

*Example:* In the event sufficient funds are not appropriated for the payment of all rental payments required to be paid in the next succeeding Renewal Term, the Lessee may terminate the Agreement at the end of the Original Term or the then current Renewal Term, as the case may be, and Lessee shall not be obligated to make payments provided for in this Agreement beyond the then current term. Lessee agrees to give notice to Lessor of such termination at least sixty (60) days prior to the end of the then current term or, if non-appropriation has not occurred by that date, promptly upon the occurrence of non-appropriation. If this Agreement is terminated under this sub-part, Lessee agrees, at Lessee’s sole cost and expense, peaceably to deliver the Equipment to Lessor at such location as is specified by Lessor, in the condition required by this Agreement, on or before the effective date of termination.

3) **Payment in Arrears:** Each payment is supported by its own consideration.

*Example:* The Lessee shall pay to the Lessor as rent, semiannually, the rental payments in accordance with the rental payment schedule attached hereto as Exhibit B and made part hereof. Each rental payment shall be payable in arrears on the business day immediately preceding its due date. Each semiannual payment of rent during each rental payment period shall be in consideration for the use and possession of the Property for the six-month period preceding the due date of such payment.

4) **Abatement:** Lessor will abate payments in the event that the Lessee loses its use of the leased property. Lessors of equipment will rarely accept such a provision. Most will, however, accept a non-appropriation clause (see item 2, above).

*Example:* During any period in which, by reason of material damage or destruction, there is substantial interference with the use and right of possession by Lessee of the Property or any substantial portion thereof, rental payments due hereunder shall be abated. The amount of abatement shall be such that the resulting rental payments represent fair consideration for the use and possession of usable portions of the Property that are not damaged or destroyed. Such abatement shall continue through the period commencing with the date of such damage or destruction and ending with the substantial completion of the work of repair or replacement of the Property or portions thereof. In the event of any such damage or destruction, this Agreement shall continue in full force and effect.
5) **Cancellation:** The Lessee may unilaterally cancel the agreement according to the agreement’s terms.\(^42\)

*Example:* The Lessee may unilaterally cancel the agreement as of any anniversary date of its signing, upon sixty (60) days’ prior notice. No penalty is imposed upon the Lessee if it chooses to cancel the agreement.

6) **Penalties:** The agreement does not impose a penalty on the Lessee if the Lessee chooses to terminate the agreement.\(^43\)

*Example:* Lessor shall not under any circumstances have the right to accelerate the rental payments that fall due in future rental periods or otherwise declare any rental payments not then in default to be immediately due and payable.

7) **Title:** Title remains with the Lessor.\(^44\)

*Example:* Title to equipment, accessories and devices rented under this contract shall remain with the Lessor. All devices and accessories furnished by the Lessor except those purchased by the Lessee, shall accompany the equipment when returned to the Lessor.

8) **Equipment Return:** If the Lessee does not exercise its purchase option, the Lessee returns the equipment to the Lessor on termination of the agreement and the Lessor may hold the Lessee responsible for returning the equipment.\(^45\)

*Example:* Upon termination of Agreement, Lessee at Lessee’s risk and expense shall promptly return the equipment to Lessor in the manner and in the condition set forth in this Agreement at such location as specified by Lessor.

9) **Loss and Damage:** Lessee is relieved of all risks of loss or damage to the equipment, except when due to the Lessee’s fault or negligence.\(^46\) At the very least, Lessee’s exposure should be limited to the proceeds of insurance (other than self-insurance).

*Example:* Except for its own fault or negligence, the Lessee is relieved of all risks of loss or damage to the equipment during periods of transportation, installation and during the entire time the equipment is in the possession of the Lessee.

10) **Maintenance:** Lessee will keep the equipment in good condition and will respond to maintenance needs.\(^47\)

*Example:* Lessee, at its own cost and expense, shall furnish necessary labor and materials to maintain the Property in good repair, condition, and working order. Lessee’s obligations to maintain the Property does not relieve the Lessor of its responsibility to fully perform with respect to all applicable Property warranties and guarantees.
B) Provisions That Weigh In Favor of a Sales Agreement

Cities should carefully consider the following provisions that may result in a sales contract rather than a lease agreement and would, therefore, violate the Section 18 requirements if the repayment period extended beyond the fiscal year.

1) **Cash Outlay:** When the agreement requires a down payment or other major cash outlay at the beginning of the lease term, the Court may find the transaction creates an economic compulsion to make future payments and purchase the item to prevent losing the down payment.  

   Example: Security Deposit. Concurrently with Lessee’s delivery of this Lease, Lessee shall deposit with Lessor the sum stated in the Basic Lease Provisions, to be held by Lessor as security for the full and faithful performance of Lessee’s obligations under this Lease (the “Security Deposit”). Upon any Default by Lessee, including specifically Lessee’s failure to pay rent or to abide by its obligations under this Agreement, whether or not Lessor is informed of or has knowledge of the Default, the Security Deposit shall be deemed to be automatically and immediately applied, without waiver of any rights Lessor may have under this Lease or at law or in equity as a result of the Default, as a setoff for full or partial compensation for that Default. If any portion of the Security Deposit is applied after a Default by Lessee, Lessee shall within five (5) days after written demand by Lessor deposit cash with Lessor in an amount sufficient to restore the Security Deposit to its original amount. Lessor shall not be required to keep this Security Deposit separate from its general funds, and Lessee shall not be entitled to interest on the Security Deposit. The Security Deposit shall be returned to Lessee (or, at Lessor’s option, to the last assignee of Lessee’s interest in this Lease) within sixty (60) days after the expiration of the Term, provided that Lessor may, in its reasonable discretion, retain all or a portion of the Security Deposit to the extent and until such time as all amounts due from Lessee in accordance with this Lease have been determined and paid in full, with any balance of the Security Deposit being returned to Lessee within sixty (60) days after the expiration of the Term.

2) **“Hell or Highwater” Lease:** The agreement requires Lessee, under any circumstance, to continue payments for the entire lease term.

   Example: Net Lease. This Lease is a net lease and Lessee agrees that its obligation to pay all rent and other sums payable under this Lease are absolute and unconditional and shall not be subject to any abatement, reduction, setoff, defense, counterclaim or recoupment for any reason whatsoever.

3) **Acceleration Clause:** Balance becomes due immediately on default.  

   Example: Remedies on Default. Upon the occurrence of an event of default, Lessor shall have the right at its sole option, by written notice to Lessee, to
declare all payments and other amounts payable by Lessee hereunder to the end of the then current Original Term or Renewal Term to be due.

C) Other Considerations

The following provisions further support a valid lease agreement rather than a sales contract.

1) Fair Rental Value: Payments by Lessee represent the fair rental value of the Property.\(^{50}\) Requiring lease payments that are far in excess of fair rental value is a frequently used tactic to disguise a sales agreement as a lease. This is especially likely when the lease term is short and the lessee becomes the owner at the end of the lease term on the payment of a nominal value. It is sometimes necessary to obtain an economic analysis to determine a fair rental value. Including a clause such as that listed below will not be persuasive if it is only self-serving and not factually correct.

Example: The rent payments under this Agreement for each Fiscal Year or portion thereof during the term of this Agreement shall constitute the total rental for such Fiscal Year or portion thereof and shall be paid by the Lessee for and in consideration of the right of use and occupancy, and the continued quiet use and enjoyment, of the Property by the Lessee for and during such Fiscal Year or portion thereof. The Lessor and the Lessee have agreed and determined that such total rental is not in excess of the total fair rental value of the Property. In making such determination, consideration has been given to the costs of acquisition and financing of the Property, the uses and purposes served by the Property and the benefits therefrom that will accrue to the parties by reason of this Agreement and to the general public by reason of Lessee’s use of the Property.

2) Purchase Option: Lessee may elect to purchase the property or equipment with credits given for paid rentals.\(^{51}\) Nevertheless, the Lessee should not pay less than the value of property.\(^{52}\) As discussed above, this would imply that a portion of the rental payments were actually installment sales payments.

Example: Provided that Lessee is not then in default under this Agreement, this Agreement will terminate and the Lessee will acquire title to the Property free and clear of all liens and encumbrances created by or arising through or under, Lessor: (a) at the end of the Full Lease Term, upon payment in full of all rental payments and other amounts payable by Lessee hereunder for the Full Lease Term; or (b) on any rental payment due date, upon payment by Lessee of the then applicable prepayment amount as set forth on the Schedule plus the rental payment due on such date and all other amounts then due by Lessee hereunder, provided Lessee shall have given Lessor no less than thirty (30) days’ prior notice of its intent to make such payment.
IV. Conclusion

Local governments frequently enter agreements to purchase property, equipment and services. If the lessee or purchaser is a city, a valid contract requires compliance with section 18 of article XVI of the California Constitution. The above discussion highlights which contract terms require scrutiny to avoid violating debt limits and consequentially invalidating the contract.

1 CAL. CONST. art. XVI, § 18 (emphasis added).
3 City of Palm Springs v. Ringwald, 52 Cal. 2d 620, 627 (1959).
6 See Rider v. City of San Diego, 18 Cal. 4th 1035, 1046 (1998) (“[T]he willingness of the courts to recognize and perpetuate these exceptions reflects ‘a concern for economic development and a perception that the debt limit [i]s too rigid and restrictive for the needs of a modern, urbanized population.’”) (citations omitted).
7 It is important to note that other voter approval requirements may be applicable to a local government’s financing arrangement. Those requirements are beyond the scope of this discussion. For example, the voter approval requirements under the various initiatives spawned by anti-tax advocate, Howard Jarvis, still must be considered when assessing whether voter approval is required.
8 See Rider, 18 Cal. 4th at 1046 (citing San Francisco S. Co. v. Contra Costa Co., 207 Cal. 1 (1929)).
9 See City of Redondo Beach v. Taxpayers, Property Owners, Citizens and Electors, 54 Cal. 2d 126, 131-32 (1960) (citing City of Oxnard v. Dale, 45 Cal. 2d 729 (1955)).
11 See City of Redondo Beach, 54 Cal. 2d at 132 (citing City of Palm Springs v. Ringwald, 52 Cal. 2d 620 (1959) for the proposition that “sales and use taxes may not be diverted from petitioner’s general funds” under the doctrine).
12 Shelton v. City of Los Angeles, 206 C 544 (1929).
13 See e.g., Rider, 18 Cal. 4th at 1046.
14 See Rider, 18 Cal. 4th at 1046; 67 Op. Cal. Att’y. Gen. 349, 353 (1984); see also City of Long Beach v. Lisenby, 180 Cal. 52 (1919) (exempting payment of tort damages); County of Los Angeles v. Byram, 36 Cal. 2d 694 (1951) (finding “the duty of providing adequate quarters for courts is mandatory” and therefore, the contract for construction of a court building was exempt).
16 See McBean v. City of Fresno, 112 Cal. 159 (1896) (applying California Constitution article XI, section 18, which is the predecessor to article XVI section 18).
17 See Doland v. Clark, 143 Cal. 176 (1904).
18 See Rider, 18 Cal. 4th at 1047.
19 19 Cal. 2d 483 (1942).
20 See Offner, 19 Cal. 2d at 484.
21 See id.
22 See id. at 485.
23 See id.
24 See id.
25 See id.
26 35 Cal. 2d 444 (1950).
27 See Dean, 35 Cal. 2d at 447–48 (applying article XVI, section 1 which is an analogous debt limit that restricts state spending in the same manner that section 18 restricts local government spending).
30 See id.
31 32 Cal. App. 3d 654 (1973) (applying article XVI, section 1 which is an analogous debt limit that restricts state spending in the same manner that section 18 restricts local government spending).
32 County of Sacramento, 32 Cal. App. 3d at 668.
35 Id. at 1047.
36 See Dean v. Kuchel, 35 Cal. 2d 444, 447 (1950) (citations omitted) (emphasis theirs).
40 See id.
41 See Rider v. City of San Diego, 18 Cal. 4th 1035, 1049 (1998).
42 See County of Sacramento, 32 Cal. App. 3d at 669.
43 See id.
44 See id.
45 See id.
46 See id.
47 See id.
48 See Garret v. Swanton, 216 Cal. 220, 233 (1932) (overruled by Oxnard v. Dale, 45 Cal. 2d 729 (1955) on other grounds) (“After a large cash payment has been made out of the general funds, if the special fund is not sufficient to pay the installments, and a failure will result in losing the cash payment . . . , as a practical matter the installments will have to be paid from the general fund in order to protect the investment already made.”).
50 See City of Los Angeles v. Offner, 19 Cal. 2d 483, 487 (1942) (reasoning that the transaction does not violate the debt limit because, among other reasons, “the rental payments are intended to represent the fair rental value”); Rider, 18 Cal. 4th at 1047 (approving of the Court’s reasoning in Offner).
51 County of Sacramento, 32 Cal. App. 3d at 668.
52 See Offner, 19 Cal. 2d at 487 (reasoning that the transaction does not violate the debt limit because, among other reasons, “in no event is the city to have the right to purchase the incinerator at less than its fair appraised value at the time it elects to purchase”); Rider, 18 Cal. 4th at 1047 (approving of the Court’s reasoning in Offner).