Retired Los Angeles Superior Court Judge Lawrence Waddington explains the development of federal preemption in arbitration law

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Lawrence Waddington, a retired judge of the Los Angeles Superior Court, is a dispute resolution neutral at JAMS. In “Federalizing Arbitration,” he examines the Supreme Court decisions that have created the federal preemption of state arbitration laws. His article begins on page 30.

Cover photo: Tom Keller

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A Fellow of the American College of Trial Lawyers and former President of the L.A. County Bar, Dick Coleman is now practicing full-time as a mediator. After 40 years of representing both plaintiffs and defendants, he is experienced in business, contract, employment, entertainment, medical and legal malpractice, real estate, and personal injury matters. In addition to a J.D. from Harvard and an LLM from Georgetown, he received a C.D.R. from Pepperdine, where he is now a professor at the Straus Institute for Dispute Resolution.

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Los Angeles Lawyer (ISSN 0162-2900) is published monthly, except for a combined issue in July/August, by the Los Angeles County Bar Association, 261 S. Figueroa St., Suite 300, Los Angeles, CA 90012, (213) 896-6503. Periodicals postage paid at Los Angeles, CA and additional mailing offices. Annual subscription price of $14 included in the Association membership dues. Nonmember subscriptions: $28 annually; single copy price: $3 plus handling. Address changes must be submitted six weeks in advance of next issue date. POSTMASTER: ADDRESS SERVICE REQUESTED. Send address changes to Los Angeles Lawyer, P.O. Box 55020, Los Angeles CA 90055.

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LOS ANGELES LAWYER / SEPTEMBER 2003
Is A Malpractice Insurance Crisis Looming In Your Horizon? Are You Ready?

11 carriers have withdrawn from the California market. Will your carrier be next? The changes in the marketplace are troubling. It is an unknown future.

Non-renewals are commonplace. Some carriers can’t secure sufficient reinsurance to operate their professional liability programs. A major carrier was recently declared insolvent. Other carriers have been downgraded by A.M. Best. Severe underwriting restrictions are now being imposed. Dramatic rate increases are certain.

It’s all very unsettling.


CHECKLIST
You owe it to yourself to find the answers to these critical questions!

✔ Will your carrier still be writing professional liability policies in California at your next renewal?

✔ Will your carrier impose a substantial rate increase at your next renewal due to unstable market conditions?

✔ Will your carrier continue to insure “your type” of practice at your next renewal?

✔ Will your carrier leave the marketplace because they can’t secure sufficient reinsurance for their professional liability program?

✔ Will your carrier offer you a tail of unlimited duration if they decide to leave the market?

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In the course of casual conversation with opposing counsel in a bitterly contested lawsuit a few years ago, I mentioned that my wife and I were expecting a baby. I also mentioned to him the due date, some two months in the future. Two weeks later, I received a notice from that attorney scheduling a deposition on the due date. The deposition was set in Orange County, far from our hospital.

Any thought that the scheduling was accidental was quickly dispelled when counsel refused to return my calls or answer my letters about the conflict. I proposed alternate dates and even an alternate venue, seven miles from the hospital, if the selected date was for some reason important to counsel’s schedule, but he still refused to change the deposition date or location. Before a motion for a protective order could be heard, opposing counsel finally, reluctantly, agreed to reschedule the deposition, presumably so he would not have to explain his conduct to the trial judge.

We all have stories about how the gamesmanship of litigation overcame the merits of the matters at issue. I have been served with dispositive motions scheduled for hearing in early January (so my client and I had to spend the holidays drafting briefs and declarations), end, and received discovery responses that consisted merely of objections. The game is also played in more subtle ways: counsel not returning calls seeking discovery extensions, only to receive those responses shortly before the hearing so the court will take the matter off calendar, depriving you of the opportunity to recover the fees and costs necessarily incurred to obtain those very responses? Counsel knows the conduct will be sanctioned by the court, so he or she tries to ensure the court never considers the issue.

Some years ago, the Los Angeles County Bar Association promulgated a series of guidelines for conduct between attorneys representing adverse parties in litigation. Those guidelines suggest the exchange of courtesies, such as extensions of time for motions or discovery; proscribe the service of papers “late on Friday afternoon” or the day before a holiday or “to take advantage of an opponent’s known absence from the office”; require that communications between counsel be civil; and encourage premotion discussions aimed at resolving issues. Nearly 10 years ago, the Los Angeles Superior Court wisely adopted these guidelines, which now appear as Local Rule 7.12.

No set of guidelines, rules, or threat of sanctions will deter the truly unprofessional, however. Local Rule 7.12 reminds us that the best way to ensure that you receive professional treatment is to afford professional treatment. Indeed, the Association’s guidelines can be summarized simply as the Golden Rule—and that is one rule that all litigators should follow.
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Letters

A very important point in “Staying Settled” (Los Angeles Lawyer, June 2003) is mentioned only in passing, and a recent case, Wacheen v. Malis (reported in April 2003), brings the issue into sharp relief. A trap for the unwary exists, for those who have not read this case, in a dismissal of an action based on the belief that Code of Civil Procedure Section 664.6 will provide jurisdiction for the trial court to enforce the settlement terms. As the case makes clear, to enforce the terms of the settlement, the parties—not the attorneys—must agree in writing or orally on the record that the trial court will retain jurisdiction after the dismissal is filed.

To clarify my point, it may be helpful to understand a settlement agreement as not one but two agreements. The first is the settlement agreement itself, usually in which one party pays money and the other party agrees to release and dismiss its action. Almost all practicing trial attorneys know that 664.6 requires that this agreement be in writing or on the record in order for the parties to obtain the benefit of 664.6.

What most practicing attorneys do not know is that after a dismissal is filed, the court cannot enforce the terms of the settlement under 664.6. The exception to this loss of jurisdiction exists when a second agreement—an agreement that the court may retain jurisdiction after the dismissal is filed—is also made. Without this second agreement, the court otherwise loses jurisdiction once the dismissal is filed. This second agreement, that the court may retain jurisdiction to enforce the settlement terms, must meet all the same requirements as the settlement agreement to be enforceable under 664.6. In other words, the agreement must be in writing signed by the parties or on the record agreed to by the parties.

The practical impact of Wacheen is that settlement agreements need a new term (one that is not typically found in most settlement agreement forms) that “the parties herein agree that the court will retain jurisdiction for the purpose of enforcing the terms of this settlement agreement pursuant to CCP Section 664.6.”

Brad T. Child

“Making Reservations” (Los Angeles Lawyer, June 2003) accurately reports that evidentiary and procedural hurdles impede suits by policyholders against insurers to force the insurers to pay Cumis counsel. But the article misses the point. Insurers can be prompted to pay Cumis counsel by disqualifying attorneys regularly hired by insurers (known as panel counsel) because of transparent violations of the Rules of Professional Conduct.

- Reservation of rights letters always create conflicts of interest between the insurer and the policyholder on all conceivable bases. See Waller v. Truck Ins. Exch., Inc., 11 Cal. 4th 1, 31 (1995) (“We conclude that an insurer does not impliedly waive coverage defenses it fails to mention” in a reservation of rights letter).
- When the insurer reserves rights, panel counsel must make written disclosure to the policyholder-client and must obtain informed written consent from the policyholder-client before panel counsel start work or accept compensation. See Rule 3-310, Rules of Professional Conduct.
- A few letters from the policyholder-client to panel counsel requesting full disclosure and a polite declination to waive the conflict will usually prompt panel counsel to withdraw without the necessity of a motion to disqualify the lawyer.

The policyholder is better served by focusing on panel counsel’s conflicts of interest at the outset of the underlying suit instead of the insurer’s violation of duties tangential to the duty to defend after the underlying suit is concluded. This remedy is preferable to a suit against the insurer because it is easy, quick, inexpensive, and prophylactic. Remaining panel counsel early in the underlying suit avoids the risk of disloyal representation, the disclosure of confidential information, the expense of a suit against the insurer, and problems of proof mentioned in the article.

Stephen L. Thomas

Correction

Laurie Harris was the first woman president of the Barristers (1978-79), not Margaret Morrow, as stated in the March 2003 Barristers Tips column.
Seventy-Five Years of the Barristers

Our advanced ways continue to keep us at the forefront of Association activities

What prompted the creation of the Barristers, and why has this group continued with such vigor for 75 years? In a September 1984 Barristers Bulletin column in Los Angeles Lawyer, David Pasternak, who was then president of the Barristers, notes how legendary attorney Joe Ball explained the popularity of the Barristers at its inception: “[D]uring those days of Prohibition, bottles of alcoholic beverages could be found under the tables at senior bar meetings...[but] the Barristers were more advanced than that—we kept our bottles on top of the tables.”

During our Barristers 75th Anniversary Celebration, which will take place in the evening on September 25, the drinks will be on top of the tables. Every past president, officer, and committee member has been invited for this special event at the Dorothy Chandler Pavilion. Tables will be organized by year on the fifth floor, and we hope that former Barristers will reconnect over good food, drinks, music, and memories. Later in the evening, a memorable program will feature all our past presidents and a few highlights from years past. The Barristers history is rich with accomplishment and great leadership, and we encourage all our current Barristers members (or soon-to-be members) to experience this special event. If you have not already done so, visit our Web site at www.lacba.org/barristers for historical photographs and Barristers trivia.

The challenges and demands of this profession can be overwhelming, and seeking solace and laughter with our peers will never go out of style. Be it 1928 or 2003, the feeling of camaraderie is a strong bond among us. We may not know exactly what instigated our organization, but we certainly know who began our group 75 years ago. In the June 21, 1928, Bar Association Bulletin, the Association’s then-president, Hubert T. Morrow, presented the newly formed Barristers as a lively, exuberant group as he described the first meeting:

[A] few weeks ago we organized the young men into a separate committee....The young men elected their own committee officers...adopted the name they preferred, passed...resolutions, and altogether showed such interest, enthusiasm and ability that it made me feel ashamed of our own general meetings.

Last year, recognizing that many of our members enter this profession as a second or third career, we revised the bylaw by extending eligibility to 36 years of age and under or practicing 10 years or less. This change granted access to our resources and opportunities to a greater number of young or new attorneys in the Los Angeles area.

We were the first young lawyers group in the country, and we remain one of the largest metropolitan area young lawyer groups, with more than two dozen committees and pro bono projects. One extraordinary project we have undertaken is assisting our military and their families through the Barristers Disaster Relief Committee. This past year, the committee mobilized to provide assistance to troops who were shipping out. However, federal laws prohibit members of our military from accepting charitable legal services. Because of this obstacle and due to the large number of troops shipping out on short notice, many legal issues were left unresolved, including whether members of our national guard could be terminated from their employment. With the efforts of Linda Harrell and Association Treasurer Charles Michaels, the committee and its chair, Angela Reddock, were able to circumvent the government’s restrictions by pairing volunteer attorneys with civilian spouses. The Barristers and the Association were the first organization to develop this procedure, and many other groups are following around the country.

While some things have not changed with our group, technology has provided us with an extraordinary venue to communicate with our more than 9,000 members on a regular basis. Our e-newsletter, Connections, is published monthly, and we continue to enhance the resources available to our members.

As our state’s budget issues linger, Barristers committees have swung into action. Our Community Outreach Committee is actively recruiting volunteers for our in-court Domestic Violence clinics, AIDS Legal Clinic, and legal clinics at West Angeles Church as well as PATH (People Assisting the Homeless) to serve the needs of our community for whom legal services remain a luxury.

In light of the fact that the average age of our state legislators is 32, the Barristers are in a unique position to mobilize and address the crisis in the courts. We formed our Ad Hoc Committee to support the Association’s efforts to curtail any decrease in court accessibility or services. For more information on any of our committees and their pro bono projects, visit www.lacba.org/barristers.

The Barristers will also be organizing the first Ambulance Chase and Briefcase Relay Fund Raiser in Downtown next spring. When you see members of our legal and judicial community running along Grand Avenue after an ambulance, you will know who is responsible.

Indeed, we hope to make our former members proud by the projects and tasks we will take on this coming year, continuing the tradition of the past 74 years of service, and by greeting our future opportunities with our bottles on top of our tables.
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OVERNIGHT DELIVERY. SYNCHRONIZED.
The Tax Traps Lurking in Subchapter S

Negative tax consequences abound for both the entity and its shareholders

The wave of popularity now enjoyed by limited liability companies has led many people to think of S corporations as dinosaurs. Because LLCs can include virtually all the advantages of S corporations (such as a single level of taxation and limited liability for LLC members) with none of the limitations that federal tax law imposes on ownership of S corporation shares, both new businesses and existing businesses that have never incorporated are much more likely to form LLCs than corporations.

Yet, unlike dinosaurs, S corporations (“small business corporations” that have a valid S election in effect) are far from extinct. Indeed, there were 186,420 California S corporation tax returns filed in calendar year 2001, and at least 3,022,589 federal S corporation returns were filed in the fiscal year that ended September 30, 2002. Thus, Subchapter S of the Internal Revenue Code remains relevant to attorneys whose clients include S corporations and to attorneys who practice through S corporations. This is particularly true because a business has entered the “lobster pot” of corporate status, it is very difficult to leave.

Lurking within Subchapter S are tax traps for S corporations that sell appreciated assets, make passive investments, or reorganize their debt. In some cases, these traps will spring on the shareholders of the S corporation; in others, on the S corporation itself.

Built-in Gain

IRC Section 3174 sets a trap for S corporations that have assets with “built-in gain”—gain that accrued on a corporation’s assets before its S status became effective. The Section 3174 tax is intended to prevent C corporations from avoiding the corporate-level taxation of built-in gain by electing S status before selling appreciated assets. All the built-in gain that an S corporation recognizes upon the sale or other taxable disposition of its assets during its 10-year “recognition period” (which begins on the date that the corporation’s S election becomes effective) is therefore subject to a corporate-level income tax at the top corporate rate, which is now 35 percent. During that 10-year period, an S corporation can avoid the Section 3174 tax only if it establishes that either 1) the asset was not held by the S corporation at the time its election became effective, or 2) the gain recognized by the S corporation exceeds the amount of gain that had accrued on the date its S election became effective. In other words, gain that accrues after a corporation’s S election becomes effective is exempt from the Section 3174 tax. A corporation may reduce, or even eliminate, its Section 3174 tax liability by:

1) Recognizing built-in loss in the same tax year that it recognizes built-in gain, since the Section 3174 tax is only imposed on net recognized built-in gain (NRBIG), and/or
2) Recognizing built-in gain only in tax years in which its taxable income would otherwise be negative. However, if a corporation’s S election was made on or after March 31, 1988, the amount of NRBIG that is sheltered by the corporation’s otherwise negative taxable income will be treated as recognized built-in gain the following year.

To demonstrate what can happen if a corporation owned appreciated assets when it elected S status, consider a sole proprietor who incorporated in 1990, contributing all the assets of the sole proprietorship, including the building in which the business operated, in exchange for all 1,000 outstanding shares of the corporation. In 1993, the shareholder/owner elects S status for the calendar-year corporation, and that election becomes effective on January 1, 1994. On September 1, 2003, the S corporation is offered $2.5 million in cash for its building. On January 1, 1994, the S corporation’s adjusted basis in the building was $150,000. The owner estimates the building’s fair market value on that date was $500,000. The S corporation’s current adjusted basis in the building is $70,000, and selling costs will be $230,000.

Based on the above facts, the S corporation would recognize $2.2 million ($2,500,000 - $70,000 - $230,000) of gain on the sale of its building in 2003, $350,000 ($500,000 - $150,000) of which would be built-in gain. Unless the S corporation also recognizes built-in loss during the year of the sale or its taxable income is otherwise negative, the sale of its building during 2003 will produce $350,000 of NRBIG, on which the S corporation will owe a Section 1374 tax of $122,500 ($350,000 x 35 percent tax rate), which is deductible as a capital loss. Separately, the owner would recognize, and perhaps pay capital gains tax on, $2,077,500 ($2,200,000 - $122,500) of capital gain.

Moreover, the IRS might succeed in collecting even more tax from the S corporation on the grounds that on January 1, 1994, the building’s fair market value was more than the owner’s estimate of $500,000. To forestall this challenge, the S corporation should have obtained a detailed appraisal of the building’s fair market value on the date its S election became effective.

The practical implications are clear: Every C corporation that elects S status should obtain an appraisal of each of its significant assets (including patents, trademarks, and other intangible assets) contemporaneously with the effective date of its S election and hold those appraisals in a safe place for 10 years. By doing so, it will reduce the risk of a successful IRS challenge of its Section 3174 tax calculations if any of the liabilities are assumable.
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those assets is disposed in a taxable transaction during its 10-year recognition period. In this example, the S corporation could have completely avoided the Section 1374 tax on the sale of its building (or any other asset) by simply delaying the closing of the sale until after the December 31, 2003, expiration of its 10-year recognition period. In this light, shareholders of eligible “small business corporations” who are interested in eventually liquidating their corporations should make an S status election as soon as possible in order to start the running of the 10-year recognition period. At the end of that period, those now-S corporations can liquidate subject to only a single level of taxation.

Excess Net Passive Income

Another corporate-level tax that incautious S corporations may incur is the one imposed by IRC Section 1375 on excess net passive income (ENPI). The tax on ENPI is intended to prevent C corporations from liquidating their assets, investing passively, and then electing S status in order to avoid the double taxation of dividends.

Unfortunately, the Section 1375 tax is quite mechanical in its application and imposes a tax on any S corporation that has accumulated earnings and profits at the close of its tax year and passive investment income that exceeds 25 percent of its gross receipts. Since only a C corporation can accumulate earnings and profits, an S corporation will only have accumulated earnings and profits if it, or one of its corporate acquisitions, was once a profitable C corporation. Whether such an S corporation has ENPI is likewise determined mechanically, with the excess that is subject to the Section 1375 tax set equal to the corporation’s net passive income (NPI) times the amount of its passive investment income (PII) divided by its PII for the year. The IRS has expressed the formula as follows:

\[ \text{ENPI} = \text{NPI} \times \left( \frac{\text{PII} - 0.25 \times \text{GR}}{\text{PII}} \right) \]

Passive investment income (PII) comprises gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (from which only gains are taken into account). NPI is PII less the allowable deductions directly connected with the production of the passive income.

To illustrate how the Section 1375 tax is applied, consider a scenario in which an S corporation realizes $30,000 of interest and dividends income, $130,000 in long-term capital gains, and $50,000 in capital losses. In the same year, the corporation’s gross business receipts are $240,000.

That year, the S corporation’s GR will be $400,000 ($30,000 + $130,000 + $240,000) and its PII will be $160,000 ($30,000 + $130,000). This PII of $160,000 exceeds 25 percent of its GR by $60,000 ($25 \times $400,000 - $100,000). Unless the S corporation has allowable deductions directly connected with production of its PII, its NPI will equal its PII and its ENPI will equal $60,000. The current maximum corporate income tax rate of 35 percent yields a Section 1375 tax of $21,000. However, the S corporation will owe this tax only if, at the end of the taxable year, it still has accumulated earnings and profits from its days as a C corporation.

The impact of ENPI on an S corporation becomes much more severe if it is liable for a tax on ENPI for three consecutive years because the S election is statutorily terminated. The corporation will then be barred for five years from again electing S status. Without this status, an S corporation must pay federal and California income taxes on its taxable income, and distributions from the S corporation to its shareholders will also be taxable to the shareholders, at least to the extent of the S corporation’s earnings and profits.

On the other hand, an S corporation can avoid both the tax on ENPI and the termination of its S election by reducing its accumulated earnings and profits to zero before the end of the applicable tax year. Consequently, IRC Section 1368(e)(3)(A) allows an S corporation to purge itself of accumulated earnings and profits by means of electing, with the consent of all the affected shareholders, to treat its distributions during any taxable year as taxable dividends and then to distribute to shareholders assets with a fair market value at least equal to its accumulated earnings and profits.

Thus practitioners should advise an S corporation that may end its current tax year with ENPI to rigorously audit before the end of the year the pre-S status tax years of the entity itself and any corporations it has acquired and determine if it has any accumulated earnings and profits. If so, the S corporation should elect Section 1368(e)(3)(A) treatment and distribute property (preferably cash) at least in equal value to its accumulated earnings and profits. Of course, the fact that the maximum federal individual income tax rate on dividends is now 15 percent, instead of the 38.6 percent rate in 2002, makes it even more attractive to flush out an erstwhile C corporation’s accumulated earnings and profits with a Section 1368(e)(3)(A) election. Note also that the IRS may waive the tax on ENPI if the S corporation establishes, to the IRS’s satisfaction, that the corporation had determined “in good faith that it had no subchapter C earnings and profits at the close of a taxable year.”

Debt Relief

Different tax traps await the shareholders of S corporations that are reorganizing and eliminating debt. If a recourse debt of a corporation, or any other debtor/taxpayer, is canceled, the debtor is treated as having received ordinary income in the amount that the canceled debt exceeds the fair market value of any property transferred from the debtor to the creditor in the course of the cancellation. The same transaction will also produce capital gain (or loss) for the debtor in the amount that the debtor’s basis in the transferred property exceeds (or falls short of) the fair market value of that property. On the other hand, if a nonrecourse debt is canceled, the debtor recognizes only capital gain (or loss) and only to the extent that the amount of debt canceled exceeds (or falls short of) the debtor’s basis in the property transferred.

If an S corporation’s debt is canceled, any income and/or loss generated by the cancellation generally will pass through the S corporation to its shareholders in the year the debt is discharged. Depending upon the shareholders’ federal and state income tax rates, they could pay as much as 45 percent of their S corporations’ discharged recourse debt in personal income taxes, even if those S corporations do not distribute any cash or other property to those shareholders. It may be of some consolation that their bases in their S corporation shares will increase by their pro rata allocations of the ordinary income and/or capital gain resulting from the cancellation of their S corporation’s debt.

However, IRC Section 108(a) provides that the ordinary income, but not the capital gain, recognized upon a discharge of debt will be excluded from taxable income if the discharge occurs in a federal bankruptcy reorganization, the debtor is insolvent, the discharged debt is “qualified farm indebtedness,” or, unless the debtor is a C corporation, the discharged debt is “qualified real property indebtedness.” For S corporations with cancellation of debt income, each of the four Section 108(a) exclusions is tested at the corporate, rather than the shareholder, level—unlike partnerships, for which the tests for exclusion are applied at the partner, rather than the partnership, level.

To the extent that Section 108(a) excludes cancellation of debt income from an S corporation’s gross income, the S corporation will not have any such income to allocate among its shareholders. Moreover, the excluded income will not increase the shareholders’ adjusted bases in their S corporation shares unless the “discharge of indebtedness [occurred] before March 1, 2002,”
AN EMERGING ESTATE PLANNING TOOL . . .

Billions of dollars are currently available for individuals over age 65 that are considering canceling or surrendering a life insurance policy that is no longer needed. The policyowner (seller) can be an individual, corporation, or trust. The policy may now be disposable for any reason. The goal is to provide the seller a one-time cash settlement in excess of the surrender value.

COMMON REASONS FOR THE DISPOSAL OF LARGE LIFE INSURANCE POLICIES . . .

- Key executive retires
- Buy-sell arrangement dissolved
- Estate no longer needs insurance for liquidity
- Individual life policy is being replaced by survivorship insurance
- Policy has not performed as well as was originally expected
- More suitable products have become available
- Policy is no longer affordable

WHAT POLICIES QUALIFY?

Most types of life insurance policies qualify for a settlement. Term, Universal, Variable Life and Whole Life are the most common. In some circumstances, even group life insurance coverage can qualify.

SOME POPULAR USES OF THE SETTLEMENT PROCEEDS . . .

- Purchase long-term care insurance
- Purchase second-to-die insurance for estate tax liquidity
- Purchase securities or annuities
- Pay off an existing mortgage or other debt
- Provide current cash flow for living expenses
- Provide gifts or other charitable donations while you are alive
- Purchase a new business

SAMPLE CASE SUMMARIES . . .

Male, Age 75
Life expectancy 5.5 years
Face amount of insurance $5,000,000
Cash surrender value $0
Amount offered to seller $1,125,000

Female, Age 85
Life expectancy 3.5 years
Face amount of insurance $550,000
Cash surrender value $165,000
Amount offered to seller $220,000

Female, Age 86
Life expectancy 4.5 years
Face amount of insurance $9,000,000
Cash surrender value $2,142,000
Amount offered to seller $2,803,000

Male, Age 79
Life expectancy 8.0 years
Face amount of insurance $5,000,000
Cash surrender value $0
Amount offered to seller $487,500

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pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001."50 Prior to those dates, the discharge of an S corporation’s debts in bankruptcy increased its shareholders’ bases in the shares of the S corporation by the amount of debt discharged, even though no taxable income would be allocated to any shareholder from that discharge.51

To the extent that the discharge of an S corporation’s debt produces capital gain and/or ordinary income that cannot be excluded under Section 108, that gain and/or income can be “trapped” at the corporate level, allowing none of it to seep through to its shareholders, by terminating the corporation’s S status before its debt is canceled. This requires only that shareholders holding more than half of an S corporation’s shares consent to the revocation of its S election.52 Further, if the corporation specifies a date for revocation that is on or after the date the revocation if filed, “the revocation is effective on and after the date so specified.”53

However, practitioners should be aware that revoking S status in order to trap income at the corporate level should never be followed by a bankruptcy filing by the former S corporation. If control of the erstwhile S corporation falls into the hands of a bankruptcy trustee, the trustee may sue to avoid the revocation, thereby placing the tax consequences of liquidating the S corporation back in the laps of its shareholders.54

After a bankruptcy liquidation of an S corporation, its shares will often be worthless. If the S corporation’s shareholders still have some basis left in their shares—for example, as a result of the cancellation of its debt55—then, in general, each shareholder may deduct his or her basis as a capital loss, but only up to the amount of other capital gains, plus $3,000, each year.56 However, the first $100,000 of loss on “Section 1244 stock” is deductible as an ordinary loss. Section 1244 stock is defined as the stock of a domestic “small business corporation” issued by the corporation for money or other property (except stock and securities), but only if the corporation derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities during the five taxable years ending before the date of the loss claimed by the stockholders.57 For purposes of Section 1244, a corporation is treated as a “small business corporation” if the aggregate amount of money and other property received by the corporation for its stock, as a contribution to capital and as paid-in surplus, does not exceed $1 million at the time of the issuance of the stock.58 Further, in
computing the $1 million limit, a shareholder need only add the basis of any property contributed to the corporation, reduced by any liability assumed by the corporation, to the amount of cash.90 The basis adjustment history of an S shareholder’s stock should be carefully reviewed before that shareholder deducts a Section 1244 ordinary loss, since subchapter S basis adjustments can only reduce, not increase, Section 1244 loss.90

With almost 200,000 S corporations continuing to operate in California, business and tax attorneys should not forget the tax traps in Subchapter S. With proper planning, those traps can often be avoided completely. ■

1 See CORP. CODE §§17000 et seq.
2 An LLC with more than one member is taxed as a partnership unless it elects to be taxed as a corporation. Treas. Reg. §§301.7701-2(d)(2), 301.7701-3(a), 301.7701-3(b)(1)(i)(B). An LLC with a single member is taxed as a sole proprietorship unless it elects to be taxed as a corporation. Treas. Reg. §§301.7701-2(c)(2), 301.7701-3(a), 301.7701-3(b)(1)(i)(B). An LLC that elects to be taxed as a corporation may elect S status provided that it meets the tests of IRC §1361(b). See infra note 6.
3 In general, “no member of a limited liability company shall be personally liable under any judgment of a court, or in any other manner, for any debt, obligation, or liability of the limited liability company whether that liability or obligation arises in contract, tort, or otherwise, solely by reason of being a member of the limited liability company.” CORP. CODE §17101(a).
4 Compare CORP. CODE §17050(b) (allowing the formation of an LLC with “one or more members”) with I.R.C. §1361(b). See infra note 6.
5 An exception to this trend is found among individuals and entities that provide “professional services,” because California bars both domestic and foreign LLCs from rendering such services within its borders. CORP. CODE §17375. “Professional services” is defined as “any type of professional service that may be lawfully rendered only pursuant to a license, certification, or registration authorized by the Business and Professions Code, the Chiropractic Act, the Osteopathic Act . . . or the Yacht and Ship Brokers Act.” CORP. CODE §§13401.6, 13401.3. Thus, dentists, doctors, and other professionals may still find that the only way to combine limited liability with pass-through taxation is to form a professional corporation and have it elect S status. Even then, those professionals will remain personally liable for their tortious acts and those of their professional corporation’s partners. However, California attorneys, accountants, and architects can obtain more liability protection than can other California professionals by entering into and practicing through limited liability partnerships. CORP. CODE §16306(e).
6 In the context of Subchapter S of the IRC, a “small business corporation” is an eligible domestic corporation with no more than 75 shareholders, none of which is a corporation or partnership or nonresident alien, and only one class of stock. I.R.C. §1361(b)(1). Insurance companies, foreign sales corporations, DISC and former DISC corporations, and certain financial institutions are not eligible to be S corporations. I.R.C. §1361(b)(2).
7 All of a corporation’s shareholders must consent to a corporation’s election to be an S corporation. I.R.C. §1362(a)(2).
8 FRANCHISE TAX BOARD, ANNUAL REPORT 2001 23 (2002). In the same period, 311,424 C corporation returns were filed with the FTB. Id.
LOS ANGELES LAWYER / SEPTEMBER 2003

York.

S corporations organized and/or doing business in California applies the IRC's subchapter S provisions to (imposing an income tax on corporations). In general, S corporation tax items to its shareholders, with no tax Compare 30 I.R.C. §1362(g).


26 See 25 I.R.C. §1375(b)(2).


23 Treas. Reg. §1.1375-1(b)(1).


21 20 I.R.C. §1375(a).

19 I.R.C. §1374(a).


16 I.R.C. §1374(d)(4).

15 I.R.C. §1374(d)(7).

13 I.R.C. §11(b).

12 I.R.C. §1374(b)(1).

11 I.R.C. §1374(d)(7).

10 Boris I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶2,01[3] (6th ed. 1997) (“Decisions to embrace the corporate form of organization should be carefully considered, since a corporation is like a lobster pot: easy to enter, difficult to live in, and painful to get out of.”) (footnotes omitted).

12 I.R.C. §1374(d)(7).

11 I.R.C. §1374(b)(1).

10 I.R.C. §1374(b)(3).


8 I.R.C. §1374(d)(4).


4 I.R.C. §1374(d)(2).

3 I.R.C. §1374(a).

2 I.R.C. §1373(a).

1 I.R.C. §1375(d)(1) (referring to “subchapter C earnings and profits”).


26 Treas. Reg. §1.1375(b)(2).

25 See I.R.C. §1375(d)(1) (imposing a tax on corporations). In general, California applies the IRC’s subchapter S provisions to S corporations organized and/or doing business in California and to their shareholders. Rev. & Tax. Code §17087.5.

33 See infra note 43.

32 See I.R.C. §301(c).


30 I.R.C. §§1(b)(1)(C), 1(b)(11).


28 I.R.C. §1375(d)(1).


26 Treas. Reg. §1.1001-2(a)(2). A debt is “recourse” if, under state law and/or a valid contract between the debtor and creditor, the creditor may proceed against the debtor personally for any deficiency realized by the creditor in a foreclosure upon the property securing the debt. See generally Knowl Biggall & Jerald L. Mosley, The Income Taxation of Foreclosures, LOS ANGELES LAWYER, Jan. 1995, at 15 for a general discussion of these issues in the context of California real property law.

25 Treas. Reg. §1.1001-2(a)(1). A debt is “nonrecourse” if, under state law and/or a valid contract between the debtor and creditor, the creditor’s rights to satisfy an unpaid debt are limited to property that secures the debt. I.R.C. §1366(a)(1)(B). I.R.C. §108(a)(1) does, however, exempt cancellation of debt from taxable income in four situations. See infra text at notes 42-45.


23 See I.R.C. §1367(a)(1)(A) (calling for an S corporation to the extent that the shareholder is allocated income under I.R.C. §1366(a)(1)).

22 In re Bakersfield Westar, Inc., 226 B.R. 227 (9th Cir. BAP 1998) (termination of an S election trapped capital gain as the “excess of liabilities over the fair market value of assets.”)

21 I.R.C. §108(a)(1)(C). This term is defined in I.R.C. §108(d)(7). This term is defined in I.R.C. §108(a)(1)(D). This term is defined in I.R.C. §108(d)(7)(A) (barring the “pass-thru” of such income to an S corporation’s shareholders under I.R.C. §1366(a)).


19 I.R.C. §108(d)(7)(A) (barring the “pass-thru” of such income to an S corporation’s shareholders under I.R.C. §1366(a)).

18 In re Bakersfield Westar, Inc., 226 B.R. 227 (9th Cir. BAP 1998) (termination of an S election trapped capital gain as the “excess of liabilities over the fair market value of assets.”)

17 I.R.C. §1366 (mandating the “pass-thru” of corporate debtors that liquidate under Chapter 7 of the Bankruptcy Code). A corporation liquidated in a Chapter 7 bankruptcy proceeding may instead be eligible for the insolvency exclusion. See infra note 43.


15 I.R.C. §108(a)(1)(C). This term is defined in I.R.C. §108(d)(7)(A)).


13 I.R.C. §108(d)(7)(A) (barring the “pass-thru” of such income to an S corporation’s shareholders under I.R.C. §1366(a)).

12 I.R.C. §1367(a)(1)(A) and (B) (calling for an increase in the basis of each shareholder’s stock in an S corporation to the extent that the shareholder is allocated income under I.R.C. §1386(a)(1)).


10 See supra text accompanying note 41.

9 I.R.C. §1211(b).

8 I.R.C. §1244(c)(1).


5 Treas. Reg. §1.1244(d)-2(a).

4 Treas. Reg. §1.1244(d)-2(a)(2).

3 In re Bakpersfield Westar, Inc., 226 B.R. 227 (9th Cir. BAP 1998) (termination of an S election trapped capital gain as the “excess of liabilities over the fair market value of assets.”)

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California’s Worker Adjustment and Retraining Notification Act

Counsel should be informed of how the new law departs from its federal precursor.

California has enacted its own version of the Worker Adjustment and Retraining Notification Act (WARN), the federal law that requires employers to give a 60-day notice before ordering a plant closure or mass layoff. This new law became effective on January 1, 2003, adding Sections 1400-08 to the California Labor Code. The California Legislature has indicated that two main purposes underlie the new law: to lower the threshold for coverage by imposing the notice requirement on companies that are too small to be subject to WARN, and to extend the notice requirement to some business decisions that affect smaller groups of employees than those to which WARN applies.

These two policy goals, however, do not tell the entire story. Rather than simply adopt the federal scheme and reduce the thresholds for coverage, the legislature has enacted a new statutory framework. Attorneys cannot navigate the new law simply by following the federal framework and lowering the threshold requirements. The new state law is patterned after WARN, but there are many differences between the two statutes. Counsel must become familiar with the California law and its significant differences from the federal law.

To understand the new state law, it is first necessary to grasp the basis for coverage under the statute, which differs significantly from that of the federal statute. Coverage under the new California law applies to an “employer,” and the term “employer” refers to any person who, directly or indirectly, owns and operates a “covered establishment.” A covered establishment is any industrial or commercial facility, or part thereof, that employs, or has employed within the preceding 12 months, at least 75 persons. Thus, coverage under the state law is determined at the “establishment” level, which obligates counsel to focus on the number of persons employed at an affected facility rather than the number of employees working for the employer companywide, as they would under the federal law.

Other coverage differences are also critical. The California law is limited to “industrial or commercial” facilities, and it is further limited to persons who “own and operate” a facility of the specified size. The federal law does not contain these limitations. In addition, the California law is silent on its applicability to nonprofit organizations and public entities. On the other hand, federal regulations make it clear, unlike the California statute, that certain nonprofit organizations and public or quasi-public entities that engage in business are covered by the federal statute. In these respects, the coverage under the state law may be narrower than the coverage under the federal law.

In other respects, however, the California law offers broader coverage. Unlike the federal law, the California coverage definition does not contain an exclusion for part-time employees. For this reason, when determining whether an establishment employs or has employed 75 persons, employers should not fail to include part-time employees in the calculation.

Another significant coverage issue raised by the new statute concerns the separate legal status of a parent corporation and its subsidiaries. This status is disregarded in determining coverage under the California law, since it treats a parent corporation as an employer with respect to any covered establishment that is directly owned and operated by its corporate subsidiary. As a result, parent corporations with sub-
sidiaries that have operations in California may now be faced with notice obligations and possible liability that they have not faced before. In addition, even if a parent corporation is required by the state law to give a notice, it appears that the subsidiary that owns and operates the covered establishment will also be required to do so, since the statute does not relieve the subsidiary of employer status. Counsel with clients across the country that own subsidiaries in California should be aware of this significant expansion of the notice obligation.

Questions of Definition

Because the legislature has adopted a new framework rather than simply lowering the federal coverage thresholds, numerous ambiguities concerning the coverage of the new statute will need clarification. First, it is not clear whether the legislature intended to distinguish between “persons” and “employees” in its definition of “covered establishment.” Coverage under that definition depends on the number of persons employed within the preceding 12 months. The term “person” is broadly defined in the California Labor Code as any person, association, organization, partnership, business trust, limited liability company, or corporation. On the other hand, the new statute defines “employee” more narrowly as a person employed for at least 6 of the 12 months preceding the date on which notice is required. If the statutory language is interpreted literally, it appears that coverage will depend on the number of persons employed within the preceding 12 months, not the number of employees. Under that interpretation, the threshold for coverage will be easier to reach, since “person” is a more inclusive term under the statute than “employee,” because “person” does not contain the requirement of six months of employment. Until this ambiguity is clarified, it is advisable for counsel to adopt a conservative approach when determining coverage by counting every “person” employed during the 12 months preceding the date on which notice is required.

Second, the requirement that 75 persons be employed “within the preceding 12 months” is ambiguous. Under one interpretation, the facility (or part thereof) must have had a full complement of at least 75 persons on its payroll at one time during the 12-month period. On the other hand, it might mean that all persons employed during the 12-month period must be aggregated, regardless of the number of persons on the payroll at any one time. It is advisable to apply the second of these interpretations until the meaning of this language is clarified.

Third, the definition of “industrial or commercial” facilities will likely require resolution by the courts. For example, would a hospital or school operated by a private company be regarded as an “industrial or commercial” facility? Because the courts may well interpret this language expansively, counsel should read it broadly until a clear judicial interpretation of the language emerges.

Finally, the “covered establishment” definition applies only if the employer “owns and operates” the facility, directly or indirectly. If an employer leases a facility that it operates, it is not clear whether that would qualify as indirect ownership. Again, until the statute has been interpreted by the courts, counsel are cautioned to err in favor of determining that coverage exists.

Triggering Events

Under the state law, notice requirements apply in the event of a “mass layoff, relocation, or termination” at a covered establishment. These terms do not precisely mirror the federal law, and they raise several issues of interpretation.

In the case of a mass layoff, the California law accomplishes one of its stated purposes by establishing a lower threshold than the federal law. A “mass layoff” is defined in the state statute as a layoff during any 30-day period of 50 or more employees at a covered establishment. Regardless of the size of the work force, a layoff of 50 employees at such an establishment will satisfy the definition. There is no exclusion for part-time employees, so any person employed for at least 6 of the past 12 months will be included. In contrast, the threshold number for a mass layoff under the federal law ranges from a minimum of 50 employees to a maximum of 500, depending on the size of the work force.

Under the California law, the term “layoff” lacks specificity. The word is defined simply as “a separation from a position for lack of funds or lack of work.” This definition raises several questions. For example, if a company has adequate financial resources but simply wants to cut payroll expenses to improve its bottom line, does that situation qualify as a lack of funds?

Second, does a “separation from a position” mean a termination of employment but not a temporary layoff? Apparently yes, because “separation” is generally used in the employment context as meaning the termination of an employment relationship. On the other hand, if “separation” does not mean termination of employment, how long must the interruption of employment last to qualify as a “layoff”? Federal law sets a six-month minimum for an employment loss, but the new state law does not. This raises the possibility that a court might consider a job site shutdown of, for example, one week—a typical event in many California companies—as a mass layoff. Until the courts clarify the meaning of “separation,” California employers will need to give careful consideration to whether a 60-day notice should be given prior to a short-term shutdown of a facility.

As with “separation,” the term “termination” in the California law may mislead practitioners. The word refers to a termination of operations, not a termination of employment. It is defined as the cessation, or substantial cessation, of industrial or commercial operations in a covered establishment. This definition also does not specify a minimum number of employees who must suffer an employment loss or a time period for measuring the number of affected employees. Despite these problems, it seems likely that under most circumstances, the California law will be interpreted to roughly the same effect as the federal law, which includes a definition of “plant closing” that defines the term as an employment loss of at least 50 employees (excluding part-time employees) at a single site during any 30-day period. The California law requires notice before the cessation of operations in a facility, or part thereof, that has employed at least 75 persons within the preceding 12 months, and it seems likely that in most cases any such facility will have at least 50 employees when operations cease. It is possible that, in some cases, a facility that has employed 75 persons in the past 12 months will not have at least 50 employees when the cessation of operations occurs, and in this situation the California law effectively lowers the threshold below that of the federal law’s plant-closing definition.

Another triggering event is relocation. The California law defines “relocation” as the removal of all, or substantially all, of the industrial or commercial operations in a covered establishment to a location at least 100 miles away. The concept of a “relocation” does not appear in the federal law as an event that triggers notice requirements. However, in some cases, a relocation under state law will equate with a “plant closing” under the federal law, because a relocation involves a shutdown of a site of employment or a facility or operating unit within such a site.

A relocation under the state law raises a question: If an employer moves all the industrial or commercial operations in a covered establishment to a different location less than 100 miles away, and as a result the employer ceases all operations in the establishment, is this act a termination (thus requiring a notice), even though it does not qualify as a relocation? Presumably, it would not, since otherwise there would have been no point in creating a category of “relocation” distinct

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from “termination.” Nevertheless, until this question is clarified, it would be prudent for counsel advising clients in this situation to treat the event as a termination and give the appropriate notice.

60-Day Notices

Under the California law, an employer must give a 60-day notice in writing in the event of a mass layoff, relocation, or termination, subject to various exceptions. The law also provides that the notice must include the same elements that are required under federal law. These elements, in turn, are detailed not in the federal law itself but in regulations that specify what the notice must contain. Although the contents of a notice that complies with the state law may thus be based on established federal rules, the persons and entities that must be given a 60-day notice under the state law differ slightly from those that must be given a notice under federal law.

The persons and entities that, under state law, must be notified include:

- The affected employees. The federal law requires that the notice be sent to the representative of the employees if there is one; otherwise, it must be sent to each affected employee.
- The California Employment Development Department (EDD). The federal law requires that the notice be sent to the entity designated by the state to carry out rapid response activities under the Workforce Investment Act. According to the EDD’s Web site (www.edd.ca.gov), sending the notice to the WARN Act coordinator at that agency’s System Support Section, Workforce Investment Division, satisfies this notice requirement.
- The Local Workforce Investment Board. Contact information for the appropriate Local Workforce Investment Board can be obtained from the EDD’s Web site. The federal law does not contain this requirement.
- The chief elected official of each city and county government within which the termination, relocation, or mass layoff occurs. The federal law requires that the notice be sent to the chief elected official of the unit of local government within which the closing or layoff is to occur; however, if there is more than one such local government unit, the employer is to notify the unit to which it pays the highest taxes for the preceding year.

Exceptions

The California law contains exceptions to the notice provisions that are similar to some, but not all, of the exceptions in the federal law, as well as some that do not appear in that
statute. Before relying on an exception in either statute, it will be critical for California employers to determine that the exception is available and its requirements are met under both statutes.

The federal law provides an important exception to the notice requirement when a business is sold, and this exception is absent from the California law, which, as a result, is unclear regarding what a seller’s notice obligation is upon the sale of a business. For example, when a company sells a plant that qualifies as a covered establishment to another company, and the buyer hires the seller’s employees, will this qualify as a mass layoff by the seller if 50 or more employees experience a separation from the seller’s payroll (even though they continue to have employment at that facility)? As the statute is written, counsel should assume that this event would trigger the notice requirements of the California law.

The federal law also provides for a reduction in the notice period if a closing or mass layoff is caused by business circumstances that were not reasonably foreseeable at the time that the notice would have been required. However, the California law does not contain a similar exception. Thus, an employer that unexpectedly loses a major client or contract may be faced with an undesirable choice between keeping an affected facility open while incurring heavy losses or closing the facility and incurring liability under the California notification law.

The California law is also silent on whether it applies to a strike or lockout. In contrast, the federal law makes clear that it does not apply if a closing or layoff “constitutes a strike or constitutes a lockout not intended to evade the requirements” of the statute. Thus, counsel must consider questions that do not arise under the federal law. For example, would a mass layoff result under the state law if an employer locks out 50 or more employees at a covered establishment? Presumably not, since under the National Labor Relations Act, employees who are locked out retain their employee status and are entitled to be reinstated when the lockout ends, and thus they are not separated from their positions. Moreover, even if they were deemed to be separated, that would not result from a lack of funds or lack of work, as required under the California definition of “mass layoff,” but instead from the employer’s tactical or defensive refusal to use their services. In any event, if a mass layoff did result, the state law would likely be preempted by the NLRA under these circumstances.

On the other hand, the California law provides for a reduction in the notice period, similar to the exception in the federal law.
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that is known as the faltering company exception. Mass layoffs are excluded from the scope of this exception,35 as they are under the federal law, and thus the exception is limited to relocations and terminations. It applies if 1) at the time that the notice would have been required, the employer was actively seeking capital or business, 2) the capital or business would have enabled the employer to avoid or postpone the relocation or termination, and 3) the employer reasonably and in good faith believed that giving the notice would have precluded it from obtaining the needed capital or business.36 However, unlike the federal law, the California statute also provides that 1) the Department of Industrial Relations must make a determination that the required conditions existed,37 2) the DIR may not do so unless the employer provides it with a written record of all documents relevant to the determination and an affidavit verifying the contents of the documents,38 and 3) the affidavit must contain a declaration signed under penalty of perjury that the affidavit and the content of the documents are true and correct.39 Thus, counsel should be aware that, unlike the federal law, under the California law employers must obtain administrative approval before the faltering company exception will apply.40

The federal law also contains an important exception that applies to the closing of a temporary facility or to a closing or layoff that results from the completion of a project or undertaking, so long as the employees were hired with the understanding that their employment was limited to the duration of the facility, project, or undertaking.41 The California law contains a similar, but much more limited, exception. It applies if 1) a closing or layoff results from the completion of a particular project or undertaking that is subject to Industrial Welfare Commission Wage Order 11 (broadcasting industry), Wage Order 12 (motion picture industry), or Wage Order 16 (on-site occupations in the construction, drilling, logging, and mining industries), and 2) the employees were hired with the understanding that their employment was limited to the duration of that project or undertaking.42 Because the exception in the state law is strictly limited to specified industries, it will not be available to most employers with operations in California. Thus, numerous employers that would not have been required to comply with the notice requirements under the federal law may have to do so under the California statute. However, a separate exception provides that the new law does not apply to seasonal employees if they were hired with the understanding that their employment was seasonal and temporary. Thus, if their temporary employees are seasonal, employers
that are not involved in any of the six specified industries might be able to rely on that exception in the California law.43

A notice is not required under the California law if a mass layoff, relocation, or termination is necessitated by a “physical calamity.”44 The federal law contains a similar provision in the case of natural disasters.45 The California law also provides that a notice is not required if a mass layoff, relocation, or termination is necessitated by an act of war.46 The federal law does not contain a similar exception.

The federal law provides that an employee will not experience an employment loss if a closing or layoff is the result of the relocation or consolidation of part or all of the employer’s business, and, prior to the closing or layoff, the employer offers to transfer the employee within the parameters described by that statute.47 This exclusion is missing from the California law; however, it appears that the same subject is addressed indirectly in the state’s definition of “relocation.”

Enforcement

Under both laws, an employer that fails to give a required notice is liable for back pay to an employee who suffers an employment loss as a result of the action.48 Back pay is calculated at the employee’s average regular rate of compensation during the last three years of employment or the final rate of compensation, whichever is higher.49 In addition, the employer is liable for any benefits that the employee would have been entitled to if employment had not been lost, including the cost of medical expenses that would have been covered under an employee benefit plan.50

Liability is calculated for the period of the violation up to a maximum of 60 days, or half the number of days that the employee was employed by the employer, whichever period is shorter.51 The language of the California statute compares favorably in this regard to the federal law; it appears that back pay under the state law will be awarded only for work days during the period of the violation, while this issue is unresolved under the federal law.52

The amount of the employer’s liability will be reduced under federal law by any wages that the employer pays to the employee for the period of the violation.53 The California law contains the same provision, but it does not reduce liability for vacation pay accrued prior to the violation period and paid to the employee during that period.54

The employer’s liability also will be reduced by any voluntary and unconditional payment made to the employee that is not required by any legal obligation.55 and any
payment to a third party or trustee (such as premiums for health benefits or payments to a defined contribution pension plan) on behalf of the employee for the period of the violation.56

The California law also provides that 1) back pay and benefit payments by an employer that failed to provide a notice of a facility closure, as required by either state or federal law, will not be construed as wages or compensation for personal services under the Unemployment Insurance Code57 and 2) unemployment insurance benefits will not be denied or reduced because the employee receives payments related to the employer’s violation.58

An employer that fails to give a required notice to the Employment Development Department, the Local Workforce Investment Board, or the chief elected official of the affected city and county is subject to a civil penalty of up to $500 for each day of violation.59 The federal law has a similar provision.60 But the civil penalty does not apply under either law if the employer pays to each aggrieved employee the amount it is liable for within three weeks from the date the employer orders the action that resulted in the violation.61

The federal law provides that a court may reduce the amount of the liability or penalty if it determines that the act or omission that violated the statute was in good faith and that the employer had reasonable grounds for believing that it was not a violation.62 The California law contains a more limited defense that allows a court to reduce only the penalty. Additionally, the defense applies only if the court also determines that the employer conducted a reasonable investigation in good faith.63

The California law authorizes the court to award attorney’s fees only to a prevailing plaintiff.64 In contrast, the federal law authorizes the court to award attorney’s fees to the prevailing party in a lawsuit to enforce the statute.65 Thus, counsel who are accustomed to practicing under the federal law should be aware that the deterrent to less meritorious lawsuits provided by the possibility that a defendant could prevail and collect its attorney’s fees has been eliminated from the California framework.

While the California law accomplishes its stated purpose of lowering the federal thresholds, it also creates an entirely new statutory framework that counsel will have to master if their clients are to avoid liability. Unfortunately, as is usually the case in such an undertaking, the legislature has left open a number of issues that will require resolution by the courts, or perhaps by legislative amendments, to clarify the meaning of the
new scheme. In the interim, it is advisable for counsel to interpret the statute broadly and to recommend that their clients provide notice when the decision to provide it hinges on a statutory ambiguity.

1 Worker Adjustment and Retraining Notification Act, 29 U.S.C. §§2101-09.
2 See the legislative history of AB 2957 at http://www.leginfo.ca.gov.
3 See, e.g., LAB. CODE §1401.
4 LAB. CODE §1400(b).
5 LAB. CODE §1400(a).
7 20 C.F.R. §639.3(a)(1).
8 LAB. CODE §1400(b).
9 LAB. CODE §18.
10 LAB. CODE §1400(h).
11 LAB. CODE §1401(a).
12 LAB. CODE §1400(d).
13 29 U.S.C. §2101(a)(3). Under the federal statute, there is an alternative 90-day period—in addition to the basic 30-day period—for measuring whether a reduction in force or plant closing causes the requisite employment loss. 29 U.S.C. §2102(d). The California law does not include a similar provision, which would be relevant only in the case of a mass layoff.
14 LAB. CODE §1401(a)(1).
15 LAB. CODE §1400(f).
17 LAB. CODE §1400(e).
18 LAB. CODE §1401(a).
19 LAB. CODE §1401(b).
20 20 C.F.R. §801.7.
21 LAB. CODE §1401(a)(1).
23 LAB. CODE §1401(a)(2).
25 LAB. CODE §1401(a)(2).
26 Id.
31 See generally THE DEVELOPING LABOR LAW 1511-1513 (Patrick Hardin & John E. Higgins Jr. eds., 4th ed. 2001). As used by the NLRB and the courts “a lockout is most simply and completely defined as the withholding of employment by an employer from its employees for the purpose of either resisting their demands or gaining a concession from them.”
32 A plant shutdown because of economic considerations has been held not to constitute a lockout. Link-Belt Co., 26 NLRB 227 (1940).
35 LAB. CODE §1402.5(d).
36 LAB. CODE §1402.5(a).
37 Id.
38 LAB. CODE §1402.5(b).
39 LAB. CODE §1402.5(c).
40 The California law states that, in any investigation or proceeding under the statute, the labor commissioner has the authority to examine an employer’s books and records. LAB. CODE §1406. The federal law does not deal with this subject.
42 LAB. CODE §1400(g)(1).
43 LAB. CODE §1400(g)(2).
44 LAB. CODE §1401(c).
46 LAB. CODE §1401(c).
49 Id.
50 LAB. CODE §1402(a)(2).
51 LAB. CODE §1402(b).
52 See, e.g., Burns v. Stone Forest Indus., 147 F. 3d 1182 (9th Cir. 1998), cert. denied, 525 U.S. 1040 (1998) (The phrase “for each day of violation” under the federal law was held to mean work days), but see United Steelworkers of Am. v. North Star Steel Co., 5 F. 3d 39 (3d Cir. 1993), cert. denied, 510 U.S. 1114 (1994) ("for each day of violation" under the federal law was held to mean calendar days.). The state law avoids this ambiguity by omitting the phrase “for each day of violation.”
54 LAB. CODE §1402(c)(1).
55 LAB. CODE §1402(c)(2).
56 LAB. CODE §1402(c)(3).
57 LAB. CODE §1407(a).
58 LAB. CODE §1407(b).
59 LAB. CODE §1405.
63 LAB. CODE §1405.
64 LAB. CODE §1404.
Federalizing
In *Southland Corporation v. Keating*, a landmark 1984 decision, the U.S. Supreme Court definitively interpreted the Federal Arbitration Act (FAA) almost 60 years after its congressional enactment. Concluding that the federal statute abrogated any state legislative or judicial animus to arbitration, the Court cited the commerce clause and supremacy clause of the U.S. Constitution to invoke the doctrine of preemption. States could no longer mandate a judicial forum for the resolution of disputes. According to the Court, arbitration offered an equally valid alternative to litigation in state and federal courts.

Disagreement with *Southland* was immediate and fierce. Within the Court itself, dissenting justices criticized the decision as unwarranted by the congressional record and unjustifiable “judicial legislation.” As late as 1996, state attorneys general urged the Court to overrule its judicially formulated preemption doctrine. The Court refused and continues to endorse arbitration offered an equally valid alternative to litigation in state and federal courts.

The judicial rationale for the Court’s preemption doctrine is twofold: to reverse historic judicial hostility to arbitration, and to confirm the right of individuals to contract according to their own terms with minimal judicial intervention in the event of a dispute. At the heart of this doctrine is “freedom of economic choice.”

Paradoxically, the doctrine of preemption in arbitration mirrors an argument as old as the founding of the U.S. Constitution and the seminal jurisdictional clashes evidenced in *Swift v. Tyson* and *Erie Railroad Company v. Tompkins*. These two cases, long relegated to the dustbin of legal history, have emerged again, Phoenix-like, and hover over arbitration as the FAA continues to engage the issue of the sovereignty of state governments and the federal government.

Federalism is generally understood as the allocation of power between federal and state governments. The doctrine of federalism unfolds in various forms, including the federal preemption of state and local legislation, but it also is evidenced by jurisdictional conflicts between the federal and state judicial systems. Federalism is inherently associated, however, with the sovereignty of states in their relationship to the national government.

Linking a governmental doctrine with arbitration thus seems intu-
itively incoherent. After all, arbitration is explicitly a private resolution of disputes that combines an extralegal format with minimal judicial intrusion into the process. Yet congressional enactment of the FAA in 1925 and the subsequent interpretation of the statute by the Supreme Court, including the Court’s evisceration of state laws limiting arbitration, are manifestations of the continuing tension inherent in interpreting sovereignty.

**Jurisdiction**

The concept of sovereignty was present at the creation of the Constitution. While the delegates at the Constitutional Convention in 1787 confronted a wide range of disputes, the thread of sovereignty wove pervasively throughout the debates. Zealously guarding their prerogatives and suspicious of creating an overwhelming national judicial power, states forced the ultimate draft of the Constitution to include language of compromise. Federal original jurisdiction was cabined into three areas: “federal questions,” constitutional issues, and treaties.8

In subsequently adopting the doctrine of diversity jurisdiction in the Judiciary Act,9 Congress implicitly acknowledged the potential for judicial bias when litigation between citizens of different states required a citizen of one state to appear in the courts of another. By providing federal courts—staffed by life-tenured judges immune from public retribution—to serve as a neutral forum, Congress offered litigants a safe harbor from state court parochial decisions. At the same time, states preserved dominance in civil litigation among their own citizenry.

Federal and state courts existed in relative harmony until the Civil War except for a handful of significant exceptions. In 1842, the Supreme Court invoked diversity jurisdiction to superimpose federal substantive common law on state courts. The Court’s decision in *Swift* authorized federal courts to craft their own interpretation of state law in litigation removed from state courts on diversity grounds. The vast majority of civil litigation had always occurred in state courts—with each state applying its laws of contract, tort, and property—but *Swift* significantly reallocated judicial power. Reaction to the decision was unrelenting and pervasive, but not until 1938 in *Erie Railroad Company* v. *Tompkins* did the Supreme Court retreat from *Swift*. The justices instructed district courts to henceforth apply state substantive law in diversity cases.

In the years between *Swift* and *Erie*, the business community urged Congress to enact a legislative alternative to expensive and dilatory litigation in federal courts. In 1925, Congress enacted the FAA consistent with *Swift*, which constituted existing federal common law. The FAA empowered courts to enforce written arbitration agreements unless they were revocable on grounds of “law and equity.” The statute excluded admiralty and railroad matters from its reach in recognition of the historic role of federal legislation in those two categories. Pursuant to the terms of the FAA and *Swift*, a federal district court lacking original jurisdiction in an underlying litigation could utilize diversity jurisdiction (if applicable) to enforce arbitration clauses in federal courts under federal common law.

For litigation originally filed in state court and removed to federal court, the FAA enabled federal courts to undermine state court animus toward arbitration in commercial interstate transactions. However, 13 years after the FAA’s enactment, *Erie* reversed *Swift* and its federal common law rationale. *Erie* required federal district courts to apply the substantive law of the state within its local federal jurisdiction. In doing so, the Court indirectly resuscitated state legislation prohibiting or inhibiting arbitration whether litigation remained in state court or was removed to federal court. The federal common law doctrine of *Swift* expired, and *Erie* resurrected substantive law in both federal and state jurisdictions. To critics of arbitration, the balance of sovereignty was restored.

Antiarbitration bias in states continued, but in the ensuing years before *Southland* the Supreme Court resolved two routine state court arbitration cases that had been removed to federal court but were seemingly unimportant to the issue of sovereignty. First, in *Prima Paint v. Flood & Conklin Manufacturing Company*,10 the Court held that the terms of the FAA restricted federal courts solely to determining whether an arbitration clause in a contract (the “making of the agreement [to arbitrate]”) was valid and enforceable. Consistent with *Erie*, the Court ruled that the district court should apply state substantive contract law in resolving this issue. Determining the issue of “arbitrability” assured federal dominance in the interpretation of arbitration clauses in diversity cases but submitted resolution of the underlying transaction to arbitration.

This rendering of the FAA, which permitted the “severability” of an arbitration clause from the contract, superficially confirmed that the resolution of factual disputes would be the province of the arbitrator. In reality, the arbitrability decision placed federal courts in a supervisory role to determine whether to compel arbitration in diversity cases and simultaneously ignore state antiarbitration legislative or judicial bias. In nondiversity litigation, a state court or legislature could continue opposing arbitration.

Next, in *Moses H. Cone Memorial Hospital v. Mercury Construction Company*,11 the plaintiff had originally filed civil actions against two defendants in state court alleging breach of contract. One defendant, who had signed a contract containing an arbitration clause, removed the litigation to federal court on diversity grounds and petitioned to compel arbitration. The district court lacked jurisdiction over the other defendant, whose contract contained no arbitration clause. Sensing the potential for inconsistent decisions and increased costs, the district court abstained from exercising jurisdiction.

On appeal, the Supreme Court held that state court litigation removed to federal court on diversity grounds did not warrant district court abstention despite potential duplication of parallel judicial proceedings. The Court acknowledged that arbitration and litigation might proceed in two jurisdictions, but the district court has an “unflagging obligation” to accept jurisdiction and not abstain. In its decision, the Court hinted that the state court might not have allowed arbitration if the district court abstained. In other words, abstention would subvert the role of federal courts in determining arbitrability.

Years later the Court would confront the dilemma caused by splitting jurisdiction between state and federal court in the same case.12

**Preemption**

Almost 60 years after Congress enacted the FAA, and citing only *Prima Paint* and *Moses H. Cone* as precedent, the Supreme Court concluded that the FAA preempted any state statutory or decisional law prohibiting, inhibiting, or subverting arbitration.13 *Southland* confirmed the right of a diverse party to seek removal of a civil action originally filed in state court, subsequently file a petition in federal court to compel arbitration, and seek an order staying litigation. More dramatically, the justices simultaneously prohibited state courts from mandating a judicial forum for the resolution of disputes in nondiverse litigation.

Citing the commerce clause and the supremacy clause of the U.S. Constitution as grounds for invoking the doctrine of preemption, the Court conceded the anomaly of the FAA in not granting independent jurisdiction to federal courts.14 The FAA could not satisfy the constitutional requirement of a “federal question,” and the language of the statute referenced federal jurisdiction under the diversity statute. Until *Southland*, litigation originally filed in state court but removed on diversity grounds to federal court would languish until the federal court resolved the arbitrability of the litigation or remedied it for lack of diversity.
In a single decision, the Court eviscerated state statutory and decisional law antithetical to commercial arbitration, whether plaintiffs filed a civil action in state court or the defendant removed litigation to federal court. In either event, arbitration clauses were subject to a form of substantive federal common law in all courts—Swift redux. State contract law governed the ultimate arbitrable resolution of the merits, but federal courts became the gatekeepers under the doctrine of preemption.

The commerce clause, cited by the Supreme Court in justifying the constitutional ground for preemption, authorized the federal government to regulate interstate commerce—transactions “involving commerce”—in historic recognition of the rivalry among states and the prospect of local law in one state adversely affecting trade in an adjoining state. In Allied-Bruce Terminix Companies v. Dobson,15 which was decided several years after Southland, the Supreme Court concluded that Congress had intended to exercise federal power under the commerce clause to the maximum degree. The underlying transaction only had to “affect” commerce. Under this expanded interpretation, the scope of the FAA embraced almost any contractual transaction containing an arbitration clause, no matter how tenuous its interstate dimension.

State legislatures did not universally embrace the preemption doctrine and attempted to avoid its coverage by imposing rules applicable only to arbitration clauses in contracts. In Doctor’s Associates v. Casarotto,16 the Supreme Court sternly reminded a recalcitrant state court that federal preemption forbids legislation singling out arbitration for any contractual requirement inapplicable to contract law. A court can only invalidate or refuse to enforce an arbitration clause consistent with general contract law.

The Supreme Court also has held that the doctrine of preemption confirms the right of private parties to negotiate commercial transactions according to their own interests.17 This rationale embodies an ideological commitment to the underlying principle of capitalism: maximize freedom of contract and eliminate, or moderate, governmental interference with private transactions. Adherence to this principle, commendable in the abstract, does not always translate into the values of efficient and inexpensive disposition of disputes in arbitration.

Whether grounded in constitutional law or ideology, the basis for preemption inevitably impinged on the role of state sovereignty by withdrawing the right of state courts and legislators to offer or reject arbitration as an alternative to the judicial resolution of disputes. After Southland, state courts must honor written arbitration agreements under a quasi-federal common law doctrine that had been repudiated in Erie. While the FAA limited its scope to “commercial” agreements, the reach of the FAA has been broadened under Allied-Bruce.

In another post Southland decision, the Court validated arbitration clauses not only in litigation alleging common law counts but also in litigation involving allegations of statutory violations. In Gilmer v. Interstate Johnson/Lane Corporation,18 the plaintiff filed litigation alleging violation of a federal statute prohibiting discrimination in employment on the basis of age.19 Enforcing the arbitration clause in the contract, the Court signaled an intent to include federal statutory claims within the scope of the FAA in the absence of congressional legislation to the contrary. Subsequent decisional law confirmed this prophecy, not only in employment litigation but unrelated federal statutes.20

The Supreme Court effectively controlled the future of arbitration by 1) insisting that district courts not abstain from jurisdiction regardless of parallel or potential inconsistent proceedings in federal and state courts, 2) invoking the doctrine of arbitrability to establish the court as gatekeeper in determining whether an arbitration clause is valid and enforceable, 3) preempting state antiarbitration laws, and 4) expanding the scope of arbitration beyond common law to statutory issues.

### Jurisdictional Clashes

Tension between federal and state courts interpreting the arbitration jurisprudence of the Supreme Court emerges frequently. With the prospect of parallel litigation in state courts, federal appellate courts have enjoined state courts from proceeding under authority of the Anti-Injunction Act21 and the All Writs Act.22 But jurisdictional clashes are not confined to disagreements between state and federal courts on arbitrability. A federal appellate court in Cigna Health Care of St. Louis, Inc. v. Kaiser23 highlights several ramifications of the collateral procedural doctrines that are involved in a federal trial court refusal to abstain from pending state litigation: consolidation of issues and parties, certification of class actions in both courts, res judicata of state court judgments on identical issues asserted in federal court, issuance of a federal injunction ordering the state court not to proceed in its litigation, and the invocation of the federal Full Faith and Credit Act.24

Each of these issues emerged in Cigna based upon arbitration
clauses in a multiparty class action. In 1999, approximately 300,000 health care providers filed an Illinois class action alleging breach of contract against the defendant insurance carrier. To avoid federal jurisdiction, the plaintiffs included one nondiverse party and sought certification of the class from the state court judge. The defendant filed a petition to compel arbitration, alleging that several of its contracts with the plaintiffs contained a standard arbitration clause and others contained a collateral agreement incorporating the arbitration clause by reference.

The defendant requested the state court judge to determine the arbitrability of both categories of arbitration clauses. Instead of holding a hearing on this issue, the judge certified a “national” class without ordering discovery. Also, the court ordered the defendant to disclose all contracts related to the merits of the litigation. One year later, discovery was complete, but the judge had not ruled on the petition to compel arbitration.

Shortly after the time elapsed for parties to opt out of the class, the defendant insurance carrier filed a petition to compel arbitration in federal district court, naming many of the same plaintiffs in the state court class action as defendants. To achieve diversity, the complaint omitted the nondiverse plaintiff and other putative members of the class. Having established diversity jurisdiction, the insurance carrier as plaintiff alleged breach of contract and sought arbitration only with those defendants who held contracts containing arbitration clauses incorporated by reference.

Pursuant to the FAA, the plaintiff insurance carrier sought to stay litigation of the defendants’ claims despite previously having sought arbitration on the same issue in state court. The issue of arbitrability in state court had not been resolved at the time of the federal suit. The district court judge abstained from exercising jurisdiction and dismissed the case.25

In abstaining, the district court judge cited the pending ruling on arbitrability in the state court, the potential conflict in ruling only on contracts incorporated by reference in the arbitration clause, and the effect of a potential judgment on an award if the court ordered arbitration. Also, the state court judge had certified the class and ordered discovery on the merits of the litigation rather than determining whether the class satisfied Illinois law. Class actions, authorized by Rule 23 of the Federal Rules of Civil Procedure, are essentially a consolidation of multiple litigants—but they are not subject to consolidation in federal court unless an arbitration agreement specifically authorizes it.

If the state court invalidates the arbitration clause incorporated by reference, the parties
in the segment of the class action in state court with this type of clause in their contracts will continue in litigation. But the federal court, in resolving the case filed in its jurisdiction, must address those parties as well. The specter of collateral estoppel, res judicata, and the Full Faith and Credit Act is obvious.

**State Sovereignty**

Jurisdictional clashes between state and federal courts exist beyond the civil law world of arbitration and are far more controversial in unrelated litigation. After the Civil War, constitutional amendments were enacted that circumscribed state sovereignty, and the due process and equal protection clauses of the Fourteenth Amendment have provided authority for federal courts to cut a wide constitutional swath limiting state autonomy. Still, arbitration is a private dispute resolution process that is not susceptible to constitutional scrutiny in any degree. Although courts initially determine whether to grant or deny petitions to compel arbitration and may correct or vacate an award, no court has suggested that arbitration satisfies the legally indispensable element of “state action” necessary for judicial intervention in constitutional issues.

Strictly speaking, the doctrine of preemption invoked under the aegis of the supremacy clause does not deny states the power to conduct arbitration but rather mandates the process as an alternative to litigation. And, unlike direct challenges to state sovereignty prohibited under the Eleventh Amendment to the Constitution, the Supreme Court endorses arbitration but shares jurisdiction. As a result, federal and state courts resolve arbitration issues but reach different results. On a practical level, lawyers drafting arbitration clauses in contracts face conflicting decisions in California attributable to disagreements between the California Supreme Court and the Ninth Circuit.

For example, the U.S. Supreme Court and the California Supreme Court had each confirmed arbitration as an appropriate forum for resolution of alleged violations of federal statutory rights—as had every other circuit court of appeals except the Ninth Circuit, which incomprehensibly concluded that the FAA did not authorize the enforcement of mandatory arbitration regarding the alleged violation of federal statutory rights contained in employment contracts. As a result, forum shopping in California is common, and drafting arbitration clauses applicable to different forums poses an obvious dilemma for lawyers.

One federal court described conflicting interpretations of the FAA in state and federal
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LOS ANGELES LAWYER / SEPTEMBER 2003
California’s anti-SLAPP statute\(^1\) permits a defendant to file a special motion to strike a suit filed primarily to chill the defendant’s exercise of First Amendment rights. The legislature enacted the anti-SLAPP statute to prevent wealthy or powerful parties from using the enormous costs of litigation to suppress opposition or unfavorable public debate. Since the passage of the statute, however, the legislature and several subsequent California Supreme Court decisions have broadened its application substantially—and this has had a significant impact on the type of anti-SLAPP motions that are currently being pursued. Indeed, recent appellate court decisions reveal that large and sophisticated litigants now invoke a statute originally designed to protect nonprofit organizations and common citizens. A credit reporting agency, an insurance company, a drug manufacturer, a dental trade association, a political action committee, and the Los Angeles County Bar Association have recently employed the anti-SLAPP statute with varying degrees of success. The anti-SLAPP statute is also being used against individuals and nonprofit organizations—the types of litigants that the drafters of the anti-SLAPP statute were trying to protect. As a result, some believe that the anti-SLAPP statute has itself become a tool for suppressing constitutional rights.

The term “SLAPP”—Strategic Lawsuit against Public Participation\(^2\)—originated from observations that powerful interests were using the expense of litigation to punish their opponents. According to one commentator, “While SLAPP suits ‘masquerade as ordinary lawsuits’ the conceptual features which reveal them as SLAPPs are that they are generally meritless suits brought by large private interests to deter common citizens from exercising their political or legal rights or to punish them for doing so.”\(^3\) The purpose of a SLAPP suit is not to win. SLAPPs smother opponents by forcing them to divert scarce time and money to the defense of litigation.\(^4\)

Before the legislature enacted the anti-SLAPP statute, numerous commentators expressed concern that common law and existing statutory protections did nothing to deter SLAPPs. One of them noted that “existing remedies such as malicious prosecution often require defendants to go to trial and spend substantial amounts of money and time in order to prevail. Rather than incur the expense and the trauma, many citizens withdraw. Others, scared off by the threat of lawsuits, never enter the fray at all.”\(^5\)

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A motion to strike a SLAPP suit precipitates a two-prong test.

The defendant must first show that the lawsuit is one “arising from” protected activity. If the defendant makes the requisite showing, then the trial court will strike the complaint unless the plaintiff can demonstrate a probability of succeeding on the claim.

In response to those concerns, the legislature enacted the anti-SLAPP statute in 1992, codified as Code of Civil Procedure Section 425.16. The legislature included in the statute its findings that “there has been a disturbing increase in lawsuits brought primarily to chill the valid exercise of the constitutional rights of freedom of speech and petition for the redress of grievances.” It therefore designed the anti-SLAPP statute “to provide an economical and expeditious remedy to SLAPP suits.”

Section 425.16(b)(1) provides that a defendant may move to strike “a cause of action against a person arising from any act of that person in furtherance of the person’s right of petition or free speech under the United States or California Constitution in connection with a public issue....”

Section 425.16(e) enumerates the acts protected by Section 425.16(b)(1):

1) Any oral or written statement made before a legislative, executive, or judicial proceeding, or other proceeding authorized by law; 2) any oral or written statement made in connection with an issue under consideration or review by a legislative, executive, or judicial body, or other official proceeding authorized by law; 3) any oral or written statement made in a public place or forum in connection with an issue of public interest; 4) any other conduct in furtherance of the exercise of the constitutional right of petition or the constitutional right of free speech in connection with a public issue or issue of public interest.

A motion to strike a SLAPP suit precipitates a two-prong test. The defendant must first show that the lawsuit is one “arising from” protected activity. If the defendant makes the requisite showing, then the trial court will strike the complaint unless the plaintiff can demonstrate a probability of succeeding on the claim. The standard for this second showing is “minimal merit.”

CONFLICTS REGARDING SCOPE

Early cases adopted varying interpretations of the scope of the anti-SLAPP statute. The court in Wilcox v. Superior Court started the judicial debate in 1994 by interpreting the statute broadly. The plaintiffs in Wilcox—court reporters who brought an unfair business practices suit against other court reporters—alleged that the defendants’ practice of “direct contracting” was unlawful. The defendants filed a cross-complaint for defamation and conspiracy to restrain trade, alleging that the plaintiffs defamed them in communications with other court reporters regarding the lawsuit. The plaintiffs moved to strike, arguing that the cross-complaint was a SLAPP. The court of appeal held that filing and supporting litigation were acts protected by the First Amendment. It further ruled that the communications “were clearly made in connection with” the judicial challenge to direct contracting and were “rationally connected to the litigation itself.” Accordingly, the court of appeal held that the cross-complaint was a SLAPP and ordered that it be stricken.

Church of Scientology v. Wollersheim expanded upon Wilcox. The Church of Scientology filed an action alleging that defendant Wollersheim had procured an earlier judgment against the Church of Scientology through fraud. In response to Wollersheim’s motion to strike, the Church of Scientology argued that the anti-SLAPP statute did not apply because, among other things, Wollersheim’s earlier tort complaint was not a matter of public interest. The court held that the anti-SLAPP statute applied to “all kinds of claims [that] could achieve the objective of a SLAPP suit—to interfere with and burden the defendant’s exercise of his or her rights.”

Shortly thereafter, in Beilenson v. Superior Court, a politician defeated in an election sued the winner, contending that the winner had defamed him in election literature. When the defendant moved to strike, the plaintiff argued that the anti-SLAPP statute did not apply to political campaigns. He argued that “the statute was designed to protect those ordinary citizens who find themselves sued in retaliation for the exercise of their rights under the First Amendment (e.g., homeowners who challenge developers).” The court of appeal held that “the statute does not limit its application to certain types of petition activity.”

Within months after the decisions in Church of Scientology and Beilenson, however, the court of appeal in Zhao v. Wong departed from the broad application of the statute. In Zhao, the plaintiff filed an action arising from an allegedly slanderous press interview regarding a highly publicized, mysterious death and ensuing will contest. The court of appeal concluded that the statute only protected activities relating to issues of “public significance” or “public interest” and that the press interview did not qualify. Several cases decided shortly thereafter also limited the anti-SLAPP statute to issues of public interest and public significance.

Against this background of conflicting jurisprudence, the legislature amended the anti-SLAPP statute in 1997. One of the otherwise minor amendments provided that the statute “shall be construed broadly.” Zhao and its progeny, which had narrowly construed the statute, apparently prompted that amendment.

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California Supreme Court in 1999 to resolve the conflicting lines of cases by eliminating the public interest requirement, at least in connection with matters under consideration in an official proceeding. In Briggs v. Eden Council for Hope and Opportunity, landlords sued a nonprofit organization that provided counseling, mediation, and referral services to tenants involved in disputes with their landlords. The landlords alleged that the nonprofit had defamed them in several instances, including a statement to an investigator for the Department of Housing and Urban Development and advice given to a tenant in connection with the tenant’s suit against the tenant’s landlord. The California Supreme Court held that “a defendant moving to strike a cause of action arising from a statement made before, or in connection with an issue under consideration by, a legally authorized official proceeding need not separately demonstrate that the statement concerned an issue of public significance.”

Even after Briggs, plaintiffs opposing motions to strike successfully argued to impose distinct proof requirements not contained in the statute itself. In Paul v. City of San Jose,24 for example, the plaintiff was an election committee that alleged the defendants violated election laws by laundering campaign contributions to an opponent.25 The court of appeal held that the anti-SLAPP statute did not protect the defendants’ illegal activities, because those activities did not constitute a valid exercise of First Amendment rights.26 In so ruling, however, the court of appeal used language that appeared to impose a separate proof requirement on a defendant bringing an anti-SLAPP motion: “[D]efendants have not shown that plaintiff’s suit was brought primarily to chill a valid exercise of their constitutional rights.”27

Plaintiffs subsequently seized on the “intent to chill” language in Paul for Council as creating a new proof requirement. That led the California Supreme Court to issue rulings in four SLAPP cases during August 2002 that clarified, and in some respects significantly changed, anti-SLAPP litigation.

**RESHAPING ANTI-SLAPP LITIGATION**

In the first of the four cases, the supreme court addressed the procedural requirements for establishing whether a lawsuit has minimal merit. Ruling on August 1 on the standard of proof required to defeat a motion to strike, the court, in Wilson v. Parker,28 held that in order to show a probability that the plaintiff will prevail, the plaintiff must state and substantiate a legally sufficient claim.29 According to Wilson, “[T]he complaint is both legally sufficient and supported by a sufficient prima facie showing of facts to sustain a favorable judgment if the evidence submitted by the plaintiff is credited.”30

In three companion cases decided on August 29, the supreme court went to the heart of the issue of the expanded use of the anti-SLAPP statute. In the first of the cases, Equilon Enterprises, LLC v. Consumer Cause, Inc.,31 an oil company sued a consumer group as a result of “notices of intent to sue” that the group served pursuant to Proposition 65.32 The oil company filed a preemptive action seeking a declaration that the notices of intent to sue were invalid as well as an injunction barring the group from filing litigation based on the allegedly defective notices. The defendant moved to strike the complaint, arguing that it was a SLAPP. The trial court granted the motion, and the court of appeal affirmed. The supreme court granted review.

Equilon argued that the anti-SLAPP statute could not apply unless its lawsuit was intended to chill the exercise of First Amendment rights by Consumer Cause. The supreme court rejected the argument and held that a defendant did not need to prove that a SLAPP had been filed with the intent to chill the defendant’s First Amendment rights in order for a court to strike the complaint.

The second companion case, City of Cotati v. Cashman,33 involved a previously filed federal court action by Cashman seeking a declaration on the constitutionality of a mobile home rent control ordinance. The city of Cotati reactively sued Cashman in superior court, conceding that it had done so in order to obtain a more favorable forum. Cashman moved to strike the state court complaint, contends that it was a SLAPP filed because of his federal litigation. The trial court granted the motion to strike the complaint, but the court of appeal reversed, and the supreme court granted review.

The supreme court first addressed conflicting evidence regarding whether the city had intended to chill Cashman’s exercise of his right to file the federal court litigation. The timing of the city’s filing obviously suggested that the city had acted in response to Cashman’s federal litigation. The supreme court held that the city’s intent was irrelevant, however, because under Equilon the defendant did not need to prove that the complaint had been filed with an intent to chill First Amendment rights.

Next the supreme court addressed whether the city’s complaint was “arising from” Cashman’s protected activity. The mere fact that the city’s litigation was responsive to Cashman’s, or constituted an “oppressive” litigation tactic, was not sufficient.34 Instead, the supreme court held that “the critical point
8. A defendant must demonstrate that communications with public officials regarding pending legislation concern the public interest.
   True.
   False.

9. In which of the following situations have courts found that an advertising or public relations campaign constituted activity protected by the anti-SLAPP statute?
   A. A major drug manufacturer sued for false statements regarding a widely used medication.
   B. A dental trade association sued by a public interest group for allegedly false statements concerning mercury amalgam fillings.
   C. A taxpayers organization sued by a political action committee for allegedly illegal political advertising.
   D. All of the above.

10. Courts apply a two-prong test in determining whether to grant a motion to strike a SLAPP suit.
    True.
    False.

11. A court may grant a motion to strike a SLAPP suit even if the lawsuit was not filed for the purpose of chilling the exercise of constitutional rights.
    True.
    False.

12. A plaintiff that defeats a motion to strike the anti-SLAPP statute?
    True.
    False.

13. A plaintiff that defeats a motion to strike the anti-SLAPP statute can recover attorney’s fees.
    True.
    False.

14. A court has the discretion to award attorney’s fees to a defendant that prevails on a motion to strike under the anti-SLAPP statute.
    A. Only if the court determines that the complaint was frivolous.
    B. Only if the court determines by a preponderance of the evidence that the plaintiff brought the action for the purpose of chilling the exercise of the defendant’s constitutional rights.
    C. If the court determines that such an award is necessary to punish and deter the filing of other SLAPPs.
    D. The award of attorney’s fees is mandatory if the defendant prevails.

15. “Garden variety” breach of contract claims can be subject to motions to strike under the anti-SLAPP statute.
    True.
    False.

16. In response to Zhao v. Wong and other decisions construing the scope of the anti-SLAPP statute, the California Legislature in 1997 amended the anti-SLAPP statute to mandate that it be broadly construed.
    True.
    False.

17. In which of the following circumstances must a defendant demonstrate that the challenged activity concerned a matter of public interest in order to be protected by the anti-SLAPP statute?
    A. Statements made before a legislative committee considering a new statute.
    B. Statements made in connection with an issue under consideration by a trial court.
    C. Commercial advertising.
    D. None of the above.

18. If the defendant shows that the lawsuit concerns communications or activity protected by the anti-SLAPP statute, the court must strike the complaint unless the plaintiff demonstrates each of the prima facie elements of the case by a preponderance of the evidence.
    True.
    False.

19. The filing of litigation is protected by the anti-SLAPP statute.
    True.
    False.

20. A lawsuit filed in state court in response to a previously filed federal lawsuit based on the same dispute will always be stricken pursuant to the anti-SLAPP statute.
    True.
    False.
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is whether the plaintiff’s cause of action itself was based on an act in furtherance of the defendant’s right of petition or free speech.”37 The supreme court reasoned that both the city and Cashman had filed cases concerning an identical dispute. Thus, the city’s case arose from the dispute, not from Cashman’s protected act in filing the federal court litigation.38 Based on this reasoning, the supreme court held that the statute was inapplicable and affirmed the court of appeal’s conclusion that the defendant’s motion should have been denied.

The last in the trio of cases, Navellier v. Sletten, complemented Cashman’s discussion of the “arising from” requirement39—but did so in a way that may ultimately discourage the filing of legitimate, albeit novel, claims. Navellier had filed an action against Sletten and others in federal court arising from disputes concerning the management of an investment fund, including the defendants’ decision to terminate Navellier’s role as adviser to the fund. The parties reached an agreement during federal court litigation in which Navellier would return to the fund as the investment adviser, and Sletten would release all claims against Navellier. The agreement did not resolve the litigation, however. Navellier filed an amended complaint, and Sletten filed a counterclaim, alleging claims arising from the failure by Navellier to procure a trustee’s errors and omissions policy.40 The district court ultimately dismissed Sletten’s counterclaim, finding in pertinent part that Sletten’s release barred his counterclaim. After trial in which a verdict for the defense was reached on Navellier’s amended complaint, Navellier appealed.

However, right before appealing the federal court judgment, Navellier sued Sletten in state court, alleging that Sletten had committed fraud in misrepresenting his intention to be bound by the release. Sletten moved to strike what he contended was a SLAPP. The trial court denied his motion and the court of appeal affirmed. The supreme court granted review and reversed in a 4-3 decision.

The supreme court emphatically rejected the argument that the anti-SLAPP statute did not apply to a “garden variety breach of contract and fraud claim.”41 Instead, the court held that Sletten had met his threshold burden of proving that the state court action arose from his constitutionally protected right to sue in federal court.

As the majority noted, the fact that the plaintiff satisfied the threshold requirement did not require that the complaint be stricken. The court instead remanded the case for a consideration whether the “fraud and contract claims have the minimal merit required to survive an anti-SLAPP motion.”42 In response to concerns by the dissent, the majority said that its decision protected appropriate remedies for breach of contract involving constitutionally protected activity by ensuring that claims “with requisite minimal merit may proceed.”43

The dissent, written by Justice Brown with the concurrence of Justices Baxter and Chin, attacked both conclusions. First, the dissenting justices argued that Sletten had “traded his right to engage in specified First Amendment activity (litigating) in exchange for consideration,” and that “his suit was not what section 425.16...characterizes as a ‘valid exercise’ of his right to petition.”44 Second, the dissenters argued that evaluating the complaint under a second-prong minimal merit analysis “amounts to a rewriting of California summary judgment law in a way that significantly disadvantages plaintiffs.”45 Contrary to protecting First Amendment rights, the dissenters argued that:

[The financial penalties associated with losing a motion to strike] will chill the right to petition, which the anti-SLAPP law was designed to protect. Parties with novel claims will now confront two layers of uncertainty: whether the court will deem the claim as arising from a former suit and whether the
court will find a probability of success. Unfavorable findings to these questions will prove costly. Many parties, especially those with limited resources, will hesitate to file under these conditions.46

These financial penalties stem from the fact that the anti-SLAPP statute contains a lop-sided attorney’s fee provision. The trial court must award attorney’s fees to a prevailing defendant but may only award attorney’s fees to a prevailing plaintiff if the motion was frivolous or solely for the purpose of delay.47

**A SLAPP FOR EVERYONE**

Whether it was the cluster of supreme court decisions, the elimination of the public interest and intent to chill requirements, application of the anti-SLAPP statute to a “garden variety breach of contract and fraud claim,” or simply a growing awareness of the available remedies, it is clear that something has galvanized the increasing use of the statute.

In the dissent in *Navellier*, Justice Brown stated that “the cure has become the disease—SLAPP motions are now just the latest form of abusive litigation.”48 This sentiment was echoed by the title of a continuing legal education program hosted this year by the Bar Association of San Francisco: “Getting SLAPPed Around: Has the Anti-SLAPP Statute Become a Monster?”49 A Westlaw search reveals that appellate courts have issued almost 125 published and unpublished decisions in appeals of SLAPP cases since August 29, 2002, when the supreme court decided *Equilon, Cashman, and Navellier*. Recent published cases show how large, well-funded litigants are using the broad construction of the anti-SLAPP statute to try to fend off suits by nonprofit, public interest groups.

The most startling example is *Yu v. Signet Bank/Virginia*.50 In *Yu*, California credit card holders brought claims for abuse of process and unfair business practices against Virginia banks that obtained default judgments against them in Virginia debt collection actions. After an earlier appeal in which a summary judgment for the banks had been reversed, the plaintiffs filed an amended complaint. The trial court sustained the bank’s demurrer without leave to amend and denied its motion to strike as moot.

The court of appeal reversed the order sustaining the demurrer, so it considered the merits of the motion to strike under the anti-SLAPP statute. Regarding the first prong of the anti-SLAPP test, the court of appeal found that the banks had proven that their conduct was privileged under the First Amendment. Noting the turnabout, the court of appeal stated: “It is ironic that a lawsuit challenging distant forum abuse—a practice calculated to prevent the plaintiffs’ “public participation” in the collection action against them—should itself meet the threshold definition of a SLAPP suit, but that is the result under the anti-SLAPP statute.”51

Despite the fact that the anti-SLAPP statute applied, the court found that the trial court should have nonetheless denied the motion because the plaintiffs had met their burden of showing that their case had minimal merit. Thus, the plaintiffs avoided losing the case and thereby subjecting themselves to liability for the banks’ attorney’s fees.

Consumers also narrowly defeated a motion to strike in *Decker v. U.D. Registry, Inc.*52 In *Decker*, the defendant collected and sold information about prospective residential tenants to landlords. The plaintiffs sued, alleging that the defendant had disseminated false, misleading, and inaccurate information about them. The reporting agency moved to strike, contending that the plaintiffs’ action was a SLAPP. The trial court denied the motion—but not on the merits. Instead, the motion failed because the defendant had neglected to notice a timely hearing. The trial court also awarded attorney’s fees to the plaintiffs. The court of appeal affirmed because the hearing was untimely, but in an indication of how precarious the outcome was for the plaintiffs, reversed the award of attorney’s fees. The court of appeal held that the anti-SLAPP motion

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was neither frivolous nor totally without merit.53

More recently, an insurance company temporarily succeeded in striking a complaint and recovering substantial attorney’s fees in Gallimore v. State Farm Fire & Casualty Insurance Company. The insured in Gallimore had filed suit alleging unfair business practices in connection with the handling of Northridge earthquake damage claims. Because the complaint was based, and arose from, confidential reports that the insurer had filed with the California Department of Insurance, the insurer argued that the complaint was a SLAPP. The trial court granted the insurer’s motion to strike and awarded it $61,000 in attorney’s fees. The court of appeal reversed, however, holding that the complaint was based upon the insurer’s conduct in settling (or perhaps more accurately, not settling) earthquake claims, not the fact that it communicated information to the Department of Insurance.54

The litigation of political disputes now inevitably involves anti-SLAPP motions. For example, in Roberts v. Los Angeles County Bar Association,55 the Los Angeles County Bar Association used the anti-SLAPP statute to defeat a disgruntled judicial candidate’s complaint arising from her “not qualified” rating by the Association. In Governor Gray Davis Committee v. American Taxpayers Alliance,56 a taxpayers group used the anti-SLAPP statute to defeat a lawsuit by the governor’s campaign committee. The lawsuit challenged an allegedly illegal, “campaign-style,” “informational” advertisement.57

Litigants challenging advertising or public relations should always expect to draw a motion to strike. For example, in DuPont Merck Pharmaceutical Company v. Superior Court,58 a major drug manufacturer invoked the anti-SLAPP statute to defeat a class action regarding the drug company’s public relations campaign about a generic alternative to Coumadin, the company’s blood thinning drug. The plaintiffs had alleged that the drug company had made false and misleading statements to regulatory bodies, the medical profession, and the general public in order to prevent regulatory approval—or consumer acceptance in the event of approval—of the generic alternative. As to the defendant’s communications with regulatory authorities, the court of appeal held that, following Briggs, the communications were protected activity. Regarding the defendant’s communications with the medical profession and general public, the court of appeal held that the communications concerned a matter of public interest because the plaintiffs had alleged that 1.8 million people take Coumadin.59 Accordingly, the court of appeal directed the trial court to consider whether the plaintiffs could establish
a probability of success.

Similarly, the California Dental Association recently used the anti-SLAPP statute to defeat a case involving multiple types of protected activity in connection with mercury amalgam filings. In *Kids Against Pollution v. California Dental Association*,60 the plaintiff alleged that the California Dental Association had disseminated false and misleading information to dentists and the public concerning the risks of mercury amalgam and retaliated against dentists who disclosed the dangers to patients through enforcement of a “code of ethics.” After the dental association filed its anti-SLAPP motion, the plaintiff withdrew its claim based on public advocacy. As to the plaintiff’s claims based solely on enforcement of the dental association’s ethical code, the court held that the activity was protected, and that the plaintiff had failed to submit sufficient evidence to show that the California Dental Association was enforcing the ethical code in an illegal manner. Accordingly, the court of appeal remanded with instructions to dismiss the action.

However, in a case showing the limits of what constitutes “public interest,” an herbal supplement corporation unsuccessfully invoked the anti-SLAPP statute to defend its advertisements for “Grobust,” which the corporation touted as the “All-Natural Way To A Fuller, More Beautiful Bust!” The court of appeal held in *Consumer Justice Center v. Tri-medica International Inc*. that, because the communications involved purely commercial speech and did not concern issues of public interest, the anti-SLAPP statute did not apply.61 The court of appeal distinguished the case from *DuPont* because DuPont’s communications regarding Coumadin had constituted matters of public interest or significance. That distinction shows how the public interest limitation remains determinative in cases challenging advertising, public relations, or other communications with the general public. Cases such as *Briggs*, which discarded the public interest requirement, involved communications with public officials concerning official proceedings. The supreme court reasoned that “any matter pending before an official proceeding possesses some measure of ‘public significance’ owing solely to the public nature of the proceeding....”62 Cases involving communications unrelated to official proceedings must be evaluated under the public interest requirement in Code of Civil Procedure Section 425.16(e)(3) and (4).

**POWERFUL INCENTIVE**

As the case law clearly indicates, motions to strike under the anti-SLAPP statute are no longer brought only to protect “the little guy.”
Sophisticated corporate defendants and trade associations now employ the anti-SLAPP statute as part of their defensive arsenal. While not all such attempts succeed, some do, and there have been some very close cases in which consumer plaintiffs narrowly escaped paying large attorney's fee awards.

The expanded use of the anti-SLAPP statute is in most respects natural and appropriate. Laws must protect everyone equally, and a law designed to protect “common citizens” must also protect large corporations and wealthy individuals. In the case of the anti-SLAPP statute, however, the legislature clearly had in mind a specific, abusive use of litigation—one that involved wealthy or powerful litigants—when it originally enacted the statute.63

Subsequent legislative amendments and case law have broadened the reach of the anti-SLAPP statute to the point in which any action based on slander, defamation, abuse of process, or malicious prosecution will likely draw an anti-SLAPP motion to strike. Similarly, almost any case based on public advocacy or interaction with governmental officials or the legislative process will be attacked.

For false advertising cases, the public interest requirement remains, but it has already proven difficult to apply. Recent cases demonstrate that a precise definition remains elusive, and, to some extent, arbitrary. For example, how could the court in Consumer Justice Center conclude that a nonsurgical alternative to breast enhancement was not a matter of public interest? How large must the advertising audience be before a plaintiff risks paying attorney’s fees as an anti-SLAPP sanction?

Given the broad scope of the anti-SLAPP statute, and examples such as Decker, it seems unlikely that attorney’s fee awards against defendants will be upheld in any but the most frivolous of motions. In short, there is a powerful incentive to bring anti-SLAPP motions, and little downside risk.

Considering a plaintiff’s risk of incurring substantial attorney’s fees for losing a motion to strike, one can question whether the concerns articulated in Justice Brown’s dissent in Navellier64 have been, or shortly will be, realized. How many individuals or nonprofit organizations can afford the risk of a $60,000 attorney’s fees award, such as the one in Gallimore? Will the broadened scope of the statute paradoxically chill the assertion of novel, untested claims by the types of plaintiffs the anti-SLAPP statute was originally conceived to protect?

At press time, the California Legislature was considering a bill that would sharply limit the circumstances under which commercial entities could move to strike complaints by...
consumers. The bill would exempt most actions brought on behalf of the general public, and, regardless of the identity of the plaintiff, would prevent companies engaged in the business of selling or leasing goods or services from invoking the anti-SLAPP statute in cases challenging “representations of fact” concerning their products.

Even if the bill becomes law, it will not completely eliminate the expanded use of the anti-SLAPP statute. The anti-SLAPP statute will continue to apply to “garden variety” claims. Furthermore, there will be considerable litigation to determine which plaintiffs are exempted from, and which defendants can bring, motions to strike.

Only one certainty exists. Until the legislature constrains its scope, every type of defendant will invoke the anti-SLAPP statute.

3 Wilcox v. Superior Court, 27 Cal. App. 4th 809, 816-17 (1994) (citing George W. Pring, SLAPPs: Strategic Lawsuits against Public Participation, 7 PACE ENVTL. L. REV. 3, 5-6, 9 (1989)).
4 Id. at 816-17 (citations omitted).
11 “Direct contracting” is the practice whereby a certified shorthand reporter or association of reporters contracts with a major consumer, such as an insurance company, for the exclusive right to report depositions. Id. at 814.
12 Id. at 823-25.
14 Id. at 652.
16 Id.
17 Id. (emphasis added).
22 Id.
23 Id. at 1123 (emphasis in original).
25 The defendants allegedly solicited $300 contributions from family members and then reimbursed them.
26 The court of appeal’s decision was made easier by the defendants’ concession that their activities were illegal. Had the legality of the activities been disputed, the plaintiff, in opposing the motion, would have been required to demonstrate a probability of success in proving the illegality of the activities. Paul for Council,
85 Cal. App. 4th at 1364.
27 Id. at 1367 (emphasis in original).
28 Id. at 821 (citing Briggs v. Eden Council for Hope & Opportunity, 19 Cal. 4th 1106, 1123 (1999)).
29 Id. (quoting Matson v. Dvorak, 40 Cal. App. 4th 539, 548 (1995)).
31 HEALTH & SAFETY CODE §25249.7.
32 The supreme court overruled the numerous cases that appeared to impose an “intent to chill” requirement. Equilon, 29 Cal. 4th at 68 n.5.
33 City of Cotati v. Cashman, 29 Cal. 4th 69 (2002).
34 Id. at 75-76.
35 Id. at 78 (citing Kajima Eng’g & Constr., Inc. v. City of Los Angeles, 95 Cal. App. 4th 921, 924 (2002)).
36 Id. (quoting Matson v. Dvorak, 40 Cal. App. 4th 539, 548 (1995)).
37 Id. (emphasis in original).
38 Id.
40 The program was held on May 7, 2003.
41 “When previously construing the statute…we have declined to hold ‘that section 425.16 does not apply to events that transpire between private individuals.’” Navellier, 29 Cal. 4th at 90-91 (citing Briggs v. Eden Council for Hope & Opportunity, 19 Cal. 4th 1106, 1116 (1999)).
42 Id. at 95.
43 Id. at 94.
45 Id. at 101.
46 Id. at 102.
47 CODE CIV. PROC. §425.16(c).
48 Id. at 101 (emphasis in original).
49 Id. at 102.
51 Id. at 1202.
56 Id. at 567. The Briggs court addressed communications with public and judicial bodies and in connection with official proceedings. It did not rule on whether the public interest requirement applied outside that context. Briggs v. Eden Council for Hope & Opportunity, 19 Cal. 4th 1106, 1116 (1999).
59 Briggs, 19 Cal. 4th at 1118.
61 Naveiller v. Sletten, 29 Cal. 4th 82, 102 (2002).
By Robert A. Briskin

FAIR Exchanges

In order to prepare a Section 1031 exchange properly, attorneys need to make their way through a mine field of rules and regulations

The tax benefits that real property owners can achieve by engaging in tax-free exchanges under Section 1031 of the Internal Revenue Code when selling their properties are significant, but can only be realized for transactions that are carefully structured to comply with the applicable rules and regulations. For exchanging parties—that is, property owners seeking to enter into a Section 1031 exchange—professional exchange companies, such as escrow companies and affiliates of escrow and title companies, offer a variety of services that provide excellent guidance—and do so at competitive fees. However, these companies generally note in their documents that an exchanging property owner should “not rely upon the professional exchange company for legal or tax advice” and further advise exchanging parties to “use their own separate tax professionals and attorneys.”

These warnings—along with recent case law and IRS pronouncements—underscore the necessity of attorney involvement in the process to ensure that Section 1031 exchanges are structured properly.

If they are not, the realized gain of an exchange can become recognized taxable income. An attorney’s task is to structure a Section 1031 exchange by traversing a mine field of requirements that demand vigilant scrutiny and analysis. What follows are nine of the more common issues that practitioners face in real property exchanges—and ways to address them.

Robert A. Briskin practices law in Century City. He is a State Bar of California Board of Legal Specialization certified specialist in taxation law.
1. The property being exchanged comprises both real estate and personal property. A basic Section 1031 exchange requirement is that the property sold (the “relinquished property”) and the property received (the “replacement property”) must be “like-kind.” Generally, real estate is considered to be like-kind to other interests in real estate. Thus, land can be exchanged for improved real estate, and a 30-year or more leasehold can be exchanged for a fee interest in real estate. However, if the relinquished property consists of personal property, then the replacement property must also consist of similar like-kind personal property. Real estate cannot be exchanged tax-free for personal property. Unfortunately, some exchanging parties unwittingly violate this like-kind requirement by failing to recognize that personal property—such as refrigerators, washers, and moveable stoves in apartment buildings—is often included as part of the building being exchanged.

The “incidental property exception,” which states that minor items of personal property do not have to be separately identified in a deferred tax-free exchange, does not apply to the like-kind property requirement of Section 1031. This exception is only used to determine whether the property is being properly identified for the purpose of complying with the time requirements of the deferred exchange rules. If even a small amount of personal property is exchanged along with real property, then like-kind personal property must also be received in the exchange in order to satisfy Section 1031’s requirements.

Personal property is present if parts of buildings are reclassified as personal property. Today, sophisticated building owners reduce their income taxes by accelerating depreciation and amortization deductions through reclassifying building parts as personal property. This reclassification allows the owners to avoid having to depreciate portions of a building over the long 39-year recovery period for commercial property and 27-year period for residential property using the straight-line method. In order to reclassify parts of buildings as personal property, real estate owners commonly perform cost segregation studies, which are based upon the tax rules outlined in Hospital Corporation of America v. Commissioner. The reclassified personal property is then depreciated over a shorter recovery period than the real property.

Reclassified personal property can be amortized and depreciated—usually over five or seven years—using the double declining balance method. Thus, the cost of carpet and window coverings can be recovered over five years. Similarly, specialized refrigeration; restaurant, medical, manufacturing, or computer equipment; and the plumbing, electrical, ventilation, and flooring systems in connection with specialized systems may be classified as personal property to be depreciated over short recovery periods. The same is true for office cabinetry, carpeting, special lighting fixtures, gasoline pump canopies, and retail signs.

In order to meet the like-kind property requirement of Section 1031 when personal property comprises part of the relinquished property, personal property of the same like-kind class should also be included in the replacement property. The multiple property like-kind rules apply to determine the classification of the various properties when both real and personal property are being exchanged. To avoid gain recognition when only the relinquished property contains personal property, some exchanging parties provide evidence that the relinquished property’s personal property has no value and thus is not part of the exchange. Alternatively, if property is reclassified as a result of a cost segregation study, exchanging parties have argued that the property still constitutes real property for purposes of the Section 1031 like-kind exchange rules based upon the definition of real property under California state law.

2. An exchanging party seeks to exchange into replacement property with improvements to be constructed in the future. Owners sometimes sell their relinquished property and then exchange into replacement property on which improvements will be constructed in the future. However, contracts to construct improvements are not like-kind to real property for tax-free exchange treatment. The Treasury Regulations indicate that the improvements under construction on the replacement property will qualify as like-kind to real estate only to the extent that the partially constructed improvements are classified as real estate under state law on the date of receipt.

In order to construct improvements on the replacement property that will qualify for like-kind exchange treatment, an exchanging party often will have the improvements on the replacement property constructed by an independent party, and then, at a later date, the exchanging party will exchange into the replacement property. For example, the seller of a relinquished property may do a “reverse tax-free exchange” by first having the replacement property acquired by an independent party (who must not be classified as the seller’s agent for tax purposes) and then have the independent party construct the improvements. When the improvements are fully constructed and become part of the real property, the replacement property—including the newly constructed improvements—is then exchanged for the relinquished property.

Another form of a reverse exchange is a “parking arrangement,” in which the replacement property is first acquired or “parked” with a third party, which is referred to in Revenue Procedure 2000-37 as an “exchange accommodation titleholder.” Revenue Procedure 2000-37 provides a safe harbor for parking arrangements when the acquisition of the replacement property is completed prior to the disposition of the relinquished property. Unfortunately, exchanging parties may have difficulty meeting the Revenue Procedure’s time requirements, which mandate that the exchanging party receive the replacement property within 180 days of the exchange accommodation titleholder acquiring title to the replacement property. Because of potential construction delays, the exchange accommodation titleholder likely may take longer than 180 days to construct the improvements. Therefore, sellers desiring to exchange into improvements that will be constructed in the future may instead choose to do an exchange based on case law authority that is outside of the safe harbor of Revenue Procedure 2000-37.

3. Partners seek to dissolve a partnership followed by a tax-free exchange. Partners seeking to dissolve sometimes first liquidate and distribute all of the partnership’s relinquished property to its partners as tenants-in-common, followed by the former partners immediately selling the relinquished property. The selling former partners then exchange into different properties, and some partners even receive cash. However, the liquidation of a partnership followed by an immediate exchange risks violating a basic requirement of Section 1031, which is that exchanging partners must “hold” both the replacement property and the relinquished property for “productive use in a trade or business or for investment” purposes. Although there is no specified length of time that the exchanging former partners must hold the relinquished property before entering into an exchange, the former partners should own the relinquished property as tenants-in-common long enough to evidence their intention to hold the property for investment or trade or business purposes.

The IRS has ruled that an exchanging party has not held the relinquished property for the required qualified use if the property was received by the exchanging party as a liquidating distribution and then immediately exchanged for the replacement property. In contrast to this ruling, however, the Tax Court in Mason v. Commissioner later held that exchanges by partners who received the relinquished property in a partnership liqui-
A safer tax strategy is to have the former partners hold their tenant-in-common interests in the relinquished property for an extended period before they exchange those interests for the replacement property. This tenancy-in-common relationship must be structured so it will not be treated as a partnership for tax purposes.25 Thus, the formalities of a tenancy-in-common relationship should be observed. The names of the tenants-in-common should be titled on the property’s deed, and the partnership’s liquidation should be legally formalized by filing the requisite state dissolution and termination documents, such as a Form LP3 Certificate of Dissolution for liquidating California limited partnerships.26 The IRS’s recently issued Revenue Procedure 2002-22 lists the conditions under which the IRS will consider a request for a revenue ruling that a tenancy-in-common interest not be treated as a partnership interest for tax purposes.27

4. A partnership in the process of reconstituting itself or dissolving seeks tax-free exchange treatment at the same time the partnership distributes cash to some departing partners. This is a common scenario, though fraught with pitfalls. The dual goals are for some partners to receive cash (the “cash-out partners”) while the remaining partners exchange partnership real estate tax-free into other real estate. In an effort to achieve these goals, partnerships sometimes sell their real estate and use a portion of the sales proceeds to exchange tax-free into other real estate, while simultaneously distributing cash to the cash-out partners in full redemption of their partnership interests. The intent is that only the cash-out partners report taxable gain proportionate to the sales proceeds that they receive, while the remaining partners receive tax-free exchange treatment. However, distributing cash to only the cash-out partners may result in all the partners being taxed on the sale’s recognized gain if the partnership agreement allocates gain to all partners in proportion to their percentage interests. Even if the partnership agreement were amended to state that all of the gain on a property’s sale is specially allocated only to the cash-out partners, and the remaining partners are to receive tax-free exchange treatment, this special allocation may not have the substantial economic effect that is required under the Section 704(b) rules to be recognized for tax purposes.28

One alternative to allocating all the sale’s taxable gain to the cash-out partners involves the partnership, prior to the sale of the relinquished property, fully redeeming the partnership interests of the cash-out partners by using partnership cash reserves. The partnership then proceeds to exchange the relinquished property for the replacement property in a qualifying tax-free exchange. Another alternative tax structure is for the partnership to sell the relinquished property for cash and a promissory note. After the sale of the relinquished property, the cash-out partners receive distribution of the promissory note in exchange for the redemption of their partnership interests. The promissory note is structured to pay the cash-out partners principal and interest in the year of the exchange and in the following calendar year.29 Those partners desiring to receive tax-free exchange treatment then continue as partners in the partnership and have the partnership use their share of the sales proceeds of the property to engage in a Section 1031 tax-free exchange.

A final alternative tax structure is for the partnership to first distribute a fractional tenancy-in-common portion of the partnership’s soon to be relinquished property to the cash-out partners in redemption of their partnership interests. The cash-out partners and the partnership (as tenants-in-common) then engage in a sale of the relinquished property. In the sale, the cash-out partners retain their cash sales proceeds (and report the sale’s gain on those proceeds), while the partnership uses its portion of the relinquished property’s sales proceeds to enter into a tax-free exchange. The tenancy-in-common relationship must be structured so it will not be treated as a continuation of the former partnership for income tax purposes.30

5. Sellers seek to contribute replacement property into a new partnership immediately after the completion of the exchange. Sellers of relinquished property in a tax-free exchange may attempt to pool their property’s equity with other persons by first completing their tax-free exchange and then contributing their replacement property (or a tenancy-in-common interest in the replacement property) to a partnership with other persons. However, contributing replacement property to a partnership immediately following an exchange risks violating the holding requirement of Section 1031.31 Thus, the replacement property was not held for productive use in a trade or business or for investment purposes. Instead, the replacement property was immediately disposed of by its contribution to a partnership.

Taxpayers might assert that the partnership’s holding of the replacement property should be attributed to the original exchanging property owner, based upon the ruling of the Ninth Circuit in Magneson v. Commissioner.32 This argument, however, could be a risky tax strategy.

In an alternative and safer tax approach, the exchanging party would hold the replacement property as a tenant-in-common with the partnership for a substantial period of time after completing the exchange and not immediately contribute the replacement property to the partnership. To avoid the exchange and subsequent partnership contribution being tied together as a step transaction for tax purposes, the exchanging party should not have an agreement to later contribute the replacement property to the partnership.33

6. Sellers exchange properties subject to deeds of trust. Gain on a Section 1031 exchange is recognized to the extent of the
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cash and the fair market value of the other property received. This money or other property is sometimes referred to as boot. If the relinquished property is subject to a deed of trust, the exchanging party (the seller of the relinquished property) is relieved of the amount owed on the deed of trust, but the amount owed is treated as money or boot received by the exchanging party. The Treasury Regulations provide that the amount of indebtedness that the seller is relieved of in the exchange is netted against the amount of the liabilities that the seller assumes or that the replacement property is subject to. However, cash or other property received by the seller in an exchange cannot be netted against the consideration given in the form of assumed liabilities on the replacement property.

Sellers of real estate in a tax-free exchange, however, still may want to receive cash but not have to recognize taxable gain. Normally cash received from an exchange escrow is taxed to the seller as boot. However, instead of receiving taxable cash as part of the exchange, the seller could refinance the relinquished property immediately before the exchange and receive these refinancing loan proceeds tax free. Of course, after the exchange, a seller needs to make sure that the replacement property is subject to at least the same amount of indebtedness for which the seller was relieved on the relinquished property. An alternate tax strategy is for the seller to first complete the tax-free exchange and then refinance the replacement property, thereby receiving the refinancing loan proceeds tax free. The refinancing of the replacement property after the exchange or the relinquished property before the exchange should not be tied to the exchange by written or oral understandings; this will avoid an assertion by the IRS that the loan proceeds received are taxable boot under a step transaction theory.

7. Related parties seek to enter into a Section 1031 exchange. Properties may be exchanged tax free between related parties, but Section 1031(f) imposes a two-year holding requirement. When a seller exchanges property with a related party, both parties to the exchange must hold their respective properties for at least two years after the exchange in order to receive tax-free exchange treatment. Thus, if either related party to the exchange disposes of the property that it received in the exchange before the end of this two-year holding period, any gain or loss that would have been recognized in the exchange by either party will be recognized on the date that the disqualifying disposition occurred. The Section 1031(f) related party rules were added to the Internal Revenue Code to prevent taxpayers from
exchanging low basis property for high basis property to avoid the recognition of gain on subsequent property sales or to accelerate a loss on retained property. Without the related party rules of Section 1031(f), taxpayers could exchange low basis relinquished property with a related party who had high basis replacement property, and that related party could then sell the relinquished property—which acquired a new high tax basis in the exchange—and receive the cash proceeds of the sale tax free.

The related party rules also cover indirect transfers between related parties. The indirect transfer rule may cause exchanging parties to unwittingly violate the related party rules when they utilize a qualified intermediary to participate in a deferred Section 1031 exchange. Consider this scenario: an exchanging party transfers its relinquished property to a qualified intermediary, who transfers the relinquished property to an unrelated third party for cash sales proceeds. The qualified intermediary then utilizes the cash proceeds from the sale of the relinquished property to enter into a deferred exchange to acquire the replacement property from a related party for cash. The replacement property is then conveyed by the qualified intermediary to the exchanging party.

Based on this fact pattern, the IRS in Revenue Ruling 2002-83 ruled that property owners exchanging low basis property would not receive tax-free exchange treatment, since the related party disposed of the replacement property for cash within the prohibited two-year holding period. This exchange (even though a qualified intermediary is utilized) is characterized by the IRS as being a prohibited disposition of the replacement property by the related party within the two-year period. Revenue Ruling 2002-83 can be interpreted to mean that when a qualified intermediary is utilized in connection with exchanges between related parties and either related party receives cash, the Section 1031(f) related party rules apply to prevent tax-free exchange treatment.

One way to avoid the application of Revenue Ruling 2002-83 when the replacement property is acquired from a related party is to structure the exchange so that neither related party receives cash in the exchange or from the sale of either the relinquished property or the replacement property during the required two-year holding period.

8. An exchanging party has difficulty identifying the replacement property within the required identification period. Sellers who engage in deferred tax-free exchanges must identify the replacement property within 45 days after closing the
sale of the relinquished property. Sellers can identify three alternative replacement properties within 45 days of the sale of the relinquished property without regard to the fair market value of the replacement properties. As an alternative, the seller can identify any number of replacement properties as long as the aggregate fair market value at the end of the 45-day identification period does not exceed 200 percent of the aggregate fair market value of the relinquished property. Another option for an exchanging party is to identify multiple replacement properties if the exchanging party timely closes the purchase of at least 95 percent of the value of all identified replacement properties before the end of the exchange period.

Some sellers may find themselves approaching the 45-day deadline without having yet identified their replacement property, and they may be tempted to backdate identification documents, in violation of the tax laws. Sellers who falsify documents or change dates in an attempt to fall within the 45-day period should keep in mind the civil negligence case of Dobrich v. Commissioner, in which the seller was liable for penalties for backdating exchange identification documents.

One strategy for a seller seeking to gain more time to identify the replacement property is to delay the sale closing date of the relinquished property. For example, a seller can provide an option to extend the closing date of the relinquished property’s escrow in the relinquished property’s sale agreement. Another alternative is for the seller to first lease the relinquished property to the buyer, with the buyer purchasing the relinquished property at a later date.

9. An exchanging party should verify the creditworthiness of the qualified intermediary. Some sellers engaging in a deferred tax-free exchange leave millions of dollars in the name of the qualified intermediary who is to complete their exchange. Surprisingly, sellers who are careful to obtain title insurance policies, perform due diligence on the replacement property, and verify the creditworthiness of their tenants often fail to verify the financial viability of their qualified intermediary. Exchanging parties should investigate the financial condition of the qualified intermediary who is holding and investing their exchange funds.

There are also several permitted techniques under the Treasury Regulations by which sellers can protect their exchange proceeds held by the qualified intermediary. For example, the Section 1031 regulations permit the sale cash proceeds of the relinquished property to be held in an escrow or trust account to purchase the replacement property. Sellers can also have the qualified...
intermediary’s obligations secured by a deed of trust, conforming standby letter of credit, or a third-party guarantee.52 The standby letter of credit must be nonnegotiable and should provide for the payment of the proceeds to an escrow account for the purchase of the replacement property rather than to the seller.53

While the benefits of Section 1031 exchanges are considerable, there are also a multitude of tax and legal issues to consider carefully. Professional exchange companies can document the exchange in a cost-effective manner, and attorneys can assist their clients to achieve tax-free exchanges by guiding them through the array of complex rules governing this area.

1 If the exchange company holds itself out to the exchanging parties as being an expert in the area of tax-free exchanges, it is questionable whether the exculpatory language of the professional exchange company will protect it from liability. See Akin v. Business Title Corp., 264 Cal. App. 2d 153 (1968). However, in one case a title company was found not liable based on an indemnification and hold harmless agreement in favor of the title company. Rooz v. Kimmel, 55 Cal. App. 4th 573 (1997).

2 Treas. Reg. §1.1031(a)-1(b).

3 Treas. Reg. §1.1031(a)-1(c).

4 In order for depreciable tangible personal property to be like-kind to other depreciable tangible personal property, the exchanged properties must be of the like class. Depreciable tangible personal properties are of a like class if the properties are within the same “General Asset Class” or “Product Class.” See Treas. Reg. §1.1031(a)-2(b)(1).


6 See Whiteco Indus., Inc. v. Commissioner, 65 T.C. 664 (1975), acq. 1980-1 C.B. 1 (setting forth the standards used in cost segregation studies to classify a particular part of a building as “tangible personal property” rather than as part of the building’s inherently permanent structure).


8 Even real estate owners who in the past may have failed to segregate personal property from real property in order to receive these increased depreciation deductions can still elect to do so on their current federal income tax returns. See Rev. Proc. 2002-9, 2002-3 I.R.B. 327 (explaining how to obtain an automatic IRS consent for an accounting method change relating to depreciation).

9 See I.R.C. §§168(c), 168(e). Most personal property associated with real estate will have a seven-year recovery period. However, the IRS has stated that certain personal property used in rental real estate, such as appliances, carpeting, and furniture, would have a recovery period of five years. IRS Announcement 99-82, 1999-32 I.R.B. 44.


12 See Shoney’s S., Inc. v. Commissioner, T.C. Memo 1984-413.
Even minors amount of personal property involved in real property exchanges can trigger gain recognition. Under the multiple asset exchange Treasury Regulations, in which both personal and real property are part of a building property that is being exchanged, the real and personal properties must be classified and put into like-kind or like-class exchange groups. See Treas. Reg. §1031(g)-1. If the relinquished property is encumbered by a deed of trust, the seller unexpectedly may recognize gain because the Treasury Regulations require that all the liabilities in an exchange be allocated among each property exchange group in proportion to the fair market value of each group’s properties—even if these liabilities are not secured by a particular exchange group’s properties. See Treas. Reg. §1.1031(g)-1(b)(2).

Exchanging parties can argue that the reclassified personal property still constitutes real estate for purposes of the §1031 like-kind exchange rules, based upon the fact that the only special statutory tax rules allow parts of buildings to be classified as personal property for tax depreciation purposes. For §1031 purposes, however, state law generally determines if property is personal or real. See, e.g., Priv. Ltr. Rul. 8443054 (July 24, 1984). California law classifies items permanently affixed to real estate as “real property.” See Civ. Code §658.

The tax rules discussed in this article also apply to limited liability companies. See Rev. Rul. 97-73 1997-2 C.B. 305.

The Ninth Circuit in Bolker stated that §1031 only requires that the exchanging party own the property before entering into the exchange, with no intent to either liquidate the property or use it for personal purposes. See Bolker, after the corporation liquidated under former IRC §333, the shareholders entered into an exchange of the liquidated property.

The Treasury Regulations allow a cotenancy to avoid being classified as a partnership if the cotenancy is simply maintaining, repairing, and renting the property. See Treas. Reg. §301.7701-1(a)(2). Management activities by the cotenancy should be limited as much as possible so that the relationship does not rise to a business relationship that results in partnership tax status. The exchanging parties should have a written cotenancy agreement that preserves the normal rights of a cotenancy under state law.

When it comes to tax purposes, the IRS may defer to the listed conditions of this revenue procedure when conducting audits. For a detailed discussion of Rev. Proc. 2002-22, see M. Lipton, see supra note 19.

If an installment obligation is received in a §1031 exchange, any gain recognized is deferred under the installment method of reporting until the note pay-
ment is received. The installment note’s distribution to the partners will not accelerate the note’s gain under IRC §453, since Treasury Regulations §1.453-9(c)(2) states that a partner’s receipt of an installment note in an IRC §731 distribution does not result in gain under IRC §453B.

30 See note 27, supra.
31 The IRS ruled that a prearranged transfer to a newly owned corporation of the replacement property did not qualify for tax-free exchange treatment because the replacement property had not been held for a permissible use. Rev. Rul. 75-292, 1975-2 C.B. 333.
32 Magneson v. Commissioner, 753 F. 2d 1490 (9th Cir. 1985). This decision was based on the contribution of the replacement property for a general partnership interest. Some commentators have argued that Magneson is no longer applicable to §1031 exchanges because the decision was based on 1) an exchange occurring prior to the enactment of §1031(a)(2)(D), which prohibited an exchange of partnership interests from qualifying under §1031, and 2) certain California partnership statutes that have since been amended.
33 See Crenshaw v. United States, 450 F. 2d 472 (6th Cir. 1971) (applying the step transaction doctrine to a partnership liquidation followed by a §1031 exchange). The tenancy-in-common relationship between the exchanging party and the partnership must still be structured so that it is not classified as a partnership for income tax purposes, See note 27, supra.
34 Treas. Reg. §1.1031(b)-1(c). There is no distinction between the assumption of a liability and the acquisition of a property subject to a liability. See I.R.C. §1031(d).
35 See I.R.C. §1031(b).
36 See Treas. Reg. §1.1031(b)-1(c). For many years there was uncertainty on how to treat the liability netting rules for partnerships engaging in deferred exchanges. The concern was that the IRC §752 constructive distribution rules would trigger gain when the relinquished property was transferred. Fortunately, the IRS has now ruled that when a partnership engages in an exchange, the §1031 netting rules also apply for the purpose of calculating the partner’s share of indebtedness under §752. See Rev. Rul. 2003-56, I.R.B. 2003-23.
37 The liability netting rules can surprisingly produce recognized gain when both real and personal property are being exchanged because of the manner that the multiple asset exchange Treasury Regulations allocate liabilities among the different property classes. See note 15, supra.
39 The IRS has noted that liabilities placed on replacement property that do not have a bona fide business reason apart from the exchange may not be applied under the liability netting rules. Priv. Ltr. Rul. 200019014 (Feb. 10, 2000).
40 See, e.g., Coastal Terminals, Inc. v. U.S., 320 F. 2d 333 (4th Cir. 1963); Fredericks, T.C. Memo 1994-27.
41 Determining who is a related party for the purpose of §1031(f) is based on the relationships described in IRC §§887(b) and 707(b)(1).
42 I.R.C. §1031(f)(4)(I). There are exceptions for a disposition within the two-year period as a result of the death of either related party, compulsory or involuntary conversion of the exchanged property, or any disposition if neither the disposition nor the exchange “has as one of its principal purposes the avoidance of federal income tax.” I.R.C. §1031(f)(2).
43 The legislative history of IRC §1031(f) states the reason for the statutory change: If an exchange of properties between related parties is shortly followed by a disposition of the property, the related parties have effectively “cashed out” of the investment, and thus §1031 nonrecognition treatment should not apply. Senate Comm. on Finance, S. Rep. No. 56, at 151 (1989).
44 A related party with a high basis in the property it exchanges will have that same high basis in the property it receives, subject to certain adjustments. See I.R.C. §1031(d).
45 Furthermore, §1031(f)(4)(I) states that transactions structured to avoid the “purposes” of the related party rules of §1031(f) will not qualify for tax-free exchange treatment.
47 However, the IRS has ruled that the related party rules do not apply if improvements on the replacement property are constructed by a related party. Priv. Ltr. Rul. 200251008 (Sept. 11, 2002).
48 See Treas. Reg. §1.1031(k)-1(c)(4)(I).
49 See Treas. Reg. §1.1031(k)-1(c)(4)(II)(A).
50 Dobrich v. Commissioner, 188 F. 3d 512 (9th Cir. 1999).
51 Treas. Reg. §1.1031(k)-1(c)(3).
52 Treas. Reg. §1.1031(k)-1(g)(2). The exchange documents must, however, limit the exchanging party’s right to receive, pledge, borrow, or otherwise receive the benefits of the cash or cash equivalents held in the account, except as permitted by the Treasury Regulations.
53 Payment of the letter of credit proceeds to the exchanging party will result in the exchanging party receiving cash, which in turn could trigger recognized gain in an otherwise tax-free exchange. See Treas. Reg. §1.1031(k)-1(c)(2), §15A.453-1(b)(3).

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Choosing the Right Web Site Components

Law firms can tailor their Web sites to meet the expectations of their clients

A successful Web site and a fine meal have a lot in common. Both of these items need to include the right ingredients, have a variety of components, be presented in an attractive manner, satisfy an immediate need, and be easy to digest. A successful Web site should be capable of attracting and retaining clients, addressing their legal concerns, and making visitors feel comfortable.

To reach these goals, first consider the site's overall presentation. With a Web site, much will depend upon the selection of its programming language and graphics. In short, how showy should the site be? Should it be developed principally in standard, plain HTML or should it be developed with Flash (which is an aptly named Web design application)? In addition, should the site include an audio component or components—for example music or spoken words—in its introduction? How creative or complicated should the graphic elements be? The answers to these questions depend on the type of clientele the firm wants to attract. For example, a labor law firm that represents management probably has a more conservative clientele who are not expecting anything flamboyant. If the firm's site uses Flash for its introduction, the conservative potential client may be alienated and skip that firm's site. So that firm may be better off using HTML. However, an entertainment firm may have more reason to use Flash (for an example, users may visit entertainmentlawyer.com). The firm's potential clients, who are members of the entertainment industry, may expect some panache, even from a lawyer.

When Flash is used, a common practice is to post on the home page a prominent link that allows users to skip the introduction or skip Flash. With this type of link, clients and potential clients will not be excluded from the site because they cannot view Flash (because they have yet to download the Flash plug-in), find it too slow to load (because they lack high-speed Internet access), or simply want to get to the meat of the site without fanfare.

A law firm Web site will likely need to tread between the extremes of plainness and ornamentation. A way to conceptualize the right balance is to design the firm's site to be as inviting as the firm's reception area, which presumably looks neither dowdy nor garish. Taking this advice to heart is the firm of Payne & Fears (www.paynefears.com), whose site invites visitors to enter by using a graphic of a handsome double door on its home page (a welcome change from the standard law firm graphic of the scales of justice). To enter the site, one clicks on the door.

Memorable Domains

The first component of a Web site is its domain name. It should be descriptive enough to grab the attention of the firm's intended audience but short enough to be easy for a client to remember. For example, a lawyer who represents dog bite victims who uses the domain name dogbitelaw.com or dogbitelawyer.com rather than the lawyer's name would be more likely to attract new clients. Adding geographical information to the domain name—for example, losangelesdogbitelawyer.com—may also be useful. Surprisingly, the American Bar Association's 2001 legal technology survey found that “[o]nly 5.0% of respondents report using a generic domain name relating to one of the firm's practice areas.” On the other hand, the survey found that “[o]ver half (50.1%) use their firm name or some version of it,” as their domain name. If a firm's intended audience is its current and former clients only, using the firm's name for the domain name may suffice. Because people may not remember a firm's full name (especially if it is longer than two names), it is best to limit the domain name to the first one or two named partners to make the URL easier to remember. Some firms use the initial of each named partner's last name, but then the domain name is memorable only to those people who actually know each named partner's last name. Therefore, it is advisable to use names and not initials.

After the domain name, the next component to consider is the home page. A site's home page should include an internal search engine to ensure easy navigation. Not every Web user wants to click on icons or search through topic pages in the hope of finding desired information. Providing a search engine allows potential clients who know what they want to type key words into the search engine's query box. This is especially true when a client wants information about a specific attorney or issue; the internal search engine is the most direct route.

In addition to internal search engines, some firms have interactive components on their sites. For example, the personal injury firm of Parker & Waichman (www.yourlawyer.com) hosts numerous interactive discussion forums in which potential clients can discuss their injuries and seek emotional support from those in similar straits. Topics are wide ranging, from clergy abuse to Ford Explorer rollover accidents. To facilitate intake, some firms add an intake form component that is filled out online by potential clients. Other firms may add a government forms component.

To show potential clients that a firm is staying on top of its practice areas, the firm can post current news articles. For example, Parker & Waichman has a Breaking News component on its home page. The current news on a law
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firm’s site should be kept current; otherwise, the site will quickly look out-of-date instead of up-to-date.

Many firms list cases (or clients) on their Web sites along with their most successful verdicts and settlements. The Landmark Cases component of the Parker & Waichman site has brief summaries of its major cases, while its Significant Settlement component highlights verdicts (with one as high as $10 million). For those who choose to place the firm’s cases, verdicts, and settlements on the firm’s site, it is best to list the most recent cases first, but if it has been some years since the firm has had a memorable case, the site may list the largest verdict or settlement first or the case that features the most well-known parties first.

Another common practice is to include newsletters (current and archived) and offer visitors the option to have newsletters e-mailed to them. A searchable database for the newsletter archive helps visitors find the information they are seeking. To increase the marketing value of the newsletter, consider posting it as a PDF to keep the graphics (especially the firm logo) intact when visitors print them. On a related note, some Web visitors have a difficult time digesting information that appears only on a computer monitor. A law firm Web site should make it easy for visitors to read the site’s information (and better understand the firm’s mission) by allowing them to print pages from the site with ease. This can be accomplished with a component that often bears the label Printer Friendly. When users click on this label, they are presented with the contents of the page in a simple format that prints out neatly.

Another simple component that should not be overlooked is a map that helps clients and potential clients find the firm’s office. The map should definitely be included in the elements of the site that appear on printer-friendly pages. To increase the chances that visitors keep and share pages from the firm’s site, designers should also add an E-mail Document component that is easy to notice and use.

Personal Communication

Firms can make their sites more inviting by personalizing them. Amazon.com, for example, welcomes returning visitors by name and recommends books based on ones previously purchased. Similarly, the law firm of Miller Nash (http://MillerNash.com) asks its online visitors to enter their name and industry (from agriculture to wholesalers) and then welcomes the visitor by name and offers a list of articles specific to the visitor’s industry.

Law firm sites typically list practice areas
by department (litigation, corporate, etc.), but firms with a keener marketing sense put themselves in the shoes of their clients and list their practice areas according to client industry. For example, Miller Nash places the names of departments that may service Affordable Housing clients under the heading of Affordable Housing.

Some Web visitors would rather communicate with a person than search a site. This need can be addressed, at least partially, by adding a chat component to the site. During regular business hours, potential clients of the firm of Miller Nash can chat live with a client services representative (http://MillerNash.com/clientservices.asp). Another component that can help a firm speak more directly to clients is an extranet. At this secure online location, firms can present information to selected visitors. Firms can use extranets to share documents, case strategy, time lines, calendars, updates, and other information with clients and cocounsel. Only those who have been granted a user name and password for the extranet can access its contents.

A surefire way to make a site more appealing is with a free offer. When a potential client visiting Visalaw.com requests a consultation, he or she is offered registration on Visajobs.com. Visajobs.com links immigrants seeking jobs in the United States to sponsoring employers. The cost to register at Visajobs.com is usually $99, but Visalaw.com visitors get the registration for free. Law firm sites can also offer free educational information, including links to useful sites. Fisher & Phillips has a Legal Links component that directs visitors to useful research sites. Aside from general sites (e.g., search engines) and legal sites (e.g., courts), Fisher & Phillips links to sites that relate specifically to their practice area, labor law (e.g., the Bureau of Labor Statistics).

If a firm offers seminars to its clients or makes a presentation at a seminar or conference, an Events or Seminars component is in order. Lists of future and past presentations by topic and attorney name showcase the expertise of the firm and its attorneys. In addition, it may be a relatively simple matter to add a Seminar component by compiling data from seminar brochures that are already written.

No single presentation style or component will magically make a law firm’s Web site successful. While it takes some time and money to develop the initial site, periodically adding new components can keep the site fresh and useful to clients and does not require excessive time or money. In any case, each firm needs to decide who its audience is and then create a site that will meet the needs of that audience.
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25th Annual Child Custody Colloquium

ON SATURDAY, SEPTEMBER 13, the Family Law Section will present “The Changing Face of Child Custody Litigation,” a program that will provide legal and mental health practitioners with vital information needed to stay current on recent issues.

Some of the topics to be discussed by panels of experts (including Roberta Bennett, Commissioner James Endman, Michael A. Guerrero, Commissioner Scott M. Gordon, Rachel Feldheim, Harvey A. Silberman, Glen H. Schwartz, Judge Richard E. Denner, Leonard J. Meyberg Jr., Howard B. Miller, Judge Aviva K. Bobb, Judge John W. Ouderkirk, Judge Susan M. Speer, Irwin Buter, and Joan Patsy Ostroy) are alternative lifestyle parenting, repercussions of domestic violence, overcoming an adverse evaluation, and the bounds of advocacy. This program will take place at the Omni Los Angeles Hotel, 251 South Olive Street, Downtown. On-site registration will begin at 8 A.M., with the program continuing from 8:30 A.M. to 4:30 P.M., including a continental breakfast and lunch at noon. The registration code number is 8095LI13.

$135—CLE+PLUS members
$190—Family Law Section members
$210—LACBA members
$230—at-the-door registrants, all categories
6 CLE hours, including 1.75 ethics hours

Commercial Credit Agreements

ON WEDNESDAY, SEPTEMBER 24, the Commercial Law Committee of the Commercial Law and Bankruptcy Section will present “Commercial Credit Agreements: What to Include, What to Leave Out, and What to Worry About.” The speakers, Adam Hofberg and Gary Samson, will cover such topics as the 10 most dangerous changes borrower’s counsel will request and recent revisions to the Uniform Commercial Code. This event will be held at LACBA, 261 South Figueroa Street, Downtown. On-site registration will begin at 11:45 A.M. and lunch at noon, with the program continuing from 12:30 to 1:30 P.M. The registration code number is 810LI24. CLE+PLUS members may attend for free (meal not included). Prices below include meal.

$55—Commercial Law and Bankruptcy Section members and Barristers
$65—LACBA members
$75—all others
1 CLE hour

Drafting Business Agreements

ON THURSDAY, SEPTEMBER 18, the Business and Corporations Law Section will present a “boot camp” program on drafting charter documents, shareholder agreements, and LLC operating agreements. This program will provide practical steps in organizing corporations and limited liability companies under California and Delaware law. Panelists Harriet B. Alexson and Mark T. Uyeda will also discuss selected topics with respect to the preparation of articles of incorporation, bylaws, shareholder agreements, and LLC operating agreements. This event is cosponsored with the Barristers and will be held at the LACBA/LEXIS Publishing Conference Center, 281 South Figueroa Street, Downtown. Parking at the Figueroa Courtyard Garage will be available for $7 with LACBA validation. On-site registration will begin at 11:45 A.M. and lunch at noon, with the program continuing from 12:30 to 2 P.M. The registration code number is 810LI24. CLE+PLUS members may attend for free (meal not included). Prices below include meal.

$50—Business and Corporations Law Section members and Barristers
$60—LACBA members
$70—all others, including at-the-door registrants
1.5 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://forums.lacba.org/calendar.cfm. For a full listing of this month’s Association programs, please consult the September County Bar Update.
Combating Hate Crimes in Public Schools

Administrators must address hate-based behavior with effective internal policies

With schools increasingly serving as surrogate parents, is it reasonable to expect schools to play a role in combating hatred? The Anti-Defamation League has been working with public schools for years to do just that. Unfortunately, hatred is something that touches the lives of students and staff members in our public schools. According to the California Department of Justice, of the 1,957 reported hate crimes in California that were committed in 2000, 10 percent occurred on school property. During that year, people under the age of 21 accounted for 50 percent of hate crimes.

It is a violation of Title VI of the federal Civil Rights Act to create a hostile environment for students on the basis of race, color, and national origin. California Education Code Section 200 has further extended the protection outlined in Title VI to include gender, sex, religion, ethnicity, disability, national origin, race, and sexual orientation. In Monteiro v. Tempe Union High School District, the Ninth Circuit relied on guidelines issued by the federal Office of Civil Rights in determining whether violations of Title VI had occurred.

Under the hostile environment theory used by the OCR, if repeated incidents of harassment or a single severe incident of harassment occurs at a school, the school administration must take action—not only to protect the victim but also to protect the school and staff from liability. In order to find that a student’s rights have been violated, three elements must be found. The first element is a determination of the presence of a hostile environment, which occurs when severe, pervasive, or persistent harassment takes place in a way that would adversely affect the enjoyment of the educational program by a reasonable person of the same age, race, gender, religion, and the like of the victim and under similar circumstances.

Second, the school administration must have actual or constructive notice of the hostile environment—either directly, such as a student filing a complaint, or indirectly, such as information from a member of the school staff, the community, or the media. Finally, a determination must be made that the school administration failed to respond adequately to redress the hostile environment. Once a school administration has notice of a hostile environment, it has a legal duty to take reasonable steps to eliminate it.

State laws also require that public schools put in place a system to address hate-motivated behavior on campuses. In California, Education Code Sections 201(f), 233, and 233.8 require the State Board of Education to provide grants and develop policies, curriculum guidelines, and teacher and administrator training programs that promote appreciation of diversity, discourage discriminatory attitudes, and prevent and respond to acts of hate-based violence in schools.

The social cost to the victims of ignoring harassment and hate-motivated behavior is significant, not only emotionally and physically but also academically. The correlation between a safe learning environment and overall student performance has been demonstrated time and time again. Even seemingly low levels of harassment, such as bullying, may have an impact on student performance in the classroom.

Public schools can take measures to address hate-motivated behavior on campus. First and foremost is the implementation of an internal policy that clearly delineates a procedure for alerting a school of hate-based incidents when they occur. The policy should be disseminated to parents, students, and staff so that everyone is aware of whom to contact and what to do in the event that they are a victim or witness of harassment or a hate crime. All staff should be trained to identify behavior that is not acceptable under the policy and how to intervene effectively.

Proactive measures also should be taken to educate students and staff regarding their rights and responsibilities. Partnering with a community-based organization, such as the Anti-Defamation League, that conducts staff and student anti-bias trainings will allow for conversations among the school community that seldom take place before incidents of hate occur. Furthermore, staff should be given the tools to effectively respond so that the pattern of escalation that so frequently follows a hate-based incident is interrupted.

Whether in the form of taunts or seemingly harmless threats against students based on their race, religion, sexual orientation, ethnicity, national origin, age, disability, or gender, hatred is something that need not, and should not, be a part of anyone’s daily existence. Hatred breeds fear and anger and impairs the ability to learn. By creating a system of policies and procedures that clearly delineate the actions that students and adults can take if they are victims of hate-motivated behavior, a school is moving toward the important goal of fostering a safe environment for all. Protecting students from hate and harassment involves awareness and action regarding the legal rights and responsibilities of everyone in the school community.

BULLETIN, Apr. 1998, at 4-5.

1 Monteiro v. Tempe Union High Sch. Dist., 158 F.3d 1022 (9th Cir. 1998).
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