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# Los Angeles Lawyer

September 2012 / \$4

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# It Ain't Me

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**Professor Marisa Cianciarulo** is a specialist in clinical teaching and immigration law with a human rights focus. She is the director of Chapman's Family Violence Clinic, which launched in 2007 to address family violence issues among Orange County's immigrant community. Professor Cianciarulo taught in the Villanova Clinic for Asylum, Refugee and Emigrant Services for three years prior to joining the faculty at Chapman. She previously served as a Staff Attorney with the American Bar Association's Commission on Immigration in Washington, D.C., was a partner in a law firm specializing in immigration matters, and served as interim legal director of a non-profit immigration services provider in Arlington, Virginia. She received her B.A. from the Catholic University of America, her J.D. from American University Washington College of Law, and her M.A. from American University School of International Service. She teaches Civil Procedure, the Family Violence Clinic, Gender & the Law, and Refugee Law, publishing on the intersection of gender and immigration with an emphasis on vulnerable immigrant populations. She is also the director of Chapman's Global Project for LGBTQ Rights and Feminism, created in 2010 to address the complex questions evoked by feminist theory and LGBTQ rights.



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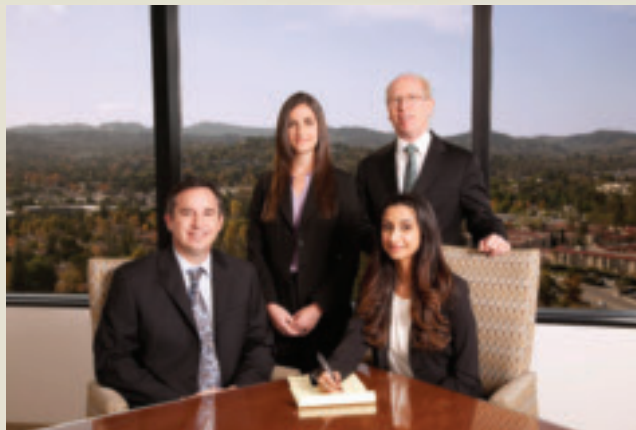
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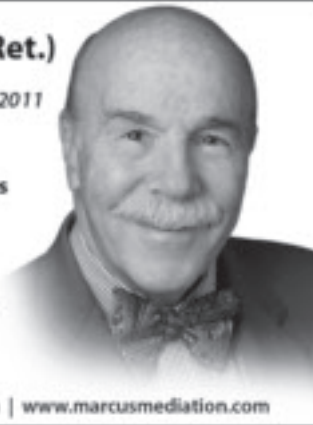
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## FROM THE CHAIR

**B**Y THE TIME YOU READ this column, summer will be behind us, and if you have children, they will be back in school. However, since I am writing this at the height of summer I would like to share my thoughts on summer vacations.

As lawyers, we have a million reasons for never taking vacations—trial preparation, transaction closings, billable hours, and any number of client demands. As I have grown older, I hope I have become wiser and, hopefully, my vacation schedule reflects this. After employment with the federal government, I joined a firm that had a very flexible vacation policy. Although I could have taken as much vacation as was reasonable, I limited myself to one week per year for at least a decade. Finally, after much discussion, my wife convinced me that since we had young children, 10 days was more appropriate. My wife was right, so we began taking longer vacations.

Why should we take vacations? Well, it is common knowledge that the practice of law is ranked among the most stressful jobs. Our jobs involve deadlines for many cases, telephone calls, client meetings, travel, and an endless number of related activities. Those of us in litigation practice also have to answer to the court. If this were not enough, we are connected to our practices 24/7 through Blackberrys, iPads, iPhones, and the like.

There have been many studies on the benefits of vacations, the most significant of which was probably the 1992 Framingham Heart Study involving 12,000 men who were at risk of heart disease and who were followed over nine years. One conclusion drawn from the data was that the more frequently the men took vacations, the longer they lived. In other words, the participants who took the fewest holidays were most likely to suffer a heart attack.

Studies have also shown that persons who go on vacation allow their creativity to be renewed. As lawyers, creativity is one of the most important components of problem solving. A good vacation can help us reconnect with ourselves and afford us the opportunity to read a good book and have new and different experiences. It is easy to see that a lawyer who spends every day in the office running from one project to another may not take the time or have the energy to think through problems as thoroughly as someone who has had the opportunity to leave the pressures of the office for a while and return refreshed, energetic, and recharged.

Vacations have the effect of strengthening relationships with family and friends. Although family vacations can create their own stresses, there is no question that the quality time that parents spend with their children, their spouses, or significant others strengthens the bonds among them. The vacation memories we retain are ours for a lifetime. I believe vacations are especially important for parents who have children. It is a truism that when you get older, you will never ask yourself whether you could have worked harder in your practice, but you will ask yourself whether you could have spent more time with your children.

It is common among lawyers to say that you pay for your vacations before you leave and after you return, but we should not let this keep us from taking the vacations we need. The health and psychological benefits from taking time off are well documented. We owe it to ourselves, our families, our friends, and our clients to recharge our batteries so we can maintain the balance in our lives that makes us good human beings—as well as effective lawyers. ■

Dennis L. Perez is a principal in Hochman, Salkin, Rettig, Toscher & Perez, PC. He is the 2012-13 chair of the Los Angeles Lawyer Editorial Board.

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## Nonlegal Considerations in Client Relations

**AN IMPORTANT ASPECT OF PROFESSIONAL GROWTH** involves developing an ability to recognize and incorporate nonlegal considerations into the fabric of a legal situation. In law school, a standard exercise for students is to apply the law or legal principle to a problem. In legal practice, however, new attorneys must learn that being a lawyer often involves a number of factors that depend on not only the law but also the circumstances of the problem. Attorneys do not just apply a legal principle to a problem but also try to do so in the greater landscape of nonlegal considerations. What are the consequences and benefits of any given course of action? What does the client want? What are the time and money limitations? Even for the most junior attorneys, these aspects color how to represent a client.

A primary nonlegal factor in any given situation is the cost-benefit analysis. There are consequences and benefits that affect the practical options of the given situation. Minimal consequences may require a minimal legal approach. For example, an ideal sales contract may be a dozen pages, addressing every issue that may arise in the contract relationship. However, if the amount of the sale and the consequences of a breach are small, a three-page agreement may be the better approach, even if it leaves some issues open. Similarly, if a course of action will result in little benefit, it may be appropriate to abandon that course, even if strictly legal considerations would dictate otherwise. For example, a claim may justify a large judgment, but such judgment is of little value if the client cannot collect on the judgment, and it may not be worth the time and effort to pursue. The nonlegal consequences and benefits of the situation may influence practical possibilities of how it will or should be handled.

### Nonlegal Factors

The priorities and proclivities of each client are an additional set of nonlegal factors in the practice of law. An attorney needs to understand what the client wants. The practice of law is a service industry, and to a certain extent a client's goals dictate the lawyer's objective. For example, one client may have a strong cause of action but does not want to spend the time or energy taking on a lawsuit. A different client may put a premium on addressing a problem quickly or quietly. Another client may be willing to undertake expense—even if it is not legally required or warranted—to maintain a good relationship with a potential defendant. Part of a lawyer's role is to consider these nonlegal goals and priorities.

In addition to understanding what the client wants, a lawyer needs to grasp who the client is. To practice law is to work with people, and understanding human nature and personalities is a crucial part of being an attorney. A client may want detailed updates and formal communications or only the broad strokes in casual phone calls. The client may be cavalier or very risk averse. An attorney needs to

factor these considerations into the relationship with the client. Identifying and addressing this variable facilitates the growth of a relationship with a client, which ultimately improves the lawyer's ability to assist the client as an attorney.

Finally, external constraints such as time and money are an unavoidable limitation on the practice of law. A thorough response to a legal question may require a few days of research, but if a client needs an answer in a few hours, the associate needs to act within those constraints. Even if there is more time, a client may only be willing to pay for a certain amount of legal research. When practicing law,

**Lawyers must inform and advise clients regarding the law, regardless of the consequences or the client's goals, and must try to protect a client's interests, despite the constraints of time and money.**

an attorney must deal with these temporal and economic constrictions.

Adding complexity to the interaction is that legal concerns and nonlegal ones, as well as more than one nonlegal concern, can be in conflict. A client may want to resolve an issue on friendly terms but may not want to accept the risks that resolution entails. A client may be litigious but also be vehemently against undertaking the expense of pursuing a claim. A lawyer must help the client navigate through these conflicts, identifying the priorities, tempering the personal elements, and ultimately helping the client reach a conclusion that is tenable from legal and nonlegal perspectives.

Perhaps the most difficult part is balancing the above with the constraints of the law and the responsibilities inherent in the role of attorney. Lawyers must inform and advise clients regarding the law, regardless of the consequences or the client's goals, and must try to protect a client's interests, despite the constraints of time and money. A client may be loathe to draw up a long legal contract, but the risks of having an abbreviated contract may be too risky to be legally sound. A client may want a project done quickly, but doing so may result in legal perils that the client must understand. Lawyers must apply the law—and the lawyer's legal training and experience—amid nonlegal complications. The nonlegal elements of a situation influence how it should be addressed but do not completely overtake the constructs of the law and the lawyer's responsibility to the client. Maturing as a lawyer requires learning to recognize and balance the many competing aspects weighing upon and influencing a lawyer's practice. ■

**Alison M. Pear is a transactional attorney specializing in securities and mergers and acquisitions at TroyGould PC in Century City.**

## Applying the California Translation Act to Consumer Agreements

**WITH OVER 37 MILLION RESIDENTS,**<sup>1</sup> California leads the nation in many population categories, and the use of foreign languages at home and in commerce is no exception. According to the 2010 U.S. census, 43 percent of Californians aged five and above converse either “sometimes” or “always” in a language other than English while in the home.<sup>2</sup> This percentage—which equates to almost 16 million Californians—is by far the highest percentage of non-English speakers for any state in the union, and it is more than two times the national average.<sup>3</sup>

A sizeable percentage of the consumer transactions that take place each day in California in which both parties are speaking a language other than English are governed by a California consumer protection law that enables parties to void certain transactions, unless a translation of the contract in the party’s native language was provided at the time of the deal. (For example, if a party negotiates a deal in Chinese but signs a standard consumer contract in English, the deal may be void.) The California Translation Act (CTA), codified at Civil Code Section 1632, governs transactions effected in the five most common non-English languages spoken in California: Spanish, Chinese, Tagalog, Vietnamese, and Korean.<sup>4</sup> Generally, for contracts negotiated in any of these five languages, the CTA requires a translation (from English into one of the five languages) of certain types of written agreements (including attorney’s fee agreements) to be provided to the consumer or client before the contract is executed.<sup>5</sup>

Although this law generally has been on the books since 1976, its impact on the legal landscape has not been widely felt. Very few California appellate decisions have been reported, although a small number of federal trial court decisions have dealt with the statute.<sup>6</sup> Legal counsel for consumers as well as those providing consumer goods and services would do well to take heed of this statute’s extensive reach, detailed requirements, and significant remedies.

### Purpose and Coverage

The widespread proliferation of unfair business practices and scams pertaining to residential leases, auto sales and leasing, personal loans, and, more recently, home loan modifications and foreclosures has caused concern particularly in cases in which non-English speakers are involved. To address such concerns, the California Legislature enacted the CTA to protect California consumers who speak languages other than English.<sup>7</sup> The statute was originally enacted for the benefit of the large Spanish-speaking population of California but has been expanded to include the “top five languages other than English most widely spoken by Californians in their homes,” as determined by the U.S. Census of 2000.<sup>8</sup> Thus, the CTA addresses concerns about fraud and unfair dealing in consumer transactions involving 43 percent of the Californians who speak a language other than English at home.<sup>9</sup>

The CTA applies to certain designated consumer transactions in which the non-English speaker is deemed to be particularly vulnerable to unfair business practices.<sup>10</sup> The law’s coverage is broad. Included within the statute’s reach are numerous transactions relat-



ing to people’s automobiles, homes, rental units, and financial relationships. For example, regarding automobiles, Section 1632 applies to credit sale contracts involving consumer goods and services under the Credit Sales Law,<sup>11</sup> the Automobile Sales Finance Act,<sup>12</sup> and the Vehicle Leasing Act.<sup>13</sup> Regarding housing, the CTA applies to loans or other extensions of credit used primarily for personal, family, or household purposes, provided the loans are not secured by real property.<sup>14</sup> The CTA also applies to residential tenancies, specifically a “lease, sublease, rental contract or agreement, for a period of longer than one month, covering a dwelling, apartment, or mobilehome, or other dwelling unit normally occupied as a residence.”<sup>15</sup>

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Although the CTA generally excludes real property-secured loans, these loans will be covered by the statute if they are negotiated by a real estate broker and if they are primarily for personal, family or household purposes.<sup>16</sup> Further, under Section 1632(b)(4), lenders who are subject to the Industrial Loan Law or the California Finance Lenders Law are also subject to the CTA's requirements.<sup>17</sup> These can include home mortgage loans, home equity loans, business loans secured by residences, secured guarantees (to the extent that the guarantee is an extension of credit), refinance loans, and residential mortgage loan modification fee agreements.<sup>18</sup>

Retainer agreements for legal services are also subject to the CTA.<sup>19</sup> Lawyers who negotiate retention agreements primarily in Spanish, Chinese, Tagalog, Vietnamese, or Korean are required to provide a translation of the retainer agreement to the client before the client signs it.<sup>20</sup> Recently, in light of concerns regarding the increasing number of "advance fee" scams by lawyers whose homeowner clients are desperately seeking to modify their home loans, the CTA has been extended to cover residential mortgage loan modification fee agreements, even if the provider is not a real estate broker.<sup>21</sup> Civil Code Section 2944.6 covers "any person" who engages in these services and applies to mortgages and deeds of trust secured by residential real property containing four or fewer dwelling units.<sup>22</sup> Thus, attorneys who provide the applicable loan modification services in one of the five CTA languages must comply with the requirements of both Sections 1632 and 2944.6(a), including a translation of the required written disclosure provided for in Section 2944.6.<sup>23</sup>

The CTA also applies to foreclosure consulting contracts as well as contracts involving reverse mortgages.<sup>24</sup> The definition of foreclosure consulting contracts has been expanded to include agreements to arrange or attempt to arrange "an audit of any obligation secured by a lien on a residence in foreclosure."<sup>25</sup> The CTA does not apply to home improvement contracts<sup>26</sup> or to any seller who is not engaged in a trade or business.<sup>27</sup>

### Translation Requirements

For businesses and persons engaged in business who are covered by the CTA, the basic requirement is to "deliver to the other party... prior to the execution thereof, a translation of the contract or agreement in the language in which the contract or agreement was negotiated, which includes a translation of every term and condition in that contract or agreement."<sup>28</sup> Failure to comply with this requirement may have drastic consequences.

The obligation to provide a written trans-

lation does not apply, however, if the consumer negotiates through his or her own interpreter.<sup>29</sup> This seems to be based on an assumption that a consumer who has brought an interpreter to a negotiation does not need the CTA's protection. No exclusion, however, exists for bilingual consumers. A borrower who is quite fluent in English but who negotiates entirely in one of the designated languages does not qualify as an interpreter and must be provided a translation of the contract.<sup>30</sup> The consumer's fluency in English is irrelevant.<sup>31</sup> Even if the consumer has written a doctoral thesis in English, the CTA still requires a written translation to be provided to the consumer as long as the transaction is negotiated in one of the five designated languages.<sup>32</sup>

Occasionally, it is difficult to translate certain English terms precisely into another language, or sometimes the translated version of the contract is just plain wrong. In cases in which a discrepancy exists between the English and translated versions of the contract, the CTA holds that the English-language version controls and determines the rights and obligations of the parties.<sup>33</sup> However, the aggrieved party may cite to the discrepancy as admissible evidence to show that the material terms and conditions of the contract were so substantially different that no contract was formed between the parties.<sup>34</sup>

In addition to handing the consumer a translation of the contract, the CTA requires notices to be posted on most business premises where such contracts are ordinarily negotiated.<sup>35</sup> Business owners who negotiate transactions in one of the five CTA languages must post the required notices in a conspicuous place where the contract is negotiated or executed.<sup>36</sup> The notice must state that the company or person who is subject to the CTA "is required to provide a contract or agreement in the language in which the contract or agreement was negotiated, or a translation of the disclosures required by law in the language in which the contract or agreement was negotiated, as the case may be."<sup>37</sup> If the person subject to the CTA does business at more than one location or branch, the notice must be posted only at the location or branch where the foreign language is used.<sup>38</sup>

The notice requirement for residential leases is slightly different, since such contracts are often prepared and executed at the premises being leased. Thus, no posting of the CTA-mandated notice is required for these leases. The required notice of rights and obligations is to be given to the lessee or tenant at the "time and place where a lease, sublease, or rental contract or agreement" is executed.<sup>39</sup> Other exceptions to the posting rule apply. No separate notice is required to be posted or

handed to the consumer by "providers of legal services or those who make or arrange loans secured by real property."<sup>40</sup>

### Effect of Noncompliance

Noncompliance with the CTA implicates consumer rights and remedies as well as administrative and governmental actions. Regarding consumer rights and remedies, the statute is clear. Upon a violation of the CTA, "the person aggrieved may rescind the contract or agreement."<sup>41</sup> Consumers have an absolute right to rescind contracts based on the other party's failure to provide a translation of the contract. Rescission is a powerful remedy. "[T]he very purpose of rescission is to restore the parties to the position they would have been in had they not entered the contract."<sup>42</sup> Although the aggrieved party is required to provide restoration to the breaching party,<sup>43</sup> in many cases under the CTA the consumer will stand to reap a windfall. Thus, a consumer who seeks to end a residential tenancy, release possession of a financed automobile, or return rental equipment or furniture will likely be freed from any onerous provisions of the governing written contracts, since the terms of the rescinded contracts will be of no legal consequence.<sup>44</sup> Even a party in default of contractual obligations is entitled to rescind, as its contractual obligations will be expunged by the rescission.<sup>45</sup> Moreover, rescission claims can coexist with separate claims to recover consequential damages arising out of the failed transaction.<sup>46</sup>

In addition to the contracting party's remedies, administrative authorities and the attorney general may impose penalties on a person who violates the CTA. For example, Section 1632.5 states that a licensing authority may impose administrative penalties against a supervised financial organization of up to \$2,500 for the first violation, \$5,000 for the second violation, and \$10,000 for each subsequent violation.<sup>47</sup> Any violation of the CTA by a supervised financial organization is also a violation of the lender's licensing law.<sup>48</sup> In addition, the law authorizes a licensing agency to administer and enforce Civil Code Section 1632.5 through other options, including by investigating and examining the licensee's books and records, and to pursue any combination of civil, criminal, and administrative authority and remedies available to it pursuant to its licensing law.<sup>49</sup> The attorney general may also bring an action to enforce the provisions of the CTA.<sup>50</sup>

Finally, if a person violates the CTA through Section 2944.6 with respect to loan modification fee agreements, it is considered a public offense, and that person can be imprisoned for a period of not less than one year, fined up to \$10,000 per violation, or



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Language rights issues have also involved claims under the Civil Rights Act of 1964 prohibiting discrimination in housing, employment, and federally funded programs.<sup>63</sup> Title VI of the Civil Rights Act of 1964 bans discrimination based "on the ground of race, color, or national origin," in "any program or activity receiving Federal financial assistance."<sup>64</sup> The seminal U.S. Supreme Court case in this area is *Lau v. Nichols*,<sup>65</sup> which deals with the language rights of non-English speaking students.

In *Lau*, the San Francisco United School District's local regulations and guidelines prevented non-English speaking Chinese students from receiving special English language instruction.<sup>66</sup> The Supreme Court found that the school system's regulations and guidelines discriminated against these students by denying them a meaningful opportunity to participate in the public educational program, in violation of Title VI of the Civil Rights Act of 1964.<sup>67</sup> The case did not, however, address the petitioners' claim under the equal protection clause.<sup>68</sup>

The Supreme Court later ruled that Title VI reaches only instances of intentional discrimination.<sup>69</sup> Contrary to the cases involving language rights that focus on English-only laws or regulations, however, the CTA attempts to provide protection and information to a wider number of California consumers by requiring translation of certain contracts into the five most prevalent non-English languages. Although one can argue that the CTA does not go far enough—it could require translation into any language in which a transaction is negotiated—this argument does not rise to the level of a constitutional violation. The legislature is entitled to consider the cost-effectiveness of an any-language requirement to businesses. For example, it would not make much business sense to pay for the cost of translating a document into a language spoken by only a very few of the customers of a certain business. Thus, given that the CTA does not intentionally discriminate against non-English speakers outside the five designated languages in that statute, Title VI of the Civil Rights Act of 1964 would not apply, and the CTA would most likely be deemed constitutional.

With millions of Californians conducting business in languages other than English, the CTA is likely applicable to large numbers of written agreements executed each day. Yet, despite its broad reach, detailed requirements, and strong remedies, the CTA seems to wield relatively little influence over the daily lives of non-English speaking Californians and the businesses that cater to them. Consumers, business owners, and their legal counsel should keep this often-overlooked statute in

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both.<sup>51</sup> If a business entity violates this section, it can be fined up to \$50,000 per violation.<sup>52</sup> Moreover, “[t]hese penalties are cumulative to any other remedies or penalties provided by law.”<sup>53</sup>

### Constitutionality of the CTA

At first glance, the fact that the CTA covers only five languages out of the dozens spoken in California may raise a question about the act’s constitutionality. For example, a Japanese-speaking Californian may argue that the CTA violates the equal protection clause because the statute does not include Japanese as one of the designated languages. Analysis, however, shows that in this respect the CTA would most likely pass constitutional muster.

Rights involving non-English speakers in the United States have focused on preventing discrimination based on the disadvantages associated with the inability to communicate and understand fully, which tends to inhibit the full exercise of rights.<sup>54</sup> Constitutional disputes involving language rights generally have been based on the suspect classification of national origin under the equal protection clause of the Fourteenth Amendment.<sup>55</sup>

The equal protection clause guarantees that no “State shall...deny to any person within its jurisdiction the equal protection of the laws.”<sup>56</sup> The level of scrutiny applied to an equal protection claim depends on whether a suspect class or a fundamental right is implicated.<sup>57</sup> If so, strict scrutiny is used, and the government must establish a compelling justification for its action.<sup>58</sup> If not, the governmental action need only be rationally related to a legitimate purpose.<sup>59</sup>

Although national origin is a suspect classification, several cases under the equal protection analysis have found that language is not the equivalent of national origin, and therefore strict scrutiny would not apply.<sup>60</sup> “As long as a municipal policy or practice distinguishes among people for reasons other than race, ethnicity, national origin, or gender and does not burden the enjoyment of a fundamental right, it will be upheld against an equal protection challenge if it is rationally related to a legitimate governmental interest.”<sup>61</sup> “And while it might be a laudable goal for cities to provide interpreters for all language groups in the provision of all services, the practical ability to meet that goal in a diverse nation in an era of limited public funds may be doubted. Nor ought the equal protection clause dictate budget priorities by elevating language services over all other competing needs.”<sup>62</sup> Consequently, the CTA would probably be found to be rationally related to a governmental interest and therefore constitutional under the equal protection clause of the



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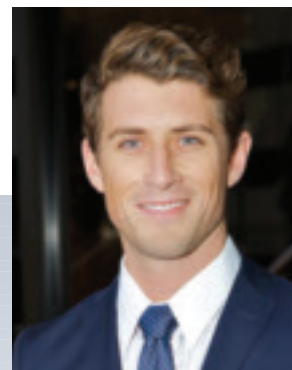
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<sup>1</sup> See U.S. Census Bureau, U.S. Census 2010, *available at* <http://quickfacts.census.gov/qfd/states/06000.html>.

<sup>2</sup> *Id.*; see also [http://quickfacts.census.gov/qfd/meta/long\\_POP815210.htm](http://quickfacts.census.gov/qfd/meta/long_POP815210.htm).

<sup>3</sup> See <http://www.census.gov/hhes/socdemo/language/index.html>.

<sup>4</sup> See *Reyes v. Premier Home Funding, Inc.*, 640 F. Supp. 2d 1147, 1151 (N.D. Cal. 2009).

<sup>5</sup> *Id.* at 1155; Civ. CODE §1632(b).

<sup>6</sup> See, e.g., *Reyes v. Superior Court*, 118 Cal. App. 3d 159 (1981); *cf. Reyes*, 640 F. Supp. 2d 1147; *ING Bank, FSB v. Chang Seob Ahn*, 758 F. Supp. 2d 936 (N.D. Cal. 2010).

<sup>7</sup> Civ. CODE §1632(a).

<sup>8</sup> Civ. CODE §1632(a)(3).

<sup>9</sup> *Id.*

<sup>10</sup> See, e.g., Civ. CODE §1632(b)(7) (foreclosure consultant contracts); Civ. CODE §2945(a) (Homeowners facing foreclosure are subject to “fraud, deception, harassment, and unfair dealing” in mortgage foreclosure consultant contracts.).

<sup>11</sup> Civ. CODE §§1801-1812.35.

<sup>12</sup> Civ. CODE §§2981-2984.6.

<sup>13</sup> Civ. CODE §§2985.7-2993; Civ. CODE §1632(b)(1).

<sup>14</sup> Civ. CODE §1632(b)(2); California Department of Consumer Affairs, Foreign Language Translation of Consumer Contracts, Legal Guide K-4 (Jan. 2010), *available at* [http://www.dca.ca.gov/publications/legal\\_guides/k-4.shtml](http://www.dca.ca.gov/publications/legal_guides/k-4.shtml) (hereinafter Legal Guide K-4).

<sup>15</sup> Civ. CODE §1632(b)(3).

<sup>16</sup> Civ. CODE §1632(b)(2), (b); *ING Bank, FSB v. Ahn*, 717 F. Supp. 2d 931, 933 (N.D. Cal. 2010).

<sup>17</sup> MILLER & STARR, 12 CALIFORNIA REAL ESTATE

§36:1.30 (3d ed. 2011); Civ. CODE §1632(b)(4).

<sup>18</sup> Civ. CODE §1632(b); Legal Guide K-4, *supra* note 14.

<sup>19</sup> Civ. CODE §1632(b)(6).

<sup>20</sup> *Id.*

<sup>21</sup> Civ. CODE §2944.6; MILLER & STARR, 4 CALIFORNIA REAL ESTATE §10:145.10 (3d ed. 2011).

<sup>22</sup> Civ. CODE §2944.6(c).

<sup>23</sup> Civ. CODE §2944.6(a); Civ. CODE §1632; MILLER & STARR, 4 CALIFORNIA REAL ESTATE §10:145.10 (3d ed. 2011).

<sup>24</sup> Civ. CODE §1632(b)(5), (7); see Civ. CODE §2945.1 (definition of “foreclosure consultant”); Civ. CODE §1923 (definition of “reverse mortgage”).

<sup>25</sup> Civ. CODE §2945.1(e)(9).

<sup>26</sup> Civ. CODE §1632(g); Legal Guide K-4, *supra* note 14.

<sup>27</sup> Civ. CODE §1632(b); Legal Guide K-4, *supra* note 14.

<sup>28</sup> Civ. CODE §1632(b).

<sup>29</sup> Civ. CODE §1632(h); *ING Bank, FSB v. Ahn*, 717 F. Supp. 2d 931, 933 (N.D. Cal. 2010).

<sup>30</sup> *ING Bank, FSB*, 717 F. Supp. 2d at 933.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> Civ. CODE §1632(j).

<sup>34</sup> *Id.*

<sup>35</sup> Civ. CODE §1632(f).

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> Civ. CODE §1632(d).

<sup>40</sup> Legal Guide K-4, *supra* note 14; see generally Civ. CODE §1632.

<sup>41</sup> Civ. CODE §1632(k).

<sup>42</sup> *Akin v. Certain Underwriters at Lloyd’s London*, 140 Cal. App. 4th 291, 298 (2006).

<sup>43</sup> Civ. CODE §1691(b).

<sup>44</sup> See, e.g., *Stenger v. Anderson*, 66 Cal. 2d 970, 978 (1967) (rescission resulting in restitution of sums paid

under life care contract).

<sup>45</sup> *FDIC v. Air Fla. Sys., Inc.*, 822 F. 2d 833, 841 (9th Cir. 1987).

<sup>46</sup> Civ. CODE §1692.

<sup>47</sup> Civ. CODE §1632.5(h)(1).

<sup>48</sup> *Id.* at §1632.5(h)(3).

<sup>49</sup> *Id.* at §1632.5(h)(2).

<sup>50</sup> *Id.* at §1632.5(h)(4).

<sup>51</sup> Civ. CODE §2944.6(c).

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> Denise Gilman, J.D., A “Bilingual” Approach to Language Rights: How Dialogue between U.S. and International Human Rights Law May Improve the Language Rights Framework, 24 HARV. HUM. RTS. J. 1, 3-4 (2011).

<sup>55</sup> *Id.* at 8.

<sup>56</sup> U.S. CONST. amend XIV, §1.

<sup>57</sup> *Regents of the Univ. of Cal. v. Bakke*, 438 U.S. 265, 290 (1978).

<sup>58</sup> *Id.*

<sup>59</sup> *Massachusetts Bd. of Retirement v. Murgia*, 427 U.S. 307, 312 (1976).

<sup>60</sup> See, e.g., *Soberal-Perez v. Heckler*, 717 F. 2d 36 (2d Cir. 1983); *Frontera v. Sindell*, 522 F. 2d 1215 (6th Cir. 1975); *Carmona v. Sheffield*, 475 F. 2d 738 (9th Cir. 1973).

<sup>61</sup> *Moua v. City of Chico*, 324 F. Supp. 2d 1132, 1137 (E.D. Cal. 2004).

<sup>62</sup> *Id.* at 1138.

<sup>63</sup> Gilman, *supra* note 54, at 4.

<sup>64</sup> Civil Rights Act of 1964 §601, 42 U.S.C. §2000d.

<sup>65</sup> *Lau v. Nichols*, 414 U.S. 563 (1974).

<sup>66</sup> *Id.* at 564.

<sup>67</sup> *Id.* at 568-69.

<sup>68</sup> *Id.* at 566.

<sup>69</sup> *Alexander v. Sandoval*, 532 U.S. 275 (2001).

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## What Are the Fiduciary Duties of Insurance Agents and Brokers?

**A COMMON MISCONCEPTION** is that insurance agents and brokers owe their insureds fiduciary duties as a matter of law.<sup>1</sup> Many attorneys also think so, basing their opinion on general agency principles, case law and treatises, or what they learned in law school regarding agency law.<sup>2</sup> Many fundamental cases addressing the fiduciary duties of agents, however, were decided before the Insurance Code was enacted in 1935, and as insurance law and the Insurance Code have evolved, California courts have become less dependent on general agency principles when determining the duties of insurance agents and brokers. Currently, under California law, there is no clear answer as to whether fiduciary duties apply to insurance agents and brokers and in what respect. While there is no appellate precedent in California permitting an insured to sue an insurance broker or agent on a common law cause of action for breach of fiduciary duty, California courts have been hesitant to confirm outright that this cause of action is inapplicable to insurance brokers and agents.

For example, in *Workmen's Auto Insurance Company v. Guy Carpenter & Company, Inc.*,<sup>3</sup> the Second District Court of Appeal initially definitively answered the question of whether insurance brokers owe any fiduciary duties to insureds in the negative.<sup>4</sup> However, any relief this decision brought to insurance agents and brokers was short-lived, as the opinion was vacated and depublished by a subsequent rehearing, which affirmed the initial opinion but remained unpublished.<sup>5</sup>

The opinion of the subsequent rehearing in *Workmen's* is illustrative of the hesitancy of California courts to establish a bright-line rule on this issue. For example, in the original opinion, the court held in its summary: "In particular, we hold that an insurance broker cannot be sued for breach of fiduciary duty."<sup>6</sup> In the opinion on rehearing, the court copied the summary of opinion from the original opinion but omitted that definitive statement.<sup>7</sup> The court stepped back further on the confidence of its original opinion by stating, "[T]hese authorities do not close the door on fiduciary duty claims against insurance brokers" and "a fiduciary duty cause of action against an insurance broker very well might pass muster in an appropriate case."<sup>8</sup> In less than a year, the same judges had drastically limited the definitiveness of their opinion. Moreover, the opinion was not officially published.

Although the *Workmen's* opinion is not citable, the case was strongly litigated on both sides, thus offering great insight into the mental processes and arguments of brokers and agents, insureds, and the Second District. After *Workmen's*, the landscape on this issue remains as polarized as before, and counsel on both sides must look to the few ambiguous cases addressing the issue, the Insurance Code, treatises, jury instructions, and other sources for guidance.

### No Outright Fiduciary Duty

Before *Workmen's*, California courts had begun to take significant strides in answering whether insurance brokers and agents owed

any fiduciary duties to insureds. The most significant cases supporting the assertion that, as a matter of law, insurance brokers and agents do not owe any fiduciary duties to insureds, are *Kotlar v. Hartford Fire Insurance Company*<sup>9</sup> and *Hydro-Mill Company, Inc. v. Hayward, Tilton & Rolapp Insurance Associates, Inc.*<sup>10</sup>

In *Kotlar*, the court refused to broaden an insurance broker's duties beyond negligence and held that "the duty of a broker, by and large, is to use reasonable care, diligence, and judgment in procuring the insurance requested by the client."<sup>11</sup> The court refused to analogize the broker-client relationship to the attorney-client relationship

**Under California law, there is no clear answer as to whether fiduciary duties apply to insurance agents and brokers.**

and held that such an attempt was "wide of the mark."<sup>12</sup> The court went on to say that "while an attorney must represent his or her clients zealously within the bounds of the law, a broker only needs to use reasonable care to represent his or her client."<sup>13</sup> To support this distinction, the court noted that unlike lawyers, who normally do not represent both parties to a transaction, insurance brokers can be dual agents, representing both the insurer and the insured.<sup>14</sup> Thus, *Kotlar* is the authority for the proposition that the scope of an insurance broker's duties is defined by negligence law, not fiduciary law.

In *Hydro-Mill*, the Second District cited and expanded on *Kotlar* but left wiggle room. Based on the complaint, the court reasoned that "the allegations of professional negligence subsume all of the allegations of breach of fiduciary duty."<sup>15</sup> Finding that the gravamen of the complaint was the insurance broker's "failure to execute its obligations as an insurance broker," the court held that only a cause of action for professional negligence applied.<sup>16</sup> Basically, the *Hydro-Mill* opinion refused to recognize a separate cause of action for breach of fiduciary duty against insurance brokers.

The *Hydro-Mill* court also relied on the California Supreme Court's holding that an insurer is not a fiduciary. In *Vu v. Prudential Property & Casualty Insurance Company*,<sup>17</sup> California's highest court held that the "insurer-insured relationship...is not a true 'fiduciary relationship' in the same sense as the relationship between trustee and beneficiary, or attorney and client."<sup>18</sup> The court further explained that any "special" or "heightened" duties imposed on insurers, which often resemble duties owed by fiduciaries, are only "fiduciary-like duties...because of the unique nature of the insurance contract, not

**Mher Asatryan is the founder of the Law Offices of Mher Asatryan, a general practice with a focus on consumer bankruptcy, civil litigation, personal injury, and transportation law.**

because the insurer *is* a fiduciary.”<sup>19</sup> One leading treatise foresees the implication of this statement and offers a practice pointer to insureds, stating that there is no apparent advantage to pleading claims for breach of “fiduciary-like” duties because breach of the duties does not by itself show the requisite oppression, malice, or fraud that is required for an award of punitive damages for breach of fiduciary duty.<sup>20</sup> The *Hydro-Mill* court found the logic in *Vu* applicable to insurance brokers and opined, “If an insurer is not a fiduciary, then arguably, neither is a broker.”<sup>21</sup>

Although *Kotlar* and *Hydro-Mill* seem to be the only direct cases discussing the fiduciary duties of brokers and agents, they represent the most recent cases in a long line of California precedent to tiptoe around the issue. For example, in *Wilson v. All Service Insurance Corporation*,<sup>22</sup> an insurance broker was sued on five theories, including negligence and breach of fiduciary duty, for placing insurance without investigating the insurer’s financial condition.<sup>23</sup> The court held that breach of fiduciary duty incorporated all the allegations of the negligence count.<sup>24</sup> Furthermore, the court held that the breach of fiduciary duty cause of action depended upon the existence of an alleged duty on the defendant’s part, and “since no duty exists, defendant is not liable to plaintiffs under any of the theories pleaded.”<sup>25</sup> In *Pabitzky v. Frager*,<sup>26</sup> the court held that the insurance broker owed no duty other than to secure for the client a policy meeting the statutory requirement.<sup>27</sup>

The opinion of Justice Joyce Kennard in *Jones v. Grewe*<sup>28</sup> is one of the seminal opinions clarifying the duties owed by an insurance broker. In *Grewe*, the insured sued the insurance broker for misrepresenting the coverage obtained and alleged causes of action for negligence and breach of fiduciary duty.<sup>29</sup> The court refused to recognize a separate cause of action for breach of fiduciary duty. Instead, the court stated that an insurance broker assumed only the normal duties found in any agency relationship, which include “the obligation to use reasonable care, diligence, and judgment in procuring the insurance requested by an insured.”<sup>30</sup> The court refused to recognize any heightened duties, fiduciary or otherwise, absent “express agreement or a holding out.”<sup>31</sup>

Numerous cases decided after *Grewe* leading up to *Kotlar* and *Hydro-Mill* supported the holding that no separate breach of fiduciary duty cause of action is available against insurance brokers and agents, reasoning that the duties of an insurance broker and agent are the same regardless of the legal theory applied.<sup>32</sup> These opinions resonate in leading treatises, one of which was cited by the *Hydro-Mill* court in explaining that it is unclear whether the fiduciary duty of insur-

ance agents, if any, differs from their duty of reasonable care.<sup>33</sup> In the eight years since *Hydro-Mill* was decided, no published California case has found that a cause of action lies for breach of fiduciary duty against an insurance broker or agent, and at least two federal courts have rejected the attempt to state such a claim when applying California law.<sup>34</sup> Notwithstanding the above decisions, insureds routinely bring breach of fiduciary claims against insurance brokers and agents.

### Basis for Fiduciary Duty

Agency law established long ago that agents can be liable for breach of fiduciary duty.<sup>35</sup> Until there is a published decision that definitively answers the issue, insureds may rely on general agency principles when suing insurance agents and brokers. Moreover, the *Hydro-Mill* opinion prefaces its discussion of fiduciary duty by observing, “It is unclear whether a fiduciary relationship exists between an insurance broker and an insured.”<sup>36</sup> This cautious statement is partially influenced by a case that insureds and others in favor of imposing outright fiduciary duties on insurance brokers and agents swear by: *Eddy v. Sharp*.<sup>37</sup> In *Eddy*, the court famously stated, “Where the agency relationship exists there is not only a fiduciary duty but an obligation to use due care.”<sup>38</sup> This sentence has formed the basis of the arguments of many insureds for imposing fiduciary duties on insurance brokers and agents.

It is interesting that insureds and trial courts have relied so heavily on *Eddy*, considering that it was declared dicta on the issue of fiduciary duty and not followed in *Hydro-Mill*.<sup>39</sup> The leading treatises on this issue also classify the statement in *Eddy* as dicta.<sup>40</sup> Nevertheless, the confidence of this statement has caused many courts much hesitancy. For example, immediately after classifying the statement in *Eddy* as dicta, the *Hydro-Mill* court went to say that, “Whether or not the broker-insured relationship is a fiduciary one, a broker still has certain fiduciary duties.”<sup>41</sup> The court was referring to California Insurance Code Section 1733, which mandates that premium payments received by insurance agents and brokers are held in a fiduciary capacity.<sup>42</sup> Interestingly, there is precedent implying that the receipt of premium payments triggers the fiduciary role of insurance agents and brokers, even if the receipt itself is not necessarily wrongful.<sup>43</sup> Regardless, Section 1733 only applies in the limited scenario in which the insurance agent or broker receives premium payments. As such, the section does not answer the question of whether insurance agents and brokers are fiduciaries as a matter of law. By shifting the focus to Section 1733 and the limited scenario to which it applies, the court in

*Hydro-Mill* effectively evaded the issue.

Aside from referencing Section 1733 for the proposition that brokers may have certain fiduciary duties, the *Hydro-Mill* court also mentioned *Westrec Marina Management, Inc.*<sup>44</sup> as an example of a case in which “brokers [were] found liable for breach of fiduciary duty where they failed to obtain insurance at [the] best available price.”<sup>45</sup> However, the applicability of this case to the issue of fiduciary duties is highly doubtful. Treatises by and large ignore this case, and the *Workmen’s* court refused to discuss it on the ground that “it does not provide guidance” because the *Westrec* court was not asked to decide on appeal whether a broker can be sued for breach of fiduciary duty.<sup>46</sup> Regardless of the shaky arguments supporting an insured’s cause of action for breach of fiduciary duty against an insurance agent or broker, trial courts are often hesitant to dismiss such claims at the pretrial stage, especially on a demurrer or motion to strike.

Although cases like *Kotlar* and *Hydro-Mill* have cast serious doubts on whether insurance brokers and agents are fiduciaries, it remains difficult for trial courts to dismiss breach of fiduciary duty causes of action against brokers and agents in the early stages of litigation. For example, a trial judge may find that alleging an insurance broker or agent relationship is sufficient, for pleading purposes, to state a cause of action for breach of fiduciary duty.<sup>47</sup>

Another complication for trial courts during the initial pleading stages is determining whether the existence of a fiduciary duty is a question of law or fact. For example, some trial courts find that a breach of fiduciary duty claim against an insurance broker or agent is not prohibited as a matter of law.<sup>48</sup> As such, the breach of fiduciary duty claim may not be summarily dismissed before there is a presentation of facts to establish that such a relationship did not exist.<sup>49</sup> This implies that, although a court may be reluctant to dismiss a breach of fiduciary duty cause of action against an insurance broker or agent on demurrer, where the facts are not disputed, the cause of action may yet be dismissed pretrial on a case-by-case basis depending on the factual circumstances of the specific insurance broker or agent.

Some appellate courts have also expressed that the determination of whether a fiduciary relationship exists is a factual one. In *Tri-Growth Centre City, Ltd. v. Silldorf*,<sup>50</sup> the court held that, based on the unique circumstances of the case, “there [was] a factual question as to the existence of a fiduciary relationship and whether defendants breached it.”<sup>51</sup> In *Liodas v. Sabadi*,<sup>52</sup> the California Supreme Court similarly held that, in the specific instance of the case, existence of a fiduciary relationship could not be deter-

mined as a matter of law but rather was a factual issue.<sup>53</sup> Yet other times, the California Supreme Court has expressed that “the existence of a duty is a question of law,”<sup>54</sup> even stating that “legal duties are not discoverable facts of nature, but merely conclusory expressions.”<sup>55</sup> In *Grewe*, the court similarly held that “whether a duty of care exists is a question of law for the court.”<sup>56</sup> One case tried to put it together and held, “While breach of fiduciary duty is a question of fact, the existence of legal duty in the first instance is a question of law.”<sup>57</sup> Regardless of which standard the courts choose, creating a new duty is a question of public policy, not something for the courts to decide.<sup>58</sup>

## Insurance Law or Agency Law

Under principles of agency law, an agent is automatically a fiduciary.<sup>59</sup> However, the Insurance Code and insurance case law are not so quick to label insurance agents and brokers as fiduciaries. The *Workmen’s* court labeled this inherent conflict as a “legal conundrum,” which could be “resolved only by stare decisis and public policy.”<sup>60</sup>

One of the essential considerations in this analysis is the effect of imposing new duties, fiduciary or otherwise, on insurance brokers and agents, and whether those duties would conflict with existing case law. The court in *Workmen’s* was wary of throwing the insurance profession “into limbo” and disrupting well-defined case law, which has been established through years of litigation.<sup>61</sup> From a policy standpoint, the court was concerned that such a disruption could increase the cost of insurance.<sup>62</sup> Another argument was that the CACI instructions on breach of fiduciary duty may not apply to insurance brokers. The “Directions for Use” following CACI No. 4102, which lays out the essential factual elements for breach of fiduciary duty, state, “This instruction is not intended for cases involving insurance brokers or agents.”<sup>63</sup> Thus, in weighing the conflicting ideologies on whether insurance agents and brokers can be liable for breach of fiduciary duty, future courts must consider the state of the policy line that decades of insurance law cases have drawn and balance the positive and negative consequences of disrupting that policy line.

Since California courts have never explicitly recognized a separate common law cause of action for breach of fiduciary duty against insurance agents and brokers, an appellate decision addressing this issue is necessary. The *Workmen’s* opinion gave an insight into the thinking process of the Second District Court of Appeal of California. It states that what is to be gleaned from “*Kotlar*, *Hydro-Mill*, *Wilson* and *Jones* is this: the agency of a broker must be viewed only through the lens of insurance law because it is a constellation

of rules and policies all its own.”<sup>64</sup> Unfortunately, this opinion was vacated. Deciding whether insurance brokers and agents owe an outright fiduciary duty to insureds is a matter of public policy and cannot be determined by the trial courts. The court of appeal must address this issue again in a published opinion that stays published. ■

<sup>1</sup> Courts often use the terms “insurance agent” and “insurance broker” inconsistently and interchangeably. See *Kurtz v. Insurance Communicators Mktg. Corp.*, 12 Cal. App. 4th 1249 n.1 (1993) (giving the terms “agent” and “broker” a generic rather than technical meaning due to the inconsistency of usage).

<sup>2</sup> See 39 CAL. JUR.: INSURANCE COMPANIES §183 (3d ed. 2012) (“[A]s a general rule, the powers of an agent of an insurance company are governed by the general laws of agency.”) (citing *Cronin v. Coyle*, 6 Cal. App. 2d 205 (1935)).

<sup>3</sup> See *Workmen’s Auto Ins. Co. v. Guy Carpenter & Co., Inc.*, 194 Cal. App. 4th 1468 (2011), *vacated*, 2012 WL 681202 (Cal. App. 2d Dist. Mar. 1, 2012).

<sup>4</sup> *Id.*

<sup>5</sup> See *Workmen’s*, 2012 WL 681202.

<sup>6</sup> *Workmen’s*, 194 Cal. App. 4th at 1470.

<sup>7</sup> See *Workmen’s*, 2012 WL 681202, at \*1.

<sup>8</sup> *Id.* at \*6.

<sup>9</sup> *Kotlar v. Hartford Fire Ins. Co.*, 83 Cal. App. 4th 1116 (2000).

<sup>10</sup> *Hydro-Mill Co., Inc. v. Hayward, Tilton & Rolapp Ins. Assocs., Inc.* 115 Cal. App. 4th 1145 (2004).

<sup>11</sup> *Kotlar*, 83 Cal. App. 4th at 1123.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> See *Id.* (“For example, an insurance broker acts as an agent for the insured in procuring insurance for the insured, but the broker may also be the agent of the insurer in respect to the policy.”) (citing *Fraser-Yamor Agency, Inc. v. County of Del Norte*, 68 Cal. App. 3d 201, 213 (1977)).

<sup>15</sup> *Hydro-Mill Co.*, 115 Cal. App. 4th at 1159.

<sup>16</sup> *Id.*

<sup>17</sup> *Vu v. Prudential Prop. & Casualty Ins. Co.*, 26 Cal. 4th 1142 (2001).

<sup>18</sup> *Id.* at 1150-51.

<sup>19</sup> *Id.* (emphasis in original).

<sup>20</sup> CAL. PRACTICE GUIDE: INSURANCE LITIGATION ¶11:155 (2011) (Pleading breach of “fiduciary-like” duties may also be ground for demurrer or motion for judgment on the pleadings, or worse still, for reversal of any judgment obtained by plaintiffs.).

<sup>21</sup> *Hydro-Mill*, 115 Cal. App. 4th at 1158.

<sup>22</sup> *Wilson v. All Serv. Ins. Corp.*, 91 Cal. App. 3d 793 (1979).

<sup>23</sup> See *id.*

<sup>24</sup> *Id.* at 799.

<sup>25</sup> *Id.*

<sup>26</sup> *Pabitzky v. Frager*, 164 Cal. App. 3d 401 (1985).

<sup>27</sup> *Id.* at 402.

<sup>28</sup> *Jones v. Grewe*, 189 Cal. App. 3d 950 (1987).

<sup>29</sup> *Id.* at 953.

<sup>30</sup> *Id.* at 954.

<sup>31</sup> *Id.*

<sup>32</sup> See generally *Ahern v. Dillenbeck*, 1 Cal. App. 4th 36 (1991) (holding *Grewe* was dispositive); *Kurtz v. Insurance Communicators*, 12 Cal. App. 4th 1249, 1257 (1993) (reiterating *Grewe’s* standard and holding that “[t]he duty of a broker, by and large, is to use reasonable care, diligence, and judgment in procuring the insurance requested by its client.”); *Fitzpatrick v. Hayes*, 57 Cal. App. 4th 916 (1997)

(relying on *Grewe* for its refusal “to effectively expand the duties of insurance agents and brokers”).

<sup>33</sup> See *Hydro-Mill*, 115 Cal. App. 4th at 1158 (citing CAL. PRACTICE GUIDE: INSURANCE LITIGATION ¶11:166 (2011)).

<sup>34</sup> See *Miniace v. Pacific Maritime Assoc.*, 2005 WL 2230149, at \*10 (N.D. Cal. Sept. 13, 2005); *Kaui Scuba Ctr., Inc. v. Padi Ams., Inc.*, 2011 U.S. Dist. LEXIS 75704 (C.D. Cal. July 13, 2011) (dismissing a claim for breach of fiduciary duty against an insurance broker because the plaintiff “failed to allege how the insurance broker entered into a relationship with plaintiff such that a fiduciary duty was imposed....”).

<sup>35</sup> 39 CAL. JUR.: INSURANCE COMPANIES §183 (3d ed. 2012).

<sup>36</sup> *Hydro-Mill*, 115 Cal. App. 4th at 1156.

<sup>37</sup> *Eddy v. Sharp*, 199 Cal. App. 3d 858 (1988).

<sup>38</sup> *Id.* at 865 (citing 1 WITKIN, SUMMARY OF CAL. LAW §§84-85 (8th ed. 1973)).

<sup>39</sup> *Hydro-Mill*, 115 Cal. App. 4th at 1158.

<sup>40</sup> See CAL. PRACTICE GUIDE: INSURANCE LITIGATION ¶11:165 (2011) (referring to *Eddy* as dictum); 2 CAL. INS. LAW DICTIONARY & DESK REF. §P91 (2011) (recognizing that *Eddy* was declared dicta).

<sup>41</sup> *Hydro-Mill*, 115 Cal. App. 4th at 1158 (emphasis in original).

<sup>42</sup> INS. CODE §1733.

<sup>43</sup> See *People v. Hewitt*, 53 Cal. App. 3d 759, 766 (1975).

<sup>44</sup> *Westrec Marina Mgmt., Inc. v. Jardine Ins. Brokers Orange County, Inc.*, 85 Cal. App. 4th 1042 (Cal. App. 4th Dist. 2000).

<sup>45</sup> *Hydro-Mill*, 115 Cal. App. 4th at 1158.

<sup>46</sup> See *Workmen’s Auto Ins. Co.*, 2012 WL 681202 n.6 (Cal. App. 2d Dist. Mar. 1, 2012) (stating “an opinion is not authority for a proposition not therein considered”) (citing *Palmer v. GTE Cal., Inc.* 30 Cal. 4th 1265, 1278 (Cal. 2003)).

<sup>47</sup> See *Howard v. Howard*, No. BC309444, 2005 WL 4925957 (Cal. Super. Ct. Oct. 17, 2005), Trial Order at 4.

<sup>48</sup> *Id.* at 4-5.

<sup>49</sup> *Id.*

<sup>50</sup> See *Tri-Growth Centre City, Ltd. v. Silldorf, Burdman, Duigan & Eisenberg*, 216 Cal. App. 3d 1139 (1990).

<sup>51</sup> *Id.* at 1151.

<sup>52</sup> See *Liodas v. Sahadi*, 19 Cal. 3d 278 (1977).

<sup>53</sup> *Id.* at 284.

<sup>54</sup> See *Christensen v. Superior Court*, 54 Cal. 3d 868, 885 (1991) (citing *Richards v. Stanley*, 43 Cal. 2d 60, 66-67 (1954)).

<sup>55</sup> See *Christensen*, 54 Cal. 3d at 885 (citing *Tarasoff v. Regents of Univ. of Cal.*, 17 Cal. 3d 425, 434 (1976)).

<sup>56</sup> *Jones v. Grewe*, 189 Cal. App. 3d 950, 954 (1987).

<sup>57</sup> *Kirschner Bros. Oil v. Natomas Co.*, 185 Cal. App. 3d 784, 790 (1986).

<sup>58</sup> See *Jones*, 189 Cal. App. 3d 950 at 954 (While the determination of whether a duty of care exists in the law is a matter for the courts, “whether, and the extent to which, a new duty is recognized is ultimately a question of public policy.”).

<sup>59</sup> See, e.g., *Kinert v. Wright*, 81 Cal. App. 2d 919, 925 (1947); *Chodur v. Edmonds*, 174 Cal. App. 3d 565, 571 (1985).

<sup>60</sup> *Workmen’s Auto Ins. Co. v. Guy Carpenter & Co., Inc.*, 194 Cal. App. 4th 1468 (2011), *vacated*, 2012 WL 681202 (Cal. App. 2d Dist. Mar. 1, 2012).

<sup>61</sup> *Id.* at 1480.

<sup>62</sup> *Id.*

<sup>63</sup> 2-4100 CACI 4101.

<sup>64</sup> See *Workmen’s*, 194 Cal. App. 4th at 1479.



## California's New Hybrid Corporation Statute

**ENTREPRENEURS WHO SEEK A BUSINESS ENTITY** that incorporates the elements of a traditional for-profit corporation while also promoting the public purposes of a nonprofit can now avail themselves of new California laws authorizing the formation of hybrid corporations.<sup>1</sup> These corporate entities—Benefit Corporations (B corporations<sup>1</sup>) and Flexible Purpose Corporations (FPCs)—are obligated to balance shareholder returns with one or more charitable or public benefit purposes.

The concept of a corporate entity based on the principle that a “business can do well while also doing good” has existed for decades but only became a legal concept in 2005 when Robert Lang proposed the creation of a “low profit limited liability company” or L3C. Lang, then chief executive officer of the Mary Elizabeth and Gordon B. Mannweiler Foundation, envisioned the L3C as a for-profit entity organized to engage in “socially beneficial activities.”<sup>2</sup> Under his concept, a private foundation could make program-related investments (PRIs) to an L3C without the due diligence otherwise required by IRS regulations before a PRI can be made to a for-profit entity. PRIs are defined as a loan or investment whose “primary purpose...is to accomplish one or more [charitable or other 501(c)(3) purposes], and no significant purpose of which is the production of income or the appreciation of property.”<sup>3</sup> Others seized upon the L3C as a business form that would allow entrepreneurs to combine the best qualities of nonprofit and for-profit organizations into a single business entity. In the nine states (not including California) that have passed enabling legislation, an LLC may be transformed into an L3C through the adoption of specific statutory language in its articles of organization.<sup>4</sup>

The L3C, however, has certain limitations. One is that the Internal Revenue Service does not automatically consider an L3C eligible for PRIs, which is contrary to Lang’s concept. Similarly, the vast majority of private foundations that make PRIs do not give special recognition to an L3C.<sup>5</sup> Thus, it is unclear what function an L3C serves other than that “it creates the illusion of value.”<sup>6</sup>

Since the L3C concept was first announced, entrepreneurs have searched for other hybrid corporate forms that overcome its limitations and would receive greater acceptance. In response, the concept of a “for-profit corporation with a nonprofit purpose” was developed. B Labs proposed the “benefit corporation” as a new corporate form to accomplish this objective and drafted model implementing legislation.<sup>7</sup> Seven states,<sup>8</sup> including California, have adopted legislation authorizing the formation of benefit corporations.

Like the L3C, the B Corporation has some drawbacks, including compliance with certain restrictive requirements such as third-party certification. To overcome these restrictions, a group called the California Working Group for New Corporate Forms created the FPC as an alternative form of hybrid corporation. California and New York are the only states that currently permit the formation of an FPC.

California’s hybrid corporation laws permit a B Corporation or an FPC to carry out public benefit purposes without requiring that shareholder returns be maximized. In addition, these hybrid entities have other common attributes:

1) The formation process for the two corporate forms is effectively the same. The articles of incorporation must identify the type of corporation being formed and describe its public benefit purpose. The personal liability of directors for monetary damages may be almost completely eliminated under the articles.<sup>9</sup> The fees for filing the articles with the secretary of state are the same as those paid by tradi-

**Hybrid corporations bridge the significant differences that exist between nonprofits and for-profits.**

tional corporations.<sup>10</sup>

2) The authorizing statutes for B corporations and FPCs emphasize transparency by requiring that all mandated reporting be made publicly available on the corporation’s Web site.<sup>11</sup>

3) A super-majority vote of shareholders is needed to modify the public benefit purposes and to affect certain other corporate changes. Specifically, a two-thirds vote by the outstanding shares of each class is required for reorganizations and for sales of all or substantially all the corporation’s assets.<sup>12</sup> In addition, dissenters to certain transactions may have the right to have their shares purchased at fair market value.<sup>13</sup>

4) Like traditional corporations, hybrids must make an election with the IRS as to which tax structure will be applied (i.e., whether the entity will be taxed as a partnership, corporation, or disregarded entity) and are taxed based upon that election. Unlike nonprofit corporations, hybrid corporations do not qualify for tax exemption.<sup>14</sup>

5) Directors of both entities are required to adhere to the standard fiduciary duties of care and loyalty.<sup>15</sup> Further, all directors are subject to the business judgment rule—that is, the rule that a director of either an FPC or a B corporation must act “in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders, and with such care, including reasonable inquiry, as an ordinary prudent person in a like position would use

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under similar circumstances.”<sup>16</sup>

While B corporations and FPCs share many similarities, entrepreneurs must also be aware of several key distinctions between them in order to decide which structure is best suited to meet their corporate and social objectives. One distinction relates to the difference in the public benefit for which an entity may be formed.<sup>17</sup> The B corporation statute mandates that an entity be formed to create a general public benefit, meaning a material positive impact on society and the environment, taken as a whole, as assessed against a third-party standard.<sup>18</sup> Incorporators also have the option to enumerate one or more specific public benefit purposes in the articles of incorporation, including services to low-income or under-served individuals or communities; economic opportunity; the environment; human health; arts, sciences, and the advancement of knowledge; flow of capital to public-benefit purposed entities; or any other benefit for society or the environment.<sup>19</sup> In contrast, the FPC statute requires that an entity be formed to further a specifically defined special purpose.<sup>20</sup> This special purpose must either be a charitable purpose that a nonprofit public benefit corporation is authorized to carry out or a purpose that promotes positive effects or minimizes negative effects on the corporation’s employees, suppliers, creditors, or customers; on the community and society; or on the environment.

Both hybrid corporate forms must prepare an annual report for shareholders, but the assessment standard used to measure a company’s success is different. While an FPC can do its own internal assessment,<sup>21</sup> the process of evaluating a B corporation is more complicated and expensive because it involves the use of an independent third-party standard.<sup>22</sup> By statute, the third-party standard for B corporations must satisfy certain criteria.<sup>23</sup> The governing body of the entity developing the third-party standard is restricted from having 1) more than one-third of its members come from the business being measured by the standard, 2) business associations whose members will be measured by the standard, or 3) businesses or an association of businesses from one specific industry. In addition, the standard-developing entity cannot have a material financial relationship with the company or any of its subsidiaries or any of the above business associations. In formulating the standard, the entity must have the necessary expertise to measure the performance of a business, use a balanced approach to create the standard, and provide for a 30-day public comment period. As part of the public comment process, the entity must disclose the criteria used in formulating the standard, the relative weight given to each criterion, the identity of those who developed and revised

the standard, the process by which revisions and changes to the third party’s governing body are made, and an accounting of financial supporters of the third party.

The required content of the annual reports also differs. A B corporation annual report must include a description of its success in pursuing its goals, the extent to which the benefits were created, any circumstances that hindered the creation of the benefits, and the process and rationale for selecting the third-party standard.

By comparison, an FPC annual report needs to disclose certain financial information and have a Special Purpose Management Discussion and Analysis (Special Purpose MD&A) related to the entity’s enumerated special purposes.<sup>24</sup> The Special Purpose MD&A must describe short- and long-term objectives for the FPC’s special purposes, identify any changes made to the special purposes, discuss material actions taken to achieve those purposes and the impact of these actions, set forth short- and long-term plans to achieve the special purposes, describe the evaluation measures and explain how they were selected, list material operating and capital expenditures incurred for the special purposes, and provide a three-year, good-faith projected budget.

FPCs are also required to provide Special Purpose Current Reports to shareholders within 45 days of the occurrence of an actual or planned expenditure made to further a special purpose unless previously reported in the most recent annual report.<sup>25</sup> These include expenditures that will likely have a material adverse impact on operations or fiscal conditions or involve a management decision to withhold a planned expenditure that would likely have a positive impact on the special purpose objectives or a management determination that the special purpose has been satisfied or should no longer be pursued either temporarily or permanently. However, if an FPC has fewer than 100 shareholders, the Special Purpose MD&A and the Special Purpose Current Reports may be waived if approved by two-thirds of the outstanding shares.<sup>26</sup>

Although shareholder protections in the two hybrid forms are primarily the same, they differ in situations involving mergers and conversions. The B corporation statute requires at least two-thirds approval by the outstanding shareholders of each class for a merger or a conversion.<sup>27</sup> Like the B corporation statute, the FPC statute also requires at least two-thirds shareholder approval of a merger when the surviving entity will be another type of for-profit business or an FPC with a materially different special purpose.<sup>28</sup> However, if an FPC is being merged into a California nonprofit corporation, all shareholders must consent.<sup>29</sup> Similarly, when an

FPC amends its articles of incorporation to convert to a nonprofit corporation or a cooperative corporation, the amendment must be approved by the entire outstanding shares of each class.<sup>30</sup> If an FPC amends its articles of incorporation to convert to a general stock corporation, however, the amendment must be approved by two-thirds of the outstanding shares of each class.<sup>31</sup>

Directors of the two hybrid forms have different fiduciary duties. A director of an FPC may consider, along with other factors selected by the board, short- and long-term prospects, the best interests of the corporation and its shareholders, and any special purpose interest set forth in the articles of incorporation.<sup>32</sup> A director is also instructed statutorily to weigh those factors that the director deems relevant. In contrast, a B corporation’s director must consider the shareholders, employees and workforce, customers, the community and society, the local and global environment, short- and long-term interests of the company, and the ability of the company to accomplish the benefits enumerated in its articles.<sup>33</sup> Although the B corporation statute does not require a director to give priority to any one particular factor unless specified by the articles, the director must consider all seven when the impact of a proposed action is being considered.<sup>34</sup>

While directors of FPCs may be sued like their counterparts at a general stock corporation, B corporation directors are only subject to benefit enforcement proceedings pursuant to which they may be sued for failing to pursue the company’s general or specific public purpose, violating a duty or standard of conduct, or failing to deliver or post an annual benefit report.<sup>35</sup> Although Benefit Enforcement Proceedings offer a unique platform to plaintiffs, standing is limited.<sup>36</sup> These proceedings may only be initiated by the corporation or derivatively by its shareholders, directors, 5 percent of the owners of the equity interest of a parent company, or other persons specified in the B corporation’s articles or bylaws.<sup>37</sup> Directors are not liable for monetary damages for failure to create the company’s general or specific public benefit.<sup>38</sup>

## Choosing between the Hybrids

When advising a client who wants to form a B corporation or an FPC, an attorney needs to understand why the client wants to start the business and what that individual hopes to accomplish as the business grows and matures. Thus, the client needs to be asked if his or her primary objective in forming the business will be to “do well,” “do good,” or “do well and do good.”

If the client’s primary motivation is to “do well” to the exclusion of the other objectives, the client needs alternatives that max-

imize ownership value and profits. Typical corporate entities—for-profit corporations, limited liability companies, limited liability partnerships, general partnerships, and limited partnerships—will satisfy this objective. If, however, the client solely wants to “do good,” the focus should be on entities that promote value and benefit to society—for example, a nonprofit organization.

Before hybrid corporations came into existence, representing a client whose primary motivation was to “do well and do good” required creating a complex structure involving one or more of the “do well” entities and one or more of those “doing good.” However, now that California has authorized the formation of B corporations and FPCs, lawyers have the capacity to present clients who want to “do well and do good” with different options, each of which may be capable of promoting value and generating profits for both owners and society.

In identifying the appropriate entity, a B corporation is likely more suitable for a client who wants to form an entity to “do well and do good” but is uncertain how it wants to “do good” or the manner in which it wants to accomplish that objective. A B corporation can be structured by its formation documents to engage in activities for any general public benefit. Corporate management is afforded the flexibility to pursue one or more general public benefits subject to the business judgment rule. Nevertheless, when management decides to engage in specific public benefit activities, the prudent course of action would be to obtain needed approvals from the board of directors and shareholders.

An FPC may be preferable for a client who wants to “do well and do good” but needs outside investors to provide start-up or growth capital. Since these investors will be less tolerant of poor corporate performance, management can take advantage of the FPC statute allowing management to structure how corporate performance is measured and presented to shareholders. However, corporate management is still subject to the business judgment rule, which helps ensure that any abuse by management is kept in check.

Directors of an FPC are also arguably held to a lower standard of care than those serving on a B corporation board. While directors of a B corporation and an FPC should consider the impact that their actions may have on the corporation and its shareholders, B corporation directors are subject to a statutory mandate to evaluate the impact that their actions may have upon the corporation, its specified purposes, and stakeholders. By contrast, FPC directors are given the statutory freedom to establish the factors that should be considered in evaluating the impact of the corporation’s actions and the rel-

ative weight to be given to each factor. Once again, subject to the business judgment rule, FPC directors can establish the standards by which their actions will be judged and, as a result, decrease the odds of a shareholder finding fault with corporate management.

In addition to establishing and operating a business, owners—including those of a B corporation or an FPC—should also have an exit strategy in place. A key consideration in developing this strategy is the future disposition of corporate shares. For owners of a B corporation or an FPC, public benefit does not necessarily equate with maximizing value. The choice to “do well and do good” will often require corporate profits to be sacrificed at the expense of public benefit. Those interested in purchasing or investing in a business that places equal or greater value on “doing good” rather than “doing well” will invariably be fewer than those interested in purchasing or investing in a traditional for-profit entity. Thus, the owner of, or an investor in, a B corporation or an FPC, may have to be content with a longer selling cycle as well as a lower return on investment than would that individual’s for-profit counterpart.

Although hybrids offer advantages to certain entrepreneurs, some individuals in the legal community are skeptical about why these entities are needed in the first place. This skepticism, however, overlooks the fact that hybrid corporations bridge the significant differences that exist between nonprofits and for-profits. Nonprofits are intended to further noncommercial purposes that benefit the general public (e.g., charitable, educational, or religious<sup>39</sup>) or serve mutual interests (e.g., chambers of commerce, advocacy organizations, or political action committees). For-profits exist primarily to increase the corporation’s value to individual shareholders, recognizing that there are many who also place a priority on social responsibility or other public purposes. For example, Interface is a publicly traded company that strives to protect the environment and shareholders.<sup>40</sup>

The emphasis on acting in the best interests of the for-profit entity and its shareholders is reinforced by the requirements of California’s general purpose corporation. A corporate director must focus primarily on maximizing the value of that entity.<sup>41</sup> A director who gives priority or even equal weight to a public benefit and profitability could arguably be subject to a claim of breach of that director’s fiduciary duties. Directors and corporate chief executives are understandably reticent to expose themselves to such liability if their efforts to be socially responsible or charitable diminish the bottom line.

Internal Revenue Code Section 501(c)(3) organizations are subject to other restrictions that may induce an entrepreneur to

form a hybrid corporation. Federal laws limit the use and disposition by a nonprofit of its charitable funds and assets. These restrictions protect the public from inappropriate use of charitable funds such as self-dealing, private inurement, and other private benefit.<sup>42</sup> For example, if a nonprofit board member wants to provide Web site development services to the organization at a reduced rate, the nonprofit must follow certain statutorily prescribed procedures<sup>43</sup> to ensure that the board member is not receiving an improper benefit (private inurement) from the transaction. Failure of the nonprofit board to comply with these procedures can result in penalties being assessed against the compensated board member and all other board members who did not oppose the arrangement. Further, in extreme cases, the nonprofit can lose its tax-exempt status.<sup>44</sup>

The restrictions also ensure that nonprofits do not take advantage of their tax-exempt status to compete unfairly with their for-profit counterparts. Although these restrictions are often necessary to protect against abuses of charitable funds, they may also prevent a nonprofit organization from carrying out its mission. Since hybrid corporations are not tax exempt, these limitations are inapplicable to them.

Nonprofits are also prohibited from distributing net income to “any private shareholder or individual.”<sup>45</sup> Thus, investors cannot support a nonprofit’s mission in return for an equity interest. Instead, a nonprofit must finance its operations and growth with earned revenue (which is nonexistent for many and seldom covers operating costs for others), contributions, and debt if it has a strong balance sheet or guarantors. Unlike nonprofits, hybrid corporations are not so constrained, and they can access equity markets and engage in activities meant to generate shareholder profits.

Nonprofits that want to form a for-profit subsidiary may find that hybrid corporations are a good option in accomplishing this objective. Tax-exempt organizations commonly establish a for-profit subsidiary to carry out commercial business activities. These subsidiaries are wholly or substantially owned by their founding nonprofits but are led by management that often has substantial independence from its parent. At the same time, the nonprofit wants to see that its subsidiaries adhere closely to the parent’s mission and will not engage in any activity that could potentially damage the reputation of the parent or cause adverse financial consequences to it. Hybrid corporations offer a means for accomplishing these objectives by, for example, including a public benefit purpose in the articles of incorporation that is consistent with and supportive of the nonprofit’s mission.





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Since hybrid corporations are relatively new in California, no precedents exist yet to guide the courts in resolving issues related to corporate governance and shareholder rights. California attorneys will also face other hurdles when working with hybrid corporations. First, certain monies held by hybrids could potentially be classified as charitable funds subject to regulatory oversight in California. Many hybrid entity investors will be seeking to profit as shareholders while also supporting the corporation's social mission. However, the attorney general could potentially classify corporate funds as being held for charitable purposes, especially when the philanthropic market funds a hybrid entity, such as through PRIs. In fact, the FPC statute has left room for this possibility, stating that nothing "shall be construed as negating existing charitable trust principles or the attorney general's authority to enforce any charitable trust created."<sup>46</sup>

According to the Charitable Trust Section of the attorney general's office, "a hybrid corporation that does hold funds for public charitable purposes would become a charitable trustee and thus subject to our jurisdiction."<sup>47</sup> If this occurred, the hybrid corporation would be required to register with the attorney general and follow the attorney general's regulations. Until there is specific guidance from the attorney general's office, attorneys for both hybrid corporations and private foundations should carefully document the intended use of PRIs to prevent their classification as funds held for charitable purposes. This action should minimize any risk that the attorney general's office will invoke its authority over the funds.

### Responsibility to Shareholders

The fundamental principle that management is accountable to corporate shareholders raises other potentially significant issues in the context of hybrid corporations. With traditional corporations, shareholders can respond to abuses of authority and acts of gross negligence by corporate management or a board of directors by filing derivative actions or forcing the termination of incompetent managers. Since the objective of B corporations and FPCs is not confined to maximizing profits, the issues are more subtle, because management can argue that poor decisions that ultimately resulted in corporate losses were made to further the hybrid corporation's charitable or public benefit purpose. Further, with FPCs, management may be operating to achieve standards and criteria that were approved by the shareholders who lacked the sophistication to understand those standards and criteria. While a benefit exists in giving B corporation and FPC corporate management the statutory authority to have greater flexibility in decision making and

broader protection against shareholder derivative actions arising from decisions made to further the hybrid corporation's declared public benefit agenda, there is also an inherent risk that in some instances such flexibility may be abused, and disgruntled shareholders will be left with little or no recourse.

The notion of a for-profit corporation having an interest in social causes and public benefits is at the heart of today's "corporate social responsibility" (CSR) movement. Many current and large publicly traded corporations recognize that corporate social responsibility can strengthen their brands and provide a competitive advantage.<sup>48</sup> Corporations that pursue these strategies promote their activities on their Web sites, annual reports and, occasionally, in advertisements. The advent of the B corporation and the FPC may help respond to skepticism over these claims because corporations that are serious about social responsibility can now incorporate that concept into their corporate structure.

However, the mere fact that a B corporation or an FPC, by definition, will be wearing its charitable heart on its sleeve for all to see will not be dispositive of that issue. The fact that B corporations and FPCs are still permitted to "do well" in the course of "doing good" means that businesses whose true, overriding objective is to maximize profits in the guise of also appearing to be socially responsible can use a hybrid corporation for that purpose. This is particularly true with FPCs, which allow corporate management the flexibility to create the various mechanisms by which a company's socially responsible activities will be judged. In the end, while these new California hybrids should help give the public a better understanding as to whether a particular company is truly committed to CSR principles, the possibility of abuse still remains.

Despite the uncertainties associated with hybrid corporations, representatives of at least a dozen companies waited for the California Secretary of State's office to open on January 3, 2012,<sup>49</sup> either to incorporate a B corporation or convert their existing corporation to one. (As of July 17, 2012, registrations for 50 B corporations and 8 FPCs had been filed in California<sup>50</sup>.) Most prominent among them was Yvon Chouinard, founder and chairman of Patagonia, the outdoor clothing company. Chouinard explained that his company made the switch to "create the legal framework to enable mission-driven companies like Patagonia to stay mission driven through succession, capital raises, and even changes in ownership by institutionalizing the values, culture, processes and high standards put in place by founding entrepreneurs."<sup>51</sup> This change is certainly not a surprise for a company whose mission is to "build the best product, cause no unnecessary

harm, use business to inspire and implement solutions to the environmental crisis."<sup>52</sup> ■

<sup>1</sup> A "B corporation" as defined in the California Corporations Code is not the same as the B Corporation or "B Corp" certification issued by B Labs, a nonprofit corporation established partly to create "standards to help us tell the difference between good companies and just good marketing." See <http://www.bcorporation.net/The-Non-Profit-behind-B-Corps>. Certified B Corporations do not need to be a corporation.

<sup>2</sup> See <http://www.communitywealth.com/Newsletter/August%202007/L3C.html> ("Community Wealth").

<sup>3</sup> I.R.C. § 4944(c). Under Treasury regulations, "[i]n determining whether a significant purpose of an investment is the production of income or the appreciation of property, it shall be relevant whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation." 26 C.F.R. § 53.4944-3(a)(2)(iii). The creators of the L3C hoped the statutory requirements for these entities would automatically meet this standard.

<sup>4</sup> Vermont, in 2008, was the first state to enact L3C legislation, and 11 states, including Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah, and Wyoming and two tribal governments followed.

<sup>5</sup> On September 18, 2011, Robert Lang indicated at a conference entitled "The L3 - New Opportunities for Community Foundations" that perhaps 10% of PRI-issuing private foundations give L3Cs any substantive advantage.

<sup>6</sup> Doeringer, *Reevaluating the L3C: Mistaken Assumptions and Potential Solutions*, in PHILANTHROPY, VOLUNTARISM, AND NOT-FOR-PROFIT MANAGEMENT 15 (Duke University, 2010), available at <http://ssrn.com/abstract=1696267>.

<sup>7</sup> [http://www.benefitcorp.net/storage/Model\\_Legislation.pdf](http://www.benefitcorp.net/storage/Model_Legislation.pdf)

<sup>8</sup> Hawaii, Maryland, New Jersey, New York, Vermont, and Virginia. See <http://www.benefitcorp.net/state-by-state-legislative-status>.

<sup>9</sup> CORP. CODE §§ 2602, 2603, 14602, and 14620.

<sup>10</sup> Two New Types of Corporations Effective January 1, 2012, <http://www.sos.ca.gov/business/bef/forms/flexible-purpose-corp-and-benefit-corp.pdf>.

<sup>11</sup> CORP. CODE §§ 3500, 14603.

<sup>12</sup> CORP. CODE §§ 1201(e), 3100(a), 3301(a)(2), 3000(b), 14603, 14604(d), and 14610(d).

<sup>13</sup> CORP. CODE §§ 3302(d), 14603(a), and 14604.

<sup>14</sup> Nonprofit entities that satisfy the requirements of I.R.C. § 501 or § 527 and REV. & TAX. CODE § 23701 generally are exempt from federal income tax and state franchise tax, respectively. To be eligible for tax exemption, California corporations must be formed as either a nonprofit public benefit corporation (i.e., a charitable corporation other than one formed for religious purposes under CORP. CODE §§ 5110 *et seq.*), a nonprofit religious corporation under CORP. CODE §§ 9110 *et seq.*, or a nonprofit mutual benefit or noncharitable, nonreligious corporation under CORP. CODE §§ 7110 *et seq.*

<sup>15</sup> CORP. CODE §§ 2700(a), 14620(a).

<sup>16</sup> CORP. CODE § 309(a). California courts apply the business judgment rule to determine a director's liability for breach of the duty of care. Under the rule, a court will not generally review a director's business decisions and impose liability for errors or mistakes in judgment if that director 1) was independent and disinterested, 2) acted in good faith, and 3) made reasonable efforts to become informed of the relevant facts. *Berg & Berg Enter., LLC v. Boyle*, 178 Cal. App. 4th 1020, 1045-46 (2009).

<sup>17</sup> CORP. CODE §§ 2602(b)(1), 14610.

<sup>18</sup> CORP. CODE § 14601(c).

<sup>19</sup> CORP. CODE § 14601(c).

<sup>20</sup> CORP. CODE § 2602(b).



<sup>21</sup> CORP. CODE §3500(a).

<sup>22</sup> CORP. CODE §14630(a)(2)

<sup>23</sup> CORP. CODE §14601(g).

<sup>24</sup> CORP. CODE §3500.

<sup>25</sup> CORP. CODE §3501.

<sup>26</sup> CORP. CODE §3501(h).

<sup>27</sup> CORP. CODE §§3200, 3201.

<sup>28</sup> CORP. CODE §3201.

<sup>29</sup> CORP. CODE §3202.

<sup>30</sup> CORP. CODE §3001.

<sup>31</sup> CORP. CODE §3002.

<sup>32</sup> CORP. CODE §2700(d).

<sup>33</sup> CORP. CODE §14620(b).

<sup>34</sup> CORP. CODE §14620(d).

<sup>35</sup> CORP. CODE §14601(b).

<sup>36</sup> CORP. CODE §14623.

<sup>37</sup> *Id.*

<sup>38</sup> CORP. CODE §14623(c).

<sup>39</sup> The most common type of nonprofit is a "charitable" nonprofit, i.e., one whose purpose falls within one of the following categories of tax exemption:

Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals....

I.R.C. §501(c)(3).

<sup>40</sup> Interface is a manufacturer of modular carpet that aims for zero emissions, zero waste, and zero oil by 2020. [http://www.interfaceglobal.com/careers/mission\\_zero.html](http://www.interfaceglobal.com/careers/mission_zero.html). Its financial performance, including shareholder return, consistently exceeds the NASDAQ composite index and that of its peer group. Interface, Inc., 2010 Annual Report 20 (2011), available at <http://phx.corporateir.net/External.File?item=UGFyZW50SUQ9OTYwNzB8Q2hpbGRJRDR0tMXxUeXBIPtM=&t=1>.

<sup>41</sup> CORP. CODE §309(a).

<sup>42</sup> I.R.C. §4958.

<sup>43</sup> *Id.* See also Miller, *Easier Compliance Is Goal of New Intermediate Sanction Regulations*, 2001 TAX NOTES TODAY 14-148 (Jan. 22, 2001).

<sup>44</sup> I.R.C. §4958.

<sup>45</sup> I.R.C. §501(c)(3).

<sup>46</sup> CORP. CODE §2700(e).

<sup>47</sup> Statement made by Belinda Johns, senior assistant attorney general in charge of the Charitable Trusts Section, at a joint meeting of the State Bar of California Business Section, Nonprofit Corporations and Unincorporated Organizations Committee, and Tax Section Tax Exempt Entities Committee on January 17, 2012, in Los Angeles. Confirmed in an email from Belinda Johns to Arthur Rieman, April 2, 2012. The Supervision of Trustees and Fundraisers for Charitable Purposes Act defines a trustee holding property for charitable purposes to include "any corporation...which has accepted property to be used for a particular charitable purpose." GOV'T CODE §12582(b). The California Attorney General has enforcement and supervisory powers over such entities. GOV'T CODE §12581.

<sup>48</sup> See, e.g., I.R.C. §4958.

<sup>49</sup> Lifsher, *Businesses Seek State's New 'B Corp' Status*, L.A. TIMES, Jan. 4, 2012, <http://articles.latimes.com/2012/jan/04/business/la-fi-benefit-corporations-20120104>.

<sup>50</sup> Todd Vlaanderen, Senior Staff Counsel & Supervisor, Office of the Secretary of State of California, speaking at the joint meeting of the California State Bar Nonprofit Organizations Committee and the Tax-Exempt Organizations Committee (July 17, 2012).

<sup>51</sup> See Lifsher, *supra*, note 49.

<sup>52</sup> See <http://www.patagonia.com/us/patagonia.go?assetid=2047>.

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by Judge Thomas Trent Lewis

# It Ain't Me

*Marriage of Davenport* offers family law practitioners clear warnings about the need for civility

When it comes to incivility and stridency between family lawyers, the usual refrain

sounds something like the words of Bob Dylan's classic folk rock song "It Ain't Me Babe." It's always the other side's attorney who acts without gentility and professionalism. Recurring calls for a return to civility in the practice of law echo through the decades. This core value is a hallmark of the bounds of effective, ethical, and efficient advocacy. And in times of increasing strain upon the judicial system, *Marriage of Davenport*<sup>1</sup> provides an important case study in civility and professionalism. Most of all, it points to behaviors best avoided.

Some might argue that *Marriage of Davenport* ranks as a mere outlier that offers little guidance in general family law proceedings because of the high net worth of the family. Being distracted by the narrow gauge of family law issues or net worth of the parties misdirects our focus from the broad application and principles of its holding. *Marriage of Davenport* provides an important reminder of frequently encountered problems in family law cases, regardless of estate size or controversy level.

The Davenports were married for more than 50 years, amassing an estate worth approximately \$57 million. The Davenports grew their estate from a small Ford automobile dealership in Northern California into a real estate and investment empire that their adult children became a part of. An established law firm represented the wife, but the youngest associate in the firm was assigned as lead counsel. Suspicious that her husband was diverting money, but early in the proceedings while complex discovery was pending, the wife filed extensive pleadings, including a 52-page declaration with more than 1,000 exhibits that joined the other portions of a 19-volume file.

The court's decision observes that the declarations filed by the wife's counsel were filled largely with inappropriate hearsay,

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HADI FARAHANI





After intense litigation in a pretrial request for orders claiming breach of duty and seeking an accounting, which spanned the course of several days of testimony, the wife was unsuccessful in proving her husband breached his fiduciary duty. Rather than being awarded sanctions against her husband, the wife was assessed sanctions of \$100,000 and fees exceeding \$300,000 payable to her husband and his counsel.

Family law uniquely intersects two core concepts not always found in other civil litigation proceedings. Recently enacted Family Code Section 217 affirms the due process right of family law litigants to request an evidentiary hearing on contested matters at the pretrial or postjudgment phase, which might otherwise be characterized as law and motion proceedings in a general civil case. With the enactment of Section 217, family law pretrial and postjudgment requests for orders morphed from primarily law and motion proceedings in which evidentiary hearings were the exception into proceedings in which the right to seek an evidentiary hearing became the norm.

Against this backdrop of due process access stands Family Law Section 271, reaffirming the stated legislative goal in family law to promote settlement and deter the pursuit of unreasonable positions. When those twin goals of reasonableness and resolution without litigation are offended, Section 271 allows the court to allocate the litigation costs by an award of fees and costs to the party who acted reasonably and avoided unnecessary

*Marriage of Davenport* supplies a perfect model for the intersection of these two concepts by assigning the trial court the duty to measure a party's due process right to access on the grid of reasonableness and effectiveness. In *Davenport*, the wife claimed that her husband breached his fiduciary duty, for which she sought sanctions against her hus-

In *Marriage of Davenport*, the wife filed pretrial proceedings claiming breach of fiduciary duty, and she sought sanctions under Section 271 and Section 2107 related to the claimed breach. Her husband responded by



*Marriage of Feldman* addressed the multiple remedies available when a party demonstrates a breach of fiduciary duty.<sup>4</sup> It underscores the court's authority to divide undisclosed property, and, when appropriate, assign it without offset to the wronged spouse. The court is further empowered to compensate the wronged spouse with attorney's fees and sanctions, including sanctions under Section 271, even in an amount beyond that sought by the wronged party, as a means of deterring future wrongful conduct. Sanctions under Section 271 can be awarded against a party who acts unreasonably in pursuing fruitless, unsubstantiated claims as in *Marriage of Falcone and Fyke*.<sup>5</sup> An award of sanctions is also warranted when a party's conduct frustrates the policy of promoting set-

At the intersection of zealousness and reasonableness are certain important lessons that *Marriage of Davenport* emphasizes that apply to nearly every family law case:

- Counsel should avoid the sloppy use of including argument in declarations—as lamented in *Marriage of Heggie*.<sup>10</sup>
- Courts presumptively rely only upon competent, relevant, and admissible evidence and ignore incompetent, irrelevant, and inadmissible evidence.<sup>11</sup>
- The language of Section 271 concerning rea-

sonable efforts to settle does not trump the mediation confidentiality exclusionary rule of Evidence Code Section 1119.

- Counsel's failure to disclose ex parte communications with a jointly retained expert can serve as a basis for Section 271 sanctions.
- Free speech and zealous advocacy are no defense to a claim under Section 271. Unnecessarily demeaning, accusatory, and personal attacks contained in correspondence or pleadings serve no useful purpose in advancing the resolution of disputed issues.
- Serving pleadings on the last possible day on a holiday weekend, without having cleared the date with counsel, demonstrates a lack of professionalism, undermines the administration of justice and conflict resolution, and justifies sanctions under Section 271.
- Failure to abide by an order to meet and confer in good faith may serve as a basis for a fee or Section 271 sanction award.

### Case Management

A further legislative response to the *Elkins* decision was an expansion of the trial court's authority to efficiently manage cases. In *Marriage of Davenport* the parties stipulated to case management, but based on revisions to Family Code Sections 2450 et seq. the court now has the authority, even without stipulation, to establish a family-centered case resolution plan. Mindful that family litigation differs from general civil litigation, the legislation focuses the court on a family-centered plan so the interests of the parties and the children are paramount while taking into account the interests of the court in prompt resolution. Family-centered case plans should also protect victims of domestic violence from unnecessary contact with the perpetrator.

New legislation empowers family courts to establish efficient case disposition goals through the use of case resolution conferences similar to the case management techniques used in general civil proceedings. The *Davenport* decision decries the numerous fouls by the wife's counsel in acting contrary to the orders made by the court to meet and confer in good faith in an effort to resolve issues and reduce litigation.

An outgrowth of the *Elkins* decision was the creation of the Elkins Task Force.<sup>12</sup> Through the enactment of various new rules, the Judicial Council has strengthened the court's authority to efficiently promote the interests of the family toward amicable and prompt resolution while preserving the due process rights for judicial determination when settlement is not possible.

To assure uniform application of procedures in California so that all citizens are treated with an appropriate level of uniformity in family court proceedings, these newly

enacted rules take effect January 1, 2013. California Rule of Court 5.83 establishes the authority of the court to set appropriate case resolution procedures and set performance deadlines to complete discovery. Among other things, the court can suspend discovery while the parties pursue settlement with appropriate protections for counsel who comply with an order suspending discovery. Likewise, the court can appoint its own expert under Evidence Code Section 730. Further extensions under Family Code Section 2032(d) allow the court to case manage attorney's fees and costs payable from any source.

In *Marriage of Davenport*, the trial court ordered the parties to meet and confer to resolve certain issues, including discovery-related matters. The decision provides a detailed litany of the wife's counsel's failure to reasonably meet and confer, including reference to his immature attacks on the husband and his counsel. Newly enacted California Rule of Court 5.98 (effective January 1, 2013) more directly formalizes the meet and confer requirements into the culture of family law throughout California for what might rightfully be called *Davenport* orders.

Most counties, including Los Angeles, already have local rules regarding meet and confer. However, these robust changes in Rule 5.98 preempt any inconsistent local rules<sup>13</sup> regarding meet and confer in family law-related matters. For example, Rule 5.98 imposes an obligation to make a prehearing exchange of all documentary evidence that will be relied upon for proof of any material fact. Excepted from the exchange of documents are items used for rebuttal or impeachment, but counsel are advised to narrowly construe, rather than unrealistically expand, the hoped-for zone of rebuttal or impeachment, since judicial officers may take a more limited view, depending on the circumstances.

With the increasing strain on already overburdened judicial resources, counsel should consider effective efforts to meet and confer in advance of any pretrial or postjudgment proceedings. Existing rules already require substantial good-faith efforts to meet and confer<sup>14</sup> in advance of trial, to assure the orderly conduct of its proceedings.<sup>15</sup> Los Angeles Superior Court Local Rule 5.14 is consistent with the newly adopted statewide rules.

*Marriage of Davenport* contains a stark reminder concerning family law proceedings: "Zeal and vigor in the representation of clients are commendable. So are civility, courtesy and cooperation. They are not mutually exclusive." The American Academy of Matrimonial Lawyers adopted the Bounds of Advocacy: Goals for Family Lawyers addressing some of the more difficult issues in family law proceedings. Consider the following

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words from the Bounds of Advocacy:

Matrimonial lawyers should recognize the effect that their words and actions have on their client's attitudes about the justice system, not just on the "legal outcome" of their cases. As a counselor, a problem-solving lawyer encourages problem solving in the client. Effective advocacy for a client means considering with the client what is in the client's best interests and determining the most effective means to achieve that result. The client's best interests include the well being of children, family peace, and economic stability. Clients look to attorneys' words and deeds for how they should behave while involved with the legal system. Even when involved in a highly contested matter, divorce attorneys should strive to promote civility and good behavior by the client towards the parties, the lawyers and the court.<sup>16</sup>

The concept of meet and confer forms the bedrock for various efforts to find solutions that reduce conflict uniformly throughout our jurisprudence. Case law rejects the notion that meet and confer means simply trumpeting in a louder voice your client's position. Instead, the cases suggest that the obligation to informally resolve issues forces

parties and counsel to reexamine their positions, "and to narrow...disputes to the irreducible minimum, before calling upon the court to resolve the matter."<sup>17</sup>

The meet and confer requirement can be particularly challenging in contested family law proceedings, where emotions are already intense and perceptions are divergent. One of the many messages of *Marriage of Davenport* is that professionalism and zeal are not mutually exclusive, despite any cultural norms or the litigation style of others.

Advocacy punctuated by embroiled personalities may unnecessarily divert the court away from the controversy that needs resolution to a wrangling of the personalities of overly agitated counsel. Often, it is difficult for the court to determine the cause of the conflict. To borrow from the Stephen Stills lyrics to the Buffalo Springfield's "For What It's Worth," "Nobody's right if everybody's wrong." Effective advocacy is not always the loudest or the most strident. The statutory scheme balances meaningful access to justice for family law litigants through guarantees of due process rights properly tempered by reasonable settlement efforts that eschew incivility and rancor. ■

<sup>1</sup> *Marriage of Davenport*, 194 Cal. App. 4th 1507 (2011).

<sup>2</sup> *Marriage of Feldman*, 153 Cal. App. 4th 1470 (2007).

<sup>3</sup> *Elkins v. Superior Court*, 41 Cal. 4th 1337 (2007).

<sup>4</sup> This article does not address the complex area of breach of fiduciary duty or the scope of the duty, or the remedies for its breach. Rather, the focus of this article is "how was the case litigated" not "what was the controversy."

<sup>5</sup> *Marriage of Falcone and Fyke*, 203 Cal. App. 4th 964 (2012).

<sup>6</sup> *Marriage of Sorge*, 202 Cal. App. 4th 626 (2012).

<sup>7</sup> See *Marriage of Daniels*, 19 Cal. App. 4th 1102 (1993).

<sup>8</sup> While *Marriage of Davenport* affirmed the trial court decision to award sanctions based solely on the notice filed by the husband, the better practice may be to file a request for order seeking sanctions that enunciates the factual and legal basis for the claim.

<sup>9</sup> Those who are interested may wish to research the ultimate result at trial, at which the trial court found that the husband did, in fact, breach his fiduciary duty.

<sup>10</sup> *Marriage of Heggie*, 99 Cal. App. 4th 28 (2002).

<sup>11</sup> See EVID. CODE §353 (Even if evidence is improperly admitted, objecting party must show miscarriage of justice.) and EVID. CODE §664 (Court presumption of official duty of judge was regularly performed.).

<sup>12</sup> The Task Force was created in response to *Elkins*, and its mandate included recommendations to the Judicial Council concerning enactment of rules of court and modification of family law forms to advance the legislation (AB 939) that was enacted as a partial response to the decision.

<sup>13</sup> See CAL. R. CT. 5.4 (effective Jan. 1, 2012).

<sup>14</sup> See LOS ANGELES SUPER. CT. R. 5.14.

<sup>15</sup> CODE CIV. PROC. §128.

<sup>16</sup> See <http://www.aaml.org/library/publications>.

<sup>17</sup> CALIFORNIA CIVIL PROCEDURE BEFORE TRIAL 8:1159 (Rutter Group).

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# YOUR WITNESS

The issue of **paying fact witnesses** most commonly concerns former or current employees of a party in litigation

**THE QUESTION OF WHETHER A PARTY** may pay a third-party fact witness for testifying routinely vexes litigants in complex litigation. The answer—at least in California and most other states—is that fact witnesses may be reimbursed for expenses incurred and time lost in connection with the litigation but may not be paid a fee for the fact of testifying (or not testifying) or for the substance of the testimony. Substantial caution should be exercised, however, in deciding whether and how much to pay a third-party witness.

The issue of witness payments arises in many situations, but often concerns former employees who know valuable information relevant to a lawsuit involving the former employer. When determining whether the payment of third parties may be prohibited,

counsel should consider the following governing authorities: 1) Rule 3.4 of the ABA Model Rules of Professional Conduct and ABA Formal Ethics Opinion 96-402, 2) the laws and ethical rules in the forum jurisdiction, 3) the federal antigravity statute, 18 USC Section 201, and 4) federal and state case law. In consulting relevant authority, counsel should attempt to gain a clear understanding of what types of payments generally fall under the prohibition against paying a fee for testifying. Counsel should also take into account 1) what constitutes reasonable compensation, 2) whether to put the agreement in writing and disclose it, 3) whether it may be proper to pay the witness pursuant to a “consulting” agreement, and 4) whether the payment of the witness’s attorney’s fees is per-

missible in the forum jurisdiction. Finally, counsel should be familiar with the possible sanctions for an inappropriate payment to a third-party witness.

A traditional common law rule prohibited any manner of compensation to fact witnesses. This rule was based on the rationale that payment could lead to obtaining perjured testimony, created an appearance of impropriety, and was inconsistent with a witness’s public duty.<sup>1</sup> However, the Model Rules of Professional Conduct, federal law, and the laws and ethical rules of most states have

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modified this traditional common law rule to allow for payment of reasonable compensation to fact witnesses—with certain caveats and under certain circumstances.

Rule 3.4(b) of the Model Rules of Professional Conduct, which has been largely adopted in most jurisdictions, and ABA Formal Ethics Opinion 96-402 provide guidance regarding what types of payment to fact witnesses are permissible. Rule 3.4(b) states that a lawyer shall not “falsify evidence, counsel or assist a witness to testify falsely, or offer an inducement to a witness that is prohibited by law.”<sup>2</sup> Comment 3 to Rule 3.4 advises that it is not improper to pay a witness’s expenses, but “the common law rule in most jurisdictions is that it is improper to pay an occurrence witness any fee for testifying....”<sup>3</sup>

The ABA has construed Rule 3.4 and Comment 3 to allow compensation to fact witnesses for time lost preparing to testify and testifying on the basis that such compensation is not equivalent to paying a “fee for testifying.”<sup>4</sup> The ABA found:

[There is] no reason to draw a distinction between (a) compensating a witness for time spent in actually attending a deposition or a trial and (b) compensating the witness for time spent in pretrial interviews with the lawyer in preparation for testifying, as long as the lawyer makes it clear to the witness that the payment is not being made for the substance (or efficacy) of the witness’s testimony or as an inducement to “tell the truth.” The Committee is further of the view that the witness may also be compensated for time spent in reviewing and researching records that are germane to his or her testimony, provided, of course, that such compensation is not barred by local law.<sup>5</sup>

Thus, under the ABA’s interpretation of Rule 3.4, a party may compensate a third-party fact witness for time lost attending a deposition or trial, meeting with a lawyer to prepare such testimony, or reviewing or researching documents relevant to such testimony, so long as the payment is reasonable, not conditioned on the fact of testifying or the content of the testimony, and does not violate the law of the jurisdiction.

### Forum Jurisdiction

As Rule 3.4 makes clear, counsel contemplating paying a third-party witness must next examine whether any such payment is permissible under the laws and ethical rules of the forum in which the litigation occurs.<sup>6</sup> Most jurisdictions, including California, follow the ABA’s interpretation of Rule 3.4(b) and allow for payment to fact witnesses for

time lost for testifying and preparing to testify as well as for reasonable expenses. Rule 5-310(B) of the California Rules of Professional Conduct states that a member of the bar shall not provide “payment of compensation to a witness contingent upon the content of the witness’ testimony or the outcome of the case,” but can, except where prohibited by law, provide payment of expenses reasonably incurred by a witness in attending or testifying and reasonable compensation to a witness for loss of time in attending or testifying.<sup>7</sup> The State Bar of California Standing Committee on Professional Responsibility and Conduct (COPRAC) has interpreted Rule 5-310(B) to include “time necessary for preparation for or testifying at deposition or trial, as long as the compensation is reasonable..., does not violate applicable law, and is not paid to a witness contingent upon the content of the witness’ testimony, or the outcome of the case.”<sup>8</sup>

### The Federal Antigratuity Statute

However, other states interpret state laws and ethical rules to disfavor payment of fact witnesses for time spent preparing to testify.<sup>9</sup> In addition to complying with the law of the forum jurisdiction, a party must ensure that any payment to a fact witness does not run afoul of the federal antigratuity law, which makes it a crime to “corruptly give[], offer[], or promise[] anything of value to any person...with intent to influence [that person’s] testimony under oath...[in] a trial, hearing, or other proceeding.”<sup>10</sup> On the other hand, the statute makes clear that Sections 201(b) and (c) do not prohibit “the payment...of witness fees provided by law” or “the payment...of the reasonable cost of travel and subsistence incurred and the reasonable value of time lost in attendance at any such trial, hearing or proceeding....”<sup>11</sup>

To comply with Section 201(c), a party contemplating paying a witness must ensure that any contemplated payment to a fact witness is not “because of” that person’s testimony.<sup>12</sup> In other words, any payment must be unrelated to the fact or content of the witness’s testimony. In *Centennial Management Services, Inc. v. AXA Re Vie*,<sup>13</sup> the District of Kansas held that a defendant insurance company did not violate Section 201 when the company paid nearly \$70,000, including an up-front payment of \$20,000, to a former employee for a number of nontestifying activities he performed while preparing for his deposition, including reviewing deposition transcripts of other witnesses and documents produced in the litigation and meeting with lawyers in preparation for the deposition. According to the court, the company did not run afoul of the federal antigratuity statute when there was no evidence that the pay-

ment to this fact witness was “for” or “because of” his testimony and no cited authority supported the argument that “a person violates the anti-gratuity statute by paying a fact witness reasonable compensation for time spent in connection with legitimate, non-testifying activities.”<sup>14</sup>

### Federal and State Case Law

Finally, lawyers should look to federal and state case law interpreting applicable federal and state laws and ethical rules and interpreting the common law to determine the boundaries of permissible payments in a particular jurisdiction.

For example, in interpreting the federal antigratuity statute and Rule 5-310(B), the Northern District of California recently held that a defendant’s challenge to a plaintiff’s payment of a \$100,000 lump sum for the time of a litigation consultant, who was also being paid under a separate contract for “general cooperation and testimony as a fact witness,” failed because the party challenging the payment did not “allege facts demonstrating that [the consultant] was improperly paid for his testimony rather than being compensated as a litigation consultant.”<sup>15</sup> Accordingly, in evaluating whether a payment is covered by the prohibition on paying for testimony, certain courts appear to require a party challenging a payment to prove that the payee is in fact being compensated for his or her services as a fact witness rather than as a consultant.

Likewise, the Southern District of New York permitted a payment to a fact witness not only for time and expenses spent preparing for his own testimony but also for time spent “participating in the preparation of other witnesses.”<sup>16</sup> According to the court, “federal courts...are generally in agreement that a witness may properly receive payment related to the witness’ expenses and reimbursement for time lost associated with the litigation.”<sup>17</sup> Regarding the burden that a party challenging payment to a fact witness must fulfill, the court held:

Petitioners have failed to present any caselaw or authority in this Circuit or elsewhere that suggests that counsel is prohibited from meeting with multiple witnesses at the same time. They have similarly failed to establish any facts to support allegations of witness tampering....In light of the foregoing, Petitioners have failed to sustain their burden of establishing that the Panel’s decision with regard to Farr’s compensation was in manifest disregard of the law.<sup>18</sup>

Although most jurisdictions allow for payment to fact witnesses for time lost for testifying and preparing to testify, a few courts

# MCLE Test No. 217

The Los Angeles County Bar Association certifies that this activity has been approved for Minimum Continuing Legal Education legal ethics credit by the State Bar of California in the amount of 1 hour.

1. Traditional common law allowed compensation to fact witnesses.  
True.  
False.
2. To violate the federal antigratuity statute, the briber must act with a "corrupt mind."  
True.  
False.
3. Possible civil sanctions for paying a witness a fee for testifying can include:  
A. Exclusion of testimony of the witness who received the improper payment.  
B. Award of attorney's fees and costs to opposing party.  
C. Mistrial.  
D. All of the above.
4. The ABA has construed Rule 3.4 to allow compensation to fact witnesses for time lost preparing to testify.  
True.  
False.
5. In *Centennial Management Services, Inc. v. AXA Re Vie*, the court upheld a payment to a former employee for nontestifying activities in the amount of:  
A. \$20,000.  
B. \$100,000.  
C. \$70,000.  
D. \$85,000.
6. Many courts have approved of the use of "consulting" agreements to compensate fact witnesses.  
True.  
False.
7. Counsel should memorialize any agreement for reasonable compensation and make it clear that the payment is for lost time and reasonable expenses.  
True.  
False.
8. In New York, a court permitted payment to a fact witness for time spent participating in the preparation of other witnesses.  
True.  
False.
9. To comply with 18 U.S.C. Section 201(c), a party must ensure that any contemplated payment to a fact witness is not "because of" that witness's testimony.  
True.  
False.
10. The California Standing Committee on Professional Responsibility and Conduct has stated that a witness's rate of pay if currently employed should be considered in determining the reasonableness of any payment to a fact witness.  
True.  
False.
11. The ABA has instructed that the following objective factor should be considered when determining the reasonableness of payment to a witness:  
A. Whether the witness has sustained any direct loss of income.  
B. The type of information that the witness will provide.  
C. The location where the witness is from.  
D. None of the above.
12. California courts have generally found that a bilateral agreement is not a necessary element of the crime of offering a bribe to a witness.  
True.  
False.
13. A person who violates U.S.C. Section 201(b)(3) shall be fined not more than \_\_\_\_ times the monetary equivalent of the thing of value.  
A. Two.  
B. Three.  
C. Four.  
D. Five.
14. New Jersey has followed the traditional common law rule and prohibited payment of fact witnesses for time spent preparing to testify.  
True.  
False.
15. The State Bar of California Standing Committee has interpreted Rule 5-310(b) to allow compensation to a witness to include the time spent for preparing or testifying at a trial as long as the compensation is reasonable and is not paid contingent upon the witness's testimony or outcome of the case.  
True.  
False.
16. The rationale for the traditional common law approach to compensating fact witnesses is:  
A. Payment could lead to obtaining perjured testimony.  
B. Payment created an appearance of impropriety.  
C. It was inconsistent with a witness's preexisting public duty to testify truthfully.  
D. All of the above.
17. Agreements to provide reasonable compensation never have to be disclosed to the court or opposing counsel.  
True.  
False.
18. Counsel may not provide protection to a third party from ongoing or future litigation in exchange for securing that party's cooperation as a fact witness.  
True.  
False.
19. Consulting agreements should be executed as late as possible.  
True.  
False.
20. Courts have often found payment to a third-party witness to be unreasonable when the hourly rate paid is significantly above the witness's current or recent rate of pay on the fair market.  
True.  
False.

## MCLE Answer Sheet #217



### YOUR WITNESS

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Law Firm/Organization \_\_\_\_\_

Address \_\_\_\_\_

City \_\_\_\_\_

State/Zip \_\_\_\_\_

E-mail \_\_\_\_\_

Phone \_\_\_\_\_

State Bar # \_\_\_\_\_

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Mark your answers to the test by checking the appropriate boxes below. Each question has only one answer.

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| 2.  | <input type="checkbox"/> True | <input type="checkbox"/> False   |
| 3.  | <input type="checkbox"/> A    | <input type="checkbox"/> B <input type="checkbox"/> C <input type="checkbox"/> D |
| 4.  | <input type="checkbox"/> True | <input type="checkbox"/> False   |
| 5.  | <input type="checkbox"/> A    | <input type="checkbox"/> B <input type="checkbox"/> C <input type="checkbox"/> D |
| 6.  | <input type="checkbox"/> True | <input type="checkbox"/> False   |
| 7.  | <input type="checkbox"/> True | <input type="checkbox"/> False   |
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| 9.  | <input type="checkbox"/> True | <input type="checkbox"/> False   |
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| 12. | <input type="checkbox"/> True | <input type="checkbox"/> False   |
| 13. | <input type="checkbox"/> A    | <input type="checkbox"/> B <input type="checkbox"/> C <input type="checkbox"/> D |
| 14. | <input type="checkbox"/> True | <input type="checkbox"/> False   |
| 15. | <input type="checkbox"/> True | <input type="checkbox"/> False   |
| 16. | <input type="checkbox"/> A    | <input type="checkbox"/> B <input type="checkbox"/> C <input type="checkbox"/> D |
| 17. | <input type="checkbox"/> True | <input type="checkbox"/> False   |
| 18. | <input type="checkbox"/> True | <input type="checkbox"/> False   |
| 19. | <input type="checkbox"/> True | <input type="checkbox"/> False   |
| 20. | <input type="checkbox"/> True | <input type="checkbox"/> False   |



have followed the traditional common law rule and prohibited payment of fact witnesses for time spent preparing to testify. In *Goldstein v. Exxon Research & Engineering Company*,<sup>19</sup> the District of New Jersey held that a corporate defendant could not pay a retired employee for “time spent preparing to testify on facts within [his] personal knowledge.” Thus, it is important for counsel considering paying a fact witness to determine whether his or her jurisdiction follows the traditional common law approach, which is significantly more restrictive with respect to

be assessed “based on all relevant circumstances,” the ABA has pointed to certain objective factors to consider in determining reasonableness, including whether the witness “has sustained any direct loss of income,” and, if not, “the reasonable value of the witness’s time.”<sup>23</sup> The California Standing Committee on Professional Responsibility and Conduct has suggested similar objective factors to consider in determining the reasonableness of any payment to a fact witness, including: “the witness’ normal rate of pay if currently employed, what the witness last

also execute the agreement as early as possible and be clear in the agreement that reasonable compensation is for time and expenses and not for the testimony itself.”<sup>30</sup>

The ABA and COPRAC have not specifically addressed the question of whether it is permissible to pay a third-party witness’s attorney’s fees in connection with litigation. However, several state bar associations have considered the topic.<sup>31</sup> Generally, these states have held that paying a third-party fact witness’s attorney’s fees is permissible provided that the payment is limited to the witness’s

## **Section 201(b)(3) of the federal antigratuity statute makes it a crime to corruptly give, offer, or promise anything of value to any person with intent to influence that person’s testimony under oath in a trial, hearing, or other proceeding. A person who violates this statute may be fined, imprisoned, or both.**

what constitutes proper payment to fact witnesses.

In all jurisdictions, the prohibition against paying third-party witnesses a “fee for testifying” generally means that counsel cannot attach any conditions to the payment that may be viewed as influencing the testimony. For example, payment to a witness will be considered unethical if it is 1) conditioned on the giving of testimony in a certain way, 2) made to prevent the witness’s attendance at trial, or 3) contingent on the outcome of the case.<sup>20</sup> Likewise, courts have found that counsel may not provide protection to a third party from ongoing or future litigation in exchange for securing that party’s cooperation as a fact witness, nor may counsel seek exclusive access to a third-party witness in exchange for payment.<sup>21</sup>

After determining that paying a third-party witness is permissible in the forum jurisdiction, counsel should consider the amount and manner of payment. Factors include 1) what constitutes reasonable compensation, 2) whether to put it in writing and disclose it, and 3) whether it may be proper to pay the witness pursuant to a consulting agreement.

### **Reasonable Compensation**

Virtually every jurisdiction that permits paying fact witnesses follows the ABA’s interpretation of Rule 3.4(b) that compensation “must be reasonable, so as to avoid affecting, even unintentionally, the content of a witness’s testimony.”<sup>22</sup> Although reasonableness must

be assessed “based on all relevant circumstances,” the ABA has pointed to certain objective factors to consider in determining reasonableness, including whether the witness “has sustained any direct loss of income,” and, if not, “the reasonable value of the witness’s time.”<sup>23</sup> The California Standing Committee on Professional Responsibility and Conduct has suggested similar objective factors to consider in determining the reasonableness of any payment to a fact witness, including: “the witness’ normal rate of pay if currently employed, what the witness last

### **Written Agreement**

Once counsel has decided on reasonable payment for a witness, it is advisable to memorialize the agreement in writing, making clear that the payment is for lost time and reasonable expenses and not for the testimony itself.<sup>26</sup> A number of courts have found that payment to a third-party witness should be considered by the trier of fact in assessing the witness’s credibility, so counsel should be prepared to disclose the agreement to the court and opposing counsel.<sup>27</sup>

Particularly in the cases in which a company pays a former employee for lost time in connection with testifying, courts have often endorsed the use of “consulting” agreements to compensate fact witnesses.<sup>28</sup> However, some courts have looked upon such agreements with skepticism.<sup>29</sup> Therefore, it is important to understand the law on the propriety of paying nonexpert litigation consultants in the jurisdiction in which the litigation is taking place. As with all agreements to pay a third-party witness, counsel contemplating the use of consulting agreements should assume the agreement will be produced in discovery and not be protected from disclosure by any privilege. Counsel should

participation in the proceeding and is not an inducement for particular testimony. Given California’s permissive approach to payments—such as explicitly allowing payment for preparation time—it is likely that California would follow the lead of these states that have permitted the payment of attorneys’ fees under certain circumstances. However, given the lack of guidance, the issue of attorney’s fees remains unsettled in California and many other jurisdictions.

### **Sanctions**

Parties and their counsel may be subject to civil and criminal sanctions for running afoul of the laws regulating the payment of fees to fact witnesses. Possible civil sanctions for paying a witness a fee for testifying or paying a witness an unreasonable amount span the full range available for discovery violations, including 1) the exclusion of the testimony of the witness who received improper payments, 2) an award of attorney’s fees and costs to the opposing party, 3) mistrial, and 4) disciplinary action by the state bar.<sup>32</sup> In addition, federal and state law set out criminal sanctions.

Section 201(b)(3) of the federal antigratuity statute makes it a crime to corruptly give, offer, or promise anything of value to any person with intent to influence that person’s testimony under oath in a trial, hearing, or other proceeding.<sup>33</sup> A person who violates this statute may be fined, imprisoned, or both, and may be “disqualified from holding any office of honor, trust, or profit under the United

States.”<sup>34</sup> In addition, Section 201(c)(2) makes it a crime to give, offer, or promise anything of value to any person, for testimony under oath.<sup>35</sup> A person who violates Section 201(c)(2) “shall be fined under this title or imprisoned for not more than two years, or both.”<sup>36</sup>

To violate Section 201(b)(3), one must act with a “corrupt mind,” but one can violate Section 201(c)(2) without acting with a “corrupt mind.”<sup>37</sup> The Eleventh Circuit—acknowledging that the distinction does not appear in the plain language of the statute—has distinguished between truthful and non-truthful testimony and held that the payments for truthful testimony were not a crime under Section 201(c)(2), even though they violated the applicable state rules of professional conduct.<sup>38</sup>

California law makes it a felony for any person to give or promise to give to any potential witness any bribe upon any understanding that 1) the testimony of the witness shall be thereby influenced or 2) the person shall not attend the trial or judicial proceeding.<sup>39</sup> California courts have interpreted Penal Code Section 137 to govern when there is a “sense...that testimony will be given, but the perpetrator will attempt to influence the testimony given” and Section 138 to govern when “the perpetrator will prevent or dissuade a prospective witness from giving testimony, or will attempt to do so.”<sup>40</sup> California courts have generally found that “a bilateral agreement is not a necessary element of the crime of offering a bribe to a witness,” but rather “bribery must be proposed by the person offering to give or to receive the bribe...with the criminal intent that a corrupt act will be committed by the one accepting the bribe.”<sup>41</sup>

Most jurisdictions have modified the traditional common law rule prohibiting any payment to third-party witnesses, recognizing the fact that civic duty alone may not compel a knowledgeable witness who values his or her time to donate that time to providing testimony that is crucial to the truth-finding function of litigation.<sup>42</sup> However, counsel contemplating payment to a third-party witness should be careful not to run afoul of the federal and state laws and ethical rules governing such payments. Further, counsel should follow a number of basic steps. These include setting the third-party witness’s compensation at a reasonable rate that reflects the fair market value of the witness’s time, entering into a written agreement making clear that payment is for time lost and reasonable expenses incurred and not for the fact or substance of the testimony, and disclosing that agreement to the court and opposing counsel when required to do so. Careful attention to and diligence in handling these issues is critical

because the potential civil and criminal exposure for violations, as well as damage to the witness’s credibility, the client’s case, and counsel’s reputation are broad and significant. ■

<sup>1</sup> See John K. Villa, *Paying Fact Witnesses*, ACCA DOCKET 19, no. 9, 112-15 (2001) (citing *Compensating Fact Witnesses*, 184 F.R.D. 425, 427)). See also, e.g., *Hamilton v. General Motors Corp.*, 490 F.2d 223, 228 (7th Cir. 1973); *Alexander v. Watson*, 128 F.2d 627, 631 (4th Cir. 1942); *In re Howard*, 372 N.E. 2d 371, 374 (Ill. 1977).

<sup>2</sup> MODEL RULES OF PROF’L CONDUCT R. 3.4(b).

<sup>3</sup> MODEL RULES OF PROF’L CONDUCT R. 3.4(b) cmt. 3.

<sup>4</sup> See ABA Comm. on Ethics and Prof’l Responsibility, Op. No. 96-402 (interpreting Rule 3.4(b), Comment 3, and DR 7-109(C), the predecessor to Rule 3.4).

<sup>5</sup> *Id.*

<sup>6</sup> See MODEL RULES OF PROF’L CONDUCT R. 8.5(b) (The rules of law of the forum jurisdiction will generally govern when question arises regarding choice of law.).

<sup>7</sup> CAL. R. PROF’L CONDUCT R. 5-310(B). Rule 5-310(B) is identical except for nonsubstantive matters to DR 7-109(C), the Model Code predecessor to Rule 3.4. See State Bar Standing Committee on Professional Responsibility and Conduct (COPRAC), Op. No. 1997-149.

<sup>8</sup> State Bar Standing Committee on Professional Responsibility and Conduct (COPRAC), Op. No. 1997-149.

<sup>9</sup> See Pa. Bar Ass’n Comm. Leg. Eth. Prof’l Resp., Informal Op. No. 95-126A (interpreting Pennsylvania ethical rule and witness compensation statute to “disfavor” payment of fact witnesses for time spent preparing to testify).

<sup>10</sup> 18 U.S.C. §201(b)(3); see also 18 U.S.C. §201(c)(2) (prohibiting a party from demanding, seeking, receiving, accepting, or agreeing to receive or accept anything of value “because of the testimony” or to ensure the absence of a witness).

<sup>11</sup> 18 U.S.C. §201(d).

<sup>12</sup> 18 U.S.C. §201(c)(2).

<sup>13</sup> *Centennial Mgmt. Servs., Inc. v. AXA Re Vie*, 193 F.R.D. 671, 681 (D. Kan. 2000).

<sup>14</sup> *Id.* at 682.

<sup>15</sup> *Aristocrat Tech. v. International Game Tech.*, No. C-06-03717, 2010 WL 2595151, at \*2 (June 28, 2010).

<sup>16</sup> *Prasad v. MML Investors Servs., Inc.*, No. 04 Civ. 380, 2004 WL 1151735, at \*5 (S.D. N.Y. May 24, 2004).

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at \*7.

<sup>19</sup> *Goldstein v. Exxon Research & Eng’g, Co.*, No. CV 95-2410, 1997 WL 580599, at \*3 (D. N.J. Feb. 28, 1997).

<sup>20</sup> John K. Villa, *Paying Fact Witnesses*, ACCA DOCKET 19, no. 9, 112-15 (2001). See also, e.g., *New York v. Solvent Chem. Co.*, 166 F.R.D. 284, 289 (W.D. N.Y. 1996); *Golden Door Jewelry Creations, Inc. v. Lloyds Underwriters Non-Marine Ass’n*, 865 F. Supp. 1516, 1526 (S.D. Fla. 1994), *aff’d in part*, 117 F.3d 1328 (11th Cir. 1997); *Ojeda v. Sharp Caballo Hosp.*, 8 Cal. App. 4th 1, 10, 10 Cal. Rptr. 2d 230, 236 (1992) (“[A] contingent fee cannot be paid for the testimony of a witness”).

<sup>21</sup> See, e.g., *Solvent Chem.*, 166 F.R.D. at 289-90 (“[T]he court finds nothing improper in the reimbursement of expenses incurred by [the witness] in travelling to New York to provide [the defendant] with factual information, or in the payment of a reasonable hourly fee for [the witness’s] time. But in providing [the witness] with protection from liability in [another] litigation, and in this action, as a means of

obtaining his cooperation as a fact witness, [the defendants] went too far.”).

<sup>22</sup> ABA Comm. on Ethics and Prof’l Responsibility, Op. No. 96-402.

<sup>23</sup> *Id.*

<sup>24</sup> State Bar Standing Committee on Professional Responsibility and Conduct (COPRAC), Op. No. 1997-149. See also, e.g., *Centennial Mgmt. Servs., Inc. v. AXA Re Vie*, 193 F.R.D. 671, 680-81 (D. Kan. 2000). (The defendants’ compensation of a fact witness at rates ranging from \$125 to \$200 per hour was not unreasonably high or disproportionate to time spent on litigation matters, particularly in light of the witness’s years of experience in the insurance industry, his firsthand experience with reinsurance agreements that were the subject of the lawsuit, and the complex nature of the litigation.).

<sup>25</sup> See, e.g., *United States v. Cineroy Corp.*, No. 99 CV 1693, 2008 WL 7679914, at \*12 (S.D. Ind. Dec. 18, 2008) (Payment of \$200 an hour to a witness was beyond “the reasonable value of time lost” for a person who was retired and had made \$88 per hour for his services at the time of his retirement three years earlier.).

<sup>26</sup> See John K. Villa, *Paying Fact Witnesses*, ACCA DOCKET 19, no. 9, 112-15 (2001).

<sup>27</sup> See, e.g., *Jamaica Time Petroleum, Inc. v. Federal Ins. Co.*, 366 F.2d 156, 158 (10th Cir. 1966), *cert. denied*, 385 U.S. 1024 (1967); *Fund of Funds Ltd. v. Arthur Andersen & Co.*, 545 F. Supp. 1314, 1370 (S.D. N.Y. 1982) (“[I]t is permissible, indeed desirable, to bring any such payments to the attention of the jury and for counsel to comment upon [their] possible effect...upon a witness’ credibility.”).

<sup>28</sup> See, e.g., *New York v. Solvent Chem. Co.*, 166 F.R.D. 284, 289 (W.D. N.Y. 1996) (consulting agreement). See also *Prasad v. MML Investors Servs., Inc.*, No. 04 Civ. 380, 2004 WL 1151735, at \*5 (S.D. N.Y. May 24, 2004).

<sup>29</sup> See, e.g., *Goldstein v. Exxon Research & Eng’g, Co.*, No. CV 95-2410, 1997 WL 580599, at \*7 (D. N.J. Feb. 28, 1997) (ordering the disclosure of a “consulting agreement”).

<sup>30</sup> See *Tainna Hill Raby, Paying Fact Witnesses: Can Do? No Can Do?*, TRIAL.COM (May 2, 2011), available at <http://www.trial.com/cle/materials/2011-fl/raby.pdf>. See also *Solvent Chem.*, 166 F.R.D. at 289 (consulting agreement not protected from disclosure under attorney work product doctrine or any other privilege).

<sup>31</sup> See, e.g., S.C. Ethics Advisory Op. 08-05 (July 28, 2008); Fl. Bar Staff Op. 23940 (July 3, 2002); Del. State Bar Ass’n Comm. on Prof’l Ethics Op. 1994-1 (Feb. 14, 1994); Ala. State Bar Ass’n Op. 82-699 (Jan. 5, 1983).

<sup>32</sup> See *Tainna Hill Raby, Paying Fact Witnesses: Can Do? No Can Do?*, TRIAL.COM (May 2, 2011) (citing cases), available at <http://www.trial.com/cle/materials/2011-fl/raby.pdf>.

<sup>33</sup> 18 U.S.C. §201(b)(3).

<sup>34</sup> *Id.*

<sup>35</sup> 18 U.S.C. §201(c)(2).

<sup>36</sup> *Id.*

<sup>37</sup> See *Golden Door Jewelry Creations, Inc. v. Lloyds Underwriters Non-Marine Ass’n*, 865 F. Supp. 1516, 1523 (S.D. Fla. 1994), *aff’d in part*, 117 F.3d 1328 (11th Cir. 1997).

<sup>38</sup> *Id.* at 1523-24 (citing *United States v. Moody*, 977 F.2d 1425 (11th Cir. 1992), *cert. denied*, 507 U.S. 1052 (1993)).

<sup>39</sup> PENAL CODE §§137(a), 138(a). See also PENAL CODE §138(b).

<sup>40</sup> *People v. Womack*, 40 Cal. App. 4th 926, 931 (1995) (emphasis in original).

<sup>41</sup> *People v. Pic’l*, 31 Cal. 3d 731, 738-39 (1982).

<sup>42</sup> See *Elizabeth J. Sher & Ronald D. Coleman, Court Nixes Fees for Fact Witnesses*, 20 NAT’L L. J. 4 (Sept. 22, 1997).

# BREAK TIMING

BY JANET GRUMER and  
AARON COLBY

***Brinker* provides employers with some clarity on their responsibilities in providing meal and rest breaks**

SINCE THE CALIFORNIA SUPREME Court's decision in April in *Brinker Restaurant v. Superior Court*,<sup>1</sup> employers have been grappling with how to manage employee meal and rest periods. The decision goes a long way toward clarifying what employers must do and not do to avoid meal and rest period litigation and reduce the likelihood of class certification, but the decision leaves many questions unanswered.

Class action litigation over missed meal and rest periods began in earnest in 2000, after California's Industrial Welfare Commission adopted monetary penalties of one hour of pay for every day on which an employee is denied a meal period and another for every day on which a rest period is denied.<sup>2</sup> In 2007, the pace of wage and hour class action filings quickened after the California Supreme Court ruled in *Murphy v.*

*Kenneth Cole Productions* that the so-called meal and rest period "penalties" were actually wage "premiums"<sup>3</sup> and that the longer statute of limitations for unpaid wages applies.<sup>4</sup> Until the supreme court's decision in *Brinker Restaurant*, the controversy over what it means to provide<sup>5</sup> meal periods and to "authorize and permit"<sup>6</sup> rest periods led to conflicting state and federal court holdings and caused employers confusion. The decision was widely anticipated as the final word on the longstanding controversy, and it did resolve some issues, but many others are open for continued debate and more class action litigation.

*Brinker Restaurant* addressed claims that a chain of restaurants failed to provide a class of restaurant employees with meal and rest periods, as required by the Labor Code and wage orders.<sup>7</sup> It also addressed when

and how it is appropriate for a court to examine the facts to determine whether class certification should be granted.

In the months since *Brinker Restaurant* was decided, employers statewide were at first grateful for the supreme court clarification, but are now scrambling to fashion new meal and rest period policies and figure out how to enforce them. The troublesome "rolling five" rule, enforced by the Division of Labor Standards Enforcement (DLSE), which required that employees work no more than five consecutive hours without a meal period, is gone. Also gone are the DLSE rules that a rest period must always take place

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before the first meal period and the rule that missed meal or rest periods automatically result in employer liability for meal and rest period penalties. But in their place are new compliance issues, including what it means to properly “relieve” employees of duty, what actions improperly “impede” the ability of employees to take meal and rest periods, and how an employer will prove that employees voluntarily chose not to take some or even all of the meal and rest periods they were entitled to.

## Meal Periods

Prior to *Brinker Restaurant*, the DLSE and the courts required employers whose employees worked through meal or rest periods to pay meal and rest period premiums, regardless of whether the employees violated company policy or even the direct orders of management by doing so. Relying on opinion letters issued by the DLSE, rather than the statutes and regulations, the *Brinker Restaurant* plaintiff claimed that his employer had violated the Labor Code by failing to ensure that restaurant employees took all meal and rest periods and that they performed no work during meal and rest periods. *Brinker Restaurant* argued that neither the statute nor the wage orders require more than permitting meal periods for those who choose to take them, and that the legislature did not intend otherwise.<sup>8</sup>

As most employers can attest, forcing unwilling employees to take meal and rest periods on a timely basis is a tall order, especially in restaurants and retail establishments, where customers often come in large numbers during narrow time frames. That problem is compounded in restaurants where tips are at stake and employees have more to gain by working through a break than taking one.

In response to the conflicting rulings from state and federal courts, the supreme court gave employers the most important item on their wish lists—a ruling that although employers must relieve employees of all duty for meal periods, they need not ensure that employees do no work during meal periods.<sup>9</sup> Finding no statutory or regulatory support for the DLSE’s position, the court held that employers are not required to pay meal and rest period penalties when employees choose not to take meal periods, providing that the employer has relieved employees of work, provided a reasonable opportunity to take the meal periods, and has not impeded employees from taking meal periods.<sup>10</sup>

Despite the good news, many questions about meal periods remain. The court left open for interpretation what it means to relieve employees of duty, explaining only that an employer satisfies this obligation if it relinquishes control over employee activities,

permits employees a reasonable opportunity to take an uninterrupted 30-minute break, and does not impede or discourage them from doing so.<sup>11</sup> The court also confirmed that employees must be “free to leave the premises” and attend to personal business during meal periods.<sup>12</sup>

What it means to “impede” employees from taking breaks also is unclear. With many employers expecting fewer employees to do more work in less time, the line between requiring good and efficient performance and actually impeding the ability of employees to take meal periods is not sharply drawn. The supreme court cites a few existing cases to assist employers with that analysis but falls short of marking a clear path for employers. For example, in one case in which a meal period penalty was due, the employer paid employees for accomplishing tasks in a manner that would effectively monetarily penalize them if they took meal and rest periods.<sup>13</sup> In another case resulting in penalties, the employer’s scheduling policy made taking breaks extremely difficult.<sup>14</sup> In another case, an informal policy against meal breaks, enforced through ridicule or reprimand, also resulted in penalties.<sup>15</sup>

The court also held that proof that an employer had knowledge that employees were working through meal periods is not enough to create liability for penalties (although it is sufficient to require employers to pay for the work).<sup>16</sup> The court held that employees may not “manipulate the flexibility granted to them by employers to generate liability for penalties.”<sup>17</sup> The same is true for rest periods, as long as the employer has authorized and permitted them. Because employers must pay for and record all time worked, the practice of deducting 30 minutes from all nonexempt employees’ time, regardless of whether they clock out, will likely result in claims that employers permitted unpaid, off-the-clock work and should be discontinued.

That leaves an open question as to whether programs offering pay for increased performance will fall into the category of impeding employees from taking breaks, because employees could make more money and gain employer approval by skipping them. Similarly, it is not clear at what point performance goals or the threat of discipline becomes an impediment to taking meal and rest periods.

Allowing employees to opt to work through meal breaks, while helpful, may also turn out to be difficult for employers to manage. Most employers have no records of whether or not an employee chose, on any particular day, to take or forego a meal or rest period. And most have no means of tracking that information. The result is that employ-

ers, who bear the burden of proving compliance, may face substantial overtime and meal period premium liability when they permit employees to decide whether or not to take meal periods.

In addition to claiming that the defendant failed in its duty to police meal periods, the plaintiff in *Brinker Restaurant* also claimed that the defendant’s uniform policy violated the Labor Code by failing to provide, for shifts exceeding 10 hours, a second meal period no later than 5 hours after the end of a first meal period.<sup>18</sup> Finding no support in the statute, the supreme court declined to enforce the DLSE’s rolling-five rule. This rule had created a scheduling nightmare for employers trying to balance operational needs, employee preferences, and difficult-to-predict quitting times. Instead, the court found that the first meal period must begin no later than the end of the 5th hour of work, but that there was no requirement that a second meal period begin within 5 hours of the end of the first.<sup>19</sup> For example, if an employee takes a first meal break in the 2nd hour of a 12-hour shift, the second meal period is now required no later than the 10th hour of work, thus easing the scheduling burden on employers.

Employers should keep in mind that when employees work through meal periods and the end of their shifts are not adjusted, the additional time worked may result in an overtime bill.

## Rest Periods

Rest period requirements and timing have also long been a source of misunderstanding for California employers. The regulation requires that employers “authorize and permit” employees to take paid 10-minute rest periods, when practicable, in about the middle of each 4-hour work period “or major fraction thereof.” Rest periods need not be given when the total time worked on a day is less than 3½ hours.<sup>20</sup> Although the requirement appears simple, there has long been controversy surrounding what “a major fraction thereof” means, how rest periods must be scheduled in conjunction with meal periods, and whether employers must ensure employees take rest periods.

The plaintiff in *Brinker Restaurant* argued that employees were deprived of appropriate rest periods because Brinker Restaurant’s policy did not provide for as much rest period time as employees were entitled to. At the time, Brinker Restaurant’s policy provided for 10 minutes of break time for every 4 hours worked. But the regulations provide for more than that.

An employee must be permitted to take a second rest break if he or she works more than 6 hours (not 8), and a third rest break if he or she works more than 10 hours (not



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12). Thus, the employer's policy failed to account for the "major fraction" language and failed to provide sufficient breaks on work days lasting between 3½ and 4 hours.<sup>21</sup> Relying on a DLSE opinion letter interpreting a wage order not at issue in the case, the plaintiff also argued that employers have a legal duty to provide a rest break before any meal period and that the defendant's policy failed to comply with this duty.<sup>22</sup>

fails to make rest periods available to employees and not when an employee chooses to skip a rest period.

### Class Certification

The court also provided specific guidance on how common policies and individualized proof should be considered in granting or denying class certification in wage and hour class action matters. The court reasoned that

Taking the same approach with the "off the clock" class claims, the court reached the opposite conclusion. In granting certification of these claims, the trial court had considered no common employer policy and only "a handful of individual instances when employees worked off the clock."<sup>28</sup> The court held that the certification of off-the-clock claims was properly vacated by the court of appeal.

Finally, on the issue of certification of the meal period class claims, the court examined the class and determined that it likely included a substantial number of participants who had no possible claims, because it included all nonexempt employees who had worked in excess of five hours in a row without a meal period (including those with only rolling-five violations). As a result of the flaw in the class definition and the likelihood that the grant of certification was based on the trial court's erroneous consideration of rolling-five violations, the court reversed and remanded the grant of certification for the meal period class.<sup>29</sup>

### Decisions after *Brinker Restaurant*

At least two trial courts have already denied class certification based on the *Brinker Restaurant* decision. In one Los Angeles Superior Court case citing *Brinker Restaurant*, the trial court declined to certify a class of nurses who claimed that their hospital employer had denied them meal periods.<sup>30</sup> The court held that the claims of the nurses, who occasionally worked double shifts, were not suitable for class treatment because a determination would require substantial individualized inquiry.<sup>31</sup>

In another Los Angeles Superior Court case, the trial court denied class certification for the same reason, finding that the claims of a group of more than 700 telecommunications workers who worked for the most part unsupervised at hundreds of locations were not suitable for class treatment.<sup>32</sup> The declarations submitted were inconsistent, showing that some employees took all breaks, others chose to leave early, and others worked straight through. The court held that there was no way to tell who was owed what without individualized inquiry.<sup>33</sup>

Now that the supreme court has decided the basics, there will be additional clarification as its ruling is tested in the courts. Notwithstanding the open questions, employers would be unwise to wait for more information and should already be modifying policies and practices and working to dispel the now commonly held belief that employers and employees no longer have to worry about meal and rest period issues.

In many respects, the *Brinker Restaurant* decision has merely changed the threshold



On this issue, the court held that employers are subject to a duty to make a "good faith effort" to authorize and permit rest breaks in the middle of each work period, but that they may deviate from that where practical considerations render it unfeasible. Furthermore, the court held that nothing in the Labor Code or wage orders requires that rest periods fall before or after a first meal period, though "as a general matter" one rest break should fall on either side of the meal break, subject to factors that might make this impractical.<sup>23</sup> In addition, the court provided a bright-line rule on the "major fraction thereof" language, finding that on shifts of 3½ to 6 hours, 10 minutes of paid rest period time is due, that for shifts of more than 6 and up to 10 hours, 20 minutes of paid rest period time is due, and that for shifts of more than 10 hours, 30 minutes of paid rest time is due.<sup>24</sup>

The court also clarified that rest period penalties are due only when the employer

any "peek" into the merits of a case for purposes of deciding the propriety of class certification must be narrowly circumscribed to include only those aspects of the merits necessary to determine if the elements required to establish liability are susceptible to common proof. If they are not, a court should consider whether there are ways to effectively manage individualized proof within a class action proceeding.<sup>25</sup> As a result, a noncompliant policy may be sufficient to establish class certification, as long as the individualized proof of claims is manageable within a class action setting.

*Brinker Restaurant's* rest period policy incorrectly stated that a 10-minute rest period was provided for every 4 hours worked.<sup>26</sup> Because the policy was wrong and the employer had conceded that it was uniformly applied to all nonexempt employees, the court remanded, finding that a common policy was at issue and that class certification was appropriate.<sup>27</sup>

question to determine when meal and rest period penalties are due from *whether* employees missed their meal or rest periods to *why* they missed meal or rest periods. As a result of the decision, employers must determine, with the help of counsel, whether they wish to permit employees to skip meal and rest periods and if so, how they will later prove whether the choice to skip was the employee's, or was instead motivated by the employer's expectations, work load, lack of sufficient staff, or other factors within the control of the employer.

The supreme court has made it abundantly clear that a noncompliant, uniformly applied policy is a path to class certification. Uniform rest period policies like that of Brinker Restaurant, which provides 10 minutes of break for every 4 hours worked, are common in employee handbooks statewide. The first line of defense to wage and hour class action litigation is to update meal and rest period policies with the clear bright-line rules provided by the court and to review and update other policies and practices to ensure compliance.

Finally, employment defense attorneys should work with their clients to plan for the defense of the next wave of class action litigation. That work should include recommendations to disseminate new *Brinker*-compliant policies, together with an agreement in

which employees agree to waive meal periods that can be waived, report meal or rest periods missed due to employer needs (so that the penalty can be paid on those instances), and agree that if a missed meal or rest period is not reported, it will be considered the employee's voluntary choice to skip the required break.

In the wake of the *Brinker Restaurant* decision, there are many unanswered questions that will likely create liability for employers and opportunity for plaintiffs, including incomplete or noncompliant policies, management's failure to follow compliant policies, permitting off-the-clock work during meal periods, assigning work in a way that makes meal or rest periods difficult to take or rewarding employees who do not take them, lacking proof of waived meal periods and voluntarily skipped meal and rest periods, and failing to pay meal and rest period penalties when the employer interferes with them. These mistakes can be avoided, but employers should start now, before the next wage and hour class action is filed. ■

<sup>1</sup> *Brinker Rest. Corp. v. Superior Court*, 53 Cal. 4th 1004 (2012).

<sup>2</sup> *Murphy v. Kenneth Cole Prods., Inc.*, 40 Cal. 4th 1094, 1105-06 (2007); LAB. CODE §226.7.

<sup>3</sup> The supreme court used the words "premiums" and

"penalties" for missed meal and rest periods interchangeably. *Brinker*, 53 Cal. 4th at 1017.

<sup>4</sup> *Murphy*, 40 Cal. 4th at 1105-06; *Brinker*, 53 Cal. 4th at 1017.

<sup>5</sup> LAB. CODE §512(a).

<sup>6</sup> *See, e.g.*, CAL. CODE REGS. tit. 8, §11050(12)(A).

<sup>7</sup> *Brinker*, 53 Cal. 4th at 1019.

<sup>8</sup> *Id.* at 1033, 1038.

<sup>9</sup> *Id.* at 1034, 1038.

<sup>10</sup> *Id.* at 1040.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.* at 1036.

<sup>13</sup> *Cicairos v. Summit Logistics, Inc.*, 133 Cal. App. 4th 949, 962-63 (2005).

<sup>14</sup> *Jaimez v. Daihous USA, Inc.*, 181 Cal. App. 4th 1286, 1304-05 (2010).

<sup>15</sup> *Dilts v. Penske Logistics, LLC*, 267 F.R.D. 625, 638 (S.D. Cal. 2010).

<sup>16</sup> *Brinker*, 53 Cal. 4th at 1040.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at 1042.

<sup>19</sup> *Id.* at 1048-49.

<sup>20</sup> CAL. CODE REGS. tit. 8, §11050(12)(A).

<sup>21</sup> *Brinker*, 53 Cal. 4th at 1028, 1032.

<sup>22</sup> *Id.* at 1031.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.* at 1029, 1031.

<sup>25</sup> *Id.* at 1024.

<sup>26</sup> *Id.* at 1017.

<sup>27</sup> *Id.* at 1032-33.

<sup>28</sup> *Id.* at 1051-52.

<sup>29</sup> *Id.* at 1049-51.

<sup>30</sup> *Kimani v. Healthcare Investments Inc.*, No. BC432360 (L.A. Super. Ct. May 11, 2012).

<sup>31</sup> *Id.*

<sup>32</sup> *Booker v. Tanintco Inc.*, No. BC349267 (L.A. Super. Ct. May 11, 2012).

<sup>33</sup> *Id.*

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## LACBA Domestic Violence Project Volunteer Training

ON THURSDAY, SEPTEMBER 6, LACBA's Domestic Violence Project will host a volunteer training session led by Judge David S. Cunningham III, Deborah Kelly, Jessica Lopez, Sara Rondon, and Stephanie Shadowens. Volunteers provide a valuable service to a vulnerable population and gain expertise in the area of family law. No previous experience is required. This training provides a very comfortable learning atmosphere with a great opportunity for open dialogue with the presenters. Program attendees will receive substantial materials, and dinner is included.

DVP volunteers (attorneys, legal professionals, and law students) make a difference every day when they assist victims of domestic violence. Last year, the Domestic Violence Project helped more than 9,000 persons. During the course of a three-hour shift, a volunteer can help as many as three victims seek protection from their abusers. Volunteers may sign up for two three-hour sessions per month for six months, in which they interview victims on a one-on-one basis, gathering information with which to complete complicated legal documents. This allows the victims to file for restraining orders with professionally prepared petitions. The Domestic Violence Project operates from two Los Angeles Superior Court locations: Central and Pasadena. This project is one of LACBA's in-house pro bono programs. Other agencies will also be present with volunteer opportunities. The program will take place at the Los Angeles County Bar Association, 1055 West 7th Street, 27th floor, Downtown. Parking is available at 1055 West 7th and nearby lots. On-site registration will begin at 5:15 P.M., and dinner is included. The program will continue from 6 to 9:15 P.M. The registration code number is 011734.

**\$85—LACBA members**

**\$100—all others**

**3 CLE hours**

## Life after *Concepcion* and *Dukes*

On Thursday, September 13, the Antitrust and Unfair Business Practices Section will host a program in which two Los Angeles Superior Court judges and three distinguished lawyers will reflect on the effect of the U.S. Supreme Court's rulings in *AT&T Mobility, LLC v. Concepcion* and *Wal-Mart Stores, Inc. v. Dukes* on consumer class actions in California. J. Michael Hennigan, Darrel J. Hieber, Judge William F. Highberger, Virginia F. Milstead, and Judge Anthony J. Mohr will review these two important cases from plaintiff and defense orientations. The program will take place at Skadden, Arps, Slate, Meagher & Flom LLP, 300 South Grand Avenue, Suite 3400, Downtown. Parking in the building costs \$11.10 after 5:00 P.M. Registration will be available beginning at 5 P.M., with the program continuing from 5:30 to 7:30. The registration code number is 011723. The prices below include the meal.

**\$45—CLE+ member**

**\$70—Antitrust, Corporate Law, Labor and Employment, or Litigation Section member or Skadden employee**

**\$90—LACBA member**

**\$130—all others**

**2 CLE hours**

## Immigration Law Training Course

ON THURSDAY AND FRIDAY,

SEPTEMBER 27 and 28, LACBA's

Immigration Legal Assistance Project

(ILAP) will host a training course designed

for attorneys who are new to the field of

immigration law or who have been

practicing in the field for less than one

year. The training—led by Frederick B.

Benson, Ally Bolour, Stuart I. Folinsky, J

Craig Fong, Carlos R. Juelle, G. Fabricio

Lopez, Mary L. Mucha, Linda M.

Nakamura, Warren M. Winston, and Judith

Leslie Wood—will focus on the procedures

and practical aspects of immigration law.

Only law school graduates or attorneys

may register for this program, which will

take place at the Los Angeles County Bar

Association, 1055 West 7th Street, 27th

floor, Downtown. Parking is available at

1055 West 7th and nearby lots. On-site

registration will begin at 8 A.M. both days,

with the program continuing from 8:30

A.M. to 4:30 P.M. The registration code

number is 011730. The prices below

include the meals.

**\$250—Immigration Law Section member**

**\$375—all others**

**13 CLE hours**



The Los Angeles County Bar Association is a State Bar of California MCLE approved provider. To register for the programs listed on this page, please call the Member Service Department at (213) 896-6560 or visit the Association Web site at <http://calendar.lacba.org>, where you will find a full listing of this month's Association programs.

## The Best 30 Seconds of Advice You Can Give a Client

**IT IS HIGHLY PROBABLE THAT** two events will happen to you or one or more of your clients in Southern California in the next five years. First, one of you will be involved in an automobile accident. And second, the driver at fault will have little or no insurance to cover the losses. A serious injury could be financially devastating if your client loses income or runs a small business. Your client will most likely be uncompensated or seriously undercompensated, despite the fact that he or she may have a strong personal injury case involving substantial damages. This potential disaster can easily be avoided if attorneys, regardless of their area of practice, provide their clients with one very simple piece of advice: Buy a large uninsured motorist policy as part of your auto policy, preferably \$500,000 per person and \$1 million per accident.

Although these policies sound expensive, they are surprisingly affordable. The premium typically costs only 10 percent to 20 percent more than the bare minimum coverage. It's a great bargain for the consumer, and it is the only way to ensure meaningful compensation if you or your client is ever seriously injured by a negligent driver. For whatever reason, insurance agents and insurance companies seem to make little effort to sell larger uninsured motorist policies, perhaps because they are not very profitable. If the agent doesn't tell your client to buy sufficient coverage, who will? The answer is you, because your client will have to take the initiative and ask for the high coverage limits. Your client may thank you for it someday.

It is shocking how many sophisticated clients with impressive backgrounds have only a small uninsured motorist policy. Clients are almost always confident that they have great policies with high, maximum coverage limits. The declarations page, however, often reveals a different story, confirming how little uninsured motorist coverage they actually have available. Unfortunately, in the practice of personal injury law, that information often comes too late. In the vast majority of personal injury cases involving serious injury, the at-fault party has minimal or no liability insurance and few assets from which to recover. There is, therefore, little that can be done if a "deep pocket" is not in sight.

It is also important to note that California is an antistacking state for uninsured motorist coverage. This means that uninsured motorist coverage does not begin to kick in until the injured party has exhausted all the underlying policies that cover the driver(s) at fault. Furthermore, the uninsured motorist insurance carrier is entitled to a credit equal to the aggregate amount of the underlying policies of the at-fault drivers. For example, if the maximum on an uninsured motorist policy is \$100,000, and two at-fault drivers carry insurance of \$50,000 each, for a total of \$100,000, the injured party will collect nothing from the uninsured/underinsured motorist policy. However, under this scenario, if the maximum of the uninsured/underinsured motorist policy was \$500,000, the carrier would still be

entitled to a \$100,000 offset, but the injured party would have \$400,000 in available coverage. This antistacking rule in California is just one more reason why it is so important to purchase an uninsured motorist policy with very high limits.

An added benefit of a large uninsured motorist policy is that it may also cover a client in other scenarios that pose a serious risk of injury. Most uninsured automobile policies extend coverage if your client is riding a bicycle, walking, or running. This is particularly important if your client is active or an athlete. Many serious-injury accident victims are either cyclists or runners who have been struck by

**It is shocking how many sophisticated clients with impressive backgrounds have only a small uninsured motorist policy.**

a car. As a competitive triathlete and marathoner myself, I am all too familiar with how much more serious the injuries are when a cyclist or a runner is involved in a collision with an automobile. These types of accidents are surprisingly common. The more serious the injury, the more coverage that is needed. If your client purchases a large uninsured motorist policy and is a runner, cyclist, or pedestrian, he or she will be covered up to the limits of the uninsured motorist policy.

The good news is that you do not need to practice personal injury law to advise your clients to purchase a large uninsured motorist policy. It's simple, it's easy, and it's the advice they aren't getting from most of their other professional advisers—not even their own insurance agent who sold them the policy. It is great business advice that they will appreciate, and it will be the easiest 30 seconds of advice you will ever give them.

In the event they are involved in a serious accident in the future, and they are a small business owner or professional, the uninsured motorist coverage could provide an extra \$1 million that they would have never have had—enough to save their business or their family home when they cannot work. After finding out the negligent driver who seriously injured them has no assets and a \$15,000 minimum policy, they may be thanking you when their personal injury attorney tells them how well prepared they were. As for us lawyers, check your own policy. You may be surprised to see that you do not have the maximum uninsured motorist coverage you can get. In the last year, many carriers have raised the maximum coverage limits you may purchase to protect you, your clients, and your family from an uninsured driver. ■

**Joe Higuera practices personal injury law throughout Southern California, with offices in Orange County and San Diego.**

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